13 January 2014

Our ref: ICAEW Rep 06/14

Mr Hans Hoogervorst
Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH

Dear Hans

A Review of the Conceptual Framework for Financial Reporting

ICAEW is pleased to respond to your request for comments on the discussion paper *A Review of the Conceptual Framework for Financial Reporting*.

Please contact me should you wish to discuss any of the points raised in the attached response.

Yours sincerely

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ICAEW REPRESENTATION

A REVIEW OF THE CONCEPTUAL FRAMEWORK FOR FINANCIAL REPORTING

Memorandum of comment submitted in January 2014 by ICAEW, in response to the IASB discussion paper *A Review of the Conceptual Framework for Financial Reporting* published in July 2013

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INTRODUCTION

1. ICAEW welcomes the opportunity to comment on the discussion paper *A Review of the Conceptual Framework for Financial Reporting* published by the International Accounting Standards Board (IASB) in July 2013.

WHO WE ARE

2. ICAEW is a world-leading professional accountancy body. We operate under a Royal Charter, working in the public interest. ICAEW's regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the UK Financial Reporting Council. We provide leadership and practical support to over 140,000 member chartered accountants in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained.

3. ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.

4. The Financial Reporting Faculty is recognised internationally as a leading authority on financial reporting. The Faculty's Financial Reporting Committee is responsible for formulating ICAEW policy on financial reporting issues, and makes submissions to standard setters and other external bodies. The faculty also provides an extensive range of services to its members, providing practical assistance in dealing with common financial reporting problems.

MAJOR POINTS

Support for the initiative

5. We welcome the discussion paper (DP), which provides the basis for the first comprehensive revision of the IASB's conceptual framework, originally published by its predecessor – the International Accounting Standards Committee – in 1989. We support the proposal that in future the framework should be reviewed 'from time to time' (DP1.33), which we interpret as meaning more frequently than in the past. We do not envisage that such reviews would involve regular fundamental changes. But the framework should evolve with developments in accounting thought, and regular reviews would help to ensure that the framework and standards keep in step (although, as we acknowledge below, this does not mean that every standard will be absolutely consistent with the framework at all times).

6. In writing a conceptual framework there is a balance to be struck between providing enough guidance to be helpful on specific issues and avoiding excessive detail. On the whole, we think that the proposals in the DP strike the right balance. The DP is much longer, though, than we would expect the revised framework to be, and we assume that much of the discussion in the DP will be removed (some of it to the Basis for Conclusions) at the exposure draft stage.

Role of the conceptual framework

7. In our view, the main purpose of the conceptual framework is to assist the IASB in developing IFRS. While it is desirable for standards to be consistent with the framework, the framework inevitably includes potentially conflicting considerations (eg, costs v benefits, relevance v verifiability, what would provide the most useful information in the balance sheet v what would provide the most useful information in the income statement). What may appear to be conflicts with the framework in particular standards may well therefore be no more than instances of one consideration under the framework outweighing another.

8. Also, it is difficult in a general framework to anticipate the advantages and disadvantages of different conclusions about all the specific questions that arise when a particular accounting problem is addressed. Accounting thought evolves in response to changes in business practices, markets, technologies and the regulatory environment, and the need for change is most likely to be recognised in considering particular issues, rather than at the level of debate on a general framework. For all these reasons, we think that the conceptual framework should be a guide for the IASB, not a straitjacket. Our comments in the rest of this response should be read in that light.

9. The key requirements are for information to give a true and fair view (or a fair presentation), to be useful to capital providers, and to pass a cost-benefit test. Other principles in the framework should be seen as providing practical guidance to standard setters on how to meet these tests.

Assets and liabilities

10. The DP takes the usual approach in conceptual framework documents of building up from a foundation of definitions of assets and liabilities, treating income as a residual that emerges from changes in net assets. In our view, the income statement and measures of 'performance' are as important as the balance sheet, and the effect on the income statement will often need to be taken into account in deciding on questions of recognition and measurement.

11. We agree with the definition of 'asset' proposed in the DP, and we note that it is very broad (as is the existing definition). This means that a lot of weight will be placed on the recognition criteria, as many assets that meet the definition are unlikely to be recognised in financial reporting.

12. In the case of liabilities, we believe that the definition proposed in the DP may be too narrow. If the proposed definition is strictly interpreted, items that would generally now be regarded as liabilities would not be recognised as such. This leads to questions, discussed in the DP and below, about what constitutes a 'present obligation', whether constructive obligations are liabilities, and how far the effect on income measurement should affect what is recognised as a liability. We believe that it may be necessary to define liabilities as comprising two categories: obligations and certain other future outflows arising from past events. The second category would be intended to cover liabilities arising from expenses such as levies, bonuses and some pension costs that are incurred in earning the income of the accounting period, but that do not necessarily give rise to what can be regarded as a 'present obligation', in the ordinary sense of these words, at the balance sheet date (see paragraphs 35 and 45-46 below).

13. Although the DP discusses recognition criteria for assets and liabilities, it also proposes that decisions on recognition should be made standard by standard, which seems to us to be sensible. Overall, the DP's discussion of assets and liabilities emphasises how inappropriate it would be to use the conceptual framework as though it were a set of axioms from which accounting requirements can be derived mechanically – an approach that the DP rightly avoids.

Measurement

14. The DP recognises that using a single basis of measurement for all assets and liabilities may not produce the most useful information, and in our view it will not do so. We agree that the approach put forward in the DP, of basing measurement on how assets and liabilities (or groups of assets and liabilities) are expected to contribute to future cash flows, reflects one of the factors that needs to be taken into account in deciding on a suitable basis of measurement for an item, but we do not believe that as applied in detail in the DP this principle will solve all questions of measurement in financial reporting. We believe that, as regards both assets and liabilities, the subject of measurement requires substantial further work before the exposure draft stage.

Profit or loss

15. We strongly urge the IASB to explain the **objective** of presenting profit or loss. We do not envisage that this will yield a hard-and-fast rule for what should be recognised in profit or loss and what should be recognised in other comprehensive income (OCI), but it should set out principles that will be taken into account by the IASB in making decisions on this issue.

16. The most used numbers in financial reporting are often measures of profit or loss (or 'earnings'), and so it is important that they should provide information that is as useful as possible. It is for this reason that some gains and losses are recognised in OCI rather than in profit or loss, usually because the gain or loss in question is not properly regarded as part of 'performance' during the period. Such amounts, if included in profit or loss, would lead to a measure of profit or loss that is less useful, when used in conjunction with other relevant information, either in judging performance during the period or in helping to make forecasts of future performance. We would expect a company's business model (or models) to be relevant to deciding what is included in profit or loss (see paragraph 24 below). This is not to suggest that 'profit or loss' should be defined as a term, which we agree would be difficult, if not impossible, to achieve.

