STAFF PAPER

May 2014

REG IASB Meeting

Project	**Conceptual Framework**
Paper topic	Chapters 1 & 3 – Other possible changes

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Purpose of paper

1. The purpose of this paper is to discuss whether to make changes to Chapter 1 – *The objective of general purpose financial reporting* ('Chapter 1') or Chapter 3 – *Qualitative characteristics of useful financial information* ('Chapter 3') of the *Conceptual Framework*.

2. The possible changes discussed in this paper were suggested by respondents to the Discussion Paper *A Review of the Conceptual Framework for Financial Reporting*.

3. However, this paper does not discuss:

    (a) Stewardship – (see AP 10G – *Stewardship*);

    (b) Reliability (see AP 10H – *Reliability*); or

    (c) Prudence (see AP 10I – *Prudence*).

Summary of staff recommendations

4. The staff:

    (a) recommend amending Chapter 3 to explain that, when the legal form of an item is different from its underlying economic substance, reporting that item in accordance with its legal form would not result in a faithful representation;

(b) do **not** recommend:

(i) making any changes to the description of the primary user group identified in Chapter 1;

(ii) elevating understandability from an enhancing qualitative characteristic to a fundamental qualitative characteristic;

(iii) adding a discussion of complexity to the *Conceptual Framework*.

Structure of paper

5. This paper is structured as follows:

(a) Background (paragraphs 6-7)

(b) Feedback (paragraphs 8-9)

(c) Possible changes (paragraphs 10-30)

(i) Substance over form

(ii) Primary user

(iii) Understandability and complexity

Background

6. When the IASB restarted work on the *Conceptual Framework* project in 2012, it did not fundamentally reconsider the chapters of the *Conceptual Framework* that it published in 2010 (Chapters 1 and 3). However, the IASB acknowledged that it would make changes if work on the rest of the *Conceptual Framework* highlights areas that need clarifying or amending.

7. Even before the publication of the Discussion Paper, we were aware that some had expressed concerns about Chapters 1 and 3 (and in particular how those chapters deal with stewardship, reliability and prudence). Consequently, Section 9 of the Discussion Paper discussed both our proposed approach to Chapters 1 and 3 and the specific concerns raised about stewardship, reliability and prudence. Respondents to the Discussion Paper were asked whether they agreed with the IASB's proposed approach to Chapter 1 and 3 (ie, not to fundamentally reconsider these chapters).

Feedback

8. About three quarters of respondents commented on this issue. Some agreed with the proposal not to fundamentally reconsider Chapters 1 and 3 of the existing *Conceptual Framework* citing the following reasons:

   (a) The concepts in Chapters 1 and 3 are sound.

   (b) Chapters 1 and 3 were completed only three years ago and have been through extensive due process. Nothing has arisen since publication that would justify re-opening Chapters 1 and 3.

   (c) Chapters 1 and 3 were developed jointly with the FASB. Any decision to change them would lead to a non-converged result.

   (d) Re-opening Chapters 1 and 3 would be a waste of time and resources, for both the IASB and constituents.

9. However, many of those who commented disagreed with the proposed approach to Chapters 1 and 3. In particular:

   (a) Many disagreed with one or more aspect of Chapters 1 and 3. The most commonly cited aspects were the treatments of stewardship, reliability and prudence and the identification of the primary user. However, a number of other changes were suggested and these are discussed in this paper.

   (b) A few respondents stated that the IASB should re-expose Chapters 1 and 3 at the same time as the rest of the *Conceptual Framework* to allow respondents to assess the coherence of the whole document. They stated that when the IASB published Chapters 1 and 3, it committed itself to review these Chapters when it completed the rest of the *Conceptual Framework*.

   (c) A few commented that the financial crisis had changed the standard-setting environment. Consequently, in their opinion, Chapters 1 and 3 reflected concepts that were no longer appropriate.

   (d) A few expressed the opinion that some aspects of Chapters 1 and 3 were the result of compromises with the FASB. Now that the project is no longer a joint project with the FASB, the IASB should revisit those aspects.

