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Basis for Conclusions
Exposure Draft ED/2015/3

Conceptual Framework for Financial Reporting

Comments to be received by 26 October 2015

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Basis for Conclusions on the Exposure Draft *Conceptual Framework for Financial Reporting*

This Basis for Conclusions accompanies the Exposure Draft *Conceptual Framework for Financial Reporting* (published May 2015; see separate booklet) and is published by the International Accounting Standards Board (IASB) for comment only. The proposals may be modified in the light of the comments received before being issued in final form. Comments need to be received by **26 October 2015** and should be submitted in writing to the address below, by email to commentletters@ifrs.org or electronically using our 'Comment on a proposal' page.

All comments will be on the public record and posted on our website unless the respondent requests confidentiality. Please see our website for details on this and how we use your personal data.

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Basis for Conclusions on the [draft] *Conceptual Framework for Financial Reporting*

This Basis for Conclusions accompanies, but is not part of, the proposed amendments.

Introduction

BCIN.1 This Basis for Conclusions summarises the considerations of the International Accounting Standards Board (IASB) in reaching the conclusions described in the Exposure Draft *Conceptual Framework for Financial Reporting* (the 'Exposure Draft'). Individual IASB members gave greater weight to some factors than to others.

Background

BCIN.2 The key motivations for the IASB in proposing change to the *Conceptual Framework for Financial Reporting* (the '*Conceptual Framework*') are set out in the Invitation to Comment on the Exposure Draft. The effects of the proposed changes (including transition provisions) are discussed in paragraphs BCE.1–BCE.31.

History of the project

BCIN.3 In 2004, the IASB and the US national standard-setter, the Financial Accounting Standards Board (FASB), started a joint project to revise their *Conceptual Frameworks*. In 2010, they issued two chapters of a revised *Conceptual Framework*. These chapters describe the objective of general purpose financial reporting and the qualitative characteristics of useful financial information. They came into effect as soon as they were published and now form part of the IASB's existing *Conceptual Framework*. Chapters 1 and 2 of the Exposure Draft are the chapters published in 2010, with some proposed modifications (see paragraphs BC1.1–BC2.33).

BCIN.4 In addition to finalising those two chapters, the IASB and the FASB also:

(a) published a Discussion Paper and then an Exposure Draft on the concept of a reporting entity;

(b) discussed the definitions of the elements of financial statements; and

(c) discussed and held public round-table meetings about measurement concepts.

BCIN.5 In 2010, the IASB and the FASB suspended work on the *Conceptual Framework* in order to concentrate on other projects on their agendas.

BCIN.6 In 2012, following the public consultation on its agenda (the 'Agenda Consultation 2011'), the IASB restarted its *Conceptual Framework* project.

BCIN.7 In July 2013, the IASB published a Discussion Paper *A Review of the Conceptual Framework for Financial Reporting* (the 'Discussion Paper'). Paragraphs BCIN.12–BCIN.21 discuss the responses to the Discussion Paper.

Approach to the project

BCIN.8 Feedback received from the Agenda Consultation 2011 reinforced the importance of giving priority to this project. Consequently, the IASB decided that it should revise the *Conceptual Framework* without delay. To achieve this, the IASB is building on the existing *Conceptual Framework*—updating it, improving it and filling in gaps instead of fundamentally reconsidering all aspects of the *Conceptual Framework*.

BCIN.9 Before 2010, the IASB and the FASB had planned to complete the project in eight separate phases. On restarting the project in 2012, the IASB decided not to continue with this phased approach and decided instead to develop a more complete set of proposals for a revised *Conceptual Framework*. The IASB believes that this approach enables it, and interested parties, to see more clearly the links between different aspects of the *Conceptual Framework*.

BCIN.10 The IASB normally establishes a consultative group for major projects. The IASB is using the Accounting Standards Advisory Forum (ASAF) as its *Conceptual Framework* consultative group. The ASAF is an advisory group to the IASB, consisting of national accounting standard-setters and regional bodies with an interest in financial reporting. Although the IASB is no longer conducting this project as a bilateral joint project with the FASB, the ASAF provides the IASB with multilateral input from a broad range of national standard-setters, including the FASB. The IASB has considered discussions by the ASAF on the following topics related to the *Conceptual Framework*: prudence, stewardship, reliability, complexity, the definition of a liability, the presentation of financial performance, the implications of long-term investment and measurement.

BCIN.11 The International Public Sector Accounting Standards Board (IPSASB) issued in October 2014 its *Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities* (the 'IPSASB *Conceptual Framework*'). The IASB considered the key similarities and differences between the IPSASB *Conceptual Framework* and the proposals in the Exposure Draft. Some of the differences arise from the different characteristics of public and private sector entities—ie the public sector focus on delivering services to citizens and others whereas the private sector focus on generating cash flows. For other differences, the IASB has rejected alternatives similar to those included in the IPSASB *Conceptual Framework*. An overview of the differences is available in Agenda Paper 10C for the November 2014 IASB meeting which can be found on the IASB's website: www.ifrs.org.

The Discussion Paper

BCIN.12 The six–month comment period for the Discussion Paper ended in January 2014. The IASB received over 220 comment letters. In addition, IASB members and staff conducted over 140 outreach meetings, including:

(a) round-table meetings in London, Toronto, São Paolo and Tokyo.

(b) outreach meetings organised by local standard-setters in Asia, Australia, Europe, Latin America, North America and South Africa.

(c) discussions with formal advisory bodies to the IASB (the IFRS Advisory Council, the ASAF, the Capital Markets Advisory Committee and the Global Preparers Forum).

(d) conducted targeted outreach with users of financial statements to discuss topics that are most directly relevant to them. Those discussions focused on the distinction between liabilities and equity, the presentation of profit or loss and other comprehensive income, measurement and issues relating to prudence, reliability and stewardship.

BCIN.13 Nearly all of those who commented on the Discussion Paper supported the decision to update the *Conceptual Framework*. Many expressed the view that a complete, clear and up-to-date *Conceptual Framework* is necessary for the effective development of Standards.

BCIN.14 Some respondents to the Discussion Paper supported the IASB's decision to set a tight timetable for the project, agreeing that this important project should be completed without delay. However, many of those who commented expressed the view that the IASB should spend more time developing robust concepts. A few respondents suggested a phased approach, completing some sections (for example, the definitions of assets, liabilities, equity, income and expenses) in line with the original timetable and undertaking further research on other areas (for example, measurement).

BCIN.15 Because of the concerns about the existing *Conceptual Framework* (see the Summary and Invitation to Comment on the Exposure Draft) and its importance in developing future Standards, the IASB still believes that significant improvements to the existing *Conceptual Framework* should be completed on a timely basis. Hence, the IASB aims to complete the revisions to the *Conceptual Framework* in 2016. To meet this tight but achievable deadline, the IASB is focusing on those changes that will provide clear and significant improvements to the existing *Conceptual Framework*.

BCIN.16 Most respondents to the Discussion Paper expressed support for the IASB's approach to the project and in particular the decisions:

(a) not to adopt a phased approach to the project; and

(b) to focus on updating, improving and filling in gaps instead of fundamentally reconsidering all aspects of the *Conceptual Framework*.

Accordingly, the IASB has continued with this approach.

BCIN.17 Some respondents expressed the view that the Discussion Paper was underdeveloped in some areas, for example, the sections on measurement and presentation and disclosure (particularly the presentation of financial performance). The relevant sections of this Basis for Conclusions discuss how the IASB has sought to address these concerns.

BCIN.18 Some respondents expressed the view that the Discussion Paper was not sufficiently aspirational, because in some areas it described the judgements that the IASB will need to make when setting Standards and, in their view, did not examine fundamental concepts. The IASB is of the view that the *Conceptual Framework* should be a practical tool that will help it to develop Standards. A *Conceptual Framework* would not fulfil this role if it merely described concepts simplistically without explaining the factors that the IASB needs to consider in making judgements when the concepts do not lead to a single answer, or when they lead to conflicting answers.

BCIN.19 Some respondents stated that the Discussion Paper appeared, in places, to aim to justify existing practice or to justify recent standard-setting decisions by the IASB. That was not the aim of the Discussion Paper and it is not the aim of the Exposure Draft. However, some concepts in recent Standards-level projects reflect the IASB's most developed thinking on these matters, and that thinking also flows into the proposals in the Exposure Draft.

BCIN.20 Some respondents stated that the Discussion Paper included too much Standards-level detail. In developing the Exposure Draft the IASB has sought to strike a balance between providing high level concepts and providing enough detail for the *Conceptual Framework* to be useful to the IASB and others.

BCIN.21 Respondents' comments on particular areas of the Discussion Paper are discussed in the relevant sections of this Basis for Conclusions.

Scope

BCIN.22 Although Chapter 1 describes the objective of financial reporting, most chapters in the Exposure Draft focus on the information provided in financial statements. They do not address other forms of financial reports such as management commentary, interim financial reports, press releases and supplementary material provided for analysis.[1] This reflects the fact that financial statements are a central part of financial reporting and most issues that the IASB addresses involve financial statements. Moreover, addressing other forms of financial reports would have substantially lengthened the time needed to complete the project, thus delaying the improvements it will bring. A few respondents to the Discussion Paper objected to this approach, but most of those who commented on this issue agreed that the *Conceptual Framework* should focus only on financial statements.

BCIN.23 The IASB considers that concepts relating to the equity method of accounting, and the translation of amounts denominated in foreign currency, would be best dealt with if the IASB were to carry out projects to consider revising Standards on these topics. As part of its research programme, the IASB is at present gathering evidence to help it assess whether to take on projects on these topics.[2] Consequently, the Exposure Draft does not address them. The absence of a discussion on these topics is not intended to imply any particular approach to them.

BCIN.24 The existing discussion of capital maintenance is included in the Exposure Draft substantially unchanged (see paragraph BC8.1) and current cost is not discussed in detail as a possible basis for measurement (see paragraph BC6.23). The IASB would consider revising the *Conceptual Framework* discussion of capital

1 Other Frameworks such as the one developed by the International Integrated Reporting Council discuss other sources of useful information for investors.

2 For the IASB to add a project to its active agenda, a formal agenda decision would be required.

maintenance and expanding the discussion of current cost if it were to carry out future work on accounting for high inflation. No such work is currently planned.

BCIN.25 The Discussion Paper included suggestions on how to distinguish between liabilities and equity. However, some responses to those suggestions raised concerns about the usefulness of the resulting accounting for particular types of claims. Consequently, the IASB decided to further explore how to distinguish between liabilities and equity in its Financial Instruments with Characteristics of Equity research project, so as not to delay other much-needed improvements to the *Conceptual Framework*. Hence, the Exposure Draft does not propose changes to the distinction between liabilities and equity (see paragraphs BC4.93–BC4.103).

BCIN.26 A number of co-operatives suggested that to deal with their special features, the IASB should develop specific guidance in the *Conceptual Framework*, in particular on the distinction between liabilities and equity. That distinction is now being considered in the research project mentioned in paragraph BCIN.25. Furthermore, the IASB considers that the *Conceptual Framework* should provide concepts with general application and should not provide different or additional concepts for application to particular types of organisations, such as co-operatives.

BCIN.27 The *International Financial Reporting Standard for Small and Medium-sized Entities* (the '*IFRS for SMEs*') includes a section on the concepts and basic principles underlying the financial statements of small and medium-sized entities. That section is based on the existing *Conceptual Framework*. The IASB will consider whether it should amend this section of the *IFRS for SMEs* at a future review of the *IFRS for SMEs*, after it has finalised the revised *Conceptual Framework*.

Business activities

BCIN.28 The Discussion Paper expressed the view that financial statements can be made more relevant if the IASB considers, when it develops or revises particular Standards, how an entity conducts its business activities. It noted that this factor may affect measurement and presentation and disclosure, including whether to include items of income and expenses in profit or loss or in other comprehensive income.

BCIN.29 Most respondents to the Discussion Paper agreed with those comments on business activities. Some also thought that the IASB should define and use the term 'business model' as the label for an overarching concept to be employed throughout the *Conceptual Framework*.

BCIN.30 Other respondents disagreed that the IASB should place emphasis on the business model. They suggested that referring to the business model could introduce management bias into financial reporting. They advocated a more objective basis to achieve a faithful representation of assets and liabilities, in which neither management's intentions nor the reporting entity's business model affect the measurement of assets or liabilities. In their view, objective measures of assets and liabilities would show clearly the outcome of the reporting entity's business model.

BCIN.31 Some respondents noted that the term 'business model' is used with different meanings by various organisations, such as the International Integrated Reporting Council, the Enhanced Disclosure Task Force of the Financial Stability Board, the European Financial Reporting Advisory Group and various regulators. They warned that the IASB might cause confusion if it were to use that term with a different meaning. Hence, the IASB has not used that term in the Exposure Draft.

BCIN.32 In addition, the IASB concluded that the nature of an entity's business activities plays different roles in different aspects of financial reporting.

BCIN.33 Accordingly, the Exposure Draft does not include a general discussion of the role played in financial reporting by how an entity conducts its business activities. Instead, it discusses how that factor affects:

(a) the unit of account (see paragraph 4.62(a)(iii));

(b) the selection of a measurement basis for an asset or a liability and related income and expenses (see paragraph 6.54(a)); and

(c) presentation and disclosure, including whether to include items of income and expenses in other comprehensive income (see paragraphs 6.76–6.77, 7.10 and 7.19).

BCIN.34 Some respondents thought that how an entity conducts its business activities would also affect the distinction between liabilities and equity and the recognition of assets and liabilities. The IASB did not identify any situations in which consideration of an entity's business activities would be relevant to the recognition of assets and liabilities. As discussed in paragraph BCIN.25, the IASB is performing further research on the distinction between liabilities and equity.

Implications of long-term investment

BCIN.35 Long-term investment, and long-term financing, is a subject that has attracted a great deal of attention from governments in recent years. Governments have indicated that encouraging long-term investment is one important tool to promote economic growth. Consequently, when developing the Exposure Draft, the IASB considered whether the *Conceptual Framework* will provide the IASB with sufficient and appropriate tools to enable it to consider the following questions when developing new Standards:

(a) Does the time horizon for investments by a reporting entity have any implications for standard-setting decisions (see paragraphs BCIN.36–BCIN.38)?

(b) Do long-term investors in a reporting entity need different information from short-term investors (see paragraphs BCIN.39–BCIN.43)?

Paragraph BCIN.44 comments on the role of accounting standards in relation to promoting long-term investment.

Long-term investment as a business activity

BCIN.36 Some have suggested that the IASB should identify long-term investment as a particular type of business activity (or business model), and develop specific measurement and presentation and disclosure requirements for entities conducting that business activity. Some commentators expressing those views have suggested that:

(a) entities should not use current value measurements for their long-term investments (and for their liabilities). They should use either cost-based measurements or measurements updated using long-term estimates and determine any impairment loss by using an entity-specific measure (such as value in use), instead of a market-based measure (such as fair value).

(b) if current value measurements are used, remeasurements should be reported in other comprehensive income (OCI), instead of in the statement of profit or loss. Furthermore, on disposal, the total gain or loss should be reclassified ('recycled') at that date from the accumulated OCI to the statement of profit or loss.

BCIN.37 The Exposure Draft proposes that one factor to be considered when selecting a measurement basis for an asset or a liability (and related income and expenses) is how the asset or the liability contributes to future cash flows. This depends, in part, on the nature of the business activities being conducted. This factor would also be considered in determining whether income and expenses should be included in OCI. The IASB concluded that the discussion on this factor in the Exposure Draft provides sufficient tools to enable the IASB to make appropriate standard-setting decisions if future projects consider:

(a) how to measure the long-term investments (or liabilities) of entities whose business activities include long-term investment; or

(b) whether such entities should include changes in the carrying amount of those investments (or liabilities) in the statement of profit or loss or in OCI.[3]

BCIN.38 For the following reasons, the IASB proposes that the *Conceptual Framework* should not refer explicitly to the business activity of long-term investment:

(a) referring explicitly to any particular business activity would, inappropriately, embed Standards-level detail in the *Conceptual Framework*.

(b) the *Conceptual Framework* does not refer to any other particular business activity. It is not obvious why it should refer to this one.

Information needs of long-term investors

BCIN.39 Some commentators have suggested that the *Conceptual Framework* should emphasise the information needs of long-term investors, and that their

3 The IASB has no current project to consider how such entities should measure their long-term investments or their liabilities (other than insurance contract liabilities), nor any project to consider whether they should include remeasurements in the statement of profit or loss or in other comprehensive income (OCI).

information needs may differ from those of short-term investors. These commentators have expressed the view that:

(a) the IASB focuses too much on the needs of short-term investors.

(b) the IASB gives too much weight to the needs of potential investors and not enough weight to the needs of existing long-term investors. Those existing investors own the reporting entity and bear the residual risks of ownership. Hence, they need information that helps them to assess management's stewardship of the entity's resources.

(c) the IASB makes excessive use of current value measurements, particularly market-based current measurements, such as fair value, and those measurements are more relevant to short-term investors than to investors who are interested in long-term value creation.

(d) excessive use of current value measurements (especially for long-term investments), and recognition of unrealised gains in the statement of profit or loss, may:

    (i) lead to dividend distributions that are excessive, imprudent, volatile and not in the best interest of long-term investors;

    (ii) lead to inflated management remuneration; and

    (iii) encourage short-termist behaviour and financial engineering, and discourage long-term investment.

BCIN.40 For the following reasons, the IASB disagrees with the views expressed in paragraph BCIN.39:

(a) the IASB does not place more emphasis on the needs of short-term investors than on the needs of long-term investors. Both long-term investors and short-term investors are considered to be primary users of financial statements.

(b) the *Conceptual Framework* identifies both existing and potential investors as primary users of financial statements. Furthermore, on the basis of extensive discussions with users in this project and many others, the IASB has no reason to think that existing investors need information that differs significantly from the information needed by potential investors. In addition, the changes to the objective of financial reporting proposed in the Exposure Draft clarify the need to provide information that helps investors to assess management's stewardship of the entity's resources (see paragraphs BC1.6–BC1.10).

(c) when the IASB has decided to require, or permit, current value measurements, that has not been because of a belief that those measurements would be particularly useful to short-term investors. Indeed, when long-term investors do not need the information provided by current value measurements, there is no reason why short-term investors would need that information either. Instead, the IASB's decisions are driven by an assessment of what information is most likely to be useful to all investors. Under the proposals in Chapter 6 of the Exposure Draft, this would continue to be the case.

(d) in the IASB's view, accounting information (such as reported profit) is not, and should not be, the sole determinant of distributions of dividends and bonuses. Distribution policy is affected by many other factors, such as the entity's financing needs, the risks faced by the entity, legal constraints and (in the case of bonus decisions) remuneration policy and incentive arrangements. These factors are likely to differ by entity, by country and over time. It would be neither desirable nor feasible for the IASB to attempt to factor them into its standard-setting decisions. Paragraph BCIN.44 contains comments on the role of accounting standards and possible effects on particular forms of behaviour.

BCIN.41 For these reasons, the IASB has concluded that the *Conceptual Framework* contains sufficient and appropriate discussion of primary users and their information needs, and on the objective of general purpose financial reporting, to address appropriately the needs of long-term investors.

BCIN.42 If the information needs of short-term investors and long-term investors were different, the IASB would need to decide whether to attempt to meet the needs of both groups, or whether to focus on only one of those groups. The IASB believes that there is no reason why short-term investors would need information that is not also needed by long-term investors.

BCIN.43 Conceivably, long-term investors may need some disclosure that is not also needed by short-term investors; for example, long-term investors may have more extensive needs for information to support decisions to vote on, or otherwise influence, management's actions. However, the IASB concluded that, to help it to identify what disclosures it should require in particular Standards, there is no need to insert in the *Conceptual Framework* a specific reference to the needs of long-term investors. In addition, when the IASB undertakes projects to develop Standards, it routinely seeks input and feedback from investors, including long-term investors, to help ensure that it understands what information they need.

Role of accounting standards

BCIN.44 The IASB wishes to emphasise the role of accounting standards in relation to promoting long-term investment:

(a) the IASB makes an important contribution to the promotion of long-term investment by producing Standards that are intended to require transparent financial reporting. This is a precondition for the healthy and efficient functioning of capital markets. Transparent financial reporting helps participants in capital markets to make more efficient and informed resource allocation and other economic decisions, and makes investment more attractive to capital providers (investors and lenders). It also provides more useful inputs for an assessment of stewardship.

(b) it is not the role of accounting standards to encourage or discourage investments that have particular characteristics. Instead, standard-setting decisions (such as which measurement basis to adopt in particular cases) are driven by the usefulness of the resulting information, so that the information is relevant and is a faithful representation of what it purports to represent.

Chapter 1—The objective of general purpose financial reporting[4]

Introduction

BC1.1 In 2010, as part of its joint project with the FASB, the IASB issued two chapters of a revised *Conceptual Framework*. These chapters deal with the objective of general purpose financial reporting and the qualitative characteristics of useful financial information.

BC1.2 When the IASB restarted its work on the *Conceptual Framework* project in 2012, it did not reconsider fundamentally these chapters, noting that they were completed only recently and had been through extensive due process. Some respondents to the Discussion Paper agreed with this approach. However, many respondents stated that the IASB should reconsider one or more aspects of these chapters. In the light of these comments, the IASB discussed whether to make changes in the following areas:

(a) the objective of general purpose financial reporting:

(i) stewardship (see paragraphs BC1.6–BC1.10); and

(ii) primary users (see paragraphs BC1.11–BC1.13).

(b) the qualitative characteristics of useful financial information:

(i) prudence (see paragraphs BC2.1–BC2.17);

(ii) substance over form (see paragraphs BC2.18–BC2.20);

(iii) reliability (see paragraphs BC2.21–BC2.25);

(iv) understandability and the related issue of complexity (see paragraphs BC2.26–BC2.27); and

(v) materiality (see paragraphs BC2.28–BC2.31).

BC1.3 In addition, the IASB proposes a limited number of editorial changes to align the wording in the chapters with the rest of the Exposure Draft including replacement of the phrase 'has the potential to be' in paragraph 2.21 (see paragraph BC2.32).

BC1.4 To help respondents provide comments, the proposed changes are shown in mark-up and the existing Basis for Conclusions on these chapters is included as an appendix to this Basis for Conclusions. The IASB is not requesting comments on other aspects of these chapters and does not expect to make other substantive changes to them.

BC1.5 The proposed changes to these chapters would make them diverge from the FASB's Concepts Statement No. 8 *Conceptual Framework for Financial Reporting—Chapter 1*, The Objective of General Purpose Financial Reporting, and *Chapter 3*, Qualitative Characteristics of Useful Financial Information. The IASB thinks that the benefits of its proposed changes outweigh the disadvantages of divergence on the issues affected. The IASB notes that the FASB proposes to

4 This Chapter is Chapter 1 of the existing *Conceptual Framework*.

change its definition of materiality and that new definition differs from both the IASB's existing definition and the IASB's proposals discussed in paragraphs BC2.28–BC2.31.

Stewardship (paragraphs 1.3–1.4 and 1.13–1.23)

BC1.6 In discussing the objective of financial reporting, Chapter 1 notes that users need information to help them assess an entity's prospects for future net cash inflows. The version of Chapter 1 published in 2010 states that part of that information is information about how efficiently and effectively the entity's management and governing board have discharged their responsibilities to use the entity's resources.[5] Paragraph BC1.27 of the related Basis for Conclusions (on the existing Chapter 1) makes it clear that this statement is intended to capture the idea that users of financial statements need information to help them assess management's stewardship of the entity's resources. In other words, the IASB considers that providing information to help users assess management's stewardship contributes to meeting the objective of financial reporting. The IASB did not use the term 'stewardship' in the 2010 version of Chapter 1, because it thought that there would be difficulties in translating it into other languages. Instead, the chapter describes what stewardship encapsulates.