17. We applaud the IASB for attempting to clarify the content of OCI. We believe that if as we propose the objective of presenting profit or loss is explained, it should be possible to set out an overarching explanation for the content of OCI based on the objective, and we urge the IASB to do so. Because of our approach to the concept of profit or loss, we support what the DP describes as 'the broad approach' to deciding which items of income and expense should be taken to OCI rather than to profit or loss.

18. This approach also leads to the conclusion that, except for fair value gains and losses on effective hedges, items should not be recycled from OCI to profit or loss. The effect of recycling would usually be to produce a less useful figure of profit or loss for the year as it would include items that do not have any predictive value and that are only weakly connected with the company's performance in the year in which they are recycled.

Stewardship

19. We do not believe that major changes to the framework are required in relation to the concept of stewardship, but it is very important that it is well-understood that financial reporting does have a dual primary role, and that the provision of information to a company's owners to facilitate their control of its management is a legitimate objective of reporting under IFRS. This includes information about a company's performance (see paragraph 84 below).

Reliability

20. We do not believe that reliability needs to be reinstated in the conceptual framework as a qualitative characteristic, as in our view it is not a characteristic that can be secured purely by compliance with accounting standards, but usually requires the addition of third party assurance. However, we question the division of qualitative characteristics into two categories – fundamental and enhancing. If this division is maintained, then we believe that verifiability should be classified as a fundamental rather than as an enhancing characteristic.

Prudence

21. We believe that it would be helpful for the role of prudence in financial reporting to be explicitly recognised in the conceptual framework. Whatever it says in the current framework, we note that standard setters consider prudence as an important factor in writing accounting standards, as do the preparers and auditors of accounts in applying them in practice. It would also be helpful to explain the role of prudence in financial reporting so as to clarify what it does not mean. It would be useful, for example, to make it clear that it is not a licence for excessive prudence or income smoothing or a reason never to recognise fair value gains, and to distinguish it from what prudential regulators are trying to achieve in their reporting requirements for regulated businesses.

22. We appreciate that there are concerns that explicit recognition of the role of prudence could have unfortunate effects on the neutrality of financial reporting information. However, in our view prudence needs to be clearly defined partly because it can be misunderstood in a way that would in practice lead to imprudent accounting. For example, on some interpretations it could result in standard setters allowing profit to be artificially depressed in one period, only for it to be artificially enhanced in the next, distorting trends over time. Moreover, if preparers were required to follow such a principle, it could lead to manipulation of profit for potentially short-term gains and to financial reporting that therefore fails to be neutral. But we believe that it should be possible to refer to prudence in the conceptual framework in an appropriately precise way that would achieve the desired objective and leave neutrality as a concept in place and not undermined.

23. The description of prudence in the pre-2010 framework seems to us to be a satisfactory starting point for drafting. This describes prudence as 'the inclusion of a degree of caution in the exercise of the judgements needed in making the estimates required under conditions of uncertainty …' While this description appears to be aimed at preparers, the principle is applicable to standard setters as the requirements they impose should, among other things, enforce a degree of caution by preparers in making estimates under conditions of uncertainty. It is therefore an appropriate issue to be dealt with at the framework level, and we would then expect it to be reflected in standards so as to apply it to preparers.

The business model

24. Business models already play a significant role in financial reporting. We support this and believe that a company's reporting should reflect its various business models so that their success or failure can be properly assessed. One way of achieving this is through the principle that measurement should reflect how an asset or liability will contribute to a company's future cash flows. As indicated above, however, we do not think that this principle as stated in the DP will provide the answer to all measurement questions, and we believe that more work needs to be done on the appropriateness of its application to particular types of asset or liability. We do not think that it would be useful to define the term 'business model' in the framework, as a definition is not needed and it would introduce unnecessary complications.

RESPONSES TO SPECIFIC QUESTIONS

Section 1: Introduction

Q1: Paragraphs 1.25-1.33 set out the proposed purpose and status of the *Conceptual Framework*. The IASB's preliminary views are that:

a) **the primary purpose of the revised *Conceptual Framework* is to assist the IASB by identifying concepts that it will use consistently when developing and revising IFRSs; and**

b) **in rare cases, in order to meet the overall objective of financial reporting, the IASB may decide to issue a new or revised Standard that conflicts with an aspect of the *Conceptual Framework*. If this happens the IASB would describe the departure from the *Conceptual Framework*, and the reasons for that departure, in the Basis for Conclusions on that Standard.**

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

25. We agree that the primary purpose of the conceptual framework should be to assist the IASB when it is developing and revising IFRS. The 1989 framework sets out a long list of purposes but, even there, assisting in the development of standards is stated first, and we think that this has been its primary role in practice. We agree, though, that the framework should also state that, in conjunction with the published Bases for Conclusions of the relevant standards, it may assist other parties to understand and interpret existing standards and to develop appropriate accounting policies in situations not covered by existing IFRS requirements (DP1.28).

26. Once a satisfactory framework has been established, it would be desirable for the IASB's standards to be assessed for consistency with it. But it is difficult in a general framework to anticipate the advantages and disadvantages of different options for all the specific questions that arise when a particular accounting problem is addressed. Also, accounting thought evolves in response to changes in business practices, markets, technologies and the regulatory environment. The need for change is most likely to be recognised in considering particular issues, rather than at the level of debate on a general framework. For all these reasons, we think that a conceptual framework should be a guide, not a straitjacket, and that the IASB should be free to depart from it when appropriate.

27. We envisage that 'departures' from the framework would cover situations such as, eg, a standard that requires a liability to be recognised that does not meet the definition of a liability (or vice versa) or an asset to be recognised that does not meet the definition of an asset (or vice versa). But it is more likely that the framework will set out potentially conflicting considerations (eg, relevance v verifiability, costs v benefits, the effect on the balance sheet v the effect on the income statement) that need to be weighed against one another in arriving at a conclusion. The fact that one consideration has been outweighed does not necessarily mean that there has been a departure from the framework.

28. We therefore assume that where there are apparent 'departures' from one aspect of the framework, these will usually occur in order to satisfy some other aspect of it. This would not necessarily be, as the DP suggests, to meet 'the overall objective of financial reporting' (DP1.32), but might be for some other reason recognised by the framework, eg, on cost-benefit grounds. For example, the 2013 exposure draft *Leases* proposes that, so as to reduce cost and complexity, there should be no requirement to recognise the related asset and liability arising from a lease of less than twelve months. Such a proposal does not seem to us to be in conflict with the framework. Similarly, different principles exist under IFRS for the recognition and measurement of assets and liabilities in consolidated accounts and in entity accounts, particularly where a business combination has taken place (eg, recognition of various intangibles, including goodwill, on an acquisition). On the face of it, it is difficult to see how such different approaches could both be consistent with the framework, but in our view they may well be.

29. It may often be a mistake therefore to talk in terms of 'departures' from the framework rather than of potentially conflicting considerations within the framework itself. As stated above (paragraph 9), in our view the key requirements are for information to give a true and fair view (or a fair presentation), to be useful to capital providers, and to pass a cost-benefit test. Other principles in the framework should be seen as providing practical guidance to standard setters on how to meet these tests. It is difficult to see how IFRS requirements that meet these tests could be in conflict with the framework.

