

AGENDA PAPER

IFRS Foundation Trustees meeting – Due Process Oversight Committee

SYDNEY

8 APRIL 2014

Agenda ref 3F(i)

Conceptual framework project: feedback from users of financial statements

1. Attached is the paper summarising the feedback from investors and analysts (users) on the IASB's July 2013 Discussion Paper (DP) *A Review of the Conceptual Framework for Financial Reporting* that was presented to the IASB at its March 2014 meeting (Agenda Paper, AP 10M for that meeting).
2. The paper summarises the feedback from users received through comment letters, face-to-face meetings and teleconferences.

STAFF PAPER

March 2014

IASB Meeting

Project	Conceptual Framework		
Paper topic	Feedback summary: user outreach		
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This paper has been prepared by the staff of the IFRS Foundation for discussion at a public meeting of the IASB and does not represent the views of the IASB or any individual member of the IASB. Comments on the application of IFRSs do not purport to set out acceptable or unacceptable application of IFRSs. Technical decisions are made in public and reported in IASB *Update*.

Purpose of paper

1. This paper is a summary of the feedback that the staff and the IASB received from investors and analysts (referred to as **users** in this paper) on the Discussion Paper A *Review of the Conceptual Framework for Financial Reporting* (the Discussion Paper) published by the IASB in July 2013. The staff and IASB will continue to seek the views of users as the IASB re-deliberates the proposals in the Discussion Paper.
2. This summary includes feedback from users received through comment letters, face-to-face meetings and teleconferences.
3. This paper provides a high-level summary of the comments received. Where appropriate, we will provide a more detailed breakdown of the comments for future meetings.
4. Comment letters are available on the *Conceptual Framework* project website:

<http://go.ifrs.org/conceptual-framework>

Structure of paper

5. This paper is structured as follows:

- (a) Demographic analysis (paragraphs 6–8)
- (b) Scope of consultation (paragraphs 9–12)
- (c) Summary of feedback on each of the topics (paragraphs 13–97)
 - (i) Section 5—Definition of equity and distinction between liabilities and equity instruments (paragraphs 13–25)
 - (ii) Section 6—Measurement (paragraphs 26–37)
 - (iii) Section 8—Presentation in the statement of comprehensive income - profit or loss and other comprehensive income (paragraphs 38–56)
 - (iv) Section 9—Other issues—Chapters 1 and 3 (paragraphs 57–80)
 - (v) Section 1—Purpose and status of the *Conceptual Framework* (paragraphs 81–84)
 - (vi) Sections 2 and 4—Elements of financial statements and recognition (paragraphs 85–87)
 - (vii) Section 3—Additional guidance to support the asset and liability definitions (paragraphs 88–92)
 - (viii) Section 7—Presentation and disclosure (paragraph 93)
 - (ix) Section 9—Other issues—The use of business model concept in financial reporting (paragraphs 94–96)
 - (x) Section 9—Other issues—Unit of account, going concern and capital maintenance (paragraph 97)

Demographic analysis

6. From July 2013 to February 2014, the IASB and staff attended more than 20 meetings with users and received 13 comment letters from them. Around half of those meetings were in-person, mostly at the investor's or analyst's offices; while the other meetings were telephone calls. Meetings held with the IASB's Capital Markets Advisory Committee were held in public. Other meetings were held in private. Meetings generally included at least one IASB member and staff. For this summary, we have only included meetings specifically for users. This analysis does not cover meetings, such as roundtables, that included other participants in addition to users.
7. Most of the users who participated in outreach stated that they were sharing their own views and not necessarily the views of their employers. However, some representatives of the investor and analyst associations and professional bodies stated that they represent the views of their members. The majority of those who participated were equity analysts, or representatives of equity analysts, but we also consulted credit analysts, including analysts from the credit rating agencies. Those who participated included both sell-side and buy-side analysts and a few were accounting analysts.
8. The users we spoke to were located in Europe (with specific input from users in France, Germany, the Netherlands, Sweden and the United Kingdom), the United States, Canada, Japan and South Africa.

Scope of consultation

9. There was unanimous support for the IASB undertaking the project. However, some suggested that they would prefer a shorter and more readable document.
10. Given the limited time of most users, we were unable to discuss all topics covered by the Discussion Paper during meetings. To best use the time available, we focused on the topics in the Discussion Paper that we thought would be of most relevance to users.
11. The following topics were more frequently discussed at meetings with, and in comment letters from, users:
 - (a) Section 5 of the Discussion Paper—Definition of equity and distinction between liabilities and equity instruments (paragraphs 13–25)
 - (b) Section 6—Measurement (paragraphs 26–37)
 - (c) Section 8—Presentation in the statement of comprehensive income - profit or loss and other comprehensive income (paragraphs 38–56)
 - (d) Section 9—Other issues—Chapters 1 and 3 (paragraphs 57–80)
12. The following topics were less frequently discussed at meetings, but some comment letters included responses to these sections:
 - (a) Section 1—Purpose and status of the *Conceptual Framework* (paragraphs 81–84)
 - (b) Sections 2 and 4—Elements of financial statements and recognition (paragraphs 85–87)
 - (c) Section 3—Additional guidance to support the definitions (paragraphs 88–92)
 - (d) Section 7—Presentation and disclosure (paragraph 93)
 - (e) Section 9—Other issues—The use of business model concept in financial reporting (paragraphs 94–96)
 - (f) Section 9—Other issues—Unit of account, going concern and capital maintenance (paragraph 97)