BC1.7 Some respondents to the Discussion Paper stated that it is unnecessary to change the discussion of stewardship in Chapter 1. They feared that giving more prominence to stewardship could lead to competing objectives of financial reporting and could appear to justify introducing inappropriate management bias into recognition and measurement decisions.

BC1.8 However, many of the respondents who commented on stewardship stated that one of the purposes of financial reporting is to hold management to account. They argued that the existing Chapter 1 gives too little prominence to this notion.

BC1.9 The IASB noted that many have interpreted Chapter 1 as ignoring the need for information to help users to assess management's stewardship. In addition, although in most cases that information is the same as the information needed to assess the prospects for future net cash inflows to the entity, this may not always be the case. For example, some information about management remuneration or other related party transactions may be important for assessments of stewardship, but arguably may be less important in assessing the prospects for future net cash inflows. Hence, the IASB proposes to make more prominent, within the discussion of the objective of financial reporting, the importance of providing information needed to assess management's stewardship of the entity's resources. The Exposure Draft does this by reintroducing the term stewardship alongside the existing description of what it encapsulates, by moving most of that description from paragraph 1.4 to paragraphs 1.22–1.23 and by referring to stewardship when appropriate in the

5 See paragraph 1.4 of the Exposure Draft (paragraph OB4 of the existing *Conceptual Framework*).

rest of the *Conceptual Framework*. The IASB thinks that the clarity provided by using the term stewardship in this way outweighs the translation difficulties identified in 2010.

BC1.10 For the following reasons, the IASB rejected the idea of identifying the provision of information to help assess management's stewardship as an additional, and equally prominent, objective of financial reporting:

(a) information about management's stewardship is part of the information used to make decisions about whether to buy, sell or hold an investment (ie resource allocation decisions). For example, information about stewardship would inform a decision to hold an investment (and perhaps improve management) instead of selling it; and

(b) introducing an additional primary objective of financial reporting could be confusing.

Primary users (paragraphs 1.2–1.10)

BC1.11 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. Some respondents to the Discussion Paper expressed the view that the primary user group is defined too narrowly. They argue that it should be expanded to include, for example, employees, customers, suppliers, regulators and others.

BC1.12 However, others expressed the view that the primary user group is defined too broadly. They stated that the primary users should be identified as the holders of equity claims against the entity (or perhaps as the holders of the most residual equity claims against the entity). Those with this view believe that those users have different (and perhaps more extensive) information needs than other capital providers because they are exposed to more extensive risks.

BC1.13 In identifying the objective of financial reporting in 2010, the IASB considered whether the primary user group should be restricted to existing shareholders or expanded to include other users. Respondents to the Discussion Paper raised no new issues that the IASB had not considered when Chapter 1 was originally developed. In addition, as explained in paragraph 1.8 of the Exposure Draft (paragraph OB8 of the existing *Conceptual Framework*), focusing on the common information needs of the primary users does not prevent a reporting entity from including additional information that is most useful to a particular subset of primary users. Consequently, the IASB proposes no changes to the description of the primary user group. (Paragraphs BCIN.35–BCIN.43 discuss whether long-term investors should be identified as a particular type of user with specific information needs.)

Chapter 2—The qualitative characteristics of useful financial information[6]

Prudence (paragraph 2.18)

BC2.1 The *Framework for the Preparation and Presentation of Financial Statements* (the 'pre-2010 *Framework*') stated that financial statements should be neutral; that is, free from bias, and went on to discuss the need for preparers to exercise prudence when preparing financial statements:

> Neutrality
>
> 36 To be reliable, the information contained in financial statements must be neutral, that is, free from bias. Financial statements are not neutral if, by the selection or presentation of information, they influence the making of a decision or judgement in order to achieve a predetermined result or outcome.
>
> Prudence
>
> 37 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 extent 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.

BC2.2 In developing the existing version of Chapter 3 (corresponding to Chapter 2 of the Exposure Draft), issued in 2010, the IASB removed the reference to prudence, because it was concerned that the term could be interpreted in ways that are inconsistent with neutrality.

BC2.3 The Discussion Paper described the changes made in 2010, and the concerns that some had raised about them.

BC2.4 Some respondents to the Discussion Paper (including some user groups) supported the removal of the reference to prudence from the *Conceptual Framework*. They stated that:

6 This chapter is Chapter 3 of the existing *Conceptual Framework*.

(a) there is no common understanding of what prudence means. Different parties interpret it differently. Consequently, including the word in the *Conceptual Framework* could lead to inconsistent application. Moreover, prudence could be misinterpreted in a way that is inconsistent with neutrality.

(b) the exercise of prudence, as interpreted by some, leads to greater subjectivity in the financial statements, which can make it difficult to assess an entity's financial performance.

BC2.5 However, many commenting on this issue (including some user groups) expressed the view that a reference to prudence should be reinstated in the *Conceptual Framework*. They gave the following reasons:

(a) some Standards, both existing and proposed, use accounting treatments that some view as motivated by a desire for prudence. It is therefore important to explain prudence in the *Conceptual Framework* so that it can be applied consistently.

(b) prudence is needed to counteract management's natural bias towards optimism.

(c) investors are more concerned about downside risk than upside potential. Prudence helps to address this concern.

(d) academic research has suggested that some forms of conservatism (a concept often regarded as similar to prudence) have a role to play in financial reporting in some cases. However, there are different views about what forms of conservatism are helpful, when and why.

(e) the exercise of prudence helps to align the interests of shareholders and managers and can reduce moral hazard.

(f) the financial crisis has demonstrated the need for prudence when making estimates.

BC2.6 Having considered how interested parties have interpreted the removal of the term 'prudence' in 2010, and the responses to the Discussion Paper, the IASB noted that prudence is a term used by different people to mean different things. In particular:

(a) some use it to refer to a need to be cautious when making judgements under conditions of uncertainty, but without needing to be more cautious in judgements relating to gains and assets than for those relating to losses and liabilities ('cautious prudence'—see paragraphs BC2.9–BC2.10).

(b) others use it to refer to a need for asymmetry: losses are recognised at an earlier stage than gains are ('asymmetric prudence'—see paragraphs BC2.11–BC2.15). There is a range of views on how to achieve such asymmetry, and to what extent. For example, some advocate a concept of prudence that would:

    (i) require more persuasive evidence to support the recognition of gains (or assets) than of losses (or liabilities); or

(ii) require the selection of measurement bases that include losses at an earlier stage than gains.

BC2.7 An understanding of prudence and its different interpretations is linked to an understanding of the term 'neutrality'. The IASB has identified two aspects of neutrality:

(a) selection of neutral accounting policies: selecting accounting policies in order to provide relevant information that faithfully represents the items that it purports to depict. A faithful representation requires, among other things, that the depiction is neutral, ie not 'slanted, weighted, emphasised, de-emphasised or otherwise manipulated to increase the probability that financial information will be received favourably or unfavourably by users';[7] and

(b) neutral application of accounting policies: applying the selected accounting policies in a neutral (unbiased) manner.

BC2.8 The IASB continues to believe that both of these aspects of neutrality make financial information more useful. The relationship between cautious prudence and the neutral application of accounting policies is discussed in paragraphs BC2.9–BC2.10. The relationship between asymmetric prudence and the selection of neutral accounting policies is discussed in paragraphs BC2.11–BC2.15.

Cautious prudence

BC2.9 The IASB considers that prudence (defined as the exercise of caution when making judgements under conditions of uncertainty) can help achieve neutrality in applying accounting policies (the aspect of neutrality described in paragraph BC2.7(b)). Thus, cautious prudence is a factor in giving a faithful representation of assets, liabilities, equity, income and expenses. Setting out that message clearly in the *Conceptual Framework* can be expected to:

(a) help preparers, auditors and regulators counter a natural bias that management may have towards optimism; for example, it would point to the need to exercise care in selecting the inputs used in estimating a measure that cannot be observed directly; and

(b) help the IASB to develop rigorous Standards that could counteract any bias by management in applying the reporting entity's accounting policies.

BC2.10 Therefore the IASB, in paragraph 2.18 of the Exposure Draft, proposes to reintroduce the term prudence, defined as cautious prudence, in the *Conceptual Framework*. It notes that the removal of the term prudence in the 2010 revisions led to confusion and perhaps has exacerbated the diversity in usage of this term. People continue to use the term, but do not always say clearly what they mean. In addition, some have claimed that, because the term was removed, financial information prepared using IFRS is not neutral but is in fact imprudent. The IASB thinks that reintroducing the term with a clear explanation that caution works both ways (so that assets and liabilities are neither overstated nor understated) will reduce the confusion.

7 See Paragraph 2.17 of the Exposure Draft (paragraph QC14 of the existing *Conceptual Framework*).

Asymmetric prudence

BC2.11 Some argue that asymmetric prudence is a necessary characteristic of useful financial information and that prudence cannot be consistent with neutrality. The IASB disagrees with this view. However, the IASB also thinks that not all asymmetry is inconsistent with neutrality.

BC2.12 The selection of neutral accounting policies means selecting accounting policies in a manner that is not intended to increase the probability that financial information will be received favourably or unfavourably by users.

BC2.13 The selection of neutral accounting policies, contrary to fears sometimes expressed:

(a) does not require an entity to recognise the value of the entire entity in the statement of financial position. Paragraph 1.7 of the Exposure Draft states that general purpose financial reports are not designed to show the value of a reporting entity.[8]

(b) does not require the measurement of all assets and liabilities at a current value. Indeed, the proposals in Chapter 6 of the Exposure Draft would not lead to such a requirement.

(c) does not prohibit impairment tests on assets measured at historical cost. Measurement at historical cost (including an impairment test) is consistent with neutrality if that measurement basis is selected without bias; in other words, without slanting, weighting, emphasising, de-emphasising or otherwise manipulating information to increase the probability that it will be received favourably or unfavourably by users.

(d) does not require the recognition of all assets and liabilities. Chapter 5 of the Exposure Draft discusses recognition criteria for assets and liabilities.

BC2.14 Hence, accounting policies that treat gains and losses asymmetrically could be selected in accordance with the proposals in the Exposure Draft if their selection is intended to result in relevant information that faithfully represents what it purports to represent. Such an approach is reflected in many existing Standards, for example IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* requires different recognition thresholds for contingent liabilities and contingent assets. However, the IASB thinks that the *Conceptual Framework* should not identify asymmetric prudence as a necessary characteristic of useful financial information. In particular, the IASB rejects the following approaches that some argue would follow from a requirement to apply asymmetric prudence in all circumstances:

(a) prohibiting the recognition of all unrealised gains. In some circumstances, for example, the measurement of many financial instruments, the recognition of unrealised gains is necessary to provide relevant information to users of financial reports.

8 Paragraph OB7 of the existing *Conceptual Framework* makes the same statement.

(b) prohibiting the recognition of unrealised gains not supported by observable market prices. In some circumstances, measuring an asset or a liability at a current value (which may require the recognition of unrealised gains) provides relevant information to users of financial reports even if the current value must be estimated.

(c) permitting an entity to measure an asset at an amount that is less than an unbiased estimate using the measurement basis selected for that asset or to measure a liability at more than such an amount. Such an approach cannot result in relevant information and cannot provide a faithful representation.

BC2.15 In addition, the IASB notes that if it were to introduce asymmetric prudence, it would need to consider how much bias is appropriate.

Link with other aspects of the 2010 *Conceptual Framework*

BC2.16 Many respondents who commented on the removal of the term prudence from the 2010 *Conceptual Framework* also expressed concerns about the absence of references to stewardship and reliability. They think that an important role for financial reporting is to hold management to account for its stewardship of the entity's resources. They argue that for financial reporting to fulfil this role, financial information needs to be reliable (in the sense of being verifiable and having little measurement uncertainty). They believe that there is a need to counteract a possible bias by management towards optimism (either conscious or unconscious), by exercising prudence to ensure that all losses are recognised and that gains are not recognised without sufficient justification (ie asymmetric prudence). Some of those respondents also expressed concerns about what they perceived was an increasing use of fair value measures. They consider fair value measures, in many cases, to be unverifiable and subject to significant measurement uncertainty (ie they consider fair value measures to be unreliable).

BC2.17 The proposals in the Exposure Draft address these issues, as follows:

(a) the need for information that can be used to assess stewardship is made more prominent within the discussion of the objective of financial reporting (see paragraphs BC1.6–BC1.10);

(b) the effect of measurement uncertainty on the relevance of financial information is clarified, both generally (see paragraph BC2.24(b)) and with specific reference to recognition and measurement (see paragraphs BC5.41–BC5.45 and BC6.56–BC6.57), thus addressing some concerns about reliability (see paragraphs BC2.21–BC2.25); and

(c) the use of fair value is discussed as one possible measurement basis among others within a mixed measurement basis approach (see paragraphs BC6.7–BC6.14).

Substance over form (paragraph 2.14)

BC2.18 The existing *Conceptual Framework* does not include an explicit reference to substance over form. However, the Basis for Conclusions points out that accounting for something in accordance with its legal form, instead of its economic substance, would not result in a faithful representation.

BC2.19 Some respondents to the Discussion Paper expressed the view that the *Conceptual Framework* should make explicit reference to substance over form. The IASB agrees that making this statement explicit would add clarity. Consequently, the Exposure Draft proposes that a faithful representation should provide information about the substance of an economic phenomenon instead of merely information about its legal form.

BC2.20 The IASB believes that reporting something in accordance with its substance, instead of just its legal form, relates to faithful representation for the following reasons:

(a) accounting for something in accordance with its legal form (even with appropriate disclosures) cannot result in a faithful representation if the economic substance of the item is different; and

(b) this is consistent with the pre-2010 *Framework*, which treated substance over form as an aspect of reliability.[9]

Reliability (paragraphs 2.12–2.13)

BC2.21 The pre-2010 *Framework* stated that:

(a) one of the two qualitative characteristics of useful financial information is reliability;

(b) information is reliable if it is free from material error and bias and can be depended on by users to faithfully represent what it purports to represent; and

(c) the characteristics of reliable information are substance over form, neutrality, prudence and completeness.

BC2.22 In 2010, the label 'faithful representation' was applied to the qualitative characteristic previously labelled as 'reliability'. Thus, financial information is useful, as well as relevant, if it faithfully represents what it purports to represent. The main reason for the change was a lack of a common understanding of the term reliability. In particular, many seemed to equate reliability solely with information being verifiable or free from material error (in other words, having a tolerable level of measurement uncertainty). The term reliability was in fact intended to describe more than just verifiability and freedom from material error.

BC2.23 Of those respondents to the Discussion Paper who commented on the use of the label faithful representation, many expressed the view that the label reliability should be reinstated in the *Conceptual Framework*. Reasons given included:

(a) the term reliability is clearer and better understood than the term faithful representation.

9 As explained in paragraphs BC2.21–BC2.25, the qualitative characteristic described before 2010 as 'reliability' is broadly consistent with what is now called 'faithful representation'.

(b) the existing *Conceptual Framework* implies that anything can be faithfully represented if sufficient disclosures are given. Consequently, the qualitative characteristic of faithful representation does not act as an effective filter to identify the types of information that should be included in financial statements. It would allow the recognition of items that cannot be measured reliably.

(c) the pre-2010 *Framework* acknowledged a trade-off between the qualitative characteristics of relevance and reliability. More relevant information may lack reliability and more reliable information may lack relevance. Some respondents expressed the view that this trade-off is missing in the existing *Conceptual Framework*.

(d) the idea that financial statements should be credible (that is, that they provide reliable information that users can depend on) is a key concept that should be acknowledged in the *Conceptual Framework*.

BC2.24 The IASB proposes not to reinstate the term reliability as a label for the qualitative characteristic now called faithful representation because:

(a) as noted in paragraph BC2.22, the decision to change the label from reliability to faithful representation was made to avoid confusion about the meaning of the term reliability. The responses to the Discussion Paper seem to confirm that many respondents equate the word reliability solely with a tolerable level of measurement uncertainty, not with the broader notion described in the pre-2010 *Framework*.

(b) paragraph QC16 of the existing *Conceptual Framework* already explains the idea that an estimate might not provide relevant information if the level of uncertainty in the estimate is very large. Nevertheless, it is apparent that this idea is not very visible and many readers of the current *Conceptual Framework* seem to overlook it. Accordingly, the IASB is proposing a number of changes intended to make the point more clearly. In particular:

   (i) paragraphs 2.12–2.13 of the Exposure Draft build on the discussion of measurement uncertainty in paragraph QC16 of the existing *Conceptual Framework*. An example based on paragraph QC16 has been added to paragraph 2.20. As a result of these changes, paragraph QC16 is now largely redundant and has been deleted.

   (ii) paragraphs 5.20–5.21, BC5.10 and BC5.45 discuss the role of measurement uncertainty in decisions about recognition.

   (iii) paragraphs 6.55–6.56 and BC6.56–BC6.57 discuss the role of measurement uncertainty in decisions about measurement.

(c) these changes clarify that the level of measurement uncertainty affects the relevance of an estimate, and that there is a trade-off between the level of measurement uncertainty and other factors that make information relevant. That trade-off is similar to the trade-off previously described as existing between relevance and reliability. For example, one piece of information may be of high interest to users of financial statements, but subject to high measurement uncertainty. Another piece of information about the same economic phenomenon may be of lower interest to users of financial statements, but subject to lower measurement uncertainty. In such cases, judgement is needed to determine which piece of information is more relevant.

(d) the enhanced discussion of measurement uncertainty, together with the discussion of the two fundamental qualitative characteristics of useful financial information (relevance and faithful representation), is intended to explain the factors that enable users to rely on financial information to provide a faithful representation of what it purports to depict. In the IASB's view, this makes it unnecessary to reintroduce any further reference to reliability.

BC2.25 Having considered respondents' concerns about measurement uncertainty, the IASB considered whether there were additional issues relating to the term reliability. The IASB noted that there is much in common between the description of reliability in the pre-2010 *Framework* and the description of faithful representation proposed in the Exposure Draft (see Table 2.1). Consequently, it is unclear to the IASB what effect it would have in practice to reinstate the term reliability as a label. Moreover, the IASB believes—for reasons given in paragraph BC2.24—that the term faithful representation describes more clearly what is meant by this qualitative characteristic.

Table 2.1

Pre-2010 *Framework* **Reliability**	**Proposed in the Exposure Draft** **Faithful representation**
Can be depended on by users to faithfully represent what it purports to represent	Information is useful if it faithfully represents the phenomena that it purports to represent (see paragraph 2.14)
Complete	Complete (see paragraph 2.16)
Neutral	Neutral (see paragraph 2.17)
Free from material error or bias	Free from error and neutral (see paragraphs 2.17 and 2.19)
Substance over form	Substance over form (see paragraph 2.14)
Prudence	Prudence (see paragraph 2.18)

Understandability and complexity (paragraphs 2.33–2.35)

BC2.26 Chapter 3 of the existing *Conceptual Framework* (Chapter 2 of the Exposure Draft) identifies understandability as an enhancing qualitative characteristic: a characteristic that makes financial information more useful. A few respondents to the Discussion Paper suggested that understandability should be elevated to become a fundamental qualitative characteristic or even to become an objective of financial reporting. However, the IASB proposes not to make such a change. To do so might result in the exclusion of information that is complex but, nevertheless, useful to users of financial statements.

BC2.27 A few respondents to the Discussion Paper suggested that the *Conceptual Framework* should discuss the sources of complexity in financial reporting and the need to avoid unnecessary complexity when setting Standards. However, the IASB believes that no such discussion is necessary because the existing material on understandability and the cost constraint provide adequate guidance.

Materiality (paragraph 2.11)

BC2.28 Paragraph QC11 of the existing *Conceptual Framework* (paragraph 2.11 of the Exposure Draft) sets out the concept of materiality as follows:

> Information is material if omitting it or misstating it could influence decisions that users make on the basis of financial information about a specific reporting entity. In other words, materiality is an entity-specific aspect of relevance based on the nature or magnitude, or both, of the items to which the information relates in the context of an individual entity's financial report. Consequently, the Board cannot specify a uniform quantitative threshold for materiality or predetermine what could be material in a particular situation.

BC2.29 In addition, IAS 1 *Presentation of Financial Statements* defines 'material' and provides guidance on the application of the concept of materiality.

BC2.30 The Discussion Paper took the position that the concept of materiality is clearly described in the existing *Conceptual Framework* and did not suggest amending or adding to that description. The Discussion Paper also noted that the IASB is considering, as part of its Disclosure Initiative (see paragraph BC7.2(b)), whether to provide guidance on the application of this concept. Many respondents to the Discussion Paper agreed with this approach.

BC2.31 Hence, the IASB proposes in the Exposure Draft to make no amendments to the concept of materiality in the *Conceptual Framework*, except to clarify that the users mentioned in the discussion of materiality are the primary users of general purpose financial reports, as described in paragraph 1.5 of the Exposure Draft (paragraph OB5 of the existing *Conceptual Framework*). This clarification would emphasise that decisions about materiality reflect the needs of the primary users, not the needs of any other group. The IASB will consider in the Disclosure Initiative (see paragraph BC7.2(b)) suggestions made by some respondents for amendments to, and clarifications of, the concept of materiality.

Applying the fundamental qualitative characteristics (paragraph 2.21)

BC2.32 To be consistent with the description of relevance in paragraph 2.6 of the Exposure Draft and to avoid confusion with the use of the term ‘potential’ in the definition of an economic resource (see paragraph BC4.16), the IASB proposes in paragraph 2.21 to replace the phrase ‘has the potential to be’ with ‘is capable of being’.

The cost constraint on useful financial reporting

BC2.33 Paragraphs QC35–QC39 of the existing *Conceptual Framework* (paragraphs 2.38–2.42 of the Exposure Draft) include a discussion of cost as a pervasive constraint on the information that can be provided by financial reporting. The cost constraint plays a particularly important role in decisions about the unit of account, recognition, measurement and presentation and disclosure. Accordingly, the Exposure Draft includes further references to the cost constraint in the discussion of those topics.

Chapter 3—Financial statements and the reporting entity

BC3.1 As explained in paragraph BCIN.22, Chapters 1 and 2 of the Exposure Draft discuss general purpose financial reports. Chapters 3–7 focus on the most important type of general purpose financial reports: financial statements.

BC3.2 The proposed objective of financial statements is discussed in paragraphs BC7.4–BC7.10.

BC3.3 Paragraph 3.9 of the Exposure Draft states that financial statements are prepared from the perspective of the entity as a whole, instead of from the perspective of any particular group of investors, lenders or other creditors. This is consistent with the IASB's reasoning in paragraph BC1.8 of the Basis for Conclusions on the existing *Conceptual Framework*. This explains that financial reports should account for the entity, instead of its primary users and their interests in the reporting entity. Taking this perspective does not imply that the IASB thinks that no distinction should be drawn between liabilities and equity. The distinction between liabilities and equity is discussed in paragraphs BC4.93–BC4.103.

BC3.4 Paragraph 3.10 of the Exposure Draft sets out the going concern assumption, which has been brought forward from the existing *Conceptual Framework*, except that the phrase 'cease trading' replaces the phrase 'curtail materially the scale of its operations'. That change is proposed to align the wording with that used in IAS 1 *Presentation of Financial Statements* and IAS 10 *Events after the Reporting Period*.

The reporting entity (paragraphs 3.11–3.25)

BC3.5 The existing *Conceptual Framework* does not discuss the following topics, on which the Exposure Draft includes proposals:

(a) what a reporting entity is; and

(b) the boundary of a reporting entity.

BC3.6 In developing these proposals, the IASB has considered comments received on the Exposure Draft *Conceptual Framework for Financial Reporting—The Reporting Entity* (the 'Reporting Entity Exposure Draft') issued in March 2010 and developed jointly with the FASB.

BC3.7 The Discussion Paper *A Review of the Conceptual Framework for Financial Reporting* did not include a further discussion of the reporting entity.