30. We agree, though, that where a standard or interpretation appears to conflict with some aspect of the framework the IASB should disclose this and state the reasons for it (DP1.32).

31. As stated above (paragraph 5), we support the proposal that the framework should be reviewed from time to time, which we believe should mean more often than in the past (DP1.33).

32. We do not believe that standards should be automatically revised if they are thought to be in conflict with some aspect of the framework, as may be the case with an extant standard when the framework itself is revised. In the first place, and as we have already indicated, such conflicts may well be with a particular aspect of the framework, rather than with the framework as a whole. Also, we doubt whether a supposed conflict would ever be sufficient reason by itself to merit an immediate revision to a standard. Although consistency with the framework should be considered when a standard is being reviewed, any changes must be justifiable in terms of the key requirements identified at paragraph 9 above (true and fair view, useful information for capital providers, cost-benefit test), and not merely on theoretical grounds. Any such proposed review of a standard should also be subject to consultation by the IASB on whether it would be worthwhile to add the project to its agenda at that time, in preference to other potential projects.

Section 2: Elements of financial statements

Q2: The definitions of an asset and a liability are discussed in paragraphs 2.6-2.16. The IASB proposes the following definitions:

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

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

33. We agree with the proposed definitions of ‘asset’ and ‘economic resource’. The DP states (DP2.13) that some users of the conceptual framework have interpreted the existing definitions of asset and liability, which refer to expected inflows and outflows, as implying a probability threshold. On the basis that the definitions should not imply such a threshold (see answer to Question 3 below), the proposed changes appear to remove this problem satisfactorily, although we have other concerns about the definition of ‘liability’ (paragraph 35 below).

34. The proposed definition of an asset is very broad (as is the existing definition), and would include many items that are not currently recognised in balance sheets. This has the effect of putting a lot of weight on the recognition criteria. The DP in effect proposes that recognition issues should continue to be decided by the IASB standard by standard – an approach that we support.

35. The proposed definition of a ‘liability’ could be construed as too narrow (as might be the existing definition) – hence the need to clarify that constructive obligations are also liabilities (DP3.40) and the question as to whether a future transfer of resources that depends on the company’s future actions can constitute a present obligation (DP3.84-3.88). That is, the word ‘obligation’ is being stretched beyond its normal meaning. It might be necessary to deal with this by defining liabilities as comprising two categories: (i) present obligations and (ii) other amounts arising from costs incurred during the period or in earlier periods (see paragraph 46 below). In both cases, there would be a past event. Our suggestions on this point are not fully developed and they would need further work by the IASB. But we believe that, unless an approach along the lines that we suggest is adopted, there is a risk that either:

- in order to comply with the DP’s definition of ‘liability’, significant expenses would not be recognised in the relevant accounting period; or
- in order to recognise expenses in the relevant accounting period, significant liabilities that do not comply with the DP’s definition would be recognised in accounts.

36. These points serve to emphasise how inappropriate it would be to use the conceptual framework as though it were a set of axioms from which accounting requirements can be mechanically derived – an approach that the DP rightly avoids. Definitions such as those for assets and liabilities may provide useful guidance, but they are unlikely on their own to provide robust answers to complex accounting questions. These have to be settled using recognition criteria whose application will probably have to be agreed standard by standard.

Q3: Whether uncertainty should play any role in the definitions of an asset and a liability and in the recognition criteria for assets and liabilities, is discussed in paragraphs 2.17-2.36. The IASB's preliminary views are that:

a) **the definitions of assets and liabilities should not retain the notion that an inflow or outflow is 'expected'. An asset must be capable of producing economic benefits. A liability must be capable of resulting in a transfer of economic resources.**

b) **the *Conceptual Framework* should not set a probability threshold for the rare cases in which it is uncertain whether an asset or a liability exists. If there could be significant uncertainty about whether a particular type of asset or liability exists, the IASB would decide how to deal with that uncertainty when it develops or revises a Standard on that type of asset or liability**

c) **the recognition criteria should not retain the existing reference to probability.**

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

37. We agree that the definitions of 'asset' and 'liability' should not be restricted to expected inflows or outflows. We also agree that the conceptual framework should not include a probability threshold for the existence of assets and liabilities, and that this issue should be dealt with when necessary in individual standards.

38. Recognition criteria are a separate issue from the question of how assets and liabilities should be defined, and it is therefore somewhat out of place to pose Question 3(c) at this point in the DP. However, we agree with the conclusion that recognition criteria in the conceptual framework should not refer to probability (see also Question 8 below).

Q4: Elements for the statement(s) of profit or loss and OCI (income and expense), statement of cash flows (cash receipts and cash payments) and statement of changes in equity (contributions to equity, distributions of equity and transfers between classes of equity) are briefly discussed in paragraphs 2.37-2.52.

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

39. In our view, the definitions of 'income' and 'expenses' at DP2.37 both have the wrong focus. Income is an increase in equity (not an increase in economic benefits) and expenses are a decrease in equity (not a decrease in benefits). This point is discussed in Richard Barker, 'On the definitions of income, expenses and profit in IFRS', *Accounting in Europe* (2010).

40. We noted in our comments (ICAEW REP 48/12) on the *Revenue from Contracts with Customers* exposure draft that there are also problems with the current definition of 'revenue'. The DP appears to acknowledge these problems – which concern the distinction between revenue and gains, whether the item is net or gross, and whether it arises from 'ordinary activities' – at DP2.45-2.46, but does not propose to address them. Instead it is proposed to address them in the revision of standards on presentation. For the reasons indicated above however we think that it would be inappropriate simply to carry forward the definitions from the 1989 framework. The issues are discussed in Christopher Nobes, 'On the definitions of income and revenue in IFRS', *Accounting in Europe* (2012).

41. We believe that it would be helpful in defining 'revenue' to link it to a firm's business models.

42. We believe that the current approach – where the primary defined elements are assets and liabilities, and income and expenses are defined as changes in assets and liabilities – gives undue priority to the statement of financial position. In our view, all the primary financial statements should be regarded as of equal importance. For example, in deciding how liabilities should be measured, it will often be appropriate to consider the measurement's effects on the income statement.

Section 3: Additional guidance to support the asset and liability definitions

Q5: Constructive obligations are discussed in paragraphs 3.39-3.62. The discussion considers the possibility of narrowing the definition of a liability to include only obligations that are enforceable by legal or equivalent means. However, the IASB tentatively favours retaining the existing definition, which encompasses both legal and constructive obligations – and adding more guidance to help distinguish constructive obligations from economic compulsion. The guidance would clarify the matters listed in paragraph 3.50.