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

Background

13. The existing *Conceptual Framework* defines liabilities and equity. However, existing IFRSs do not apply the definitions consistently. Apart from the resulting requirements being complex and difficult to apply for preparers and auditors, these inconsistent requirements result in economically similar items being classified differently, with very different accounting outcomes. These differences in accounting for similar items make it unnecessarily difficult and complex for a user to understand an entity's financial position and performance.
14. The Discussion Paper explored two approaches to defining equity and distinguishing between liabilities and equity:
 - (a) The 'strict obligation approach'—This approach would retain the existing definition of equity as the residual interest in the assets of the entity after deducting all liabilities.
 - (b) The 'narrow equity approach'—This approach would define equity as only the existing equity instruments in the most residual class of equity instrument issued by the parent. All other claims would be treated as liabilities.
15. The Discussion Paper suggested that the strict obligation approach should be used to distinguish between liabilities and equity. To supplement the strict obligation approach, the Discussion Paper suggested that more information could be provided to help users understand the effect of different equity claims on each other. For example, the IASB might require changes in the value of some equity claims to be recognised in the statement of changes in equity.
16. The focus of the outreach on this section was to seek analyst and investors' thoughts on the Discussion Paper's analysis of the problem and whether the proposals to address the problem would improve the usefulness of the financial statements. We contrasted the results of the two approaches using a simple example.

Summary of feedback

17. Users generally agreed that the current distinction between liabilities and equity, as implemented in existing Standards, is problematic. However, users with a focus on financial services, or in jurisdictions where entities regularly issue complex securities, were more aware of the problems in this area than other users.
18. Users identified the following problems with the current accounting:
 - (a) The effect of different classes of equity on each other is difficult to understand. Users stated that at the moment they do not receive enough information about the different types of claims (both existing and potential) on a reporting entity, including potential dilution.
 - (b) The distribution of risk and returns among claimholders classified as equity is difficult to see. Users think that information about the risks and returns of each claim is very important.
 - (c) The entity's capacity to pay dividends is difficult to see. Equity should be disaggregated to show items such as distributable reserves, accumulated OCI and capital requirements. Retained earnings is a 'fixed' amount that is not subject to change, while accumulated OCI is 'tentative'.
 - (d) Inconsistent accounting reduces the usefulness of commonly used ratios such as leverage and earnings per share.
 - (e) Recognising in profit or loss changes in the fair value of derivatives on an entity's shares is not useful.

Approaches to distinguish liabilities from equity

19. Users expressed mixed views on the 'strict obligation approach' and the 'narrow equity approach'. While users welcomed greater consistency in Standards, they wanted to understand the effect on the accounting results. They expressed concerns that the strict obligation approach might result in many instruments being reclassified as equity. Some participants requested a field study on the proposals to help understand the effects.

20. Some users, including many equity analysts and investors, preferred the ‘narrow equity approach’. They stated that:
- (a) it was unclear what additional information they would get from the ‘strict obligation approach’, given that under the ‘narrow equity approach’ all senior claims would be remeasured through the income statement.
 - (b) for equity investors, dilution of return is a key concern and the narrow equity approach would provide better information about potential dilution.
 - (c) the ‘strict obligation approach’ creates more opportunities for structuring instruments to be treated as either a liability or equity. The advantage of the ‘narrow equity approach’ is that equity is a very narrow group and opportunities for structuring would be limited. If a bright line is required, the narrow equity approach is a better place to begin.
 - (d) an instrument should be classified as a liability even if the instrument’s value is linked to the market value of equity.
21. Some users, including credit analysts, preferred the ‘strict obligation approach’. They stated that:
- (a) Whether an entity has an obligation to transfer cash or other economic resources is a critical factor in credit analysis.
 - (b) The approach would provide more comparability, because instruments with identical features would be treated consistently across entities.
 - (c) In contrast to those users that stated otherwise (see paragraph 20(d)), some users do not want amounts recognised in profit or loss arising from instruments whose value is linked to the market value of equity (in some cases, even if the instrument would be cash settled).
22. Some expressed concerns about the treatment of an obligation to issue a variable number of own shares to a specified amount. They stated that:

- (a) Such an obligation introduces a risk of extreme dilution for existing shareholders. Prominent disclosures should be required if instruments of this type are issued, especially if they are classified as equity.
 - (b) If the share price collapses, the issuer may not have the authority to issue enough shares to satisfy its obligation. In practice, the instrument would require the issuer to settle any shortfall in cash or to default.
 - (c) If these obligations to issue shares need an exception to the definition to be classified as liabilities, the strict obligation approach might not be very useful in practice.
23. Other users disagreed with both approaches and offered alternatives including the following:
- (a) Only instruments that allow the holder to participate in the returns of the entity without upper limit should be treated as equity. This approach will classify as equity all of the dilutive instruments which can only be valued by reference to the fair value of the whole entity. Changes in value of these instruments should not be reported in the primary financial statements. However disclosures are required so that the risks and rewards of each class of equity claim are clear to the users.
 - (b) Standards should require three categories of claim: liabilities, equity and a third category (hybrid or mezzanine). However, some cautioned that this might increase complexity.
 - (c) A liability is any obligation to give up resources including own shares. Arguments for liability treatment would be stronger if the entity settles an obligation to issue shares by buying those shares in the market.
 - (d) The definition of equity should be based on identifying the class of instrument that has the potential to grant the holder control of the entity, given that ‘control’ is the basis for the definition of assets and for consolidation.
 - (e) Non-controlling interests (NCI) should be classified as liabilities.

Remeasuring equity claims

24. Nearly all users were supportive of requiring entities to provide more information regarding different types of claims. However, there were differing views about the form and content of the information. Comments included the following:
- (a) Additional information (such as the proposed enhancements to the statement of changes in equity) would be beneficial regardless of where it was placed, whether the items were classified as liabilities or equity. However, some preferred the information to be presented in profit or loss rather than within the statement of changes in equity.
 - (b) Additional disclosures would help users understand the wealth transfer amounts in the proposed statement of changes in equity. Typically users suggested that these additional disclosures should include the number of shares, or potential shares, within each class of equity and any related terms.
25. Some did not support the idea that the most residual claim should be treated as if it were equity if no claim meets the definition of equity. However, this was not discussed in detail.

Section 6—Measurement

Background

26. The existing *Conceptual Framework* provides little guidance on measurement and on when a particular measurement basis should be used. The Discussion Paper described guidance on measurement that could be included in a revised *Conceptual Framework*.
27. The Discussion Paper suggested that a single measurement basis for all assets and liabilities may not provide the most relevant information to users of financial statements.
28. In addition, the Discussion Paper suggested that 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 basis for a particular asset or liability should depend on:

- (a) How the asset contributes to future cash flows or how the entity will fulfil or settle the liability; and
- (b) What information that measurement basis will produce in the statement of financial position and in the statement(s) of profit or loss and other comprehensive income.

Summary of feedback

Mixed measurement approach

29. Many users who commented agreed that:
- (a) a single measurement basis for all assets and liabilities may not provide the most relevant information to users of financial statements; and
 - (b) different measurement bases are useful depending on the circumstances.
30. Nevertheless, some users also commented that a mixed measurement approach diminishes the usefulness and comparability of aggregate measures such as the financial statement totals, profit or loss, return on equity and return on investment. Using different measurement bases also reduces understandability, particularly if the measurement basis is complex.
31. One use group held a different view, that the *Conceptual Framework* should state that fair value is the most relevant measurement. In their view, fair value measures reflect the most current and complete estimations of the value of the asset or obligation, including the amounts, timing, and riskiness of the future cash flows attributable to the asset or obligation. Such expectations lie at the heart of all asset exchanges.
32. Some also referred to the Discussion Paper's proposals on the use of OCI, stating that using different measurement bases in the statement of financial position and statements of financial performance could also be useful.

Basis of measurement selection

33. Users had mixed views on the basis of measurement selection:

- (a) On the one hand, the concept that the selection of a measurement will depend on how an asset contributes to cash flow or how a liability will be fulfilled is attractive for particular items. In particular, some suggested that this approach would better reflect an entity's business model.
 - (b) On the other hand, this will reduce comparability and consistency of accounting, particularly if management intent is used to decide on the measurement.
- 34. Some expressed concern about the usefulness of information if management is allowed to choose the measurement basis depending on what they decide their business model is. Instead, they think that the IASB should determine the most relevant measurement basis for a particular asset based on its characteristics. They want the measurement basis that best captures the most relevant economic phenomenon.
- 35. Some users focused on how they would use different measurements in the different statements. They stated that:
 - (a) In estimating future cash flows, the revenue and expense during the reporting period are more important than values in the statement of financial position.
 - (b) The relationship between future cash flows and revenue and expenses becomes less understandable when profit or loss includes fair value changes for operating assets and liabilities (however, some mentioned that banking or insurance might be exceptions).
 - (c) Fair values might be more relevant for non-operating assets because non-operating assets can be sold without reducing the operating capacity of the business.
- 36. Other users suggested that the material in the Discussion Paper would not help the IASB in deciding which measurement to select and how to balance the qualitative characteristics and costs.

Other comments

- 37. Other comments on various aspects of measurement included the following:

- (a) If some items, such as inventory, are measured at fair value, users might think that the quantity has changed rather than the value.
- (b) Replacement cost might also be a relevant measurement basis. Replacement cost would indicate the amount needed to maintain the operating capital of the business.
- (c) If liabilities and assets are closely related, then they should be measured on the same basis.
- (d) Having both cost and current cost information for an item or transaction might be useful.
- (e) The measurement chapter should consider discounting in more depth.
- (f) Liability measurement should not include changes in own credit risk.