The reporting entity (paragraphs 3.11–3.12)

BC3.8 In the Reporting Entity Exposure Draft, the IASB described a reporting entity and its features:

RE2 A reporting entity is a circumscribed area of economic activities whose financial information has the potential to be useful to existing and potential equity investors, lenders and other creditors who cannot directly obtain the information they need in making decisions about providing resources to the entity and in assessing whether management and the governing board of that entity have made efficient and effective use of the resources provided.

RE3 A reporting entity has three features:

(a) economic activities of an entity are being conducted, have been conducted or will be conducted;

(b) those economic activities can be objectively distinguished from those of other entities and from the economic environment in which the entity exists; and

(c) financial information about the economic activities of that entity has the potential to be useful in making decisions about providing resources to the entity and in assessing whether the management and the governing board have made efficient and effective use of the resources provided.

These features are necessary but not always sufficient to identify a reporting entity.

BC3.9 Many respondents to the Reporting Entity Exposure Draft stated that it did not clarify whether entities that met the description of a reporting entity *must*, *should* or *could* prepare general purpose financial reports. As noted by many of these respondents, the IASB has no authority to determine who must or should prepare general purpose financial statements. Accordingly, the Exposure Draft describes a reporting entity as an entity that chooses, or is required, to prepare general purpose financial statements. In addition, the Exposure Draft clarifies that a reporting entity:

(a) need not be a legal entity;

(b) can be a portion of an entity; and

(c) can comprise two or more entities.

Paragraph 3.18 of the Exposure Draft proposes guidance on how to set the boundary of a reporting entity that is not a legal entity.

Boundary of the reporting entity (paragraphs 3.13–3.25)

BC3.10 In the Reporting Entity Exposure Draft, the IASB proposed that the boundary of a reporting entity should be determined by control. Hence, if an entity controls one or more entities, it should present consolidated financial statements in which the assets, liabilities, equity, income, expenses and cash flows of the entity (the parent) and the entities it controls (its subsidiaries) are presented as those of a single unit.

BC3.11 Most respondents to the Reporting Entity Exposure Draft agreed that an entity controlling one or more entities should prepare consolidated financial statements.

BC3.12 In the Exposure Draft, the IASB proposes that the boundary of a reporting entity could be determined by:

(a) direct control only resulting in unconsolidated financial statements;[10] or

(b) both direct and indirect control, resulting in consolidated financial statements. The Exposure Draft states that, in general, consolidated financial statements are more likely to provide useful information to users of financial statements than unconsolidated financial statements.

BC3.13 In the Reporting Entity Exposure Draft, the IASB expressed the view that unconsolidated financial statements may provide useful information if they are presented together with consolidated financial statements.[11] However, some respondents suggested that the IASB should permit entities to present their unconsolidated financial statements:

(a) in a separate document that is different from their consolidated financial statements, possibly issued on a different date; or

(b) without preparing accompanying consolidated financial statements at all, as is permitted in some jurisdictions.

BC3.14 The IASB concluded that unconsolidated financial statements can provide useful information to users of financial statements, but are not a substitute for consolidated financial statements in cases in which Standards require an entity to produce consolidated financial statements. Hence, the IASB proposes that the *Conceptual Framework* should state that:

(a) a parent may choose, or be required, to prepare unconsolidated financial statements in addition to the consolidated financial statements that it is required to prepare; and

(b) if an entity prepares unconsolidated financial statements, those statements need to disclose how users can obtain the consolidated financial statements.

Hence, the consolidated financial statements need not be presented together with the unconsolidated financial statements.

BC3.15 The Reporting Entity Exposure Draft also stated that joint control and significant influence do not give rise to control. The IASB still agrees with that conclusion, but sees no need to embed the notions of joint control and significant influence in the *Conceptual Framework*. Hence, the Exposure Draft does not refer to these notions.

BC3.16 The Reporting Entity Exposure Draft stated that combined financial statements might provide useful information about entities under common control. Many

10 The Exposure Draft uses the term 'unconsolidated financial statements' instead of the term 'separate financial statements', which is defined in IAS 27 *Separate Financial Statements* to cover specific circumstances.

11 The Reporting Entity Exposure Draft used the term 'parent-only financial statements'.

of those who commented welcomed a discussion of this issue, but disagreed with restricting the preparation of combined financial statements to entities under common control.

BC3.17 The IASB acknowledges that combined financial statements can provide useful information to users of financial statements in some circumstances. Accordingly, paragraph 3.17 of the Exposure Draft acknowledges the concept of combined financial statements but does not discuss when or how entities could prepare them. The IASB concluded that such discussion would be best developed if the IASB were to undertake a Standards-level project on this subject, instead of in the *Conceptual Framework*.

Chapter 4—The elements of financial statements

Introduction

BC4.1 The existing *Conceptual Framework* defines the following elements of financial statements:

(a) an asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.

(b) a liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

(c) equity is the residual interest in the assets of the entity after deducting all its liabilities.

(d) income is increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.

(e) expenses are decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants.

Income and expenses defined in terms of changes in assets and liabilities

BC4.2 The existing *Conceptual Framework* defines income and expenses in terms of changes in assets and liabilities, and the Discussion Paper indicated that there would be no change to this approach. A few respondents questioned this approach. They argued that this gives undue primacy to the statement of financial position over the statement(s) of financial performance, and does not sufficiently acknowledge the importance of accounting for transactions in the statement(s) of financial performance or of matching income and expenses.

BC4.3 As explained in paragraphs BCIN.14–BCIN.16, the IASB decided in this project to build on the existing *Conceptual Framework*. Thus, it does not intend to reconsider fundamentally the approach of defining income and expenses in terms of changes in assets and liabilities. Nevertheless, the IASB wishes to emphasise some important points about that approach:

(a) it is incorrect to assume that the IASB focuses solely or primarily on the statement of financial position. Financial statements are intended to provide information about an entity's financial position and its financial performance. Hence, when making decisions about recognition, measurement and presentation and disclosure, the IASB considers whether the resulting information provides useful information about both an entity's financial position and its financial performance. The

IASB has not designated one type of information (about financial position or about financial performance) as the primary focus of financial reporting.

(b) information about transactions is relevant to users. Hence, much of financial reporting is currently based on transactions and will continue to be so.

(c) transactions that result in income and expenses also cause changes in assets and liabilities. Consequently, identifying income and expenses necessarily leads to identifying which assets and liabilities have changed. The IASB and other standard-setters have found over many years that it is more effective, efficient and rigorous to define assets and liabilities first, and to define income and expenses as changes in assets and liabilities, instead of trying to define income and expenses first and then describe assets and liabilities as by-products of the recognition of income and expenses.

(d) the definitions of an asset and a liability are not merely accounting technicalities. They refer to real economic phenomena (economic resources and obligations to transfer economic resources). A statement of financial position depicting assets, liabilities and equity provides users with more relevant and understandable information about an entity's financial position than does a mere summary of amounts that have arisen as by-products of a matching process. Those amounts do not depict economic phenomena.

(e) an approach based on matching income and expenses does not define the period to which the income and expenses relate. As explained in paragraph 5.8 of the Exposure Draft, related income and expenses will often be recognised simultaneously because of simultaneous changes in related assets and liabilities. However, an intention to match income and expenses does not justify the recognition of items in the statement of financial position that do not meet the definition of assets or liabilities. That explanation has been brought forward from the existing *Conceptual Framework*.

Definitions—issues common to both assets and liabilities

BC4.4 The IASB has found the existing definitions of assets and liabilities to be useful for solving many issues in standard-setting. However, confusion can arise because:

(a) the explicit reference in the definitions of assets and liabilities to the flows of economic benefits blurs the distinction between the resource or obligation and the resulting flows of economic benefits; and

(b) some readers interpret the term 'expected' as a probability threshold.

BC4.5 To address these issues, for the reasons given in paragraphs BC4.7–BC4.22, 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; and

(c) an economic resource is a right that has the potential to produce economic benefits.

BC4.6 Proposed supporting guidance for the definition of an asset is discussed in paragraphs BC4.24–BC4.44 and for the definition of a liability in paragraphs BC4.45–BC4.81.

Separate definition of an economic resource (paragraph 4.6)

BC4.7 The main structural change from the existing definitions is the proposal to introduce a separate definition of an economic resource. This repositions the references to future flows of economic benefits so that they appear in the supporting definition of an economic resource, instead of in the definitions of an asset and a liability.

BC4.8 Many respondents to the Discussion Paper agreed with this suggestion. They stated that the proposed definitions were clearer and easier to understand than the existing definitions.

BC4.9 A few respondents to the Discussion Paper stated that there was no need to change the existing definitions. They argued that:

(a) the existing definitions are well accepted and have not created confusion or major problems for preparers or users;

(b) the proposed definitions do not differ from the existing definitions sufficiently to warrant the change; and

(c) readers should be able to understand what an asset or a liability is without having to look up a separate definition of an economic resource.

BC4.10 The IASB still proposes to move the reference to future economic benefits into a supporting definition of 'economic resource'. Doing so emphasises more clearly that an asset (or a liability) is a resource (or obligation), instead of the ultimate inflow (or outflow) of economic benefits that the resource (or obligation) may produce. This approach also streamlines the definitions and shows more clearly the parallels between assets and liabilities.

Deletion of the notion of an expected flow (paragraphs 4.13–4.16)

BC4.11 The Discussion Paper suggested replacing the notion that an inflow or outflow of resources is expected with the notion that an asset (or a liability) is capable of generating economic benefits (or requiring a transfer of economic resources).

BC4.12 Some respondents stated that the IASB should retain the notion of an expected inflow or outflow of resources. They argued that defining an asset as being 'capable of producing economic benefits' results in too broad a definition and the result is not understandable. Users and preparers do not regard an item as an asset if no inflows of economic benefits are expected. Benefits must be reasonably possible. Those respondents argued that the definition in the

Discussion Paper would considerably widen the range of items that will be identified as assets and liabilities. This may lead to:

(a) pressure to identify every possible asset and liability, imposing a significant operational burden, for little benefit if ultimately the asset or the liability is not recognised or is measured at nil;

(b) recognition as assets and liabilities of more items that are uncertain, improbable or hard to measure, unless the recognition criteria are made more robust;

(c) a presumption that, in principle, all assets and liabilities should be recognised even if inflows or outflows are not expected; and

(d) pressure for irrelevant disclosure about unrecognised assets and liabilities for which inflows or outflows are unlikely.

BC4.13 Some respondents also argued that if the term expected is being interpreted inconsistently or misunderstood, the IASB could clarify how to interpret the term instead of deleting it. Replacing expected with 'capable' merely replaces one difficulty with another. The term capable is equally subjective, may create ambiguity and is not as easily understood.

BC4.14 However, many respondents agreed with the proposal to replace the notion of an expected inflow or outflow of resources. They expressed the following views:

(a) removal of expected appropriately focuses the definition on the resource. To retain a notion of expected or probable outflows or inflows would exclude many items that are clearly assets and liabilities, such as written and purchased options, stand-ready obligations and insurance contracts.

(b) the notion of expected flows is unhelpful, because interpretations of this term can vary widely and are often tied to a notion of a threshold level of probability. Uncertainty is best dealt with in recognition criteria or measurement, instead of within the definitions.

(c) removing the probability criterion would not, as suggested by some, require considerable effort to identify assets and liabilities that will not be recognised. In practice, potential recognition will be in focus from the very beginning.

(d) a broad definition of an asset may result in the disclosure to users of useful information about items for which recognition is not appropriate.

BC4.15 In the Exposure Draft, the IASB has retained the Discussion Paper's suggestion to delete from the definitions of assets and liabilities the notion that an inflow or outflow is expected. The IASB acknowledges that many respondents have significant concerns about recognising assets or liabilities when the probability of an inflow or outflow of benefits is low, but believes that those concerns are best addressed in recognition, not in the definitions. Paragraphs 5.17–5.19 of the Exposure Draft set out how the recognition criteria would address these concerns.

BC4.16 The Discussion Paper used the term capable. That term is already used in the discussion of relevance in paragraphs QC6–QC7 of the existing *Conceptual Framework* (paragraphs 2.6–2.7 of the Exposure Draft). It would be confusing to use the term capable with one meaning describing what information is relevant and with a different meaning in defining an economic resource. Hence, the IASB proposes instead to use in the definition of an economic resource the term 'has the potential to'. That term captures the following points:

(a) it is not sufficient that the economic benefits may arise in the future. Those economic benefits must arise from some feature that already exists within the economic resource. For example, a purchased option has the potential to produce economic benefits to the holder, but only because the option already contains a term that will permit the holder to exercise the option.

(b) the definition is not intended to impose a minimum probability threshold. The important thing is that there must be at least one circumstance in which the economic resource will generate economic benefits.

BC4.17 The IASB does not think that eliminating the term 'expected' from the definitions and replacing it with the notion of 'having the potential to produce' will make the definitions either broader or narrower than the existing definitions. It notes that this approach is consistent with how it has applied the existing definitions in practice for several years.

Past event (paragraphs 4.5 and 4.36–4.39)

BC4.18 The Discussion Paper suggested that:

(a) the phrase 'as a result of past events' should remain in the definitions of an asset and a liability; and

(b) the word 'present' should remain in the definition of a liability and be inserted in the definition of an asset.

BC4.19 Several respondents explicitly supported retaining the reference to past events to emphasise the need to prevent recognition of items that depend largely on the entity's own future acts, such as the costs of future operations. It also focuses on the need to identify when and how an obligation was incurred, in order to decide how to account appropriately for the asset acquired, or expense incurred, in incurring the obligation. This is consistent with the fact that accounting is largely transaction-based.

BC4.20 Other respondents opposed the reference to past events, arguing that it is redundant. A present asset or liability cannot exist without a past event. Identifying that past event may help to determine how to portray that event in financial statements, but this point could be explained in the supporting guidance instead of in the definitions. Having such a reference in the definition may appear to create a requirement to search for, and identify, the past event. It may also lead to an excessively strict view of what is necessary to constitute a present obligation, and to accounting that some find counterintuitive, such as some of the accounting required by IFRIC 21 *Levies*. Further, it is not clear which past events are sufficient to create an obligation. Moving the focus to the present condition would make the definition easier to apply in practice.

BC4.21 As discussed in paragraphs BC4.48–BC4.75, the IASB thinks the phrase 'as a result of past events' is important to its proposed definition of a liability. In fact, the IASB proposes retaining that phrase in the definitions both of an asset and a liability. By identifying the past event, an entity can determine how best to portray that event in its financial statements; for example, how best to classify and present income, expenses or cash flows arising from that event. The IASB has not identified any significant problems that arise from the inclusion of that phrase in the existing definitions.

BC4.22 For the same reasons, the IASB also proposes to retain the term 'present' in the definition of a liability and add it to the definition of an asset. That addition emphasises the parallels between the two definitions.

Assets

BC4.23 This section discusses the following aspects of the asset definition:

(a) economic resources (see paragraphs BC4.24–BC4.28);

(b) focus on rights (see paragraphs BC4.29–BC4.39); and

(c) control (see paragraphs BC4.40–BC4.43).

Economic resources (paragraphs 4.6 and 4.13–4.16)

BC4.24 Paragraphs BC4.7–BC4.10 discuss the proposed separate definition of an economic resource and paragraphs BC4.11–BC4.17 discuss the proposal to remove the notion of expected flows from the definition of an asset.

BC4.25 The Discussion Paper proposed defining the concept of 'economic resource' using the term 'economic benefits', but did not define that term. Hence, some respondents argued that the proposed definitions would not enhance clarity or add new insights. However, the IASB notes that the term 'economic benefits' already appears in the existing definitions of assets and liabilities and the IASB has identified no major problems caused by its use.

BC4.26 Other respondents commented that because the definition of an economic resource refers to future economic benefits, an asset should be defined as those future economic benefits, not as the economic resource itself. What gives the resource value is the possibility of future inflows. The IASB noted that although an asset derives its value from its potential to produce future benefits, the thing that the entity controls today is that existing potential, not the future economic benefits. In addition, if an asset were defined as the possible future benefits, it would be unclear:

(a) whether an asset exists if the possible future benefits are uncertain; and

(b) which possible future economic benefits qualify as assets at any given date.

Consequently, the IASB proposes that the definition of an asset should continue to refer to the (economic) resource, not to the resulting economic benefits.

BC4.27 Others suggested that the term 'economic resource' is too limiting and may indicate only resources that have a market value. These respondents suggested using the term 'resource' instead. The IASB notes that the term 'economic resource' is not intended to be limited to resources for which a market currently exists. It covers all resources that have the potential to produce economic benefits. The IASB prefers the term 'economic resource' because it helps to emphasise that the resource in question is not, for example, a physical object, but rights over a physical object, as discussed in paragraphs 4.12 and 4.15 of the Exposure Draft.

BC4.28 Finally, some noted that the IASB's *Conceptual Framework* is applied in some jurisdictions in the public sector, not-for-profit and non-capital market settings. Consequently, they stated that the definition of an asset should include resources that provide benefits other than cash flows, such as social or environmental services or benefits to the reporting entity, to other parties or to wider society. Similarly, the definition of a liability should include obligations to transfer such benefits, and obligations entered into for prudential or moral purposes, or to meet expectations of a broader group of stakeholders or to maintain public support. However, the IASB focuses currently on for-profit entities. The IASB therefore proposes that the definition of an asset should continue not to refer to resources that provide benefits other than economic benefits.

Focus on rights (paragraphs 4.8–4.12)

BC4.29 The term 'resource' appears in the existing definition of an asset. The Discussion Paper used the amended economic resource term and suggested defining an economic resource (and, hence, an asset) as a right. To illustrate the effect of this change in emphasis, the Discussion Paper suggested that, for a physical object, such as an item of property, plant and equipment, the economic resource is not the underlying object but a right (or a set of rights) to obtain the economic benefits generated by the physical object.

BC4.30 Respondents who agreed with the Discussion Paper's proposal to focus on rights suggested that this would confirm a shift away from the traditional notions of accounting for physical objects and towards accounting for different rights that compose economic resources. They expressed the view that this shift would be particularly helpful in addressing the derecognition of components of assets.

BC4.31 However, some respondents disagreed with the focus on rights and stated that an asset should be defined as a right or resource, not merely as a right. They argued that:

(a) some assets, for example, tangible assets, are best described as resources instead of rights. The concept of accounting for tangible assets as a set of rights is inconsistent with reality, especially when combined with the idea of 'unbundling' rights from an asset.

(b) unless the *Conceptual Framework* explains what factors drive the identification of the unit of account, it would be difficult to explain consistently, for a single asset comprising several rights, whether to recognise that single asset as a whole or to recognise some of those rights separately.

(c) a focus on rights within a larger set of rights would put more pressure on the recognition and derecognition criteria and the unit of account. Entities would need to ask themselves numerous questions in order to determine or deny the existence of new assets and liabilities, without any clear benefit. Indeed, these respondents argued that the rights approach has caused challenges in developing Standards (for example, the current project on leases), and also in applying them, particularly to derecognition (for example, for financial instruments).

BC4.32 In developing the Exposure Draft, the IASB noted that many assets (such as financial assets, a lessee's rights of use of a leased machine, and many intangible assets, such as patents) are rights that are created by contract or law. However, it is equally true that ownership of a physical object arises only because of rights conveyed by law. Furthermore, full legal ownership of a physical asset differs from the right to use an asset for 99 per cent (or 50 per cent or even 1 per cent) of its useful life, but although those rights differ in their extent, they do not differ fundamentally in nature—they are all rights of one kind or another. In addition, because of legal differences or changes, a particular bundle of rights may constitute full legal ownership in one jurisdiction but not in another jurisdiction, or at one date but not at another date.

BC4.33 Hence, the IASB sees no advantage in defining two separate types of asset, one described as a resource (for example, in cases of full legal ownership of a physical object) and the other described as a right (all other rights over all or part of a resource). Nevertheless, the Exposure Draft notes in paragraph 4.12 that describing the set of rights as a physical object will often provide the most concise, clear and understandable information.

Other sources of value

BC4.34 The Discussion Paper's suggested definition of an economic resource included not only 'rights' but also 'other sources of value' that are capable of producing economic benefits. Some respondents commented that the phrase 'other sources of value' does little to place boundaries around the concept of an economic resource and permits wide interpretations in practice.

BC4.35 The IASB included references to 'other sources of value' in the Discussion Paper's definition of an economic resource, because of concerns that the term 'rights' may not capture items, such as know-how, when an entity controls them by having the ability to keep them secret from other parties instead of through legal rights. The IASB thought—and still thinks—that an asset can exist in such cases.

BC4.36 However, the IASB now thinks that the notion of 'other sources of value' is too vague to be useful in a formal definition. Instead it proposes to explain that the notion of a 'right' encompasses not merely legal rights but also access that an entity controls in other ways, for example, by having the ability to keep know-how secret and thus prevent all other parties from directing its use and benefiting from it. The proposed explanation of that concept in the Exposure Draft builds on material that is already in paragraph 4.12 of the existing *Conceptual Framework*.

BC4.37 Some respondents to the Discussion Paper suggested that the definition of an asset should require assets to be identifiable or separable. Doing so would, in their view, appropriately exclude from the definition of an asset some of the items listed in the Discussion Paper under 'other sources of value'. For example, IAS 38 *Intangible Assets* requires an intangible asset to be identifiable, so as to distinguish it from goodwill. It states that an asset is identifiable if it is either separable from the entity, or arises from contractual or other legal rights. In the IASB's view, if an asset is separable, or arises from contractual or other legal rights, it is likely to be easier to identify, measure and describe the asset. This may affect whether or not recognition is appropriate (see paragraph BC5.35). However, the IASB believes that these criteria should not form part of the definition of an asset. Including those criteria would unnecessarily restrict the concept of an asset.

Rights that all entities have

BC4.38 The Exposure Draft proposes that if an entity has only the same rights as all other parties, those rights do not create an economic resource for the entity. It could be argued that such rights, for example, a right to access a road network, are, in principle, a resource for the entity. However, including information about them in financial statements is unlikely to be useful, because they do not give the entity access to greater economic benefits than those available to any other entity. Hence, the IASB proposes that they should not be regarded as economic resources for any specific entity.

Rights that are immediately consumed

BC4.39 Paragraph 4.9 of the Exposure Draft clarifies that goods or services that are received and immediately consumed are momentarily rights to obtain economic benefits until they are consumed, at which point the consumption is recognised as an expense. This is consistent with IFRS 2 *Share-based Payment*, which treats the receipt of employees' services as an asset that is immediately consumed.

Control (paragraphs 4.17–4.23)

BC4.40 Both the existing definition of an asset and the definition proposed in the Discussion Paper require the economic resource to be 'controlled by the entity'. The existing *Conceptual Framework* does not define control. The Discussion Paper proposed adding the following definition:

> An entity controls an economic resource if it has the present ability to direct the use of the economic resource so as to obtain the economic benefits that flow from it.

BC4.41 The following paragraphs discuss:

(a) risks and rewards of ownership (see paragraphs BC4.42–BC4.43); and

(b) other suggested changes (see paragraph BC4.44).

Risks and rewards of ownership

BC4.42 Some respondents suggested that the definition of an asset should incorporate the notion of exposure to risks and rewards of ownership. The IASB notes that some recent Standards identify exposure to the risks and rewards of ownership (or, in other words, to variable returns) as an aspect or indicator of control:

(a) IFRS 10 *Consolidated Financial Statements* states that 'an investor controls an investee when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee'.

(b) IFRS 15 *Revenue from Contracts with Customers* lists indicators of the transfer of control of an asset to a customer. One of the indicators is that 'the customer has the significant risks and rewards of ownership of the asset'. The Basis for Conclusions accompanying IFRS 15 explains that exposure to the risks and rewards of ownership of an asset may indicate control.