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

43. We agree that constructive obligations should be regarded as liabilities. While the current definition of constructive obligations appears to include obligations that are unconditional or practically unconditional, it does not appear to cover situations envisaged in View 3 in Question 6 below: ie, where an obligation may be conditional on the entity's future actions. We agree that guidance would be helpful, but do not think that DP3.50 as it stands provides the right basis for it. In developing its approach to this issue, we again suggest that the IASB should consider the effect on the measurement of income (paragraph 46 below).

Q6: The meaning of 'present' in the definition of a liability is discussed in paragraphs 3.63-3.97. A present obligation arises from past events. An obligation can be viewed as having arisen from past events if the amount of the liability will be determined by reference to benefits received, or activities conducted, by the entity before the end of the reporting period. However, it is unclear whether such past events are sufficient to create a present obligation if any requirement to transfer an economic resource remains conditional on the entity's future actions. Three different views on which the IASB could develop guidance for the *Conceptual Framework* are put forward:

a) **View 1: a present obligation must have arisen from past events and be strictly unconditional. An entity does not have a present obligation if it could, at least in theory, avoid the transfer through its future actions.**

b) **View 2: a present obligation must have arisen from past events and be practically unconditional. An obligation is practically unconditional if the entity does not have the practical ability to avoid the transfer through its future actions.**

c) **View 3: a present obligation must have arisen from past events, but may be conditional on the entity's future actions.**

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

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

44. We agree that View 1 is unsatisfactory. It would, for example, exclude constructive obligations, which it is generally accepted should be regarded as liabilities. Views 2 and 3 do not seem to be mutually exclusive, and we think that some items might reasonably be regarded as liabilities on the basis of View 2 and others on the basis of View 3. We suggest that the IASB should reconsider this point and develop a view that draws on both the present Views 2 and 3, depending on the circumstances.

45. We suggest that the overall definition of a liability should be based on View 3, and therefore that the word 'obligation' in the definition is too restrictive. Either a wider word should be found, or the definition should contain two categories: obligations and certain other items (paragraph 35 above). However, even if View 3 is generally adopted, the IASB could narrow down what should be recognised as a present obligation, ie, take a View 2 approach, in particular standards where this is considered appropriate. We suggest below when it should be considered appropriate.

46. In developing its views, we suggest that the IASB should give considerable weight to the effects of different approaches on the measurement of income. View 3 will usually be more appropriate where an effect of recognising the liability is that a corresponding expense will also be recognised, and where recognising the expense produces a more useful measurement of financial performance during the period. For example, a company may know that it is likely to pay bonuses or a levy or to incur certain pension costs based on its performance during the current period, but until a later date it may not have an unavoidable commitment to pay them. In our view it would usually be more useful to recognise these items in the accounting period to which they relate rather than when they become an unavoidable commitment.

47. Where recognising a liability has no effect on the measurement of performance, but instead gives rise to the recognition of a corresponding asset or a movement within equity (eg, for a proposed distribution), View 2 will usually be more appropriate as it should provide the most useful information on the company's financial position.

Q7: Do you have comments on any of the other guidance proposed in this section to support the asset and liability definitions?

48. We note that DP3.102(f) refers to the question of interpreting form in accordance with substance. As we state in our response to Question 22 below, we believe that it would be helpful to include a reference to this principle in the conceptual framework. This would be a useful contribution to the guidance on assets and liabilities. 'Substance over form' – which should in our view be expressed as 'interpreting form in accordance with substance' – was removed from the 2010 version because it was argued to be redundant, but the discussion at DP3.102(f) suggests that it would not be redundant, and no doubt there are many other cases in practice to which it would be relevant.

49. In discussing the role of economic compulsion in assessing the substance of contractual obligation, DP3.103 seems to be mixing recognition with measurement. The IAS 32, *Financial Instruments: Presentation*, example is about recognition; but the leases example is about measurement.

50. We doubt whether the propositions at DP3.34 – that for every liability there is an asset (except in the case of environmental reinstatement costs), but there is not a liability for every asset – will provide helpful guidance.

Section 4: Recognition and derecognition

Q8: Paragraphs 4.1-4.27 discuss recognition criteria. In the IASB's preliminary view, an entity should recognise all its assets and liabilities, unless the IASB decides when developing or revising a particular Standard that an entity need not, or should not, recognise an asset or a liability because:

a) **recognising the asset (or the liability) would provide users of financial statements with information that is not relevant, or is not sufficiently relevant to justify the cost; or**

b) **no measure of the asset (or the liability) would result in a faithful representation of both the asset (or the liability) and the changes in the asset (or the liability), even if all necessary descriptions and explanations are disclosed.**

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

51. As noted above (paragraph 34), the definition of assets is very broad, and covers many assets that are not currently recognised. The definition of liabilities is in our view too narrow (paragraph 35). It is likely, however, to be given a wider interpretation in the supporting discussion and guidance in the conceptual framework, so that again, and even with the currently proposed wording, it would potentially cover items that are not currently recognised. Indeed, it would do so if, as we suggest, View 3 in Question 6 is adopted in relation to what constitutes a 'present obligation'. We therefore believe that in practice it will often be up to the IASB to determine standard by standard which assets and liabilities should be recognised. The removal of the probability test from the recognition criteria will, in our view, reinforce the need for this approach. We agree with the proposed approach, and the point underlines the limited extent to which the conceptual framework will determine the IASB's decisions, rather than set out potentially conflicting considerations that it will take into account in developing standards.

Q9: In the IASB's preliminary view, as set out in paragraphs 4.28-4.51, an entity should derecognise an asset or a liability when it no longer meets the recognition criteria. (This is the control approach described in paragraph 4.36(a).) However, if the entity retains a component of an asset or a liability, the IASB should determine when developing or revising particular Standards how the entity would best portray the changes that resulted from the transaction. Possible approaches include:

a) **enhanced disclosure;**

b) **presenting any rights or obligations retained on a line item different from the line item that was used for the original rights or obligations, to highlight the greater concentration of risk; or**

c) **continuing to recognise the original asset or liability and treating the proceeds received or paid for the transfer as a loan received or granted.**

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

52. We do not agree that an entity should necessarily derecognise an asset or liability when it no longer meets the recognition criteria (although in many circumstances this will be appropriate). Other factors that need to be taken into account are the consequences of derecognition for profit or loss and the usefulness of information on changes in assets and liabilities. While automatic derecognition may produce more comparable information in the balance sheets of different entities, this may be less important than useful information in profit or loss or about changes in assets and liabilities. Such information might be lost if automatic derecognition applies.

53. For example, entities sometimes enter into sale and repurchase ('repo') transactions in relation to liquid assets such as listed shares. An entity holding shares sells them to another party for cash and, at the same time, agrees to buy them back on a fixed future date at a specified price. This price is usually set such that, overall, the other party receives back the cash it had advanced together with a lender's return on that cash for the period between sale and repurchase. It is sometimes argued that an entity with an outstanding repo transaction is in exactly the same position economically as a company that never held such shares and has simply entered into a forward contract to buy them. Therefore, if the only focus is on recognition criteria (ie, a balance sheet focus), it might be argued that the entity should derecognise the shares previously held, recognise the cash received as proceeds, and recognise a derivative in respect of the forward contract. However, if derecognition principles also focus on whether it is meaningful to report changes in assets and liabilities, then it might be argued that it is not appropriate to derecognise the shares and, instead, that the arrangement is a form of secured borrowing.