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

The problem identified in the Discussion Paper

38. Many respondents to the IASB's 2011 agenda consultation suggested that it is important for the *Conceptual Framework* project to address profit or loss, OCI and the 'recycling' of amounts from OCI to profit or loss. Currently, there is no principle in Standards to determine:
- (a) which items of income or expense should be presented in profit or loss and which should be presented in OCI; and
 - (b) whether, and when, items previously recognised in OCI should be recycled subsequently from OCI to profit or loss.

Summary of feedback

39. Many users suggested that the root cause of the problem is the lack of any definition of profit or loss or performance. However, they did not suggest how the IASB might address this problem. In their view, the Discussion Paper focused too much on the current state of affairs and appeared to be an attempt to 'shoehorn' concepts to justify items that

are in OCI today. Some users think that the IASB might lose an opportunity to define performance or net income and to look more closely at non-GAAP information.

40. Many requested that the IASB re-activate the *Financial Statement Presentation* project. They noted that such a project may be a better place to answer some of the detailed questions discussed in the Discussion Paper than the *Conceptual Framework* project.
41. Other comments included:
- (a) The IASB should take a step back and identify the objective that the profit or loss total is intended to satisfy.
 - (b) Performance is more than just a change in assets and liabilities. Performance is multi-dimensional. Something like OCI might result from the process of defining performance, but the IASB should not start with a presumption that there is OCI.
 - (c) If the IASB focused on equity investors as the primary users of financial statements and stewardship as the primary objective, then it might have more success in defining financial performance.
42. Some users observed that analysts always adjust profit or loss to get to a number that they will use in their models. In deciding what adjustments to make, they consider various factors. Therefore, it might not be possible to find a number that will eliminate the need for these adjustments. No single answer is suitable for all users. For example, some analysts follow a small number of entities and investigate the numbers in detail, making many adjustments, while other analysts follow a broader range of entities and rely more heavily on summary measures of performance.

Awareness of OCI and recycling

43. Many acknowledged that OCI and recycling are not well understood by the broader user community and are not looked at by many users. Some remarked that this limited understanding or awareness made them question whether there should be a separate OCI category. They suggested the following reasons for the lack of attention to OCI:

- (a) They are aware of the items currently in OCI but believe that they do not reflect an entity's performance.
 - (b) They are unaware of the items in OCI because they do not look beyond profit or loss.
 - (c) Items in OCI are better understood or more relevant in some industries than others, for example some users analysed insurers and other financial institutions differently from other entities.
44. Some suggested that the IASB should change the name of OCI because it does not describe items included in OCI and might prevent less-informed users from making the effort to understand those items better.

Profit or loss, OCI and recycling

Background

45. To address the problems identified in paragraph 38, the Discussion Paper suggested that the *Conceptual Framework*:
- (a) should require a profit or loss total or subtotal that also results, or could result, in some items of income or expense being recycled; and
 - (b) should limit the use of OCI to items of income or expense resulting from changes in current measures of assets and liabilities (remeasurements).
- However, not all such remeasurements would be eligible for recognition in OCI.

Profit or loss as the primary performance measure

46. Many users expressed support for the IASB's preliminary view that profit or loss is the primary indicator of an entity's performance. They stated the following:
- (a) Profit or loss is important as the bottom line profit left to shareholders and the source of future dividends. This should give a clear indication to investors of the return management has made on the economic resources entrusted to it.
- Some suggested that profit or loss should be defined as an element.

- (b) Earnings per share and the price earnings ratio, both of which are established indicators and commonly used by analysts, are derived from profit or loss. Therefore, these performance measures should be defined to ensure comparability.
 - (c) Defining income and expenses based on changes in assets and liabilities is less relevant for companies that generate cash from off-balance sheet intangible assets. Including remeasurements together with transaction based income makes it difficult to predict future cash flows.
 - (d) If everything is in profit or loss, that reduces its relevance and may increase the use of non-GAAP measures. OCI is valuable because it helps exclude items from profit or loss that users do not think are relevant for performance, or forecasting cash flows.
47. Other users placed less emphasis on profit or loss as a primary subtotal. These users suggested that:
- (a) Better disaggregation in both the statement of financial position and statement of profit or loss and other comprehensive income reduces the need to have a single performance measure. As long as items are well described and disaggregated on a consistent and transparent basis, users can use their own judgement as to how these items should be treated.
 - (b) The level of relevance of profit or loss and OCI depends on the entity's industry.
 - (c) Other subtotals should be required in addition to profit or loss. These subtotals closely reflected the attributes described by users as useful for distinguishing profit or loss from OCI (see below).
 - (d) The IASB should explore the possibility of a columnar approach to the statement of financial performance, rather than retaining the distinction between profit or loss and OCI. The IASB explored a columnar approach in the previous project on financial statement presentation.

- (e) The distinction between profit or loss and OCI is arbitrary.