BC4.43 The IASB thinks that it would be helpful for the *Conceptual Framework* to explain in general terms the relationship between control and exposure to risks and rewards of ownership. However, instead of using the term 'risks and rewards of ownership', the Exposure Draft uses wording that captures the meaning conveyed by that term, ie 'exposure to significant variations in the amount of economic benefits' (see paragraph 4.22 of the Exposure Draft).

Other suggested changes

BC4.44 Respondents suggested other changes to the definition and treatment of control proposed in the Discussion Paper:

(a) a few respondents questioned whether the definition of an asset needs to include a reference to control. They argued that it is implicit in the definition of a resource as a right that the entity controls the resource. The IASB agrees that this may be implicit but believes that explicitly referring to control is a helpful way of structuring the definition and supporting guidance.

(b) a few respondents suggested that the requirement for control should be a recognition criterion, instead of part of the definition of an asset. They argued that this approach would separate two questions that are independent of each other (namely: does an asset exist? and to whom does the asset belong?). The IASB does not propose to move the reference to control into the asset recognition criteria, because such a move:

    (i) would be unlikely to change the population of recognised assets—there are no problems in practice that the IASB would be seeking to address if it made this change; and

    (ii) would add some complexity to the recognition criteria and might imply a need to identify all possible assets before then using the recognition criteria to eliminate those assets that are not assets of the reporting entity.

(c) a few respondents suggested that the IASB should amend the definition of control to refer to substantially all the economic benefits. However, the IASB considers that the question of whether to include a threshold such as 'substantially all' is a Standards-level decision.

(d) a few respondents commented that it was not clear whether the definition of control ('the ability to direct the use of ... *so as* to obtain economic benefits') was intended to be a single criterion or two separate criteria. They suggested amending the definition of control to make it clearer that an entity must have both the ability to direct the use of the economic resource and the right to obtain the benefits from it. The IASB agrees that these are separate criteria. Hence, the Exposure Draft defines control as 'the present ability to direct the use of the economic resource *and* obtain the benefits that flow from it'.

Liabilities (paragraphs 4.24–4.39)

BC4.45 The existing *Conceptual Framework* defines a liability as a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

BC4.46 The Exposure Draft defines a liability as a present obligation of the entity to transfer an economic resource as a result of past events. The main changes from the existing definition are as follows:

(a) deletion of the reference to an expected outflow of economic benefits. For reasons discussed in paragraphs BC4.11–BC4.17, this is replaced by accompanying guidance that an obligation to transfer an economic resource must have the potential to require the entity to transfer an economic resource to another party (see paragraph 4.27 of the Exposure Draft).

(b) replacing the phrase 'resources embodying economic benefits' with the new defined term 'economic resources' (see paragraphs BC4.7–BC4.10).

BC4.47 Paragraph 4.30 of the Exposure Draft explains that an obligation of an entity to transfer its own equity instruments to another party is not an obligation to transfer an economic resource. This is a consequence of the proposed definition of a liability. The classification of some such obligations is being addressed in the IASB's Financial Instruments with Characteristics of Equity research project (see paragraphs BC4.93–BC4.103).

Present obligation (paragraphs 4.31–4.39)

BC4.48 In applying the existing definition of a liability, it is generally accepted that one case in which an entity has a present obligation to transfer an economic resource is when the obligation is unconditional and legally enforceable—in such situations, the entity clearly has no ability to avoid the transfer. However, in some situations an entity has some limited ability to avoid a future transfer. Problems have arisen in practice because it is unclear how limited that ability must be for an entity to have a 'present obligation'.

BC4.49 The Exposure Draft proposes that two conditions must be met for a present obligation to transfer an economic resource to exist:

(a) the entity has no practical ability to avoid the transfer; and

(b) the obligation has arisen from past events; in other words, the entity has received the economic benefits, or conducted the activities, that establish the extent of its obligation.

BC4.50 The IASB developed these conditions by considering the problems arising when:

(a) a requirement already exists for an entity to transfer an economic resource, but the outcome of that requirement is conditional on the entity's own future actions; or

(b) an entity does not have a legal obligation to transfer an economic resource, but its ability to avoid the transfer is limited by its customary practices, published policies or specific statements (sometimes referred to as constructive obligations).

BC4.51 The Discussion Paper considered those two situations separately. However, some respondents noted that the underlying issues are similar in both situations: the entity has some ability to avoid a transfer, but its ability is constrained. In the Exposure Draft, the two conditions in paragraph BC4.49 form an overarching concept that would apply in all circumstances.

Obligations conditional on an entity's own actions (paragraphs 4.32–4.35)

BC4.52 The definition of a liability in the *Conceptual Framework* has always required a present obligation to be the result of past events.

BC4.53 However, the existing *Conceptual Framework* is unclear about how to identify the past event and whether a past event is sufficient to create an obligation. Questions arise if there has been some event in the past that could result in a transfer of economic resources but the entity still has some ability (at least in theory) to avoid the future transfer; in other words, if the requirement to transfer an economic resource remains conditional on some future action of the entity.

BC4.54 Different Standards have applied different approaches to such situations. For example:

(a) IAS 37, as it has been interpreted in IFRIC 21, requires that for a present obligation to exist, the entity must have no ability, even in theory, to avoid the future transfer.

(b) IAS 34 *Interim Financial Statements* addresses lease payments that are contingent on exceeding an annual threshold. It requires a liability to be recognised if the entity has no realistic alternative but to make the future lease payments.

(c) IAS 19 *Employee Benefits* requires a liability to be recognised for benefits that are conditional on future employment (unvested benefits) if those benefits are given in exchange for service already provided by employees.

BC4.55 The IASB identified these Standards as applying three different views on when a present obligation to transfer an economic resource has arisen:

(a) View 1—the entity must have no ability to avoid the future transfer.

(b) View 2—the entity must have no practical ability to avoid the future transfer.

(c) View 3—there need be no limits on the entity's ability to avoid the future transfer. It is sufficient that, as a consequence of a past event, the entity may have to transfer an economic resource if further conditions are met.

BC4.56 In the Discussion Paper, the IASB tentatively rejected View 1 but did not express a preference between Views 2 and 3.

BC4.57 A few respondents to the Discussion Paper thought that the definition of a liability should encompass only legally enforceable, unconditional obligations to transfer an economic resource, ie those that the entity has no ability to avoid (View 1). They argued that:

(a) unless a requirement is unconditional, it is avoidable and not an obligation;

(b) applying View 1 would provide useful information about the future outflows that an entity has no ability to avoid; and

(c) applying View 1 would enhance comparability, because it uses the clearest, least subjective and most operational criteria.

BC4.58 However, nearly all respondents commenting on this issue thought that the definition of a liability should encompass both constructive obligations and at least some obligations that are conditional on the entity's future actions. Most of those respondents favoured a concept that would identify as a liability any obligation to transfer an economic resource that the entity has no practical ability to avoid (View 2). They argued that such a concept would give the most faithful representation (or best report the substance) of the obligations that an entity cannot avoid.

BC4.59 Some respondents thought that the definition of a liability should encompass all future transfers of economic resources that arise from past events (View 3). They argued that such a concept would ensure that entities report expected expenses in the same period as the past event that caused them. However, against such a concept, some respondents argued that:

(a) unless a requirement is unconditional, it is avoidable and not an obligation.

(b) it could result in the recognition and subsequent derecognition of liabilities that the entity later avoids and so never has to fulfil.

(c) it could be difficult to measure liabilities if the entity has the practical ability to avoid them, because the measurement would need to take into account the possibility and economic consequences of the avoiding action. Recognition criteria may be needed to filter out very unlikely, or very uncertain, future transfers. Without such criteria, the accounting would be complex and subjective.

BC4.60 Some respondents suggested other approaches that incorporate elements of View 2 or View 3, with modifications. Most notably, several respondents suggested a probability threshold: an entity should be regarded as having an obligation if it is probable (or perhaps reasonably certain) that the requirement will result in the entity transferring an economic resource. They argued that such a threshold would provide the most relevant measure of the expenses in the period.

BC4.61 The IASB now proposes that the definition of a present obligation should reflect View 2, ie that the entity must have no practical ability to avoid the transfer of an economic resource. The reasons are:

(a) firstly, the IASB rejected the suggestion (mentioned in paragraph BC4.60) of applying a threshold based on the probability of future outflows. The definition of a liability focuses on a present obligation, for the reason set out in paragraphs BC4.11–BC4.17. Hence, the IASB believes that the supporting guidance should focus on what the entity is able (or not able) to do—not on the likelihood of the possible outcomes.

(b) secondly, the IASB continues to reject limiting the definition of a liability to obligations that are legally enforceable and strictly unconditional (View 1). When an entity has no practical ability to avoid transferring an economic resource as a result of a past event, omitting the requirement to make that future transfer from a list of the entity's obligations would exclude information that many users would find useful. Nearly all respondents to the Discussion Paper agreed that View 1 would define a liability too narrowly.

(c) although View 3 may lead to the most complete recognition of expenses in a period, the IASB rejected it because the term 'obligation' implies some limit on the entity's ability to avoid the transfer of an economic resource.

BC4.62 As noted in paragraphs BC4.52–BC4.53, the existing *Conceptual Framework* requires a present obligation to be the result of past events but does not specify how to identify the event that brings an obligation into existence (sometimes called the 'obligating event').

BC4.63 The IASB observed that some obligations arise in full from a single obligating event, such as receiving goods. Other obligations build up over time from a series of single obligating events, or through a single continuous obligating event, such as conducting a continuous activity. The obligating events that have already occurred determine the extent of the obligation (its quantum). Thus, the IASB proposes in the Exposure Draft to specify that the obligating event is receiving the economic benefits, or conducting the activities, that establish the extent of the entity's obligation. The IASB noted that establishing the extent of the obligation does not determine what measurement basis should be used for the obligation.

BC4.64 As explained in paragraphs BC4.18–BC4.22, the IASB proposes to retain the reference to past events in the definition of a liability. If the definition of obligations were limited to encompass only those that are unconditional and legally enforceable (View 1), the explicit reference to a past event would, arguably, have been redundant. However, the IASB proposes a broader approach (View 2). In the IASB's view, that proposal makes it important to explain as clearly as possible that, because no obligating event has yet occurred, an entity has no obligation for costs that will arise if it receives benefits, or conducts activities, in the future.

BC4.65 As noted in paragraph BC4.54, existing Standards take different approaches in defining whether an entity has a present obligation when it has a limited ability to avoid a transfer of economic benefits. Consequently, no approach will be consistent with all existing Standards. Applying the proposed approach, the main inconsistency would be between the *Conceptual Framework* and IAS 37 as interpreted by IFRIC 21.[12] The inconsistency would affect, in particular, levies that accumulate over time but are payable only if a further condition is met; for example, if the entity is still operating in the market on a later date. Applying IFRIC 21, liabilities are identified only once all conditions are met. However, applying the proposed approach, liabilities would be identified as arising over time, unless the entity has the practical ability to avoid the remaining conditions (for example, leave the market) without significant business disruption or without economic consequences that would be significantly more adverse than paying the levy. The IASB thinks that it is likely that, in practice, many liabilities for levies would be identified as accruing over time.

BC4.66 Introducing the proposed criteria for identifying a present obligation would not necessarily lead to a change in IAS 37 or IFRIC 21. The *Conceptual Framework* does not override individual Standards, and any decision to amend an existing Standard would require the IASB to go through its normal due process for adding a project to its agenda and developing an Exposure Draft and an amendment.

Constructive obligations (paragraph 4.34)

BC4.67 The existing *Conceptual Framework* states that, in addition to legally enforceable obligations, obligations may arise from normal business practice, custom and a desire to maintain good business relations or act in an equitable manner. IAS 37 defines a constructive obligation as an obligation that derives from an entity's actions where:

(a) by an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities; and

(b) as a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities.

BC4.68 Examples of situations in which it is sometimes argued that a constructive obligation exists are when an employer has an established, informal practice of paying employee bonuses that exceed the contractual entitlement; or when a

12 Inconsistencies may also arise with the definition of financial liabilities in IAS 32 *Financial Instruments: Presentation* both in relation to the identification of contractual obligations and in the distinction between financial liabilities and equity. The IASB is exploring how to distinguish between liabilities and equity in its Financial Instruments with Characteristics of Equity research project (see paragraph BCIN.25).

mining company has a publicly stated policy of restoring mined land to a similar standard throughout the world, even in countries whose legislation demands lower standards.

BC4.69 The Discussion Paper suggested that the definition of a liability should encompass both legal and constructive obligations. Nearly all respondents who commented on constructive obligations supported that suggestion. The Exposure Draft addresses constructive obligations in its discussion of whether an entity has the practical ability to avoid a transfer of economic resources. It proposes that obligations can arise from an entity's customary practices, published policies or specific statements if the entity has no practical ability to act in a manner inconsistent with those practices, policies or statements. The IASB views this concept as being broadly consistent with the existing IAS 37 definition: another party could validly expect the entity to transfer an economic resource only if the entity has no practical ability to avoid the transfer.

Terminology

BC4.70 Some respondents to the Discussion Paper suggested that terms such as the following could be easier to interpret than 'no practical ability to avoid':

(a) 'no realistic alternative'; or

(b) 'little or no discretion (in practice) to avoid'.

BC4.71 The IASB thinks that these two terms have a similar meaning to 'no practical ability to avoid'. However, the IASB proposes the term 'no practical ability to avoid', because it thinks that it most effectively conveys the need to identify what the entity is able to do, instead of what the probable outcome will be. Furthermore, it mirrors the term 'practical ability', which is applied in some existing Standards in assessing whether an entity has control of an asset.

BC4.72 Many respondents asked for guidance on the meaning of 'no practical ability to avoid'. The IASB acknowledges that applying that concept will require judgement. The IASB will, if necessary, develop guidance on applying that concept to particular cases as it develops specific Standards.

Economic compulsion

BC4.73 On various occasions, interested parties have suggested that an entity should recognise a liability if it is 'economically compelled' to transfer an economic resource. In the light of those suggestions, some existing Standards state explicitly that 'economic compulsion' is not sufficient to create a present obligation.

BC4.74 The Exposure Draft does not use the term 'economic compulsion'. In assessing whether it has a liability, an entity would need to consider both criteria listed in paragraph 4.31 of the Exposure Draft.

BC4.75 The IASB thinks that these criteria make it clear that:

(a) economic compulsion may be a factor that reduces the entity's practical ability to avoid a future transfer—so it would need to be considered in assessing whether that criterion is met; but

(b) economic compulsion on its own cannot create a present obligation—there is also the requirement for the obligation to have arisen from a past event (receiving economic benefits, or conducting activities, that establish the extent of the entity's obligation).

An obligation for one party is a right for another party

BC4.76 Paragraph 4.25 of the Exposure Draft states that if one party has an obligation to transfer an economic resource, it follows that another party (or parties) has a right to receive that economic resource.

BC4.77 Most respondents did not disagree with a similar suggestion in the Discussion Paper. However, a few respondents questioned whether the counterparty to a constructive or conditional obligation has any asset that it controls if the obligation is not legally enforceable, or is conditional on the reporting entity's own actions. In the IASB's view, the counterparty does control an asset in such cases. According to paragraph 4.21 of the Exposure Draft, 'this aspect of control does not imply that the entity can ensure that the resource will produce economic benefits in all circumstances. Instead [that aspect of control] means that, if the resource produces economic benefits, the entity is the party that will receive them'.

BC4.78 The IASB thinks that making the general point set out in paragraph 4.25 of the Exposure Draft would help people to apply the definitions (for example, it indicates that the counterparty to a constructive obligation has an asset). A liability necessarily involves an obligation to transfer an economic resource to another party. It follows that the other party must have an asset in the form of the right to receive the economic resource being transferred.

BC4.79 The relationship does not hold true the other way round. For some assets, such as rights over physical objects, no corresponding liability exists for another party. An asset could be an economic resource that will be used to produce economic benefits, instead of a claim requiring another party to transfer economic resources.

BC4.80 The Discussion Paper identified environmental obligations as an exception to the general principle that for every obligation, a corresponding resource exists. Some respondents questioned whether this case is an exception. They argued that there is a corresponding asset for society at large. The people living in the area have the right to receive the services required to restore their environment. The IASB agreed with this view, so the Exposure Draft identifies no exception to the general case.

Other guidance on liabilities

BC4.81 The Exposure Draft proposes to add guidance on some other matters not covered by the existing *Conceptual Framework*:

(a) that liabilities include performance obligations, such as obligations to provide services (see paragraph 4.28(d) of the Exposure Draft) and obligations to stand ready to transfer an economic resource if a specified future event occurs (see paragraph 4.27 of the Exposure Draft); and

(b) the role of 'going concern' in assessing whether an entity has a present obligation (see paragraph 4.33 of the Exposure Draft).

Executory contracts (paragraphs 4.40–4.42)

BC4.82 The existing *Conceptual Framework* comments:

> 4.46 ... In practice, obligations under contracts that are equally proportionately unperformed (for example, liabilities for inventory ordered but not yet received) are generally not recognised as liabilities in the financial statements. However, such obligations may meet the definition of liabilities and, provided the recognition criteria are met in the particular circumstances, may qualify for recognition. In such circumstances, recognition of liabilities entails recognition of related assets or expenses.

BC4.83 The Discussion Paper suggested that the IASB could improve the *Conceptual Framework* by clarifying that:

(a) in principle, a net asset or a net liability arises under an executory contract if the contract is enforceable.

(b) however, if the contract was priced on arm's length terms, the initial measurement of that contract would typically be zero, because the rights of one party have the same value as its obligations to the other party. Accordingly, usually neither party recognises a net asset or a net liability at contract inception. After contract inception, one or both parties may need to recognise its asset or liability, depending on the measurement basis applied.

(c) the nature of the purchaser's rights and obligations under an executory contract may depend on the circumstances:

(i) in some cases, the purchaser may have a single net right, or a single net obligation, to exchange the underlying asset and the purchase price simultaneously. Often, that net right or net obligation would be measured at zero.

(ii) in other cases, the purchaser may have a separate gross right to receive the asset and a separate gross obligation to pay the purchase price. In practice, such rights and obligations are sometimes offset, ie presented as a single net amount.

BC4.84 Respondents who commented on this part of the Discussion Paper generally welcomed the proposal to improve the discussion of the concepts underlying the accounting for executory contracts. However, some respondents thought that the proposed guidance appeared to focus too much on rationalising current practice, and that the underlying concepts would have to be clearer and more fully developed.

BC4.85 The IASB notes that an entity's rights and obligations under an executory contract are highly interdependent:

(a) the entity's right to receive one resource is conditional on it fulfilling its obligation to transfer the other resource, and its obligation to transfer the other resource is conditional on it receiving the first resource.

(b) when the parties perform their obligations, there is only a net inflow or outflow of resources: each party transfers one resource but receives another resource in exchange. This is the case even if the parties perform their obligations at different times: when the first party transfers one resource (the first underlying resource), it simultaneously receives another resource (a right to receive the second underlying resource from the second party).

BC4.86 In some cases, a court may enforce 'specific performance' of a contract—ie the court may rule that a party in breach of its obligations must perform those obligations instead of paying compensation or penalties. However, even in these cases, the court would not typically enforce performance by one of the parties without also enforcing performance by the other party.

BC4.87 The IASB therefore concluded that an executory contract contains a right and an obligation to exchange economic resources, instead of a right to receive one economic resource and an obligation to transfer another economic resource.

BC4.88 The IASB considered whether the right and obligation to exchange economic resources could give rise to both a separate asset (a right to exchange resources, equivalent to a purchased option) and a separate liability (the obligation to exchange resources, equivalent to a written option).

BC4.89 A purchased option to exchange economic resources gives the holder the right either to make an exchange (for example, if it turns out to be favourable) or to withdraw from the exchange without penalty (for example, if it turns out to be unfavourable). Conversely, the issuer of the written option undertakes the obligation to make the exchange, if the holder exercises its right. However, if an entity is both the holder of an option and the issuer of an option for the same underlying exchange of economic resources, then:

(a) the entity's right under its purchased option to withdraw from the exchange is negated by its obligation to exchange if the counterparty exercises its right under the entity's written option; and

(b) the counterparty's right under the entity's written option to withdraw from the exchange is negated by its obligation to exchange if the entity exercises its right under its purchased option.

BC4.90 Consequently, if an entity is both the holder of an option and the issuer of an option for the same underlying exchange, then neither party has the right to avoid exchanging economic resources. It follows that for an executory contract, there is only one outcome under the terms of the contract—the exchange will occur. Moreover, the entity's right and obligation to exchange economic resources are so interdependent that they cannot be separated. Hence, the contract cannot be decomposed into more than a single asset or liability. If the exchange is on terms that are favourable, the contract is an asset; if it is on terms that are unfavourable, it is a liability.

BC4.91 Some may ask how this conclusion relates to the treatment of assets and liabilities arising under a lease contract or to trade date accounting for financial assets:

(a) as explained in the Basis for Conclusions on the 2013 Exposure Draft *Leases*, a lease contract is no longer an executory contract once the lessor has delivered the right-of-use asset to the lessee. The lessor has performed its obligation and the contract is no longer a contract to exchange resources. The lessee controls the right-of-use asset and has a liability for the lease payments.

(b) IFRS 9 *Financial Instruments* permits 'trade date accounting' for a 'regular way' purchase or sale of a financial asset. This treats the financial asset as having already been delivered at the commitment (trade) date, instead of accounting for the purchase or sale contract as a derivative until settlement. IFRS 9 permits trade date accounting as a simple and practical method of managing and recording transactions that have only a short duration. In other words, its acceptance results from considering the cost constraint, ie from considering the relative costs and benefits of trade date accounting and settlement date accounting (the other permitted treatment). The IASB has no plans to reconsider the use of trade date accounting.

BC4.92 In many cases in current practice, an asset or a liability is not recognised for an executory contract. The IASB expects that this will continue to be the case. The same measurement considerations that apply to all other assets and liabilities (see Chapter 6) apply also to the single asset or liability that arises from an executory contract. When a historical cost measurement is applied to an executory contract, the contract is measured at zero (which has the same practical effect as not recognising the contract) unless it is onerous. For example, the historical cost of an executory contract for the purchase of inventories is zero (assuming no transaction costs) unless the contract is onerous. To achieve consistency with the existing requirements in IAS 2 *Inventories*, that contract would be regarded as onerous if the contractual price payable for the inventory exceeded its net realisable value.

Equity (paragraphs 4.43–4.47)

BC4.93 The existing *Conceptual Framework* defines liabilities and equity. However, existing Standards do not apply the definitions consistently. These inconsistent requirements result in economically similar items being classified differently, with very different accounting outcomes. For example, subsequent changes in the carrying amount of a claim against the entity are income or expenses if the claim is classified as a liability, but are not income or expenses if the claim is classified as equity. In addition, existing Standards generally require more information about items classified as liabilities than about items classified as equity.

BC4.94 The Discussion Paper suggested that the *Conceptual Framework* should:

(a) retain the existing definition of equity as the residual interest in the assets of the entity after deducting all its liabilities; and

(b) state that the IASB should use the definition of a liability to distinguish liabilities from equity.

BC4.95 Many respondents to the Discussion Paper supported using the definition of a liability to distinguish liabilities from equity. Others supported different approaches that would:

(a) eliminate the distinction between liabilities and equity; or

(b) define equity directly and introduce a new element of financial statements—claims that are neither liabilities nor equity.

BC4.96 The inherent limitation of a distinction between liabilities and equity is that it attempts to make a single, binary distinction between claims that have various characteristics in varying degrees. Eliminating the distinction and defining a single element for claims would allow the accounting for each item to be determined individually to depict its specific characteristics. However, the IASB agrees with respondents who stated that, unless all claims are measured directly, any approach would need to identify at least one residual class of claim that would be measured indirectly by reference to the carrying amounts of assets and liabilities. Moreover, it is not possible to measure all claims directly without valuing the entire entity, which goes beyond the stated objective of general purpose financial reports. Thus, dividing claims into at least two categories is unavoidable.