Section 5: Definition of equity and distinction between liabilities and equity instruments

Q10: The definition of equity, the measurement and presentation of different classes of equity, and how to distinguish liabilities from equity instruments are discussed in paragraphs 5.1-5.59. In the IASB's preliminary view:

a) **the *Conceptual Framework* should retain the existing definition of equity as the residual interest in the assets of the entity after deducting all its liabilities.**

b) **the *Conceptual Framework* should state that the IASB should use the definition of a liability to distinguish liabilities from equity instruments. Two consequences of this are:**

   i. **obligations to issue equity instruments are not liabilities; and**

ii. **obligations that will arise only on liquidation of the reporting entity are not liabilities (see paragraph 3.89(a)).**

c) **an entity should:**

i. **at the end of each reporting period update the measure of each class of equity claim. The IASB would determine when developing or revising particular Standards whether that measure would be a direct measure, or an allocation of total equity.**

ii. **recognise updates to those measures in the statement of changes in equity as a transfer of wealth between classes of equity claim.**

d) **if an entity has issued no equity instruments, it may be appropriate to treat the most subordinated class of instruments as if it were an equity claim, with suitable disclosure. Identifying whether to use such an approach, and if so, when, would still be a decision for the IASB to take in developing or revising particular Standards.**

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

54. We agree with the IASB's preliminary views on all these points, except at (c). On (c), we have some sympathy with what the IASB is trying to achieve, but we believe that the approach set out in the DP has not yet been fully thought through, and that it needs further work before the exposure draft stage. Some updating of equity in total, and potentially of different classes of equity, will follow logically from changes in net assets reported in the accounts. But we are not clear what beyond this the IASB intends or why remeasurements of all individual classes of equity would be worthwhile. We agree with the approach described at (d) on the basis that, as stated, it may be appropriate, and the IASB will decide whether it is in fact appropriate in developing individual standards.

55. On a point of drafting, DP5.7(a) says that an 'equity claim' is 'a … claim on the equity of an entity'. Presumably it should say: 'a … claim on the net assets…'

Section 6: Measurement

Q11: How the objective of financial reporting and the qualitative characteristics of useful financial information affect measurement is discussed in paragraphs 6.6-6.35. The IASB's preliminary views are that:

a) **the objective of measurement is to contribute to the faithful representation of relevant information about:**

i. **the resources of the entity, claims against the entity and changes in resources and claims; and**

ii. **how efficiently and effectively the entity's management and governing board have discharged their responsibilities to use the entity's resources.**

b) **a single measurement basis for all assets and liabilities may not provide the most relevant information for users of financial statements;**

c) **when selecting the measurement to use for a particular item, the IASB should consider what information that measurement will produce in both the statement of financial position and the statement(s) of profit or loss and OCI;**

d) **the relevance of a particular measurement will depend on how investors, creditors and other lenders are likely to assess how an asset or a liability of that type will contribute to future cash flows. Consequently, the selection of a measurement:**

i. **for a particular asset should depend on how that asset contributes to future cash flows; and**

ii. **for a particular liability should depend on how the entity will settle or fulfil that liability.**

e) **The number of different measurements used should be the smallest number necessary to provide relevant information. Unnecessary measurement changes should be avoided and necessary measurement changes should be explained; and**

f) **The benefits of a particular measurement to users of financial statements need to be sufficient to justify the cost.**

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

56. Subject to some concerns about the measurement criteria set out at (d) in the question (see below), we agree with these preliminary views and, indeed, we support the Board's view that using a single basis of measurement may not provide the most relevant information. We would put the point more strongly: a single measurement basis does not provide the most relevant information – this is implicit in the IASB's preliminary views at (c)-(f) in the question, and in the existing body of accounting standards. As regards (d)(i), we discuss in our response to Question 12 below the appropriateness of basing asset measurements on how the asset contributes to future cash flows. As regards (d)(ii), we note that the approach to liability measurement set out in Question 13 does not appear to be primarily based on how the entity will settle or fulfil the liability.

Q12: The IASB's preliminary views set out in Question 11 have implications for the subsequent measurement of assets, as discussed in paragraphs 6.73-6.96. The IASB's preliminary views are that:

a) **if assets contribute indirectly to future cash flows through use or are used in combination with other assets to generate cash flows, cost–based measurements normally provide information that is more relevant and understandable than current market prices.**

b) **if assets contribute directly to future cash flows by being sold, a current exit price is likely to be relevant.**

c) **if financial assets have insignificant variability in contractual cash flows, and are held for collection, a cost-based measurement is likely to provide relevant information.**

d) **if an entity charges for the use of assets, the relevance of a particular measure for those assets will depend on the significance of the individual asset to the entity.**

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

The overall approach

57. We do not think that the IASB's preliminary views as set in Question 12 are quite right yet, and believe that this topic needs substantially more work before the exposure draft stage. For example, purely on the basis of the criteria set out in the question, it might be assumed that a manufacturer's finished goods or a retailer's inventories would be valued at current exit price. We can see how this information can be relevant to the prediction of cash flows. But we do not agree that it would form a good basis for financial reporting, and it is clear from the discussion at DP6.80-6.81 (but not from Question 12) that the IASB would not support it.

58. However, even the discussion at DP6.80-6.81, although it arrives at the right conclusion, does not seem to us to provide good criteria for deciding when to use cost-based measurements. The argument in the DP lays stress on whether an asset generates cash flows independently of other assets. But it may be argued that, for example, a manufacturer's finished goods could be sold independently of its other assets. If the DP's implicit argument is that the sale of a manufacturer's finished goods in fact depends on other assets – skilled sales staff, storage facilities, perhaps delivery facilities as well – then this is an argument that could equally well be applied to other assets that are currently (rightly in our view) measured at current exit value.

59. The typical company, for example, would not be able to realise the full value of a derivative financial instrument. This requires skilled traders, access to the relevant markets, and expensive infrastructure, including technology and back-office support. Indeed, it is difficult to think of any business asset other than cash the realisation of whose value does not depend in some way on complementary assets of the company holding it.

60. Another consideration that it may be useful to take into account in deciding when to use cost-based measurements and when to use current exit prices, is whether the item in question forms part of a process of transformation of assets and services into other assets and services or whether it remains unchanged by the business between purchase and sale. This is a somewhat different line of argument from that in DP6.80-6.81. As ever, it does not provide an answer to all measurement questions, but it would help with some of them.