Possible changes

10. The staff continue to believe, for the reasons outlined in paragraph 8, that we should not fundamentally reconsider Chapters 1 and 3. However, we believe you should discuss the following suggestions from respondents:

    (a) the treatment of substance over form in Chapter 3 (paragraphs 12-20);

    (b) the primary user identified in Chapter 1 (paragraphs 21-25); and

    (c) whether to discuss complexity or elevate understandability to a fundamental qualitative characteristic in Chapter 3 (paragraphs 26-30).

11. The staff plan to include in the *Conceptual Framework* Exposure Draft the full text of Chapters 1 and 3 (including any changes proposed by you). However, we will explain in the invitation to comment that we do not plan to revisit those aspects of Chapters 1 and 3 for which we propose no amendment.

Substance over form

Background and feedback

12. The *Framework for the Preparation and Presentation of Financial Statements* (the 'pre-2010 *Framework'*) included reference to the concept of substance over form (as part of the discussion of reliability):

> If information is to represent faithfully the transactions and other events that it purports to represent, it is necessary that they are accounted for and presented in accordance with their substance and economic reality and not merely their legal form. The substance of transactions or other events is not always consistent with that which is apparent from their legal or contrived form. For example, an entity may dispose of an asset to another party in such a way that the documentation purports to pass legal ownership to that party; nevertheless, agreements may exist that ensure

> that the entity continues to enjoy the future economic benefits embodied in the asset. In such circumstances, the reporting of a sale would not represent faithfully the transaction entered into (if indeed there was a transaction)[1].

13. The existing *Conceptual Framework* does not include an explicit reference to substance over form. However, the Basis for Conclusions on Chapter 3 states that accounting for something in accordance with its legal form, rather than its economic substance, would not result in a faithful representation.

14. Many of the respondents who suggested making changes to Chapter 3 expressed the view that Chapter 3 should make explicit reference to substance over form to make it clear that it should still be considered when applying Standards:

> We believe that faithful representation captures the aim of reflecting the underlying economic reality. We would support the idea of making this more explicit. This could be done by including in Chapter 3 a sentence from the basis for conclusions for the 2010 Framework which says: "Representing a legal form that differs from the economic substance of the underlying economic phenomenon would not result in a faithful representation." *CFA Society UK*

Staff recommendation

15. We believe that accounting for things in accordance with their substance, rather than just their legal form, provides useful information to the users of financial statements. However, this is not clear in Chapter 3. Consequently, we agree that the role of substance over form should be clarified.

16. The wording in the Basis for Conclusions on Chapter 3 would suggest that accounting for something in accordance with its substance, rather than just its legal form, is necessary to provide a faithful representation (ie substance over form is an aspect of a faithful representation).

17. However, it has been suggested that it might be more appropriate to treat substance over form as an aspect of relevance. That is, reporting something in

[1] Paragraph 35, pre-2010 *Framework*

accordance with its legal form when the legal form is different from the underlying economic substance could not possibly provide relevant information. In addition, it could be argued that reporting a legal form that differs from the economic substance could be a faithful representation if it were properly described as a representation of the legal form and if the reporting also explained that the legal form was different from the economic substance.

18. The staff disagree with this view and believe that reporting something in accordance with its substance rather than just its legal form should be treated as an aspect of a faithful representation for the following reasons:

   (a) It is consistent with the view expressed in the Basis for Conclusions on Chapter 3;

   (b) It is consistent with the pre-2010 *Framework* which treated substance over form as an aspect of reliability[2];

   (c) We disagree with the idea that accounting for something in accordance with its legal form (even with appropriate disclosures) could result in a faithful representation if the economic substance of the item is different.

19. The staff, therefore, recommend amending Chapter 3 to explain that, when the legal form of an item is different from its underlying economic substance, reporting that item in accordance with its legal form would not result in a faithful representation.

Question 1
The staff recommend amending Chapter 3 to explain that, when the legal form of an item is different from its underlying economic substance, reporting that item in accordance with its legal form would not result in a faithful representation. Do you agree?

20. The staff note that Section 3 of the Discussion Paper discussed reporting the substance of contractual rights and contractual obligations (paragraphs 3.98 –

[2] The qualitative characteristic of reliability was replaced with faithful representation when Chapter 3 was issued in 2010.