BC4.97 Defining equity directly and introducing another element (a third class of claim) may better depict claims that have some characteristics of both liabilities and equity. However, introducing another element would make the classification and resulting accounting more complex. In addition, it would be necessary to determine whether changes in this third class of claim should meet the definition of income or expenses. Furthermore, an outcome similar to introducing a new element could be achieved by simply introducing a new subclass within liabilities or equity.

BC4.98 Thus, the Exposure Draft:

(a) continues to make a binary distinction between liabilities and equity;

(b) continues to define equity as the residual interest in the assets of the entity after deducting all its liabilities; and

(c) continues to allow the separate presentation of different classes and categories of equity to provide useful information to users.

BC4.99 Although they supported using a definition of a liability to distinguish between liabilities and equity, some respondents questioned whether useful information would result from using the definition suggested in the Discussion Paper to classify claims that have characteristics of both liabilities and equity. That definition focused solely on whether the reporting entity has a present obligation to transfer any of its own economic resources. In particular, they questioned whether it would be appropriate to classify:

(a) as equity, an obligation to deliver a variable number of equity instruments equal to a specified amount (ie when an entity uses its own shares as 'currency'); and

(b) as a liability, an obligation to transfer a variable amount of cash or other economic resources equal to the value of an equity instrument.

BC4.100 In addition, the Discussion Paper suggested that, if all claims against an entity meet the proposed definition of a liability, it may be appropriate to treat the most subordinate class of instruments as if it were equity, with suitable disclosure. Some respondents did not support that suggestion. They objected to including in the *Conceptual Framework* such an exception to the definition of a liability. Others, particularly co-operatives and limited liability partnerships that issue puttable or redeemable instruments, supported the suggestion, but opposed describing it as an exception.

BC4.101 The IASB will further explore how to distinguish between liabilities and equity in its Financial Instruments with Characteristics of Equity research project. That research project:

(a) will consider various approaches to distinguishing between liabilities and equity, including approaches that could require changes to the definitions of a liability or equity in the *Conceptual Framework*. The IASB will use the output from that project when it decides, in due course, whether to add to its active agenda a project to amend the relevant Standards, the *Conceptual Framework*, or both. Any decision to start an active project would require the IASB to go through its normal due process for adding a project to its agenda.

(b) is unlikely to result in changes to the proposals in the Exposure Draft that focus on identifying whether the reporting entity has a present obligation to transfer an economic resource. Those proposals are not designed to address problems in distinguishing between liabilities and equity.

BC4.102 The Discussion Paper also explored potential enhancements to the statement of changes in equity to illustrate how entities could provide useful information about claims classified as equity, and to emphasise that classifying a claim as a liability is not the only way to provide useful information about that claim.

BC4.103 Many users and other respondents to the Discussion Paper supported the idea of providing additional information on the effects of different classes of equity claim, although not necessarily by enhancing the statement of changes in equity. The Exposure Draft does not propose such enhancements, although the IASB may explore such enhancements as part of its Financial Instruments with Characteristics of Equity research project.

Income and expenses (paragraphs 4.48–4.52)

BC4.104 Paragraphs BC4.2–BC4.3 explain why the IASB proposes to continue with the existing approach of defining income and expenses in terms of changes in assets and liabilities. No major problems have been identified with the definitions of income and expenses. Hence, the only changes proposed are those necessary to make them consistent with the proposed definitions of assets and liabilities.

BC4.105 Much of the discussion of income and expenses in the existing *Conceptual Framework* relates to their presentation and disclosure. Presentation and disclosure are discussed in Chapter 7 of the Exposure Draft. The rest of the existing discussion refers to various types of income and expenses; for example, revenue, gains and losses. That material has not been included in the Exposure Draft. The IASB thinks that it was originally included to emphasise that income includes revenue and gains and expenses include losses. The IASB thinks that emphasis is now unnecessary and the implication that the *Conceptual Framework* defines subclasses of income and expenses is unhelpful. The IASB does not expect the removal of that material to cause any changes in practice. The terms 'revenue', 'gains' and 'losses' are used in the Exposure Draft only in examples.

Other possible elements

BC4.106 The Discussion Paper suggested that it may be helpful for the *Conceptual Framework* to define elements for the statement of cash flows and the statement of changes in equity, but did not suggest any wording for the definitions. The elements suggested were:

(a) in the statement of changes in equity—contributions of equity, distributions of equity and transfers between classes of equity; and

(b) in the statement of cash flows—cash inflows (cash receipts) and cash outflows (cash payments).

BC4.107 Respondents were divided on whether to add such definitions to the *Conceptual Framework*. Those in favour of introducing contributions to equity, distributions of equity and transfers between classes of equity as new elements argued that:

(a) the existing definitions of income and expenses refer to changes in assets and liabilities, excluding those resulting from contributions from equity participants and distributions to equity participants. It may be confusing, and arguably is conceptually inconsistent, to define one type of movement as an element if that definition refers to another type of movement that is not identified explicitly as an element.

(b) there is lack of clarity about the distinction between income (expenses) and contributions (distributions). Explicit clarification in the *Conceptual Framework* may help.

(c) defining these items as elements is consistent with the FASB's *Conceptual Framework*.

BC4.108 The arguments against are:

(a) it may be difficult to create a clear definition without making significant amendments to the definitions of income and expenses.

(b) the absence of a definition of contributions of equity and distributions of equity has not caused major problems.

(c) the Discussion Paper suggested making the statement of changes in equity more prominent. Defining these elements was one part of this suggestion. However, the Exposure Draft does not include that suggestion (see paragraph BC4.103). Thus, defining contributions and distributions of equity may not provide great benefits.

BC4.109 The key argument in favour of defining elements for the cash flow statement is that it would emphasise the importance of cash flow information. The arguments against doing so are that:

(a) defining elements of cash flows may have unintended consequences and would not solve any known practical problem.

(b) defining elements of cash flows would imply that all entities should produce a statement of cash flows. Some argue that, as currently structured, cash flow statements do not provide useful information in the case of financial institutions. The IASB is researching the use of the statement of cash flows. Until that research is complete, it would be premature to consider whether to define elements for cash flow statements.

(c) the most obvious definitions of elements of cash flows may imply a preference for the direct method. It would not be appropriate to embed such a preference in the *Conceptual Framework* without conducting further research. (The IASB has no current plans to consider the introduction of a requirement for a direct cash flow statement.)

BC4.110 The IASB concluded that the disadvantages of defining elements for the statement of changes in equity and the statement of cash flows outweigh the advantages and, hence, proposes no such definitions.

Reporting the substance of contractual rights and obligations (paragraphs 4.53–4.56)

BC4.111 As explained in paragraphs BC2.18–BC2.20, the Exposure Draft proposes that, to provide a faithful representation of an economic phenomenon, an entity should report the substance of that phenomenon, not merely its legal form. The Exposure Draft also proposes concepts for reporting the substance of contractual rights and obligations. Those concepts already underlie requirements and guidance in several Standards. The IASB thinks that including the underlying concepts in the *Conceptual Framework* would help to ensure that these concepts are applied more consistently. The concepts proposed in the Exposure Draft are the same as those proposed in the Discussion Paper. Most responses on this matter supported the proposal to include concepts and agreed with the specific concepts proposed.

Unit of account (paragraphs 4.57–4.63)

BC4.112 The unit of account is the group of rights, the group of obligations or the group of rights and obligations to which recognition and measurement requirements are applied.

BC4.113 The Discussion Paper suggested that selecting a unit of account would be a Standards-level decision, not a decision that can be resolved conceptually for a broad range of Standards.

BC4.114 Many of those respondents who commented on this issue stated that they agreed that the selection of a unit of account should be a Standards-level decision. However, some respondents stated that the *Conceptual Framework* should provide more detailed discussion on this topic.

BC4.115 Having considered the comments from respondents, the IASB continues to believe that selecting a unit of account should be a Standards-level decision. The unit of account is driven by decisions about recognition and measurement: those decisions are made in developing Standards and, hence, so will be the decision about the unit of account. The IASB has included in the Exposure Draft a discussion on the issue, including examples of possible units of account and the factors that could determine which unit of account to use. The IASB proposes not to rank the factors by priority, because their relative importance depends on the specific features of the item that the entity is accounting for. No single ranking could determine the most useful unit of account consistently for a broad range of Standards.

BC4.116 Selecting a unit of account is not the same issue as:

(a) determining that an executory contract creates a single asset or liability. In an executory contract, the right to exchange and the obligation to exchange are not separable (see paragraphs BC4.82–BC4.92) and, hence, they cannot form separate units of account.

(b) offsetting. The question of offsetting arises after recognition and measurement have been applied to identified units of account for both an asset and a liability.

Chapter 5—Recognition and derecognition

Recognition process (paragraphs 5.2–5.8)

BC5.1 The existing *Conceptual Framework* defines recognition as follows:

> Recognition is the process of incorporating in the balance sheet or income statement an item that meets the definition of an element and satisfies the criteria for recognition set out in paragraph 4.38 [of the existing *Conceptual Framework*]. It involves the depiction of the item in words and by a monetary amount and the inclusion of that amount in the balance sheet or income statement totals.[13]

BC5.2 There are three minor problems with this existing definition:

(a) most items are depicted by including them in line items, not by depicting them individually.

(b) the cross-reference to the recognition criteria is unnecessary. It also means that the definition would not be met if recognition criteria in a particular Standard are inconsistent with the recognition criteria in the *Conceptual Framework*.

(c) the terminology is out of date. For example, it refers to the balance sheet instead of the statement of financial position.

BC5.3 To address these minor points, the Exposure Draft adapts the existing definition to read as follows:

> Recognition is the process of capturing, for inclusion in the statement of financial position or statement(s) of financial performance, an item that meets the definition of an element. It involves depicting the item (either alone or as part of a line item) in words and by a monetary amount, and including that amount in the relevant statement.

BC5.4 The IASB also proposes to explain in the *Conceptual Framework* how recognition links the statement of financial position and the statement(s) of financial performance.

Recognition criteria (paragraphs 5.9–5.24)

Existing requirements

BC5.5 The recognition criteria in the existing *Conceptual Framework* state that an entity recognises an item that meets the definition of an element if:

(a) it is probable that any future economic benefit associated with the item will flow to or from the entity; and

(b) the item has a cost or value that can be measured with reliability.

BC5.6 In addition, as with all other aspects of the existing *Conceptual Framework*, the cost constraint applies. Thus, an asset or a liability is not recognised if the benefits of recognition do not justify the costs.

13 See paragraph 4.37 of the existing *Conceptual Framework*.

BC5.7 The existing criteria have caused some problems, which are discussed in the following paragraphs.

Problems with probability criterion

BC5.8 Some existing Standards do not apply a probability recognition criterion, for example, IFRS 9 *Financial Instruments*. Those that do apply such a criterion use different probability thresholds. These include 'probable', 'more likely than not', 'virtually certain' and 'reasonably possible'. The use of the different terms indicates a lack of consistency in the meaning attached at the Standards-level to the term probable used in the *Conceptual Framework*.

BC5.9 Some have argued that a probability recognition criterion could prevent the recognition of some financial instruments, for example, derivatives. Moreover, it could sometimes result in a gain being recognised for a transaction when no economic gain has occurred. For example, suppose that, in exchange for receiving cash, an entity incurs a liability to pay a fixed amount if some unlikely event occurs in the future. If an outflow of economic benefits is not considered probable, the entity will recognise an immediate gain when it receives the cash.

Problems with reliable measurement criterion

BC5.10 Using reliable measurement as a criterion could be confusing because reliability is not identified as a qualitative characteristic (see paragraphs BC2.21–BC2.25). In practice, the criterion seems to have been interpreted as relating to measurement uncertainty. Hence, a broadly similar result can be achieved by acknowledging that, in some cases, the level of measurement uncertainty can affect the relevance of the information provided by recognising a particular asset or liability (see paragraphs BC5.41–BC5.45).

Approach in the Discussion Paper

BC5.11 The Discussion Paper suggested that the discussion of whether to recognise an asset or a liability should refer directly to the qualitative characteristics of useful financial information. Accordingly, an entity would recognise all its assets and liabilities, unless the IASB decides when developing 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 both of the asset (or the liability) and of the changes in the asset (or the liability), even if all necessary descriptions and explanations are disclosed.

BC5.12 The Discussion Paper also suggested that the *Conceptual Framework* should list the following indicators explaining when recognition may produce information that does not possess those qualitative characteristics:

(a) if the range of possible outcomes is extremely wide and the likelihood of each outcome is exceptionally difficult to estimate;

(b) if an asset (or a liability) exists, but there is only a low probability that an inflow (or outflow) of economic benefits will result;

(c) if identifying a resource or obligation is unusually difficult;

(d) if measuring a resource or obligation requires unusually difficult or exceptionally subjective allocations of cash flows that do not relate solely to the item being measured; and

(e) if recognising an asset (in particular, internally generated goodwill) is not necessary to meet the objective of financial reporting.

Responses to the Discussion Paper

BC5.13 Some respondents believed that the suggestions in the Discussion Paper were intended to increase the range of assets and liabilities recognised and expressed concerns about that outcome. However, in developing the Discussion Paper, and subsequently the Exposure Draft, the IASB's aim has been solely to develop tools that enable it to take decisions based on a more coherent set of principles, which result in useful information. The IASB has not had, and does not have, an objective of either increasing or decreasing the range of assets and liabilities recognised, although the proposed guidance on the definition of a liability might broaden slightly the population of items identified as meeting that definition.

BC5.14 With regard to the overall direction, some respondents favoured recognising all, or almost all, assets and liabilities:

(a) a few respondents suggested that an entity should recognise all its assets and liabilities, with no exceptions. They argued that this would promote completeness, comparability, consistency and conceptual integrity in financial reporting.

(b) a few other respondents suggested that the *Conceptual Framework* should not provide for departures from the general principle that an entity should recognise all assets and liabilities. If limited exceptions are needed, they could be developed in particular Standards by referring to the qualitative characteristics of useful financial information.

(c) some respondents suggested that the *Conceptual Framework* should establish a rebuttable presumption that all assets and liabilities should be recognised. They indicated that recognition would generally result in the most relevant information.

BC5.15 However, most respondents believed that it is neither relevant nor feasible for an entity to recognise all of its assets and liabilities and that the *Conceptual Framework* should acknowledge this:

(a) some respondents felt that recognition should occur only when there is clear evidence that it provides a relevant and faithful representation. The concerns of those respondents centred on particular items, such as some litigation liabilities and some intangible assets, for which they viewed recognition as inappropriate. They also expressed a wish to avoid any requirements that could result in a time-consuming and costly search to identify all possible assets and liabilities.

(b) others argued that the *Conceptual Framework* should provide criteria for when to recognise assets and liabilities, because:

(i) delegating these decisions to specific Standards may lead to inconsistencies between Standards and create rules instead of principles.

(ii) such criteria would assist preparers and others who need guidance to help them decide when to recognise an asset or a liability that no Standard covers. The use of these criteria by parties other than the IASB should cause no concerns, because the *Conceptual Framework* does not override recognition criteria in Standards.

BC5.16 The IASB concluded that the *Conceptual Framework* should take an even-handed approach to recognition, with neither:

(a) a presumption that all assets and liabilities should be recognised; nor

(b) a presumption that assets and liabilities should be recognised only if they meet stringent criteria.

Instead, the *Conceptual Framework* should simply set out criteria based on the qualitative characteristics and describe the factors that drive recognition decisions.

BC5.17 Many respondents to the Discussion Paper agreed that:

(a) the approach to recognition should refer to relevance and faithful representation;

(b) the *Conceptual Framework* should acknowledge that significant uncertainty and significant measurement difficulties may undermine relevance and make it difficult to provide a faithful representation; and

(c) the cost constraint should play a role in recognition decisions.

BC5.18 Respondents who commented on recognition were evenly divided on how best to refer to relevance and faithful representation and how best to acknowledge the effects of significant uncertainty and significant measurement difficulties:

(a) some favoured retaining one or both of probability and reliability of measurement as explicit recognition criteria. They argued that such criteria are suitable filters to be used in practice for identifying cases in which recognition is not likely to provide information that possesses the qualitative characteristics of useful financial information. There were considerably more requests to retain an explicit probability criterion than requests to retain an explicit reliability criterion.

(b) others favoured the approach suggested by the Discussion Paper, namely to refer more directly to the qualitative characteristics and supplement this by guidance.

BC5.19 Proponents of using probability and reliability as practical filters argued that these criteria would be clearer, more robust and less judgemental than the approach suggested in the Discussion Paper. Some feared that the lack of robust criteria would result in broader, and excessive, recognition of assets and liabilities.

BC5.20 The IASB continues to think that referring directly to the qualitative characteristics of useful financial information is appropriate. Basing recognition criteria on the qualitative characteristics should result in useful information. Nevertheless, the IASB thinks that merely referring directly to the qualitative characteristics, without providing supporting guidance, could lead to inconsistent recognition decisions at the Standards level.

BC5.21 Paragraph 5.9 of the Exposure Draft sets out the IASB's proposed recognition criteria, which refer to:

(a) relevance (see paragraphs BC5.22–BC5.45);

(b) faithful representation (see paragraphs BC5.46–BC5.47); and

(c) the cost constraint (see paragraph BC5.48).

Relevance (paragraphs 5.13–5.21)

BC5.22 The guidance supporting the proposed recognition criteria lists the following indicators to help in identifying some of the cases when recognising an asset or a liability may not provide users of financial statements with relevant information:

(a) if it is uncertain whether the asset exists, or is separable from goodwill, or whether a liability exists (see paragraphs BC5.25–BC5.35);

(b) if an asset or a liability exists, but there is only a low probability that an inflow or outflow of economic benefits will result (see paragraphs BC5.36–BC5.40); or

(c) if a measurement of an asset or a liability is available (or can be obtained) but the level of measurement uncertainty is so high that the resulting information has little relevance and no other relevant measure is available or can be obtained (see paragraphs BC5.41–BC5.45).

Those indicators cover some (but not necessarily all) cases in which the recognition criteria in the existing *Conceptual Framework* might have led to a conclusion that a flow is not probable or that reliable measurement is not possible.

BC5.23 The indicators are derived from indicators suggested by the Discussion Paper (see paragraph BC5.12). Some respondents stated that:

(a) it would be useful to explain how the qualitative characteristics might be applied in recognition, but that indicators are not necessary to achieve this.

(b) the indicators, and supporting examples illustrating how the indicators might be applied, do not provide concepts. The *Conceptual Framework* should contain clear concepts.

BC5.24 Other respondents stated that such indicators are essential to make the recognition criteria sufficiently robust. The IASB continues to agree with that view. However, to avoid providing Standards-level detail, the IASB has deleted the specific examples that the Discussion Paper had provided as illustrations of how the indicators might be applied.

Existence uncertainty (paragraphs 5.15–5.16)

BC5.25 The definitions of assets and liabilities allow for uncertainty about whether the inflows or outflows of economic benefits will ultimately occur (see paragraphs BC4.11–BC4.17). But there could also be uncertainty over the existence of an asset or a liability.

BC5.26 Feedback on the Discussion Paper's discussion on existence uncertainty focused on:

(a) whether to distinguish existence uncertainty from outcome uncertainty (see paragraphs BC5.27–BC5.31); and

(b) whether the *Conceptual Framework* should address existence uncertainty (see paragraphs BC5.32–BC5.34).

BC5.27 Several respondents commented explicitly that it is useful to differentiate between existence uncertainty and outcome uncertainty. Doing so would clarify how to deal with both types of uncertainty.

BC5.28 Other respondents stated that it can be difficult to distinguish the two types of uncertainty. They often occur together and hence need to be dealt with together.

BC5.29 In the IASB's view, it is helpful to distinguish existence uncertainty from outcome uncertainty. Making this distinction makes it easier to decide what information is most likely to be relevant to users of financial information and how to provide the most faithful and understandable representation of that information. Outcome uncertainty affects many assets and liabilities. Although outcome uncertainty does not always cause measurement uncertainty, it may sometimes contribute to measurement uncertainty. It could therefore affect decisions about recognition and the selection of a measurement basis. Existence uncertainty, on the other hand, may be a separate factor to consider for decisions about recognition.

BC5.30 The Discussion Paper stated that existence uncertainty is rare. Several respondents disagreed with this statement. They supplied the following examples of existence uncertainty:

(a) litigation. Several respondents feared that if the *Conceptual Framework* does not retain a probability threshold that could apply for existence uncertainty, this may lead to the inappropriate recognition of liabilities for actual or potential claims under lawsuits.

(b) constructive obligations, because there is no contract or legislation that establishes the liability.

(c) cases in which there is some doubt whether an entity controls a resource.

(d) items acquired or incurred in non-monetary exchange transactions.

BC5.31 Although the vast majority of assets and liabilities are not typically subject to existence uncertainty, the IASB agrees that existence uncertainty is not rare so that statement is not included in the Exposure Draft.

BC5.32 Several respondents agreed with the suggestion in the Discussion Paper that the *Conceptual Framework* should not set a probability threshold for cases in which it is uncertain whether an asset or a liability exists. The IASB could decide how to deal with that uncertainty when the IASB develops or revises a Standard on that type of asset or liability.

BC5.33 Some respondents disagreed, stating that the *Conceptual Framework* should explain explicitly how to approach recognition when asset or liability existence is uncertain. They argued that:

(a) deciding how to deal with existence uncertainty should be principle-based and should not vary by transaction. Dealing with existence uncertainty in individual Standards could lead to an unnecessary proliferation of Standards and inconsistencies.

(b) preparers need guidance for assets and liabilities that no Standard covers.

BC5.34 The Exposure Draft lists uncertainty over whether an asset or a liability exists as one of the indicators that may lead to a conclusion that recognition of that asset or liability may not produce relevant information. The IASB believes that it would not be useful to provide more detailed guidance on how to address existence uncertainty, because the relevant factors are likely to depend very much on particular circumstances.

Separability from goodwill

BC5.35 The Discussion Paper stated that, because the recognition of internally generated goodwill would require a valuation of the entity as a whole, its recognition is unnecessary to meet the objective of financial reporting. Although the IASB continues to believe that this statement is valid, the Exposure Draft does not include this case as an indicator that recognition might not result in relevant information. The IASB agrees with those respondents who argued that such an indicator is not useful because it applies only to internally generated goodwill. However, the IASB concluded that difficulty in assessing whether an asset exists separately from the business as a whole (that is whether there is an asset distinct from goodwill) is a factor that could indicate that recognition of the asset would not provide relevant information.

Low probability of a flow of economic benefits

BC5.36 As noted, the existing *Conceptual Framework* includes a probability-based recognition criterion. The Discussion Paper suggested that this should be removed and many respondents agreed. They argued that:

(a) it would not be possible to construct probability thresholds that result in useful information for all types of assets and liabilities. The *Conceptual Framework* should not include probability thresholds, but should give guidance on how to construct probability thresholds and recognition criteria at a Standards level. This guidance could explain when recognition is unlikely to be appropriate and how uncertainty affects relevance and reliability.

(b) many uncertainties relate to measurement and can be dealt with by choosing an appropriate measurement basis.

(c) a probability threshold has a disproportionate effect when an item crosses the threshold. The economic change that causes the item to cross the threshold may be small, but the resulting accounting effect could be large.

(d) any thresholds set by the IASB will prevent management from considering carefully how to present relevant information. Management should apply materiality and a higher threshold for recognising assets than for liabilities.

BC5.37 Many other respondents argued that the recognition criteria should continue to refer to probability. They argued that:

(a) probability has a significant effect on whether information is capable of faithful representation and also on whether it is relevant. The probability criterion provides a practical and inexpensive way to filter out assets and liabilities with low probability, which are not relevant to users and are costly for preparers to identify and measure.