61. It would help explain why, for example, manufacturers' finished goods and retailers' stocks are usually measured at historical cost. Manufacturers' finished goods are the last stage in a process of physical transformation and so are retailers' inventories – where the transformation is also a physical one, but of division and relocation into amounts and to places where they can be sold to retail customers. In such processes of transformation, the most useful information is usually provided by an income statement based on matching revenue from sales with the relevant costs incurred, which users can employ as a basis for calculations of repeatable income. Revaluing to current exit price the assets that form part of such a process of transformation does not usually provide particularly useful information.

62. By contrast, many items that are usually measured at current value, such as investment properties or financial assets held for trading, are not transformed by the business, but are held for investment income or to be sold in the same market in which they were acquired (as opposed to, eg, being bought from a wholesaler and sold retail). Revaluing such assets to current exit price may well provide useful information as it shows in some cases how successful the business has been in buying assets that have risen in value and/or in others the value of the investment on which a return is being made. For these businesses, income still measures performance, but is less useful – where assets are traded – as a basis for calculations of repeatable income, and the balance sheet becomes relatively more important (see paragraph 84 below).

The meaning of 'cost-based'

63. Although cost-based measurements could in principle include current cost or replacement cost, we do not believe that the IASB proposes to implement such a meaning in a standard, so we interpret the DP's term 'cost-based' to refer to historical cost.

Arguments for and against historical cost

64. We believe that the arguments for historical cost are primarily about verifiability and costs v benefits, rather than about superior relevance. For example, we do not see how a 20-year-old cost of an asset provides the most relevant measure of the asset or a relevant basis for a depreciation expense.

65. DP6.82 lists a number of arguments against using historical cost. An additional argument is therefore that historical cost margins can be misleading if, eg, costs are incurred at different dates and different prices, and – at a time of rising prices – may overstate the margins that would be obtainable if costs were incurred at current prices. This is an argument in favour of using replacement costs.

‘Selling assets’

66. The discussion of ‘selling assets’ at DP6.83-6.85 is not helpful as it not only omits inventories held for resale, but focuses mainly on investment properties, which under IAS 40, *Investment Property*, are not held for sale in the ordinary course of business.

Charge-for-use items

67. DP6.94 suggests that ‘cost-based information is likely to provide relevant information’ for ‘large groups of low value charge-for-use’ items, whereas this is said not to be the case for other charge-for-use items. We do not follow the logic of this, and we think that the argument is really one about costs v benefits, rather than about relevance.

Q13: The implications of the IASB’s preliminary views for the subsequent measurement of liabilities are discussed in paragraphs 6.97-6.109. The IASB’s preliminary views are that:

a) **cash-flow-based measurements are likely to be the only viable measurement for liabilities without stated terms.**

b) **a cost-based measurement will normally provide the most relevant information about:**

   i. **liabilities that will be settled according to their terms; and**

   ii. **contractual obligations for services (performance obligations).**

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

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

68. We agree that cash-flow-based measurements are likely to be the only viable measurements for liabilities without stated terms.

69. We believe that it would be more accurate in relation to liabilities to speak of proceeds-based measurements rather than cost-based ones. However, even with this improvement it is difficult to see how a proceeds-based approach would be appropriate for all the liabilities covered by part (b) of the question. For example, we do not think a proceeds-based measurement would be the most appropriate for a defined-benefit pension liability or a leasing liability.

70. It is difficult to think of categories of liability that are transferred other than, occasionally, pension obligations, and we are not aware even in relation to pensions of any existing measurement requirements relating to liabilities to be transferred. Sometimes, liabilities are dealt with other than in accordance with their stated terms by paying off the person to whom the liability is owed (again, pensions would be an example), but this is regarded as a settlement rather than a transfer. However, this sort of settlement does not come into the category of ‘settling according to the stated terms’, and so DP6.107 and part (c) of the question may need to be extended to cover ‘transferring and settling other than according to the stated terms’. Current standards do not require such liabilities to be measured at current market prices, so the proposal in the DP would be proposing a departure from existing practice.

Q14: Paragraph 6.19 states the IASB’s preliminary view that for some financial assets and financial liabilities (for example, derivatives), basing measurement on the way in which the asset contributes to future cash flows, or the way in which the liability is settled or fulfilled, may not provide information that is useful when assessing prospects for future cash flows. For example, cost-based information about financial assets that are held for collection or financial liabilities that are settled according to their terms may not provide information that is useful when assessing prospects for future cash flows:

a) **if the ultimate cash flows are not closely linked to the original cost;**

b) if, because of significant variability in contractual cash flows, cost-based measurement techniques may not work because they would be unable to simply allocate interest payments over the life of such financial assets or financial liabilities; or

c) if changes in market factors have a disproportionate effect on the value of the asset or the liability (ie the asset or the liability is highly leveraged).

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

71. DP6.19 and the first sentence of this question do not appear to make sense, as they suggest that basing measurement on how an asset or liability will contribute to future cash flows will not help in assessing the prospects for future cash flows. We assume that the argument is in fact that for some financial assets or financial liabilities (eg, derivatives) basing measurement on their cost or proceeds will not help in assessing future cash flows, in which case we agree with the IASB's preliminary view.

Q15: Do you have any further comments on the discussion of measurement in this section?

72. DP6.63 states that arm's-length transactions can normally be considered to be at fair value. Actual transactions reflect the various value judgements of the particular market participants engaged in the transaction, as well as their differing bargaining skills, information and power. Thus, transactions are not necessarily at fair value, which under IFRS 13, *Fair Value Measurement*, is a unique amount. Also, where the cost includes transaction costs, which IFRS 13 excludes from fair value, an asset's cost to its purchaser is higher than fair value. The circumstances in which fair value differs from cost or proceeds are therefore significantly wider than the list at DP6.64 indicates.

73. DP6.65-6.67 discuss exchanges of items with different values. This assumes that differences in value can be identified. As noted in the previous paragraph, perceptions of value are subjective, and it is common for the parties on either side of a transaction to have different perceptions of an item's value, so in practice it may be difficult to establish that such an 'unequal' exchange has indeed taken place, rather than an exchange that a third party considers to be of unequal value.

74. DP6.66(a) states that 'if an asset were initially measured at more than its recoverable amount, an impairment loss would arise at the next measurement date'; 'could arise' would be more accurate.

75. DP6.108 appears to assume that current-value-based measurements do not provide useful information for assessing future margins. We do not see why this should be the case where current-value-based measurements are based on replacement costs or current costs.

76. DP6.128-6.130 discuss own credit risk without arriving at any conclusions, nor are there any questions on this subject. We believe that the conceptual framework should come to a conclusion on this. As the DP points out, the pricing of liabilities in the market reflects credit risk, and where liabilities whose pricing reflects own credit risk are remeasured, this should therefore reflect any changes in own credit risk. Where such remeasurement is appropriate, we do not believe that any unrealised gain or loss should be included in profit or loss. Where liabilities do not reflect own credit risk in the first place – eg, provisions – the issue should not arise.