Recycling

48. Some users think that all items included in OCI should be recycled either because of the importance of profit or loss or because recycling was necessary to achieve their preferred approach to distinguish profit or loss from OCI (for example, realisation and other attributes discussed below). These users suggested that being unable to determine the appropriate trigger for recycling is not a good reason for not recycling at all.
49. Some suggested that recycling increases the risk of earnings management, and decreases understandability and comparability. Therefore, they would prefer to prohibit or limit recycling. On the other hand, others suggested that using OCI without recycling would give management an incentive to understate profit or loss (for example, by underestimating service cost in pensions).
50. Regardless of their views, many users suggested that the treatment of items as recycled or not should be clearly disclosed to improve users' understanding of recycling and to help them make adjustments. Some suggested that they are happy to have some items recycled and others not, as long as there is clear disclosure of the treatment.

Categories of items to be included in OCI

Background

51. The Discussion Paper discussed two approaches that describe which items could be included in OCI:
- (a) a 'narrow' approach (2A)—items that meet the definitions of bridging items or mismatched remeasurements may be recognised in other comprehensive income. All items recognised in this approach would be recycled. Bridging items and mismatched remeasurements were described as follows:
- (i) A **bridging item** arises when the measurement used in the statement of financial position is different from the measurement used to determine the amounts included in the statement of profit or loss. The difference between the two measurements is recognised in OCI (eg items classified as fair value through OCI

under the upcoming limited amendments to IFRS 9 *Financial Instruments*).

- (ii) A **mismatched remeasurements** arises when an item of income or expense represents the effects of part of a linked set of assets, liabilities or transactions so incompletely that the item provides little relevant information about the performance of the entity in the period (for example, the effective portion of a cash flow hedge of a forecast transaction).
- (b) a ‘broad’ approach (2B)—In addition to the items in 2A, items meeting the definition of transitory remeasurements may be recognised in other comprehensive income. In this approach, items would be recycled when, and only when, this would provide relevant information in profit or loss.
Transitory remeasurements are remeasurements that have all of the following characteristics:
 - (i) they arise on long-term assets and liabilities;
 - (ii) they are likely to reverse fully or significantly change over the holding period; and
 - (iii) recognising the remeasurement partially or fully in OCI would enhance the relevance of profit or loss for the period.

Summary of feedback

- 52. Views regarding the categories identified in the Discussion Paper were diverse. While many comment letters supported the ‘broad’ approach, this was to a large extent simply because the ‘narrow’ approach was considered too restrictive, while other users supported the ‘narrow’ approach because they believed that the broad approach permitted too many things to be included in OCI.
- 53. Users suggested that the three categories identified in the Discussion Paper were not useful in analysing the problem. They noted overlaps between the categories, for example some suggested that all OCI items identified could be included within the bridging category, but this might have been because the Discussion Paper did not explain that

category clearly enough for users to understand the boundaries implied by the way it was defined.

54. Users raised a number of concerns regarding the approaches considered in the Discussion Paper:

- (a) The transitory remeasurements category is not well defined and will provide a perceived conceptual basis to pressure the IASB to use OCI for unwanted items, ‘noise’ or other volatile items.
- (b) Only one measurement basis should be used in the primary financial statements. Therefore bridging items should not arise.
- (c) Mismatched remeasurements are caused by standards-level problems not conceptual problems.

55. Users suggested a number of different attributes that could determine which items should be recognised within profit or loss or OCI. While many agreed that there was not a single distinguishing attribute, some questioned why the IASB had not explored distinguishing attributes further. Instead of a single attribute, a combination of attributes may be needed to define what should be reported outside profit or loss. Some users acknowledged that there were problems associated with defining some of them.

56. Attributes suggested included (in no particular order):

- (a) operating income;
- (b) recurring items;
- (c) changes within management control;
- (d) realisation;
- (e) an entity’s business model;
- (f) estimation uncertainty;
- (g) reliability;
- (h) short-term volatility;

- (i) distributable income.

Section 9—Chapters 1 and 3

Background

- 57. When the IASB restarted work on the *Conceptual Framework* in 2012, it decided not to reconsider fundamentally those chapters of the *Conceptual Framework* that it published in 2010 (Chapter 1 *the Objective of General Purpose Financial Reporting* and Chapter 3 *Qualitative Characteristics of Useful Financial Information* (‘Chapters 1 and 3’). However, the IASB acknowledged that it would make changes if work on the rest of the *Conceptual Framework* highlighted areas that need clarifying or amending.
- 58. Some interested parties raised concerns about how those chapters address stewardship, reliability and prudence. The IASB included a summary of those concerns in the Discussion Paper to seek respondents’ views on these matters.

Summary of feedback

- 59. Many users expressed the view that the IASB should reconsider at least some aspects of Chapters 1 and 3 of the existing *Conceptual Framework*. However, some users indicated that Chapters 1 and 3 are fundamentally sound. During meetings with users various definitions of the concepts emerged, prompting some to suggest that reconsidering some of the issues would at least help to reduce misunderstandings and confusion. Some expressed concern that re-visiting Chapters 1 and 3 might result in divergence from US GAAP, given that Chapters 1 and 3 were developed jointly by the IASB and the FASB.
- 60. Users focused their comments on the three issues identified in the Discussion Paper:
 - (a) Stewardship (paragraphs 62–~~Error! Reference source not found.~~67)
 - (b) Reliability (paragraphs 68–72)
 - (c) Prudence (paragraphs 73–80)
- 61. In addition to commenting on the above issues, some users also suggested the following:
 - (a) The ‘true and fair’ override should be given more prominence. Some users believe it is too easy for accounts to be signed off as technically compliant with the Standards when, in their view, they do not provide a ‘true and fair’ view of

the performance of the entity. ‘True and fair’ was not defined (at least not internationally), however some suggested that it should be left to professional judgement. Some UK based users suggested that to provide a true and fair view in the United Kingdom, stewardship, prudence and reliability need to be reinstated as fundamental characteristics of the *Conceptual Framework*. However, one user group held the opposite view, in particular that the use of prudence would not result in a true and fair view.