(b) recognising assets and liabilities that have a low probability of generating inflows or outflows of economic benefits would:

    (i) produce information that is not relevant to users and is complex and hard to understand. For example, it could result in a multitude of items being recognised at small amounts or lead to frequent reversals in subsequent periods when the inflow or outflow does not occur.

    (ii) require costly, and perhaps complex systems, involve significant management time and judgement and lead to an endless search for potential rights and obligations.

    (iii) lead to wider, and excessive, use of measurements based on expected value techniques, and of fair value measurements. Disclosures are sometimes more useful than a measure that uses weighted averages or fair value. Such measures provide an illusion of 'precision' that does not exist.

    (iv) intensify measurement problems, because measurement may be sensitive to small changes in probability estimates.

(c) retaining a probability threshold within the recognition criteria in the *Conceptual Framework* may lead to more consistent recognition decisions in Standards.

(d) the Discussion Paper overstates the range of assets and liabilities that would be filtered from recognition by the existing probable criterion. For example, for an obligation to provide a service of standing ready to meet any insurance or warranty claim by a customer, the economic resource transferred is the service provided, not the payment or receipt of cash that may or may not occur ultimately.

BC5.38 Some respondents suggested applying a probability filter for some assets or liabilities, but not for all. For example:

(a) a probability filter may be necessary for non-financial assets with uncertain benefits, such as patents and research and development. For these items, it is doubtful whether multiplying the estimated chance of success by the estimated pay-off would provide a meaningful figure or more reliable information than providing information in the notes. Moreover, for these items, it may not be possible to make reasonable estimates of the probabilities of each outcome. On the other hand, a probability filter could inappropriately exclude assets such as options or other financial instruments for which a market price is available or for which well-developed measurement models exist.

(b) in considering whether to use a probability filter in a particular case, relevant factors could include whether there is a large number of similar objects (for example, product warranties) or a single object (for example, a single large lawsuit) and the uncertainty in the probability amount of each outcome.

(c) it is not reasonable to remove the probability requirement from the recognition criteria simply to permit the recognition of some financial instruments. In such cases, it is only necessary to stipulate an exception for particular financial instruments in a particular Standard.

BC5.39 The IASB acknowledges that a probability threshold could be a practical way to filter out assets and liabilities whose recognition would not provide relevant information. However, an explicit, specified probability threshold is not sufficiently aligned with the concept (relevance) that it is supposed to achieve. Too many assets and liabilities would not be recognised when recognition would have provided relevant information. The IASB also noted that the measure of any recognised asset or liability with a low probability of an inflow or outflow would be likely to reflect that low probability—it is unlikely that a required measurement basis would reflect only the maximum inflow or outflow.

BC5.40 Hence, the Exposure Draft does not propose a specific probability threshold. Instead, low probability is noted in the Exposure Draft as an indicator that recognition may sometimes not provide relevant information, for reasons discussed in paragraphs 5.17–5.19 of the Exposure Draft.

Measurement uncertainty and reliability

BC5.41 The recognition criteria in the existing *Conceptual Framework* state that an entity recognises an asset or a liability only if it has a cost or value that can be measured with reliability.

BC5.42 As previously noted, the Discussion Paper suggested that reliability should no longer be a recognition criterion. Many respondents did not comment explicitly on reliability. However, some respondents explicitly opposed the retention of reliable measurement as a recognition criterion. They felt that it may inappropriately preclude the recognition of some assets and liabilities that are subject to considerable measurement uncertainty, such as pension liabilities and insurance liabilities.

BC5.43 In contrast, other respondents suggested retaining reliability of measurement as an explicit recognition criterion. They provided the following arguments, which focused on cases of high measurement uncertainty:

(a) including unreliable estimates would obscure financial performance, confuse users, undermine their trust in financial statements and pollute the whole communication process, even if estimation uncertainty is disclosed in footnotes. Disclosures cannot compensate for large margins of errors in measurement. Moreover, disclosures about estimation uncertainty would contribute to disclosure overload.

(b) some elements of reliability exist in relevance and faithful representation. However, reliability would provide a more understandable and operational basis for determining whether assets and liabilities should be recognised.

(c) reliability is as important as relevance, and there is a trade-off between them. Consequently, if relevance is used as a recognition filter, then so should be reliability. Reliable information may not always be relevant, and relevant information may not always be reliable.

(d) reliability is a key element of faithful representation. No measure will result in a faithful representation if it is not capable of reliable measurement.

(e) recognition of items measured with a high degree of estimation uncertainty adds costs and complexity for preparers and results in information that is difficult to audit.

(f) if reliability is replaced as a recognition criterion by faithful representation (defined as complete, neutral and free from error), anything could be recognised. This is because any estimate, however uncertain, could be faithfully represented if supported by sufficient disclosure about the estimation process.

(g) although the *Conceptual Framework* no longer defines reliability as a qualitative characteristic, there is no reason why the recognition criteria cannot still use that term.

BC5.44 The IASB proposes in the Exposure Draft not to retain reliability as a recognition criterion, because:

(a) the concerns expressed by some respondents about the removal of 'reliability' as a recognition criterion appear to relate mainly to concerns about measurement uncertainty. Paragraph QC16 of the existing *Conceptual Framework* already captures the idea that an estimate might not provide relevant information if the level of uncertainty in the estimate is too high. The IASB proposes to make this idea more visible (see paragraphs 2.12–2.13 and BC2.21–BC2.25). The IASB also proposes that measurement uncertainty should be discussed as an indicator that recognition may not provide relevant information.

(b) the former notion of a trade-off between relevance and reliability still exists, but is now captured by a trade-off within relevance itself. As explained in paragraphs 2.13 and BC2.24(c), there is sometimes a trade-off between measurement uncertainty (which is a factor that affects relevance) and other factors that also affect relevance.

BC5.45 Some respondents to the Discussion Paper suggested that more measurement uncertainty is tolerable when recognising expenses than when recognising income. They described this as an application of asymmetric prudence (applying the terminology in paragraph BC2.6), not cautious prudence. The IASB thinks that the level of measurement uncertainty that makes a measure lose relevance depends on the circumstances and can be determined only when developing specific Standards. Hence, the *Conceptual Framework* neither requires nor prohibits a symmetrical approach that would set the same level of measurement uncertainty as being tolerable for the recognition of both income and expenses.

Faithful representation (paragraphs 5.22–5.23)

BC5.46 The Discussion Paper suggested that faithful representation could be used as a recognition criterion (see paragraph BC5.11). A few respondents commented on this:

(a) the recognition criteria need not refer separately to faithful representation. There are no circumstances when recognising an asset or a liability would provide information that is relevant but yet could not result in a faithful representation of that asset or liability and of changes in that asset or liability, given adequate disclosure.

(b) if measurement uncertainty is part of relevance, not of faithful representation, it is not clear what faithful representation means. The Discussion Paper included no examples of measurements that are not faithful representations of assets or changes in assets.

(c) the Discussion Paper suggested that one case in which information is not relevant (or does not give a faithful representation of what it is trying to depict) is if it is incomplete or hard to understand; for example, if related assets and liabilities are not recognised. The answer is to produce complete information in an understandable form, not to omit the item.

BC5.47 The IASB continues to think that faithful representation is a necessary factor to consider when deciding whether to recognise an element. In particular, problems may arise in giving a faithful representation of a transaction or other event when some of the assets or liabilities affected by the transaction or other event are not recognised. Partial recognition of the effects of the transaction or other event (ie the effect only on the recognised assets and liabilities) may give a misleading depiction of the effect of the transaction.

Cost constraint (paragraph 5.24)

BC5.48 Paragraph BC2.33 explains why there is an explicit reference to the cost constraint in the chapter on recognition.

Derecognition (paragraphs 5.25–5.36)

BC5.49 The existing *Conceptual Framework* does not define derecognition, nor does it describe when derecognition should occur. Because there is no agreed conceptual approach to derecognition, different Standards have adopted different approaches.

BC5.50 The IASB suggested in the Discussion Paper, and proposes again now in the Exposure Draft, that accounting requirements for derecognition should aim to represent faithfully both:

(a) the assets and the liabilities retained after the transaction or other event that led to the derecognition; and

(b) the changes in the assets and the liabilities as a result of the transaction or other event.

BC5.51 Achieving that twin aim is straightforward if an entity disposes of an entire asset or an entire liability and retains no exposure to that asset or liability, but can be more difficult if an entity disposes of only part of an asset or a liability or retains some exposure.

BC5.52 The following two examples illustrate some difficulties that can arise. In both examples, derecognising the asset would result in accounting that faithfully represents any asset or liability retained. However, it may sometimes misrepresent the extent of the changes in the entity's financial position:

(a) sale of receivables with recourse—suppose that an entity sells some receivables to another party, but guarantees the third party against any credit losses it may incur on the receivables. If the entity derecognises the receivables and recognises its obligation under the guarantee as a liability, that may significantly reduce the total assets and total liabilities recognised in the statement of financial position, even though the credit risk is unchanged.

(b) sale and repurchase agreement—suppose that an entity sells an asset and at the same time contracts to buy it back at a fixed price. Derecognising the asset could suggest that the entity's asset mix has changed significantly, even though the change is only temporary and will be reversed. In addition, if the asset is measured on a historical cost basis, derecognising the asset would lead to the recognition of income and expenses at the time of the original sale, and then a corresponding increase or decrease in the carrying amount of the asset when the repurchase is completed.

BC5.53 In the Discussion Paper, the IASB discussed two approaches to derecognition when the entity retains a component of the asset or the liability:

(a) a control approach—derecognition is simply the mirror image of recognition. Thus, an entity would derecognise an asset or a liability when it no longer meets the criteria for recognition (or no longer exists, or is no longer an asset or a liability of the entity).

(b) a risks-and-rewards approach—an entity would continue to recognise an asset or a liability until the entity is no longer exposed to most of the risks and rewards generated by that asset or liability. This would apply even if the remaining asset (or liability) would not qualify for recognition if acquired (or incurred) separately at the date when the entity disposed of the other components.

BC5.54 The IASB concluded in the Discussion Paper that neither approach would necessarily produce the most useful information in all circumstances. Instead, the IASB suggested that:

(a) an entity would, in most cases, achieve the twin aim described in paragraph BC5.50 by derecognising an asset or a liability when it no longer meets the recognition criteria (or no longer exists, or is no longer an asset or a liability of the entity); but

(b) if the entity retains a component of the asset or the liability, the IASB should determine, when developing particular Standards, how the entity would best portray the changes that resulted from the transaction. The Discussion Paper suggested that possible approaches for this could include:

(i) enhanced disclosure;

(ii) 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

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

BC5.55 Views of the respondents to the Discussion Paper were mixed. Some respondents favoured the control approach (possibly including risks and rewards as an indicator of control). Other respondents favoured the risks-and-rewards approach. Yet other respondents stated that the *Conceptual Framework* should discuss both approaches, including the relative merits of the approaches, and indicate when each should be used.

BC5.56 The IASB noted that it is possible to resolve some, but not all, apparent conflicts between the control approach and the risks-and-rewards approach by considering:

(a) whether a transferee acquires an asset as a principal or as an agent; and

(b) the fact that, in some cases, continuing exposure to variations in benefits (sometimes known as exposure to the significant risks and rewards of ownership) is an indicator of continuing control.

BC5.57 In the IASB's view, the control approach focuses more on the aim mentioned in paragraph BC5.50(a) and the risks-and-rewards approach focuses more on the aim mentioned in paragraph BC5.50(b). The difficulties that the IASB has encountered in practice have arisen when those two aims conflict. The IASB views both aims as valid. Accordingly, the Exposure Draft does not advocate using the control approach or the risk-and-rewards approach in all circumstances. Instead, the Exposure Draft describes the alternatives available and discusses what factors the IASB would need to consider when developing particular Standards.

BC5.58 The Discussion Paper also discussed factors that the IASB should consider in deciding which approach to use when derecognition occurs: partial derecognition (derecognise the transferred component and continue to recognise the retained component) or full derecognition (derecognise the entire asset or liability and recognise the retained component as a new asset or liability). The Exposure Draft does not discuss this aspect of derecognition, because it is closely linked to issues of determining the unit of account and selecting the measurement basis for the retained component.

Modification of contracts (5.33–5.36)

BC5.59 The Discussion Paper did not discuss how modifications of contracts would affect decisions about derecognition. As requested by some respondents to the Discussion Paper, the Exposure Draft proposes some guidance on this topic. The guidance is consistent with the sections in the Exposure Draft on the unit of account and on reporting the substance of contractual rights and obligations.

Chapter 6—Measurement

BC6.1 The existing *Conceptual Framework* provides very little guidance on measurement. The Discussion Paper discussed:

(a) how the objective of financial reporting and qualitative characteristics of useful financial information influence measurement requirements;

(b) three categories of measurement bases; and

(c) how to identify an appropriate measurement basis and the implications of the proposed approach for particular types of assets and liabilities.

BC6.2 Many respondents agreed with the overall approach to measurement suggested in the Discussion Paper. Their comments on particular aspects of that approach are discussed in the following paragraphs. However, some respondents suggested that the IASB should undertake further research on measurement and either:

(a) delay issuing a revised *Conceptual Framework* until that research is completed;

(b) issue a revised *Conceptual Framework* without a measurement section; or

(c) develop high level interim guidance on measurement for use until rigorous concepts and principles can be developed.

BC6.3 The lack of guidance on measurement is a serious gap in the existing *Conceptual Framework* and many respondents to the Discussion Paper broadly supported the suggested approach to measurement. Moreover, the IASB believes that it is not necessary or appropriate to delay all or part of the *Conceptual Framework* to undertake more research on measurement. The IASB also does not support the idea of issuing high level interim guidance. High level guidance may not be sufficient to help the IASB develop measurement requirements and could be in place for a long time.

BC6.4 Some respondents expressed the view that the measurement section of the Discussion Paper contained too much Standards-level detail. The IASB agrees with them and has removed some of that detail.

BC6.5 Accordingly, Chapter 6 of the Exposure Draft focuses on:

(a) measurement bases, the information they provide and their advantages and disadvantages (paragraphs BC6.15–BC6.37); and

(b) the factors to consider when selecting a measurement basis (paragraphs BC6.41–BC6.68).

BC6.6 Paragraphs BC6.7–BC6.14 discuss the mixed measurement basis approach proposed in the Exposure Draft.

Mixed measurement basis (paragraph 6.3)

BC6.7 When developing both the Discussion Paper and the Exposure Draft, the IASB considered whether the *Conceptual Framework* should advocate a single or default measurement basis. The main advantages of a single measurement basis are:

(a) the amounts included in the financial statements can be more meaningfully added, subtracted and compared; and

(b) a single measurement basis makes the financial statements less complex and, arguably, more understandable.

BC6.8 However, the Discussion Paper suggested that a single measurement basis for all assets, liabilities, income and expenses may not always provide the most relevant information to users of financial statements. Hence, the Discussion Paper suggested that the *Conceptual Framework* should adopt a mixed measurement basis approach.

BC6.9 Nearly all respondents to the Discussion Paper who commented on this issue agreed that a single measurement basis for all assets, liabilities, income and expenses may not provide the most relevant information to users of financial statements.

BC6.10 A few respondents disagreed with the suggestion to adopt a mixed measurement basis approach and proposed one of the following as a single or default measurement basis:

(a) historical cost;

(b) fair value;

(c) current entry value (such as current cost, see paragraph BC6.18(a)); or

(d) deprival (relief) value (see paragraph BC6.18(c)).

BC6.11 One respondent suggested that a single measurement basis could be derived if the IASB identified an ideal concept of wealth that would meet the information needs of users of financial statements.

BC6.12 Most of the respondents who suggested the use of a single measurement basis conceded that this could not be achieved in practice, at least in the short term. However, they expressed the view that the *Conceptual Framework* should aspire to a single measurement basis and that the IASB should be required to explain any decisions not to use that measurement basis.

BC6.13 When developing the Exposure Draft, the IASB noted that different information, derived from different measurement bases, may be relevant to users of financial statements in different circumstances. In addition, in particular circumstances, particular measurement bases may be:

(a) easier to understand and implement;

(b) more verifiable, less prone to error or subject to less measurement uncertainty; or

(c) less costly to implement.

BC6.14 Hence, the IASB has concluded that consideration of the objective of financial statements, the qualitative characteristics of useful information and the cost constraint is likely to result in the selection of different measurement bases for different assets and liabilities.

Measurement bases and the information they provide (paragraphs 6.4–6.47)

BC6.15 The Discussion Paper grouped measures into three categories:

(a) cost-based measures;

(b) current market prices including fair value; and

(c) other cash-flow-based measures.

BC6.16 A few respondents to the Discussion Paper stated that they found the discussion of the three different categories of measures to be confusing. In particular, it was not always clear how a particular measurement basis would be categorised. Other respondents suggested that the *Conceptual Framework* should identify only two measurement categories: cost-based measures and current measures. Cash-flow-based measures would then be identified as techniques used in estimating either a cost-based measure or a current measure.

BC6.17 The IASB agrees that:

(a) the discussion would be clearer if measurement bases were characterised as either historical cost measurement bases or current value measurement bases. Hence, the Exposure Draft describes these two categories of measurement basis. Paragraphs BC6.19–BC6.23 discuss historical cost and paragraphs BC6.24–BC6.30 discuss current value measurement bases.

(b) cash-flow-based measurement techniques are generally used to estimate the measure of an asset or a liability on a defined measurement basis. Consequently, the Exposure Draft does not identify those techniques as a separate category of measurement basis. Paragraphs BC6.31–BC6.33 discuss those techniques.

BC6.18 A few respondents to the Discussion Paper stated that the discussion of measurement bases should include more about the following areas:

(a) the use of entry and exit values. The IASB rejected the idea of categorising measurement bases according to whether they provide information about the inputs to an entity's business activities (ie entry values such as historical cost and current cost) or information about the outputs from an entity's business activities (ie exit values such as fair value, value in use and fulfilment value). The IASB thinks that there is often little difference between entry and exit values in the same market, except for transaction costs, which are discussed in paragraphs BC6.34–BC6.37.

(b) the use of entity-specific values and market values. The Exposure Draft identifies, where relevant, measurement bases as entity-specific values or market values and discusses the different information that they provide.

(c) the role of deprival (relief) value as a measurement basis. The deprival (relief) value of an asset (liability) is the loss (benefit) that an entity would suffer (enjoy) if it were deprived (relieved) of the asset (liability) being measured. The IASB discussed the use of deprival (relief) value. However, the IASB did not include a discussion of this approach to measurement in the Exposure Draft, because it is more complex than other measurement bases and is not well accepted in some jurisdictions. Hence, the IASB thinks that it is unlikely to use this approach when developing new Standards.

(d) the treatment of transaction costs. The proposed guidance on this topic is discussed in paragraphs BC6.34–BC6.37.

Historical cost

BC6.19 The Exposure Draft identifies historical cost measures as measures that provide monetary information about assets, liabilities, income and expenses using information from the past transaction or event that created them.

BC6.20 The Exposure Draft explains that historical cost is initially the value of all the costs incurred to acquire or construct an asset, or the value of the net consideration received to take on a liability. Whether that initial value is fair value, or some other value, will be a Standards-level decision.

BC6.21 In response to comments from some respondents to the Discussion Paper, the IASB expanded the description of historical cost for non-financial assets and non-financial liabilities. In particular, the Exposure Draft explains that the historical cost:

(a) of assets is decreased as the asset is consumed (depreciation or amortisation) or if it becomes impaired; and

(b) of liabilities is decreased as they are fulfilled and increased if they become so onerous that the historical consideration is no longer sufficient to depict the requirement to fulfil the liability.

BC6.22 The amortised cost basis of measurement for financial assets and financial liabilities combines information about the historical yield of financial assets and financial liabilities with updated estimates of cash flows. The Exposure Draft categorises the amortised cost basis of measurement for financial assets and financial liabilities as a historical cost measurement basis. This reflects the fact that the amortised cost of financial assets and financial liabilities is not adjusted to reflect subsequent changes in prices.

BC6.23 Paragraph 6.18 of the Exposure Draft contains a brief discussion of current cost as a measurement basis. The IASB noted that a detailed discussion of current cost would be unnecessary because the IASB would be unlikely to consider selecting current cost as a measurement basis when developing future Standards.

Current value

BC6.24 The Exposure Draft identifies current measurement bases as measures that provide monetary information about assets, liabilities, income and expenses, using information that is updated to reflect conditions at the measurement date. It goes on to describe fair value, value in use (for assets) and fulfilment value (for liabilities) as examples of current measurement bases.

BC6.25 The description of fair value in the Exposure Draft is consistent with its description in IFRS 13 *Fair Value Measurement*. The descriptions of value in use and fulfilment value are derived from the definition of entity-specific current value in IAS 16 *Property, Plant and Equipment*, which is the most explicit of the various definitions of entity-specific value in existing Standards.

BC6.26 In existing Standards, value in use is used only in determining whether an asset measured at historical cost is impaired. Within that context, when an impairment loss has been recognised on an asset, the carrying amount of the asset equals the part of historical cost that is currently recoverable. Nevertheless, the IASB proposes in the Exposure Draft to describe value in use as a separate measurement basis because:

(a) although value in use is used in determining recoverable historical cost, it differs conceptually from historical cost; and

(b) there may be situations in the future when the IASB decides that an entity should measure an asset using an entity-specific current value (ie value in use) instead of fair value.

BC6.27 The Exposure Draft explains that value in use and fulfilment value reflect the same factors in their measurement as fair value, but base those factors on entity-specific assumptions instead of assumptions by market participants.

BC6.28 Hence, value in use and fulfilment value reflect the price for bearing the uncertainty inherent in the cash flows (ie a risk premium). Including such a risk premium produces information that can be relevant, because it reflects the economic difference between items that are subject to different degrees of uncertainty. For example, the inclusion of a risk premium is already implicit in the way in which value in use is described in IAS 36 *Impairment of Assets*.[14]

BC6.29 The Exposure Draft states that, to provide the most useful information, value in use and fulfilment value may need to be customised. In particular, the Exposure Draft notes that fulfilment value for liabilities may need to be customised so that the measure does not reflect the possibility of non-performance by the reporting entity. The IASB has found in many projects that the information provided by including non-performance risk is thought by many to be counterintuitive and not relevant. In addition, including in the measure of a liability the effect of a change in the entity's own non-performance risk may not faithfully represent the effect of the event that causes the change, because that event will probably also affect unrecognised assets (for example, unrecognised goodwill). Hence, although conceptually fulfilment value would reflect the risk of non-performance by the reporting entity, the IASB thinks that it might set Standards that would not require such risks to be reflected in an entity-specific measurement basis for a liability.

BC6.30 The Exposure Draft does not describe the following current measurement bases:[15]

14 See paragraphs 55–56, A1 and A15–A21 of IAS 36.

15 The decision not to include in the Exposure Draft a detailed discussion of current cost is described in paragraph BC6.23.

(a) net realisable value. Net realisable value depicts the estimated consideration from the sale of the asset adjusted for the estimated costs of sale. The IASB believes it is unnecessary to describe net realisable value separately, because it is simply a current measure for assets that has been reduced to reflect the estimated costs of sale.

(b) cost of release. Cost of release depicts the estimated cost (including transaction costs) of obtaining release from a liability by negotiation with the counterparty. Because it is relatively unusual for entities to obtain release from liabilities, instead of fulfilling them, the IASB believes that it is unlikely that it would use this measurement basis.

Cash-flow-based measurement techniques (paragraphs 6.5 and A1–A10)

BC6.31 As explained in paragraph BC6.17(b), cash-flow-based measurement techniques are techniques used in applying a defined measurement basis. The Exposure Draft includes a brief discussion of these techniques in Appendix A.

BC6.32 The Discussion Paper discussed factors to consider when developing cash-flow-based measures. A few respondents suggested expanding this discussion to provide the IASB with more guidance on:

(a) the use and determination of discount rates. As part of its research programme, the IASB is at present gathering evidence to help it assess whether to take on a project to develop guidance on the use and determination of discount rates.[16]

(b) whether the effect of changes in own credit risk should be included in a cash-flow-based measure (see paragraph BC6.29).