Section 7: Presentation and disclosure

Q16: This section sets out the IASB's preliminary views about the scope and content of presentation and disclosure guidance that should be included in the *Conceptual Framework*. In developing its preliminary views, the IASB has been influenced by two main factors:

a) the primary purpose of the *Conceptual Framework*, which is to assist the IASB in developing and revising Standards (see Section 1); and

b) other work that the IASB intends to undertake in the area of disclosure (see paragraphs 7.6-7.8), including:

i. a research project involving IAS 1, IAS 7 and IAS 8, as well as a review of feedback received on the Financial Statement Presentation project;

ii. amendments to IAS 1; and

iii. additional guidance or education material on materiality.

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

a) presentation in the primary financial statements, including:

i. what the primary financial statements are;

ii. the objective of primary financial statements;

iii. classification and aggregation;

iv. offsetting; and

v. the relationship between primary financial statements.

b) disclosure in the notes to the financial statements, including:

i. the objective of the notes to the financial statements; and

ii. the scope of the notes to the financial statements, including the types of information and disclosures that are relevant to meet the objective of the notes to the financial statements, forward-looking information and comparative information.

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

77. We agree with the IASB's preliminary views about the scope and content of presentation and disclosure guidance.

78. We do not think, though, that a company's financial performance is simply a subset of changes in its economic resources and the claims against it. We therefore suggest that DP7.18(b) should read 'information about the entity's financial performance and changes in its recognised economic resources and claims against it'.

Q17: Paragraph 7.45 describes the IASB's preliminary view that the concept of materiality is clearly described in the existing *Conceptual Framework*. Consequently, the IASB does not propose to amend, or add to, the guidance on the *Conceptual Framework* on materiality. However, the IASB is considering developing additional guidance or education material on materiality outside of the *Conceptual Framework* project.

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

79. We believe that it would be helpful to include more guidance on materiality in the conceptual framework. This guidance should focus on how standard setters believe the disclosures they prescribe will influence users' decisions and on how they are to decide whether a particular item of information will influence users' decisions.

Q18: The form of disclosure requirements, including the IASB's preliminary view that it should consider the communication principles in paragraph 7.50 when it develops or amends disclosure guidance in IFRSs, is discussed in paragraphs 7.48-7.52.

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

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

80. We agree with the IASB's preliminary views on communication principles and with the principles proposed.

Section 8: Presentation in the statement of comprehensive income – profit or loss and other comprehensive income

Q19: The IASB's preliminary view that the *Conceptual Framework* should require a total or subtotal for profit or loss is discussed in paragraphs 8.19-8.22.

Do you agree? Why or why not?

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

81. We agree that there should continue to be a total or sub-total of profit or loss, which we believe is helpful to users. The answers to this question and Questions 20 and 21 depend on the meaning of 'profit or loss', so we address this important issue now.

82. We strongly urge the IASB to explain the objective of presenting profit or loss. We note that IAS 33, *Earnings per Share*, requires a listed company to disclose prominently its earnings per share (EPS), and that earnings for most companies is the profit or loss for the period. If the IASB proposes to continue requiring the disclosure of profit or loss and of EPS (which we support), we believe that it should explain the concept of profit or loss. Otherwise, it becomes impossible to answer questions such as those in Section 8 on the basis of a principle, and standard setters will continue to write inconsistent standards.

83. We suggest that the objective of presenting profit or loss should be to provide a measure of an entity's performance during a period and to provide information that is helpful, when used in conjunction with other relevant information, in trying to forecast future cash flows. At its simplest, selling inventories is part of performance, but remeasuring the value of the head office is not; the profit or loss on selling inventories will help to forecast next year's performance, but the increase in the value of the head office will not. Similarly, an increase in the fair value of trading financial assets is performance, but an increase in the net assets of a foreign subsidiary caused by currency appreciation is not and nor is a gain on liabilities reflecting a deterioration of own credit risk (paragraph 76 above).

84. Whether the increase in the fair value of trading assets helps forecast future trading gains or losses is debatable. We admit that past changes in fair value may not predict future changes in fair value, but for trading items they do measure the trader's success or failure, which is relevant information for stewardship purposes (paragraph 19 above), and may also indicate the trader's ability to make profits in the future. An increase in the net assets of a foreign subsidiary caused by changing currency values or a gain on liabilities reflecting a deterioration of own credit risk neither measures performance nor helps forecast future earnings.

85. Even such a high-level approach to the concept of profit or loss as we have suggested should be helpful. It tells us, for example, that even when the head office or the foreign subsidiary is sold, the cumulative gains should not be recorded in profit or loss, because they are realised holding gains of previous periods. Incidentally, this also implies that, even if a head office has not been revalued, the gains or losses on its sale should not go through profit or loss. The same principle would apply to other items of property, plant and equipment except where the profit or loss on the sale could be regarded as a truing up of prior periods' depreciation charges. This would require revisions of IAS 16, *Property, Plant and Equipment*, and IAS 38, *Intangible Assets*, and it would give greater consistency in profit or loss between entities that choose to revalue and those that do not.

86. We would expect a company's business model to be relevant when deciding what should be recognised in profit or loss and what in OCI. For example, two otherwise identical properties might be inventory for one company, but the head office for another; and two otherwise identical financial instruments might be trading assets for one company but not for another. In each case, it will be the role of the item in the company's business model that determines how the profit or loss should be measured.

87. In some cases, the principles that we have described will conflict and it will be a matter of judgement as to which leads to the more useful information. For example, it is important for stewardship purposes that management should be accountable for its performance, and this implies that 'truing up' type adjustments should be recognised in profit or loss even though they may lead to a less useful measure of repeatable income. Such adjustments would usually include, for example, impairment charges and corrections of prior year estimates. It is less clear whether actuarial gains and losses should be recognised in profit or loss. Arguably, they are a form of truing up adjustment, although given the nature of pension schemes, there is no final truing up until the scheme closes – which may well be at some point in the distant future. Also, there is a stewardship argument for recognising all adjustments to pension costs in profit or loss. On balance, though, we take the view that actuarial gains and losses are best excluded from profit or loss as they should not be regarded as part of performance during the period and do not help arrive at a measure of repeatable income. We recognise that views differ on this. Standard setters would also need to consider whether the extra complexity of truing up would be too costly or difficult to understand.

88. None of the principles we have suggested is intended to be a hard-and-fast rule for what should be recognised in profit or loss or taken to OCI. But they indicate what we believe to be important factors that should be taken into account by standard setters.

Q20: The IASB's preliminary view that the *Conceptual Framework* should permit or require at least some items of income and expense previously recognised in OCI to be recognised subsequently in profit or loss, ie recycled, is discussed in paragraphs 8.23-8.26.

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

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

89. Because of our suggested approach to the concept of profit or loss, we do not agree that items should be recycled from OCI to profit or loss. The effect of recycling would usually be to produce a less useful figure of profit or loss for the year as it would include items that do not have any predictive value and that are only doubtfully connected with the company's performance in the year in which they are recycled.