3.108). This issue and the feedback on the proposals in the Discussion Paper will be discussed at a future meeting. At that meeting, we will discuss whether the guidance proposed in paragraph 3.102 of the Discussion Paper should be included in Chapter 3 (Appendix B includes the wording of paragraph 3.102).

Primary user

Background and feedback

21. Chapter 1 identifies the primary users of financial reports as those existing and potential investors, lenders and other creditors who cannot require entities to provide information directly to them. Although the Discussion Paper did not discuss the primary user of financial statements, a few respondents commented on this issue.

22. Some expressed the view that the primary user group is defined too narrowly. A few respondents suggested that the primary user group should be expanded to include, for example, employees, customers, suppliers, regulators and others.

23. However, others (including some users) expressed the view that the primary user group is defined too broadly. They believe that the primary users of financial reporting should be identified as the owners of the entity (perhaps defined as the entity's ordinary shareholders). Those with this view believe that ordinary shareholders have different (and perhaps more comprehensive) information needs because they are exposed to different types of risk than other capital providers. This view appears to be linked to the idea that stewardship should play a more prominent role in the objective of financial reporting.

Staff recommendation

24. In developing Chapter 1, the IASB considered both whether the primary user group should be restricted to existing shareholders or expanded to include the needs of other users.

25. Respondents to the Discussion Paper did not raise any new issues that were not considered by the IASB when Chapter 1 was developed. In addition, the staff note that paragraph OB8 states that focusing on the common information needs of the primary users does not prevent the reporting entity from including additional

information that is most useful to a particular subset of primary users (for example, the ordinary shareholders). Consequently, the staff do not recommend making any changes to the description of the primary user group identified in Chapter 1.

> **Question 2**
>
> The staff do **not** recommend making any changes to the description of the primary user group identified in Chapter 1.
>
> Do you agree?

Understandability and complexity

26. Chapter 3 identifies understandability as an enhancing qualitative characteristic of useful financial information:

> QC30 Classifying, characterising and presenting information clearly and concisely makes it *understandable*.
>
> QC31 Some phenomena are inherently complex and cannot be made easy to understand. Excluding information about those phenomena from financial reports might make the information in those financial reports easier to understand. However, those reports would be incomplete and therefore potentially misleading.
>
> QC32 Financial reports are prepared for users who have a reasonable knowledge of business and economic activities and who review and analyse the information diligently. At times, even well-informed and diligent users may need to seek the aid of an adviser to understand information about complex economic phenomena.

27. A few respondents to the Discussion Paper suggested that understandability should be elevated to a fundamental characteristic or that simplicity should be included as an objective of financial reporting. However, others disagreed with this, stating that business is complex and this can make accounting complex.

28. In addition, the Accounting Standards Advisory Forum (ASAF) discussed at its meeting in March 2014 a bulletin, published by EFRAG and the French, German, Italian and UK standard-setters, on complexity. The bulletin discusses the different sources of complexity and whether the *Conceptual Framework* should include additional discussions on complexity, so that complexity becomes an issue that is explicitly addressed when the IASB develops or revises Standards. Appendix A includes a summary of the discussion at the ASAF meeting on this issue.

Staff recommendation

29. The Basis for Conclusions on Chapter 3 explains that the IASB decided not to treat understandability as a fundamental qualitative characteristic because to do so might result in information that is useful to users of financial statements being excluded on the grounds that it is very complex. Consequently, the staff do not recommend elevating understandability from an enhancing qualitative characteristic to a fundamental qualitative characteristic.

30. Although the staff acknowledge that complexity is an important issue that the IASB should consider when setting Standards, we do not believe it is necessary to add a discussion of complexity to the *Conceptual Framework*. Chapter 3 includes a discussion of understandability and requires the IASB to consider whether the benefits of requiring particular information justify the costs of providing that information: the discussion of these concepts will provide a trigger for the IASB to address complexity issues when it develops or revises Standards.

Question 3

The staff do **not** recommend:

(a) elevating understandability from an enhancing qualitative characteristic to an fundamental qualitative characteristic;

(b) adding a discussion of complexity to the *Conceptual Framework*.

Do you agree?