(c) approaches to dealing with uncertain cash flows (for example, using the mean, median or mode of a cash flow distribution, and the inclusion and calculation of a risk adjustment). Paragraphs A6–A10 of the Exposure Draft include a discussion of these approaches.

BC6.33 The Exposure Draft notes that cash-flow-based measurement techniques can be used to customise measurement bases. Customising measurement bases could result in more relevant information for users of financial statements, but the resulting information may also be more difficult for users to understand. Hence, if the IASB decides to use a customised measurement basis, the Basis for Conclusions on the relevant Standard will explain the reasons for that decision.

Transaction costs (paragraphs 6.7–6.9, 6.26 and 6.37–6.38)

BC6.34 Transaction costs can arise both when an asset (liability) is acquired (incurred) and when an asset (liability) is realised (settled or transferred). Defining which costs are transaction costs is beyond the scope of the *Conceptual Framework*. They are normally defined in particular Standards as incremental costs (other than the transaction price) that would not have been incurred if the particular asset (or liability) being measured had not been acquired (incurred) or realised

16 For the IASB to add a project to its active agenda, a formal agenda decision would be required.

(transferred or settled). The IASB frequently discusses the treatment of transaction costs when it discusses the measurement requirements for new or revised Standards. Consequently, the Exposure Draft proposes guidance on the treatment of transaction costs.

BC6.35 Transaction costs incurred in acquiring an asset or taking on a liability are a feature of the original transaction in which the asset was acquired or the liability was incurred. Hence:

(a) the cost of an asset or a liability reflects (among other things) the transaction costs of acquiring the asset or incurring the liability. Although the transaction costs are not part of the transaction price, the asset could not have been acquired or the liability incurred without incurring those transaction costs.

(b) if a measure is intended to depict the fair value, fulfilment value or value in use of an asset or a liability, the measure would not reflect those transaction costs. Those costs do not affect the current value of that asset or liability.

BC6.36 Transaction costs that would be incurred in realising an asset, or settling or transferring a liability, are a feature of a possible future transaction. Hence:

(a) because value in use depicts the present value of the cash flows that are estimated to arise from the continued use of the asset and from its disposal at the end of its useful life, estimated transaction costs on that disposal are deducted in arriving at those cash flows. Similarly, because fulfilment value depicts the present value of the cash flows needed to fulfil a liability, the transaction costs (if any) of fulfilment are included in those cash flows. As implied by their definitions, both value in use and fulfilment value reflect the present value of those cash flows.

(b) it would be inconsistent with historical cost measurement to reduce (increase) the cost-based measure of an asset (liability) to reflect transaction costs that will arise only if a future transaction occurs (historical cost uses information about past transactions). However, the transaction costs that would be incurred in realising an asset (or settling or transferring a liability) may become relevant in determining whether the asset is impaired (or whether the liability has become onerous) or in determining the residual value of an asset for depreciation purposes.

BC6.37 A fair value measure depicts the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Because the costs to sell an asset (or transfer a liability) are not part of the price of the asset (or liability) that is being sold or transferred, they are not included in a fair value measure. However, this does not preclude the IASB from deciding that an entity should measure an asset at fair value less costs to sell (or a liability at fair value plus costs of transfer).

Objective of measurement (paragraphs 6.2 and 6.49)

BC6.38 The Discussion Paper suggested that the objective of measurement is to contribute to the faithful representation of relevant information about:

(a) the resources of the entity, claims against the entity and changes in resources and claims; and

(b) how efficiently and effectively the entity's management and governing body have discharged their responsibilities to use the entity's resources.

BC6.39 Although many respondents to the Discussion Paper agreed with that suggested objective, some stated that it simply repeats the objective of financial reporting and the qualitative characteristics of useful information. Consequently, these respondents believe that the suggested objective would not provide useful guidance to the IASB in setting measurement requirements.

BC6.40 The IASB agrees with these comments, but believes that it is important to provide a link between measurement and the objective of financial reporting. Hence, the Exposure Draft does not define an objective for measurement. Instead, it describes the measurement process (see paragraph 6.2 of the Exposure Draft) and the factors to consider when selecting a measurement basis in order to contribute to the overall objective of financial reporting (see paragraph 6.49 of the Exposure Draft).

Factors to consider when selecting a measurement basis (paragraphs 6.48–6.73)

BC6.41 In order to meet the objective of financial reporting, information provided by a particular measurement basis must be useful to users of financial statements. A measurement basis achieves this if it provides information that is relevant and faithfully represents what it purports to represent. In addition, the selected measurement basis needs to provide information that is, as far as possible, comparable, verifiable, timely and understandable. The Exposure Draft discusses how these factors affect the selection of a measurement basis.

BC6.42 Paragraph BC2.33 explains why there is an explicit reference to the cost constraint in the chapter on measurement.

Relevance

BC6.43 The Exposure Draft discusses a number of factors that can affect the relevance of the information provided by a particular measurement basis:

(a) effect on both the statement of financial position and the statement(s) of financial performance (see paragraph BC6.44);

(b) contribution to future cash flows (see paragraphs BC6.45–BC6.49);

(c) an entity's business activities (see paragraphs BC6.50–BC6.53);

(d) characteristics of an asset or a liability (see paragraphs BC6.54–BC6.55); and

(e) measurement uncertainty (see paragraphs BC6.56–BC6.57).

Effect on both the statement of financial position and the statement(s) of financial performance

BC6.44 The Discussion Paper stated that selecting a measurement basis by considering the information that would be included in either the statement of financial position alone or the statement(s) of financial performance alone will not usually produce the most relevant information for users of financial statements. Most respondents to the Discussion Paper agreed with this suggestion. However, some suggested that the IASB should give more weight to the effect that a particular measure would have on the statement(s) of financial performance. Nevertheless, the IASB believes that the relative importance of the information produced in the statement of financial position and the statement(s) of financial performance will depend on the circumstances. Hence, the Exposure Draft carries forward the suggestion made in the Discussion Paper unchanged.

Contribution to future cash flows

BC6.45 The Discussion Paper suggested that the relevance of a particular measure 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:

(a) for a particular asset should depend on how that asset contributes to future cash flows; and

(b) for a particular liability should depend on how the entity will settle or fulfil that liability.

BC6.46 A few respondents disagreed with this suggestion, arguing that the IASB should adopt a single or ideal measurement basis (see paragraphs BC6.7–BC6.14). However, most of those who commented agreed with this suggestion.

BC6.47 The IASB continues to believe that the amounts included in the financial statements can be more relevant if the way in which an asset or a liability contributes to future cash flows is considered when selecting a measurement basis. Hence, this suggestion has been retained.

BC6.48 Some respondents disagreed with referring to how investors, creditors and other lenders are likely to assess how a type of asset or liability will contribute to future cash flows. They stated that preparers are unlikely to know what assessments users would make and that investors, creditors and other lenders do not have the information to assess how an asset or a liability will contribute to future cash flows. The IASB agrees with those comments. Consequently, the IASB has removed the reference to the assessments of investors, creditors and other lenders.

BC6.49 Respondents expressed concerns that the Discussion Paper contained too much Standards-level detail on the implications for subsequent measurement of how an asset or a liability contributes to future cash flows. In response, the IASB has removed much of that discussion.

An entity's business activities

BC6.50 The IASB considers that the way in which an asset or a liability contributes to future cash flows depends, in part, on the nature of the business activities being conducted. For example:

(a) non-financial assets can be sold as inventory, leased to another entity or used in the entity's business;

(b) financial assets can be held to collect cash flows or be sold;

(c) a non-financial institution will normally repay its financial liabilities in accordance with their contractual terms instead of seeking to transfer them to a third party;

(d) a financial institution is likely to seek a net cash settlement of a commodity contract (by closing out the contract) instead of receiving, and paying for, the underlying commodity; and

(e) a provider of services will normally fulfil its performance obligations by providing services instead of seeking release from the contract from its customer and instead of transferring the obligation to a third party.

BC6.51 Some respondents to the Discussion Paper feared that inconsistencies and subjectivity could result if the nature of the business activities were to be considered when selecting a measurement basis. However, the IASB believes that:

(a) measuring in the same way assets (or liabilities) that contribute to cash flows differently could reduce comparability by making things that are different appear the same.[17]

(b) in many cases, the nature of the business activities is a matter of fact instead of an opinion or management intent. When this is not the case, the IASB will need to consider how to address any subjectivity.

BC6.52 The Exposure Draft, therefore, states that how an asset or a liability contributes to future cash flows will depend, in part, on the nature of the business activities being conducted.

BC6.53 Some respondents to the Discussion Paper argued that the IASB should identify long-term investment as a particular type of business activity and develop specific measurement requirements for entities conducting that business activity. However, the IASB believes that the *Conceptual Framework* need not (and should not) refer explicitly to any particular business activity, such as long-term investment, for the reasons set out in paragraphs BCIN.35–BCIN.38.

Characteristics of an asset or a liability

BC6.54 The Discussion Paper suggested that for some financial assets and financial liabilities (for example, derivatives), selecting a measurement basis by considering how the asset or the liability contributes to future cash flows may not provide information that is useful in assessing prospects for future cash flows. Instead, the characteristics of the asset or liability would be a key factor in selecting a measurement basis. The Discussion Paper went on to describe when cost-based information may not be useful in the case of financial assets that are held for collection or financial liabilities that are fulfilled in accordance with their terms. Although many respondents to the Discussion Paper agreed with these suggestions, some expressed the view that these were Standards-level conclusions.

17 Paragraph QC23 of the *Conceptual Framework* (paragraph 2.26 of the Exposure Draft) states: 'Comparability is not uniformity. For information to be comparable, like things must look alike and different things must look different.'

BC6.55 The IASB acknowledges that the suggestion in the Discussion Paper was phrased in a way that made it look like a Standards-level decision. However, the IASB believes that underpinning the suggestion is an important idea that the characteristics of an asset or a liability are one of the factors that need to be considered when selecting a measurement basis. One example of that factor is the nature or extent of the variability in the item's cash flows or the sensitivity of the item's value to changes in market factors or to other risks inherent in the item.

Measurement uncertainty

BC6.56 Some respondents to the Discussion Paper suggested that one factor to be considered in selecting a measurement basis is the degree of measurement uncertainty associated with each measurement basis. Some respondents use the term 'reliability' to describe that factor. For reasons noted in paragraphs BC2.21–BC2.25, the IASB proposes not to reintroduce the term reliability to describe that factor. However, paragraph 2.13 of the Exposure Draft states that for some estimates, a high level of measurement uncertainty may outweigh other factors to such an extent that the resulting information may have little relevance, even if the estimate is properly described and disclosed. Consequently, the IASB believes that the level of uncertainty associated with the measurement of an item should be considered when assessing whether a particular measurement basis provides relevant information. However, it is only one of the factors that should be considered in that assessment. Sometimes a measure with a high degree of uncertainty provides the most relevant information about an item. For example, this may be the case with many financial instruments for which prices are not observable.

BC6.57 Some respondents to the Discussion Paper stated that applying prudence as they understand the term would imply that the tolerable level of measurement uncertainty would be greater for liabilities than for assets (see paragraphs BC2.1–BC2.15). The IASB thinks that the level of measurement uncertainty that makes information lack relevance depends on the circumstances and can only be decided when developing particular Standards. Hence, the *Conceptual Framework* neither requires nor prohibits setting different levels of tolerable measurement uncertainty for assets and liabilities.

Faithful representation (paragraphs 6.57–6.58)

BC6.58 The Discussion Paper suggested that:

(a) although a faithful representation is free from error, that does not mean that measures must be perfectly accurate in all respects; and

(b) when deciding whether a particular measure faithfully represents an entity's financial position and financial performance, it may be necessary to consider how best to portray any link between items.

BC6.59 Few respondents to the Discussion Paper commented on these suggestions. The IASB still supports these suggestions and has carried them forward to the Exposure Draft.

BC6.60 A few respondents objected to the statement in the Discussion Paper that an estimate of an unobservable price can be a faithful representation if adequate disclosures are made. They agreed that an estimate of an unobservable price could be a faithful representation of that estimate. However, they argued that, if the uncertainties associated with an estimate are too large, the estimate cannot be a faithful representation of the item itself. The IASB thinks that these concerns are addressed, at least in part, by:

(a) the statement in paragraph 2.20 of the Exposure Draft (paragraph QC17 of the existing *Conceptual Framework*) that, to be useful, information must be both relevant and faithfully represented; and

(b) the discussion of the role of measurement uncertainty in selecting a measurement basis (see paragraphs BC6.56–BC6.57).

Enhancing qualitative characteristics (paragraphs 6.59–6.63)

BC6.61 The existing *Conceptual Framework* identifies four 'enhancing qualitative characteristics' that make financial information more useful: comparability, verifiability, timeliness and understandability.

BC6.62 The Discussion Paper suggested that the understandability of financial statements could be enhanced if the number of different measurement bases used is limited to the smallest number necessary to provide relevant information. Many of those who commented agreed with this suggestion. However, some respondents disagreed, stating that there should not be an artificial limit on the number of measurement bases used. In their view, a different measurement basis should be selected if it will provide relevant information to the users of financial statements.

BC6.63 It was not the IASB's intention to impose an artificial limit on the number of measurement bases used. A different measurement basis should be used if it will provide the most relevant information to users of financial statements. Hence, the IASB has replaced the statement that the number of different measurement bases used should be limited to the smallest number necessary with a discussion (in paragraph 6.62 of the Exposure Draft) on the advantages and disadvantages of introducing new or different measurement bases.

BC6.64 The Discussion Paper also suggested that the understandability of financial statements would be enhanced by avoiding unnecessary changes in measurement bases and by explaining necessary changes. Most respondents who commented agreed with this suggestion. The Exposure Draft retains that discussion and clarifies that avoiding unnecessary measurement changes does not preclude:

(a) current values being used as a deemed cost on initial measurement (see paragraph 6.11 of the Exposure Draft); or

(b) a change in measurement basis to enhance the relevance of the information provided (see paragraph 6.63 of the Exposure Draft).

BC6.65 The Discussion Paper also discussed the implications of the enhancing qualitative characteristics of timeliness, verifiability and comparability for measurement. Few respondents commented on this discussion. Those commenting suggested that:

(a) verifiability has a significant role to play in the selection of a measurement basis; and

(b) comparability could be enhanced by removing the ability for preparers to choose between measurement bases.

BC6.66 The IASB believes that the discussion of verifiability in the Discussion Paper appropriately reflected the importance of verifiability as one of the factors that should be considered when selecting a measurement basis. In addition, paragraph 2.28 of the Exposure Draft (paragraph QC25 of the existing *Conceptual Framework*) already acknowledges that permitting alternative accounting methods for the same economic phenomenon diminishes comparability. Consequently, the Exposure Draft includes the discussion of verifiability and comparability suggested in the Discussion Paper, largely unchanged. The IASB considers that the enhancing qualitative characteristic of timeliness has few implications for the selection of a measurement basis.

Factors to consider on initial recognition (paragraphs 6.64–6.73)

BC6.67 The Discussion Paper included a discussion on factors to consider when deciding how to measure an asset or a liability on initial recognition. Few respondents commented on that discussion. However, a few stated that the discussion was too prescriptive for the *Conceptual Framework*. In response, the IASB has shortened that discussion and removed some Standards-level detail.

More than one relevant measurement basis (paragraphs 6.74–6.77)

BC6.68 The IASB considers that, in some cases, consideration of the objective of financial reporting, and of the qualitative characteristics of useful financial information, will indicate that using more than one measurement basis for the same item in the same financial statements could provide useful information to the users of financial statements. Hence, the Exposure Draft discusses how information about more than one measurement basis could be provided.

Measurement of equity (paragraphs 6.78–6.80)

BC6.69 Although total equity is not measured directly, the IASB considers that, in order to provide useful information, it may be necessary to measure directly individual classes or categories of equity. Hence, the Exposure Draft discusses this notion.

Chapter 7—Presentation and disclosure

Introduction

BC7.1 Presentation and disclosure are not addressed in the existing *Conceptual Framework*. Respondents to the Agenda Consultation 2011 identified presentation and disclosure as a priority topic. A particular issue identified was providing information about an entity's financial performance, including the use of other comprehensive income (OCI).

BC7.2 In response to that feedback:

(a) the Exposure Draft proposes:

(i) high level concepts that describe what information is included in financial statements (see paragraphs 7.2–7.7) and how that information should be presented and disclosed (see paragraphs 7.8–7.18). Those concepts would guide the IASB in setting presentation and disclosure requirements in Standards and would guide entities in providing information in financial statements.

(ii) guidance on reporting financial performance, including the use of OCI (see paragraphs 7.19–7.27);

(b) the IASB is undertaking:

(i) a Disclosure Initiative, a collection of implementation and research projects aimed at improving disclosure in IFRS financial reporting. In the Disclosure Initiative, the IASB will seek to provide additional specific guidance to support the application of the presentation and disclosure concepts proposed in the Exposure Draft.

(ii) a research project to explore whether to add to its agenda a project on performance reporting.

BC7.3 The following paragraphs discuss:

(a) objective and scope of financial statements (see paragraphs BC7.4–BC7.16);

(b) presentation and disclosure as communication tools (see paragraphs BC7.17–BC7.23); and

(c) information about financial performance (see paragraphs BC7.26–BC7.57).

Objective and scope of financial statements (paragraphs 7.2–7.7)

BC7.4 The Discussion Paper suggested introducing in the *Conceptual Framework* the term 'primary financial statements' to collectively refer to:

(a) the statement of financial position;

(b) the statement(s) of financial performance;

(c) the statement of changes in equity; and

(d) the statement of cash flows.

BC7.5 The Discussion Paper also suggested setting out in the *Conceptual Framework* separate objectives for the identified primary financial statements and the notes to the financial statements. However, the Exposure Draft does not identify primary financial statements nor does it propose separate objectives for the individual statements within the financial statements or the notes to the financial statements. The IASB considers that such definitions and objectives are best considered in the Performance Reporting project and the Disclosure Initiative.

BC7.6 However, the IASB considers that setting out an objective for the financial statements as a whole would clarify their scope and, hence, clarify the boundary between financial statements and other forms of financial reports, such as management commentary.

BC7.7 The IASB proposes, for use in the *Conceptual Framework*, an adapted and updated version of the objective of financial statements set out in IAS 1 *Presentation of Financial Statements*. Paragraph 9 of IAS 1 states:

> Financial statements are a structured representation of the financial position and financial performance of an entity. The objective of financial statements is to provide information about the financial position, financial performance and cash flows of an entity that is useful to a wide range of users in making economic decisions. Financial statements also show the results of the management's stewardship of the resources entrusted to it. To meet this objective ...

BC7.8 The proposed objective of financial statements is set out in paragraph 3.4 of the Exposure Draft. It differs from the objective in IAS 1 in the following ways:

(a) in order to provide a link to the elements of financial statements, the objective in the Exposure Draft refers to:

(i) assets, liabilities and equity instead of the financial position; and

(ii) income and expenses instead of financial performance.

(b) the objective in the Exposure Draft does not refer to providing information about cash flows. Although information about cash and cash flows is important to users of financial statements, cash flows are not identified as separate elements of financial statements in the *Conceptual Framework*.

(c) the objective in the Exposure Draft describes what makes information useful to users of financial statements (ie the information needs to be useful in assessing prospects for future net cash inflows to the entity and in assessing management's stewardship of the entity's resources).

BC7.9 Paragraphs 7.2–7.7 of the Exposure Draft summarise the types of information that financial statements normally include. However, the Exposure Draft does not include more detailed examples of the types of disclosures, such as roll-forwards and reconciliations. Although the Discussion Paper discussed such examples, a discussion of such disclosures is too detailed for the *Conceptual Framework*. Instead, the IASB will explore disclosure of this type in its Disclosure Initiative.

BC7.10 The Discussion Paper suggested that the objectives of presentation and disclosure do not include providing information that enables a user of financial statements to recalculate the amounts recognised in the primary financial statements. A few respondents did not support this suggestion. They argued that such information could be useful in making economic decisions. However, the IASB believes that the Disclosure Initiative would be the best place to discuss whether providing such information is necessary to meet the objective of financial statements. Hence, the Exposure Draft does not comment on this aspect of presentation and disclosure.

Information about risks (paragraph 7.3(a))

BC7.11 The Exposure Draft proposes that financial statements should provide information about the nature of recognised and unrecognised items that meet the definition of an element and about the risks arising from them. Some respondents to the Discussion Paper expressed a concern that the term 'risk' is not defined. Hence, 'information about risks' could be understood to include almost any type of information, including information that could be best placed outside the financial statements. For example, some argued that the information about how an entity manages risk belongs outside the financial statements.

BC7.12 However, the IASB noted that information about the risks associated with an entity's existing assets and liabilities is likely to be useful in assessing the entity's ability to generate cash flows and also in assessing management's stewardship of the entity's resources. Thus, this information contributes to meeting the objective of financial statements.

Forward-looking information (paragraphs 7.4–7.6)

BC7.13 The Discussion Paper proposed that forward-looking information should be required in financial statements only if it provides relevant information about the assets and the liabilities that existed at the end of, or during, the reporting period. Other types of relevant forward-looking information could be presented outside the financial statements.

BC7.14 Some respondents to the Discussion Paper argued that the suggested description of forward-looking information that should be included in the financial statements is too narrow and could result in excluding useful information. For example, they argued that this description could exclude from the financial statements information about some types of non-adjusting events, as defined in IAS 10 *Events after the Reporting Period*.

BC7.15 Other respondents also expressed a concern about the suggested description of the types of forward-looking information that could be included in the financial statements. They stated that the description would be too broad.

BC7.16 The IASB continues to believe that financial statements should focus on providing information about an entity's assets, liabilities and equity that existed at the end of, or during, the period and income and expenses for the reporting period. However, it also notes that information about transactions or events that have occurred after the end of the reporting period (including the non-adjusting events identified in IAS 10) is not forward-looking information. It is information about events that have occurred. Thus, paragraph 7.6 of the Exposure Draft states that it may be necessary to provide such information to meet the proposed objective of financial statements.

Presentation and disclosure as communication tools (paragraphs 7.8–7.18)

BC7.17 The Discussion Paper included a discussion of classification, aggregation and offsetting in financial statements. The IASB received little specific feedback on this discussion. Hence, the IASB has included an updated discussion of these issues in the Exposure Draft.

BC7.18 The Discussion Paper described presentation and disclosure as the mechanisms by which a reporting entity communicates information about its financial position and financial performance to users of financial statements. To help make that communication more effective, the Discussion Paper suggested:

(a) that each Standard that sets out presentation and disclosure requirements should have a clear objective that would guide entities in determining how best to provide information in the financial statements; and

(b) specific communication principles that the IASB should consider when it sets presentation and disclosure requirements in Standards.

BC7.19 Many respondents who commented on the communication principles agreed with including those principles in the *Conceptual Framework*. However, some respondents suggested that some or all of the communication principles suggested in the Discussion Paper would be better placed in a Standard, such as IAS 1.

BC7.20 The feedback received on the communication principles suggested in the Discussion Paper is generally consistent with the feedback from the IASB's Discussion Forum on Financial Reporting Disclosure, held in January 2013. Participants in that forum, including investors and preparers, agreed that financial reports are an important communication tool that should enable preparers 'to tell the story' and investors 'to hear the story'.

BC7.21 Consequently, the IASB proposes that the *Conceptual Framework* should:

(a) discuss how presentation and disclosure contributes to effective communication (see paragraphs 7.8–7.15 of the Exposure Draft);

(b) include an explicit reference to the cost constraint in the chapter on presentation and disclosure (see paragraph BC2.33);

(c) explain how presentation and disclosure objectives in Standards help entities to communicate information effectively and efficiently (see paragraphs 7.16–7.17 of the Exposure Draft); and

(d) specify presentation and disclosure principles that facilitate effective communication of useful financial information (see paragraph 7.18 of the Exposure Draft).