- (b) The primary user group identified in the *Conceptual Framework* is too broad. The IASB should focus on existing shareholders because they are the bearers of residual risk, whereas others are protected by other rights.
- (c) Simplicity should be included as an objective, or understandability should be elevated to a fundamental characteristic. However, others disagreed with this, stating that business is complex and this complexity can require complex accounting. Some commented that complexity is often introduced by the feedback that we receive from preparers.
- (d) The discussion of the objective of financial reporting in Chapter 1 gives too much priority to assets and liabilities without discussing why. Some users think that income, expenses and cash flows should be given more prominence.

Stewardship

Background

62. Before Chapter 1 was published in 2010, the *Conceptual Framework* made explicit reference to stewardship. Although Chapter 1 does not use the phrase stewardship, it was not the intention of the IASB to remove the concept of stewardship from the objective of financial reporting. Chapter 1 states that users of financial statements need information about how effectively and efficiently the entity’s management and governing body have discharged their responsibilities.

Summary of feedback

63. Users generally acknowledged that providing information used in assessments of what is commonly referred to as stewardship is already encompassed by the objectives of the *Conceptual Framework*. However, some stated that the absence of the phrase created confusion and suggested that the IASB could alleviate that confusion by re-instating the term.
64. Some suggested that financial statements should show the results of stewardship by management and provide a basis for the providers of capital to hold the governing bodies of the reporting entity to account for the resources entrusted to them. They believe that the absence of a more prominent reference to stewardship will result in Standards that focus more on the needs of short-term investors, rather than the needs of long-term investors.
65. Some urged the IASB to be cautious in re-introducing the term or elevating it, given that it covers a wide range of management's responsibilities (within the framework provided by corporate governance), and does not refer solely to the role of financial reporting in providing financial information about how management exercised its responsibilities. Some suggested that "accountability" might be a better label.
66. Other users went further and expressed the view that stewardship should not be given more prominence in the *Conceptual Framework* because some would seek to use stewardship as a justification to introduce management bias in recognition and measurement.
67. Some users suggested that the accounts are not for providing decision-useful information because they are months after the event. Instead they confirm to the market what the resources have been used for.

Reliability

Background

68. Before Chapter 3 was published in 2010, the *Conceptual Framework* stated that one of the qualitative characteristics of useful financial information was reliability. In 2010, Chapter

3 replaced reliability with the qualitative characteristic of faithful representation—information is useful if it faithfully represents what it purports to represent.

69. The concepts of reliability and faithful representation have much in common. Both concepts require neutrality, completeness and freedom from error. Faithful representation is described in the pre-2010 *Conceptual Framework* as an aspect of reliability (that is, information is reliable if it can be depended upon to represent faithfully what it purports to represent). The main difference between the two concepts is that Chapter 3 does not refer to prudence (see paragraphs 73–80). In addition, Chapter 3 does not refer explicitly to substance over form, though the Basis for Conclusions on Chapter 3 explains that representing a legal form that differs from the economic substance could not result in a faithful representation.

Summary of feedback

70. Some users supported maintaining the current fundamental characteristic of faithful representation and stated that faithful representation conveys the intended meaning better than reliability does. They gave the following reasons:
- (a) In practice, the term ‘reliability’ was often given a meaning other than what was described in the previous version of the *Conceptual Framework*. Such meanings often focused on verifiability, freedom from error or precision.
 - (b) The audit process is designed to ensure that financial statements are reliable.
 - (c) What is most important is that information is relevant. Many times, highly ‘reliable’ or verifiable numbers are irrelevant to users.
71. Some users support the reintroduction of reliability (or the replacement of faithful representation with reliability) and stated that reliability is important because it means users ‘can depend on’ or ‘can trust’ the information.
72. Other users were indifferent between the phrases ‘reliability’ and ‘faithful representation’ because both were expressed in very similar terms in their respective versions of the *Conceptual Framework*. However, some expressed regret that the *Conceptual*

Framework no longer contains an explicit reference to substance over form and suggested reinstating the pre-2010 *Conceptual Framework* discussion.

Prudence

Background

73. Both Chapter 3 of the existing *Conceptual Framework* and the pre-2010 *Conceptual Framework* state that financial statements should be neutral, that is, free from bias. However, the pre-2010 *Conceptual Framework* went on to describe prudence. Chapter 3 does not include any reference to prudence.