90. We believe that an exception should be made for fair value gains or losses on effective hedges, which should be recycled when the hedged transaction is recognised in profit or loss. The rationale for this exception is that it helps to produce a more useful figure of repeatable profit and one that better reflects performance during the year.

91. As stated above, we strongly urge the IASB to try to explain the concept of profit or loss as without one there will be no clear principle for determining what should be taken to profit or loss and what to OCI. At the very least, we believe that there should be an overarching explanation for the items recognised in OCI, and we would urge the IASB to provide one, which we assume would probably be done by explaining why it makes sense to exclude the items in question from profit or loss.

Q21: In this Discussion Paper, two approaches are explored that describe which items could be included in OCI: a narrow approach (Approach 2A described in paragraphs 8.40-8.78) and a broad approach (Approach 2B described in paragraphs 8.79-8.94).

Which of these approaches do you support, and why?

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

92. Our above views on the concept of profit or loss lead us to support the broad approach (Approach 2B) to what should be included in OCI. The application of Approach 2B to particular cases described in the DP also seems to us to be reasonable.

Section 9: Other issues

Q22: *Chapters 1 and 3 of the existing* Conceptual Framework

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

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

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

Stewardship

93. We do not believe that major changes to the framework are required in relation to stewardship, but it is very important that it is well-understood that financial reporting does have a dual primary role, and that the provision of information to a company's owners to facilitate their control of its management is a legitimate objective of reporting under IFRS. Perhaps this could be done by pointing out in the framework's reference to this subject (paragraph OB4 in the 2010 framework) that in some jurisdictions the provision of information for this purpose is known as the stewardship function of financial reporting.

Reliability

94. We do not believe that reliability needs to be reinstated in the framework as a qualitative characteristic. In our view, reliability is not something that can be secured simply by complying with accounting standards. Usually it also requires some form of third party assurance. This is discussed in the Audit Quality Forum's report, *Reliability Matters: Reliability and the Central Role of the Auditor* (2013).

95. However, in commenting on the proposals that led to the 2010 framework we argued against the two-tier approach for qualitative characteristics and said that, if it was to be retained, verifiability should be classified as a fundamental characteristic rather than as an enhancing characteristic. The point here is that information that is verifiable can then be made reliable by means of third party assurance. We still believe that these would be improvements to the framework.

Prudence

96. We believe that it would be helpful for the role of prudence in financial reporting to be explicitly recognised in the conceptual framework. Whatever it says in the current framework, we note that standard setters consider prudence as an important factor in writing accounting standards, as do the preparers and auditors of accounts in applying them in practice. It would also be helpful to explain the role of prudence in financial reporting so as to clarify what it does not mean. It would be useful, for example, to make it clear that it is not a licence for excessive prudence or for income smoothing or a reason never to recognise fair value gains, and to distinguish it from what the prudential regulators of certain sectors are trying to achieve, which is to set up buffers to protect creditors and policy holders, rather than to give a true and fair view. Given that the 2010 conceptual framework (paragraph OB10) explicitly acknowledges that regulators are among the users of general purpose financial reporting, there may otherwise be a risk that 'prudential' values required in returns from regulated businesses will be argued to be appropriate in financial reporting.

97. We appreciate that there are concerns that explicit recognition of the role of prudence could have unfortunate effects on the neutrality of financial reporting information. However, in our view prudence needs to be clearly defined partly because it can be misunderstood in a way that would in practice lead to imprudent accounting. For example, on some interpretations it could result in standard setters allowing profit to be artificially depressed in one period, only for it to be artificially enhanced in the next, distorting trends over time. Moreover, if preparers were required to follow such a principle, it could lead to manipulation of profit for potentially short-term gains and to financial reporting that therefore fails to be neutral. But we believe that it should be possible to refer to prudence in the conceptual framework in an appropriately precise way that would achieve the desired objective and leave neutrality as a concept in place and not undermined.

98. The description of prudence in the pre-2010 conceptual framework seems to us to be a satisfactory starting point. This description states that prudence is 'the inclusion of a degree of caution in the exercise of the judgements needed in making the estimates required under conditions of uncertainty …' It also emphasises that the exercise of prudence does not allow, eg, hidden reserves or excessive provisions, which would contravene the principle of neutrality. While the pre-2010 description appears to be aimed at preparers, the principle is applicable to standard setters as the requirements they impose should, among other things, enforce a degree of caution by preparers in making estimates under conditions of uncertainty. It is therefore an appropriate issue to be dealt with at the framework level, and we would then expect it to be reflected in standards so as to apply it to preparers.

Substance over form

99. The 2010 version of the conceptual framework also removed any reference to substance over form. This was done, as DP9.14 points out, because it was considered redundant – it was argued that preferring form over substance would not give a faithful representation. In our view, it would be desirable to insert a reference to the interpretation of form in accordance with substance (which we believe is how the 'substance over form' principle should more accurately be described). As noted above in our answer to Question 7, this would be, among other things, a helpful contribution to the guidance on assets and liabilities.

Q23: *Business model*

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

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

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

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

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

100. Business models already play a significant role in financial reporting. We support this and we believe that a company's reporting should reflect its business model or models so that their success or failure can be properly assessed. Often the key point in relation to a particular item or transaction is not so much differences between business models as differences between the roles that the item or transaction can play in the business model. We therefore agree with the IASB's preliminary view that financial statements can be made more relevant if the IASB considers, when developing or revising standards, how a company conducts its business activities. One way of reflecting this is through the principle that measurement should reflect how an asset or liability will contribute to a company's future cash flows. As indicated above, however, we do not think that this principle as stated in the DP will provide the answer to all measurement questions, and we believe that more work needs to be done on the appropriateness of its application to particular types of asset or liability.

101. As stated earlier (paragraphs 41 and 86), we also believe that it would be helpful in defining 'revenue' and explaining the concept of profit or loss to link them to a company's business models.

102. We do not think that the term 'business model' needs to be defined in the framework. Trying to define it would introduce unnecessary problems, partly because many companies have multiple business models for their various activities. The framework would be unlikely to suffer from the absence of a definition.

Q24: *Unit of account*

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

Do you agree? Why or why not?

103. We support the IASB's preliminary view that unit of account questions should be settled in individual standards, but it would be helpful to have some discussion in the framework of the IASB's general approach to the unit of account and to the measurement of portfolios of items.

Q25: *Going concern*

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

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

104. The going concern 'assumption' is of course a misnomer for a view that needs to be assessed for each set of accounts, rather than simply assumed. We think that it would be useful to extend the discussion of this subject in the conceptual framework, as going-concern-type judgements are often made in financial reporting in relation to issues such as asset lives.

Q26: *Capital maintenance*

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

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

105. The discussion at DP9.45-9.46 implies that the capital maintenance concept is still an open question and one that companies decide for themselves: 'Most entities adopt a financial concept of capital maintenance' (DP9.46). In fact, IFRS standards are based on a financial capital maintenance concept, and it would be helpful for the framework to state this explicitly, rather than appear to leave it as an option for standard setters or reporting entities.

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