Appendix A – Summary of the discussion on Complexity at the March 2014 ASAF meeting

A1. ASAF members discussed a bulletin, published by EFRAG and the French, German, Italian and UK standard-setters, on complexity. The bulletin discusses the two different types of complexity–unavoidable complexity that arises with increasing complexity in business transactions, and avoidable complexity.

A2. The bulletin considers whether in some cases avoidable complexity could be reduced with improved standard-setting, education and presentation. The bulletin acknowledges that the *Conceptual Framework* already includes a discussion of complexity under the heading of 'understandability' and that the IASB considers complexity when assessing whether the benefits of a new Standard justify the costs. The bulletin also describes where avoidable complexity arises and acknowledges the view of those who believe that IFRS is unnecessarily complex.

A3. Some IASB members asked whether the sources of complexity identified in the bulletin were examples of unavoidable complexity.

A4. ASAF members expressed differing views, including the following:

(a) It would be helpful to discuss complexity more prominently in the *Conceptual Framework* (for example, in what is Chapter 3 of the existing *Conceptual Framework*). This would ensure that the IASB, and others using the *Conceptual Framework*, would give this topic more attention and perhaps address complexity earlier in the standard-setting process.

(b) The current discussion in the *Conceptual Framework* is sufficient, so it is unnecessary to include a discussion of complexity in the *Conceptual Framework*. It could be addressed more effectively by other means (for example, by revising the IASB's processes for developing and revising Standards).

(c) Those who argue that some Standards or proposals are too complex are in reality expressing disagreement with the requirements of the Standards.

A5. It was also suggested that some of the problems associated with complexity could be dealt with by working more closely with regulators (including audit regulators), auditors and preparers of financial statements to address behavioural factors that lead to increased complexity (for example, the tendency of preparers to simply repeat last year's disclosures, or the inefficient use of technology).

A6. ASAF members suggested that the following are sources of complexity:

(a) complex Standards. It was stated that anti-abuse measures in Standards and detailed disclosure requirements can add to the complexity of Standards.

(b) disagreements about the economic substance of transactions. When this is the case, preparers often state that the requirements are too complex or that the IASB has misjudged the cost-benefit trade-off.

(c) exceptions to principles and additional disclosures. It was stated that these are usually added in response to feedback received on due process documents.

(d) political pressure.

(e) constant changes to accounting requirements.

(f) the absence of a disclosure framework. It was suggested that a disclosure framework would ensure that disclosure requirements are as simple and targeted as possible.

A7. After listening to other ASAF members, the EFRAG representative suggested that ASAF members had too easily dismissed the perception that IFRS was a cause of complexity. She considered that it was the duty of ASAF members to remedy this perception.

Appendix B

B1. The following is an extract from Section 3 of the Discussion Paper. It describes proposed guidance on reporting the substance of contracts:

> 3.102 Consistent principles underlie the guidance in those Standards. The IASB thinks that it would be helpful to add those underlying principles to the *Conceptual Framework* itself. The *Conceptual Framework* could state that:
>
> (a) an entity should report the substance of a contract. In some cases, the legal form of a contract is an important part of the substance of the contract. In other cases, the legal form is only a minor part of the substance of the contract.
>
> (b) a group or series of contracts that achieves, or is designed to achieve, an overall commercial effect should be viewed as a whole. One situation in which this treatment may be particularly important is if rights or obligations in one contract entirely negate obligations or rights in another contract.
>
> (c) conversely, if a single contract contains two or more sets of rights and obligations that would all have been identical if they had been created through more than one legal document, the entity may need to account for the different sets of rights as if they were separate contracts.
>
> (d) all terms—whether explicit or implied—should be taken into consideration. Implied terms could include, for example, obligations imposed by statute, such as statutory warranty obligations imposed on entities that enter into contracts for the sale of goods to customers.
>
> (e) terms that have no commercial substance should be disregarded. A term has no commercial substance if it has no discernible effect on the

economics of the contract. Terms that have no commercial substance could include, for example:

(i) terms that bind neither party; and

(ii) rights (including options) that the holder will not have the practical ability to exercise.

(f) if, after disregarding options with no commercial substance, an option holder has only one remaining option, that option is in substance a requirement.