74. Paragraph 37 of the pre-2010 *Conceptual Framework* describes prudence as follows:

The preparers of financial statements do, however, have to contend with the uncertainties that inevitably surround many events and circumstances, such as the collectability of doubtful receivables, the probable useful life of plant and equipment and the number of warranty claims that may occur. Such uncertainties are recognised by the disclosure of their nature and by the exercise of prudence in the preparation of financial statements. 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, such that assets or income are not overstated and liabilities or expenses are not understated. However, the exercise of prudence does not allow, for example, the creation of hidden reserves or excessive provisions, the deliberate understatement of assets or income, or the deliberate overstatement of liabilities or expenses, because the financial statements would not be neutral and therefore, not have the quality of reliability.

75. In developing Chapter 3 of the *Conceptual Framework*, the IASB removed reference to prudence. However, many continue to object to the removal of the reference to prudence.

Summary of feedback

76. Many user groups suggested that the IASB should reintroduce prudence, in some form, in the *Conceptual Framework*. However, some user groups would object to the reintroduction of prudence. Others were indifferent to re-introducing prudence because, in their view, it would not change anything.
77. Some users commented that there are many different interpretations of what is meant by prudence. Some suggested the IASB should explore the characteristics of prudence, and who it should be exercised by, and document this thought process in the *Conceptual Framework*.
78. Those who supported re-instating in the *Conceptual Framework* the concept of prudence **as it was defined in the previous version** gave the following reasons:
- (a) It needs to be in the *Conceptual Framework*, as a guiding note for preparers. The exercise of prudence (caution) by preparers is good and will align the interests of shareholders, managers, auditors, and other stakeholders.
 - (b) If the concept of prudence is used in both the existing and proposed Standards as has been suggested, then it is important to explain it in the *Conceptual Framework* so that it can be applied consistently.
 - (c) Caution should always be exercised as all values are inherently uncertain.
79. Those who support re-instating the concept of prudence **with a different definition (ie a conservative bias)** gave the following reasons:
- (a) Slightly conservative accounting may counteract management's bias towards optimism and bring about desired neutrality for markets.
 - (b) Investors are more concerned about downside risk than upside potential. Prudence helps to address this concern.
 - (c) Companies should err on the side of caution when estimating uncertain amounts such that:
 - (i) there is later rather than earlier recognition of revenues and assets;

- (ii) there is earlier rather than later recognition of costs (including impairments) and liabilities; and
 - (iii) assets and income are not overstated and liabilities and expenses are not understated.
 - (d) There is prudence in existing standards, such as inventory write-downs and impairment. The proposed expected loss model for financial assets appears to be prudent and more likely to encourage good stewardship.
 - (e) Prudence provides a greater degree of assurance than does neutrality.
 - (f) Without prudence, management can pick any asset value within a range.
80. Those who do not support the IASB re-introducing the concept of prudence expressed the following views:
- (a) There is no common understanding of what the term means. Different parties interpret it differently. Consequently, including the term in the *Conceptual Framework* could lead to inconsistent application.
 - (b) Faithful representation, including neutrality, much better reflects the objective of depicting economic phenomena than reliability or prudence.
 - (c) Management should be required to be neutral and make best estimates in financial statements. Leaning against management optimism is for the auditors, regulators and users; not for the financial reporting standards. Asking preparers to apply prudence will introduce in accounting estimates management bias that would not be supportable or verifiable.
 - (d) Many equate prudence with bias. If the intent is a conservative bias, then it would be very difficult to specify what level of conservatism is appropriate.
 - (e) Users are aware of the potential for management bias towards optimism and adjust for it. The exercise of prudence leads to greater subjectivity in the financial statements that can make it difficult to assess an entity's financial performance and ultimately does not provide a 'true and fair' view.

- (f) The idea that preparers should be wise and cautious is important but that should not mean that preparers add prudence to numbers which are already subjective.
- (g) Support for prudence is, for many, a means of reducing or rejecting fair value measurements. It would be useful to have an open debate on fair value rather than have it indirectly through prudence.
- (h) Financial reporting objectives should be clearly distinguished from prudential regulatory objectives.
- (i) The incurred loss model may not have helped in the financial crisis but the real problem was imprudent lending not imprudent accounting.

Section 1—Purpose and status of the *Conceptual Framework*

- 81. Users in general did not have many questions or comments on the purpose and status of the *Conceptual Framework*. Any questions were more clarifications about the process that will result in updated Standards, such as when and how changes in the *Conceptual Framework* will affect individual Standards.
- 82. Some questioned whether the *Conceptual Framework* is intended for use by the IASB only. They suggested that the *Conceptual Framework*'s status as the foundation of Standards results in it being referred to by many constituents, including users, preparers, auditors and academics.
- 83. Others suggested that the *Conceptual Framework* is perceived by many to be similar to behavioural guidance. They noted that the concepts of stewardship, reliability and prudence are particularly important as behavioural guidance.
- 84. Some suggested that the *Conceptual Framework* should establish a solid foundation of basic concepts to defend against poor interpretations or undermining of Standards.

Sections 2 and 4—Elements and recognition

Background

- 85. The Discussion Paper suggested improvements to:
 - (a) the existing definitions of assets and liabilities; and

- (b) the guidance on when assets and liabilities should be recognised and derecognised.

Summary of feedback

- 86. Of the few that commented on these sections, many supported improving the definitions. Some suggested that the IASB define ‘net income’ or ‘profit or loss’ and ‘other comprehensive income’ in addition to ‘income’ and ‘expense’. They suggested that a definition of net income as the difference between income and expense would be consistent with the definition of equity as the difference between assets and liabilities.
- 87. However there were mixed views about removing any reference to expectation or probability from both the definitions and recognition criteria. Some users noted that removing the probability threshold from the recognition criteria or from the definition of an asset might make them too broad, while others supported clarifying that items should be recognised regardless of uncertainty. Others were unsure whether the IASB intended the new definitions to imply a probability threshold. Some requested more disclosure on internally generated intangible assets, whether recognised or not.

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

Background

- 88. The additional guidance to support the definition of a liability suggests retaining the existing notion that liabilities encompass both legal and constructive obligations. The Discussion Paper also discussed the meaning of ‘present obligation’ in the context of obligations to transfer economic resources that are conditional on an entity’s future actions. An example is a levy that is based on a percentage of the previous year’s revenue, but is payable only if the entity is operating on a particular date.
- 89. The IASB identified three different views:
 - (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.

Summary of feedback

- 90. Most users preferred 'View 2' or 'View 3' to 'View 1' for liabilities conditional on an entity's future actions and supported retaining the notion of a constructive obligation.
- 91. Some users expressed a view that the IASB should adopt a 'matching' approach for some items, instead of defining assets and liabilities by reference to rights and obligations. Using the levy example in the Discussion Paper (as discussed in the Background section above), they suggested that the expense should be recognised during the period, together with an accrued liability. Such an approach enables them to forecast working capital needs better. In their view, prepayments and accrued liabilities are part of the working capital, even if they do not meet the definitions of assets and liabilities. In their view, 'View 1' in the Discussion Paper (strictly unconditional) focuses too much on the legal position and does not provide information about the actual costs that have arisen in the period.
- 92. Using investment bank bonuses as another example, one user expressed the view that:
 - (a) Not accruing expected bonuses in interim periods could be misleading.
 - (b) Focusing solely on the legal position could lead to structuring transactions to achieve a desired accounting result.
 - (c) View 1 would introduce artificial volatility into both profit or loss and working capital. They would need to strip this out for their analysis.

Section 7—Presentation and Disclosure

93. Presentation and disclosure was not discussed at many meetings, except in relation to presentation in the statement of comprehensive income and the IASB’s disclosure initiative. Users provided the following comments on this section:
- (a) Some requested more focus on presentation than disclosure.
 - (b) Some do not think that the problem is disclosure overload, it is more about transparency and quality. Others think there are too many disclosures. Users commented that disclosures are often debated as an afterthought, and would like the IASB to rethink the process of setting disclosures to promote consistency in disclosure requirements.
 - (c) Some stated that the material suggested by the Discussion Paper for inclusion in the *Conceptual Framework* was not comprehensive enough and that it was difficult to see what impact the material will have at the Standards level.
 - (d) Some requested that the IASB reconsider whether the primary financial statements remain appropriate or whether a different structure would be more effective at communicating relevant information. There were different views regarding the relative importance of the primary financial statements.
 - (e) As noted previously, many suggested that the IASB should restart the *Financial Statement Presentation* project.
 - (f) On materiality:
 - (i) There was general support for more guidance or educational material on materiality. However, others suggested that education material may not be enough.
 - (ii) Some suggested that the *Conceptual Framework* should not preclude quantitative thresholds. Others suggested that a qualitative assessment of materiality is equally important.

Section 9—The use of business model concept in financial reporting

94. Users that identified themselves as long-term investors placed emphasis on the use of the business model in developing Standards. They commented that defining ‘business model’ will be difficult. However, some suggested that it could be defined generally with a

specific focus on the means by which the company intends to generate returns in excess of the cost of equity on a sustainable long-term basis.

95. However, other users disagreed with emphasising the business model. They suggested that referring to the business model is a pathway to the introduction of management bias and they advocated a more objective basis to achieve a faithful representation of assets and liabilities. They expressed the view that neither management intent nor business model changes the values of assets or liabilities. The outcome of the business model should be clear through the use of objective measures of assets and liabilities.
96. Other users typically commented on the business model within the context of particular topics (for example, profit or loss and OCI, or measurement). The following comments were made:
- (a) Segment reporting is important and a useful application of the business model.
 - (b) Business model should be distinguished from management intent. If management has discretion over which business model is suitable from a reporting stand-point then that could result in earnings management.
 - (c) It should not affect individual transactions or elements; the business is a collection of elements, such as a cash generating unit.
 - (d) An entity's financial reporting should allow a user to understand the business model.
 - (e) It might make sense for some industries more than others.
 - (f) It might be difficult to define and enforce over time as entities and businesses develop. Thus it could add a layer of complexity.

Section 9—Unit of account, going concern and capital maintenance

97. Of the users that commented on these sections, many supported the general direction in the Discussion Paper.