BC7.22 Some of the communication principles suggested in the Discussion Paper focus more on the preparation of the financial statements than on the underlying concepts. Accordingly, the IASB proposes to include in the *Conceptual Framework* communication principles that describe the underlying concepts and to explore whether to provide additional guidance in the Disclosure Initiative.

Financial statements in an electronic format

BC7.23 The Discussion Paper suggested that, when developing presentation and disclosure requirements, the IASB may need to consider the impact of technology and to support advances in its application and wider use. The IASB received little specific feedback on that suggestion. However, as suggested by many of those who did comment on this topic, the IASB has not included such a discussion in the Exposure Draft.

Information about financial performance (paragraphs 7.19–7.27)

Terminology

BC7.24 The Exposure Draft uses the term 'statement(s) of financial performance' to refer to the combination of the statement of profit or loss and the statement of other comprehensive income.[18] The Exposure Draft uses this term because it is consistent with the term 'statement of financial position' that is used in existing Standards and is clearer than the term 'comprehensive income'.

BC7.25 Existing Standards use the term 'other comprehensive income' to refer to income and expenses recognised outside the statement of profit of loss. Feedback on the Discussion Paper suggested that this term is not particularly descriptive or well understood, particularly by investors. Nonetheless, the IASB considers that avoiding the use of the term or using a different term to refer to income and expenses recognised outside profit or loss could be confusing. Hence, the Exposure Draft refers to 'other comprehensive income'.

Discussion Paper

BC7.26 The Discussion Paper:

(a) discussed principles that could be used to determine whether income and expenses should be included in the statement of profit or loss or in other comprehensive income ('OCI'). In particular the Discussion Paper suggested that:

  (i) income and expenses included in the statement of profit or loss provide the primary source of information about the return that an entity has made on its economic resources in a period; and

18 The Exposure Draft does not specify whether the statement(s) of financial performance comprise a single statement or two statements.

(ii) all income and expenses should be included in the statement of profit or loss unless including an item in OCI enhances the relevance of the statement of profit or loss for that period.

(b) suggested that the *Conceptual Framework* should permit or require at least some OCI items to be reclassified (recycled) from OCI to profit or loss.

(c) suggested that the *Conceptual Framework* should require a total or subtotal for profit or loss.

BC7.27 In addition, the Discussion Paper discussed an alternative approach whereby:

(a) income and expenses included in OCI would not be recycled to the statement of profit or loss;

(b) the *Conceptual Framework* would not require a total or subtotal for profit or loss; and

(c) the *Conceptual Framework* would not describe which items of income and expenses should be included in the statement of profit or loss.

Feedback on the Discussion Paper

BC7.28 Some respondents to the Discussion Paper agreed with the proposal to address the reporting of income and expenses in the statement of profit or loss, and OCI, in the *Conceptual Framework*. However, others stated that it is more appropriate to address those topics in Standards.

BC7.29 Respondents also expressed mixed views on most of the proposals on the reporting of income and expenses in the statement of profit or loss and OCI. Some respondents supported more extensive use of OCI whereas others advocated less use of OCI. Some respondents supported subsequent recycling of some, or all, income and expenses included in OCI to the statement of profit or loss. However, their views varied on which items should be recycled and on when those items should be recycled to the statement of profit or loss. Other respondents opposed recycling in principle.

BC7.30 Regardless of their views on the types of income and expenses that should be included in OCI and on recycling, most respondents agreed that the *Conceptual Framework* should refer to a total or subtotal for profit or loss. The few respondents who disagreed with requiring such a total or subtotal instead advocated a single statement of performance that would not draw a line between profit or loss and OCI (ie they favoured the alternative approach described in paragraph BC7.27).

BC7.31 Many respondents stated that the use of profit or loss and OCI requires further thought and analysis. Some urged the IASB either to define financial performance or OCI or to define, or directly describe, profit or loss and its purpose. Other respondents acknowledged the difficulty of developing such definitions and pointed out that decades of research and numerous attempts at producing such definitions have not yielded a satisfactory result. Only a few respondents suggested how the IASB might approach developing such definitions. Most of those suggestions did not extend beyond the approaches already considered and rejected by the IASB in developing the Discussion Paper. A few respondents proposed variations of those approaches or new approaches.

For example, one respondent suggested describing profit or loss as an all-inclusive measure of irreversible outcomes. These suggestions were considered by the IASB as part of the feedback on the Discussion Paper.

BC7.32 Views expressed by investors and analysts were also mixed and were generally consistent with other feedback received. In addition, many investors and analysts made the following comments:

(a) there are many facets to an entity's performance and no single performance number would be suitable for all users' needs;

(b) the use of OCI and of recycling are not well understood by the user community and OCI is not looked at by many users; and

(c) users need transparency and meaningful disaggregation of information in financial statements, including the appropriate use of totals and subtotals, regardless of whether OCI exists as a separate category.

Approach to reporting financial performance

BC7.33 Having considered the feedback received on the Discussion Paper, the IASB discussed whether to explore the use of the statement of profit or loss and OCI in a separate research project instead of providing guidance in the *Conceptual Framework*. However, the IASB concluded that conceptual guidance on this issue is urgently needed.

BC7.34 The IASB noted that respondents to the Discussion Paper and others have consistently asked the IASB to define, or better describe, profit or loss or OCI or to define financial performance. However, the IASB's previous work on presentation and disclosure, as well as its work in developing the Discussion Paper, has shown that no single characteristic can be used to separate items of income and expenses usefully into two clear-cut categories, with all items within one category sharing the same characteristic. For example, many items currently included in OCI are remeasurements of assets or liabilities expected to be held for a long period. However, some such remeasurements are currently included in the statement of profit or loss. Feedback from users suggests that there is little appetite for including those particular remeasurements in OCI. The conclusion that income and expenses cannot be divided consistently into two categories in a manner that would provide useful information is also consistent with the idea that there are many facets of an entity's financial performance (see paragraph BC7.32).

BC7.35 In addition, in developing proposals for the use of OCI, the IASB has considered the current and proposed use of OCI in Standards. The IASB notes that whereas each use of OCI has an explanation, there is no single conceptual basis that underlies all of those cases.

BC7.36 Accordingly, the IASB decided that it is not feasible or appropriate to attempt to define, or precisely describe, in the *Conceptual Framework* when an item of income or expenses should be included in the statement of profit or loss or OCI. Instead, the IASB proposes to include in the *Conceptual Framework* high level guidance on this topic and on subsequent reclassification.

BC7.37 In developing the Exposure Draft, the IASB built on the high level principles discussed in the Discussion Paper (see paragraph BC7.26). However, it did not develop further the more specific suggestions in the Discussion Paper on the types of income and expenses that could be included in OCI and the related approaches to recycling. Respondents did not generally find those more specific suggestions helpful as a way of analysing this topic.

Describing the statement of profit or loss (paragraphs 7.19–7.22)

BC7.38 The Exposure Draft proposes that the *Conceptual Framework* should:

(a) describe the statement of profit or loss as the primary source of information about an entity's financial performance for the period;

(b) require a total or subtotal for profit or loss; and

(c) state explicitly that the purpose of the statement of profit or loss is to both:

 (i) depict the return that an entity has made on its economic resources during the period; and

 (ii) provide information that is helpful in assessing prospects for future cash flows and in assessing management's stewardship of the entity's resources.

The IASB thinks that it is important to emphasise this dual purpose of the statement of profit or loss to prevent excessive focus on one purpose over another.

BC7.39 Describing the statement of profit or loss in this way would reflect the feedback from some respondents who argued that profit or loss is the primary measure of performance and, for that reason, its prominence should be established in the *Conceptual Framework*. The IASB noted that such a description would also be consistent with how the statement of profit or loss is used in practice. That is, many users incorporate the total or subtotal for profit or loss in their analysis, either as a starting point or as the main indicator of an entity's financial performance.

BC7.40 On the other hand, the Exposure Draft emphasises that the statement of profit or loss is not the only source of information about an entity's financial performance for the period. An in-depth understanding of performance requires an analysis of all recognised income and expenses (including income and expenses included in OCI), as well as other information included in the financial statements.

BC7.41 The IASB acknowledges that merely describing the statement of profit or loss would be unlikely to satisfy those who asked for a definition of 'profit or loss'. However, as discussed in paragraphs BC7.34–BC7.36, the IASB did not think that a robust and appropriate definition of profit or loss would be feasible for the *Conceptual Framework*.

Presumption of inclusion in the statement of profit or loss (paragraph 7.23)

BC7.42 If the statement of profit or loss is the primary source of information about an entity's financial performance for the period, it follows that excluding income and expenses from that statement without compelling reasons could undermine the usefulness of that statement. That is, the statement of profit or loss should be as inclusive as possible.

BC7.43 Accordingly, the Exposure Draft includes a presumption that income and expenses will be included in the statement of profit or loss. Only in limited circumstances could the IASB require, or permit, income and expenses (or a component of income and expenses) to be excluded from the statement of profit or loss and, hence, be included in OCI. Those circumstances would be when the IASB concludes that doing so would enhance the relevance of the information in the statement of profit or loss for the period.

BC7.44 Only the IASB when setting Standards would be able to rebut the presumption that an item of income or expenses should be reported in the statement of profit or loss. Preparers would not be able to rebut that presumption, because IAS 1 prohibits the inclusion of items of income and expenses in OCI when no Standard permits or requires this.

Types of income and expenses (paragraphs 7.23–7.24)

BC7.45 The IASB discussed whether the *Conceptual Framework* should require the following types of income and expenses to be included in the statement of profit or loss:

(a) income and expenses arising on initial recognition of an asset or a liability;

(b) income and expenses arising on assets and liabilities measured at historical cost;

(c) the following types of income and expenses arising on assets and liabilities carried at current values:

  (i) consumption of the economic resource that constitutes the asset (depreciation or amortisation);

  (ii) accrual of interest, accretion of a discount or amortisation of a premium on acquisition; or

  (iii) impairment of assets or increases in the carrying amount of liabilities that have become onerous.

(d) dividend income.

BC7.46 The IASB considers that a detailed list would be inappropriate in the *Conceptual Framework*. However, the IASB noted that the items listed in paragraph BC7.45 relate to transactions and events of the period, such as consumption of an asset or interest income and expenses, but not to other changes in the value of assets and liabilities. Classifying income and expenses arising from transactions and events separately from changes in value can provide useful information.

BC7.47 Hence, consistently with the suggestions in the Discussion Paper, the IASB proposes to specify that only income and expenses related to changes in current value measures of assets and liabilities (remeasurements), or components of such income and expenses, could be included in OCI. Income and expenses related to changes in a historical cost measure of assets and liabilities would need to be included in the statement of profit or loss. Likewise, if an asset or a liability is being measured on a current value basis, but components of income and expenses of the type that would arise if the asset or liability were measured at historical cost are identified separately, those components would need to be included in the statement of profit or loss. This is because excluding such items from the statement of profit or loss would not enhance the confirmatory or predictive value of the information included there. Table 6.1, following paragraph 6.47 of the Exposure Draft, sets out the types of income and expenses that arise under a historical cost basis.

BC7.48 Recognising some items of income and expenses in the statement of profit or loss, and some items in OCI, is a particular case of classification, namely classification between two separate statements (or, within a single statement between profit or loss and OCI). As stated in paragraph 7.11 of the Exposure Draft, separate classification is appropriate when the components have such different characteristics that classifying them separately would enhance the relevance and understandability of financial information. Paragraph 7.10 notes that such characteristics include, but are not limited to, the role (function) of the item within the business activities conducted by the entity and how it is measured.

Use of more than one measurement basis (paragraph 7.25)

BC7.49 One example of when components of income and expenses will be included in OCI is when the IASB selects a current measurement basis for an asset or a liability in the statement of financial position and selects a second measurement basis for determining the related income and expenses in the statement of profit or loss (a 'dual measurement' approach). When such an approach is used:

(a) the current measurement basis is used in the statement of financial position.

(b) the income and expenses included in the statement of profit or loss are determined by measuring the asset or the liability on the second measurement basis.

(c) the cumulative amount of that income or expense is the same as if the second measurement basis had also been used in the statement of financial position. Thus, the cumulative amount of income and expenses included in other comprehensive income equals the difference between the two measures of the asset or the liability.

(d) the measure of the asset or the liability on the second measurement basis needs to have an independent meaning and not be a mere accumulation of amounts included in the statement of profit or loss.

BC7.50 For example:

(a) measuring a financial asset at fair value in the statement of financial position and related income and expenses at historical cost in the statement of profit or loss is a case of dual measurement.

(b) but the treatment of a pension liability applying IAS 19 *Employee Benefits* is not a case of dual measurement. This is because the income and expenses included in the statement of profit or loss in each period reflect assumptions (including discount rates) for that period. Thus, the cumulative amounts included in that statement reflect different assumptions (including discount rates) for each period. Those cumulative amounts correspond to a measure for the pension liability that has no independent meaning and can be described only as the accumulation of the amounts included in the statement of profit or loss.

Reclassifying items into the statement of profit or loss (paragraphs 7.26–7.27)

BC7.51 The IASB considered whether items of income and expenses included in OCI should be subsequently reclassified into the statement of profit or loss. Such reclassification is often described as recycling.

BC7.52 When the dual measurement approach described in paragraph BC7.49 is used, reclassification of the cumulative amount included in OCI over the holding period of the asset or the liability is a necessary consequence of that approach. This is because the income or expenses included in profit or loss on derecognition of the asset or the liability (for example, on sale) include any income or expenses relating to the asset or the liability that have not already been included in the statement of profit or loss. Hence, any income and expenses previously included in OCI will, unless they have already reversed, now be included in profit or loss.

BC7.53 However, when income and expenses are included in OCI in cases other than dual measurement, such reclassification is not a necessary consequence of the approach adopted.

BC7.54 If the amounts included in the statement of profit or loss are the primary source of information about an entity's financial performance for the period, it follows that the cumulative amounts included over time in that statement should also be as complete as possible. Hence, no income and expenses should be excluded from the statement of profit or loss permanently, unless there is a compelling reason to do so.

BC7.55 Accordingly, the IASB proposes to include in the *Conceptual Framework* a presumption that income and expenses included in OCI must subsequently be reclassified to the statement of profit or loss. Reclassification takes place in the period when including the income and expenses in the statement of profit or loss enhances the relevance of the information included in that statement for that period.

BC7.56 However, in some cases, reclassifying the income and expenses to the statement of profit or loss might not enhance the relevance of the information in that statement in any period. Thus, there would be no appropriate basis for reclassification. In such cases, the presumption of reclassification can be rebutted because reclassification could occur only on an arbitrary basis, which would not provide useful information. The absence of an appropriate basis for reclassification may be an indication that this particular item of income and expenses should not be included in OCI in the first place.

BC7.57 The IASB does not propose to include in the *Conceptual Framework* specific guidance on when reclassification may be appropriate. The IASB expects to take that decision when developing individual Standards.

Chapter 8—Concepts of capital and capital maintenance

BC8.1 The material in Chapter 8 is carried forward unchanged from the existing *Conceptual Framework*, except for a limited number of editorial changes (see paragraph BCIN.24).

Effects of the proposed changes to the *Conceptual Framework*

BCE.1 The Invitation to Comment on the Exposure Draft discusses the effects of the proposed changes to the *Conceptual Framework*. The following paragraphs discuss:

(a) inconsistencies with existing Standards (see paragraphs BCE.2–BCE.24); and

(b) transition and effective date (see paragraphs BCE.25–BCE.31).

Inconsistencies with existing Standards

BCE.2 Some respondents to the Discussion Paper suggested that the IASB should undertake a review of existing Standards to identify any inconsistencies with the proposals for a revised *Conceptual Framework*. They stated that such a review would enable them to better understand the implications of the proposals.

BCE.3 The IASB reviewed existing and proposed Standards, other than those to be superseded before the revised *Conceptual Framework* becomes effective.

BCE.4 In doing this, the IASB has not attempted to predict what judgements it would now make if it were to set requirements in existing Standards applying the concepts proposed in the Exposure Draft for:

(a) judgements on recognition and measurement requirements; and

(b) reclassification to the statement of profit or loss of income and expenses included in OCI in an earlier period.

BCE.5 In addition, the IASB has not identified the following requirements as being inconsistent with the proposals for the *Conceptual Framework*:

(a) requirements that, although consistent with the concepts now proposed, are currently explained using different concepts in the Basis for Conclusions; and

(b) requirements that seem to have been driven by cost-benefit considerations (ie the cost constraint).

BCE.6 Paragraphs BCE.7–BCE.11 discuss the main inconsistencies between existing Standards and the proposed *Conceptual Framework* that were identified in the course of the review. Paragraphs BCE.12–BCE.21 discuss minor inconsistencies that would arise from the proposed changes to the *Conceptual Framework*. Paragraphs BCE.22–BCE.24 explain that some existing inconsistencies would be eliminated by the newly proposed concepts.

Main inconsistencies

IAS 32 *Financial Instruments: Presentation*

BCE.7 Some of the classification requirements of IAS 32 *Financial Instruments: Presentation* are inconsistent with both the existing *Conceptual Framework*'s definitions and the proposed definitions of liability and equity. In particular, these inconsistencies arise from:

(a) the share-settlement clauses of the definitions of financial assets and financial liabilities. Situations to which these clauses apply include, for financial liabilities:

  (i) a non-derivative for which the entity is, or may be, obliged to deliver a variable number of the entity's own equity instruments; and

  (ii) a derivative that will, or may, be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments.[19]

  These instruments are classified as liabilities even though obligations that an entity must settle, or may have the right to settle, by issuing its own equity instruments, do not meet either the existing or the proposed *Conceptual Framework*'s definition of a liability.

(b) the exceptions for puttable instruments contained in paragraphs 16A–16D of IAS 32. These result in some financial instruments being classified as equity, even though they meet the *Conceptual Framework*'s definition of a liability.

BCE.8 As discussed in paragraphs BC4.93–BC4.103, the IASB proposes not to make changes in this area at this stage. The IASB will further explore how to distinguish liabilities from equity claims, including consideration of whether to add to its agenda a project to amend the definitions of a liability and equity, in its Financial Instruments with Characteristics of Equity research project.[20]

IFRIC 21 *Levies*

BCE.9 As discussed in paragraph BC4.65, the requirements of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* as interpreted in IFRIC 21 *Levies* are inconsistent with the proposed new concepts for identifying liabilities.

BCE.10 An entity must often conduct a series of activities before it is required to pay a levy. IFRIC 21 identifies the last event in the series as the event that gives rise to a liability. The IFRS Interpretations Committee ('the Interpretations Committee') concluded that, because economic compulsion does not create a present obligation, earlier events in the series do not give rise to a liability even if the entity would have to take unrealistic actions to avoid the obligations. In contrast, applying the IASB's proposed guidance on a present obligation, an entity would identify a liability when the entity has no practical ability to avoid a transfer of economic benefits and the obligation has arisen from past events; in other words, the entity has received benefits or conducted activities that establish the extent of the obligation. Accordingly, a liability for some levies could be identified earlier by applying the *Conceptual Framework* proposals than by applying IFRIC 21.

19 See paragraph 11 of IAS 32.

20 For the IASB to add a project to its active agenda, a formal agenda decision would be required.

BCE.11 The IASB is considering, as part of its research agenda, whether it should take on an active project to consider amending aspects of IAS 37.[21] That research will take into account the inconsistencies between IFRIC 21 and the proposed new concepts for identifying present obligations.

Minor inconsistencies

Quotes of existing definitions

BCE.12 Some existing Standards quote existing *Conceptual Framework* definitions:

(a) IAS 37 quotes the existing definition of a liability; and

(b) IAS 38 *Intangible Assets* quotes the existing definition of an asset.

BCE.13 The implications for IAS 37 are discussed in paragraph BCE.11. The IASB is not proposing to update the quotation in IAS 38 at this time. It has considered possible implications for this Standard of the proposed changes in the definitions of assets and concluded that the changes would not cause any practical problems in applying the Standard. The IASB's aim in revising the definitions in the *Conceptual Framework* was to provide more clarity, not to fundamentally change the way in which the definitions are applied in any existing Standard.

Presentation and disclosure

BCE.14 In the Exposure Draft, the IASB notes the benefits of including a specific presentation and disclosure objective in a Standard (see paragraph 7.16 of the Exposure Draft). Recent Standards already include an objective for disclosure requirements. However, many older Standards do not contain such an objective.

BCE.15 The Exposure Draft proposes that financial statements should include forward-looking information only if it provides relevant information about the assets and liabilities that existed at the end of, or during, the period (see paragraph 7.4 of the Exposure Draft). IAS 19 *Employee Benefits* requires entities to disclose expected contributions to the defined benefit or the defined contribution plan for the next annual reporting period. This requirement is arguably inconsistent with the approach to forward-looking information proposed in the Exposure Draft.

BCE.16 The IASB proposes not to address these inconsistencies in the *Conceptual Framework* project. A review of disclosure requirements in existing Standards to identify and assess redundancies, conflicts and duplication is included in the Disclosure Initiative (see paragraph BC7.2(b)).

Faithful representation vs reliability

BCE.17 In existing Standards the term 'reliability' is used in two different ways:

(a) to mean that the level of measurement uncertainty associated with an item is tolerable. This use of the word is consistent with the recognition criteria in the existing *Conceptual Framework* (an item that meets the

21 For the IASB to add a project to its active agenda, a formal agenda decision would be required.

definition of an element is recognised only if it is probable that there will be a flow of economic benefits and it has a cost or value that can be measured with reliability).

(b) in a broader sense, as a qualitative characteristic explained in the pre-2010 *Framework* as encompassing freedom from error, neutrality, prudence, completeness and substance over form.

BCE.18 The IASB proposes not to reinstate the term reliability as a label for the qualitative characteristic now called 'faithful representation'. However, it considers that there is much in common between the qualitative characteristics of reliability (pre-2010 *Framework*) and the description of faithful representation proposed in the Exposure Draft (see paragraphs BC2.21–BC2.25).

BCE.19 The IASB considered whether to replace the term reliability with the term faithful representation in the Standards that refer to reliability as a qualitative characteristic. However, the IASB concluded that until it completes the revised *Conceptual Framework*, it would be premature to consider whether to propose such amendments. Similarly, it would be premature to consider whether to propose replacing the term reliability in the Standards that use the term to refer to a tolerable level of measurement uncertainty.

IAS 1 *Presentation of Financial Statements* and IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*

BCE.20 Two existing Standards—IAS 1 *Presentation of Financial Statements* and IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*—rely directly on the guidance in the *Conceptual Framework* and act as a direct link between the Standards and the *Conceptual Framework*. IAS 1 prescribes the basis for preparation of general purpose financial statements. It requires the faithful representation of the effects of transactions, other events and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses set out in the *Conceptual Framework*, to achieve fair presentation in financial statements. IAS 8 provides guidance to help entities develop and apply accounting policies when there are no specifically applicable Standards.

BCE.21 The guidance in these Standards is based on the qualitative characteristics described in the *Conceptual Framework* and, hence, the concepts in the *Conceptual Framework* are essential to the application of these Standards. When the revised *Conceptual Framework* is finalised, the IASB will consider whether to develop proposals to amend IAS 1 and IAS 8 to reflect the revised *Conceptual Framework*.

Existing inconsistencies

BCE.22 Some existing inconsistencies between the Standards and the existing *Conceptual Framework* would be eliminated by the proposals in the Exposure Draft.

BCE.23 For example, the existing *Conceptual Framework* specifies that an asset or a liability should be recognised only if it is probable that future economic benefits will flow to or from the entity. The IASB has not applied this recognition criterion in some Standards—it decided that recognition of some assets and liabilities (such as some derivatives) meets the objectives of financial reporting irrespective of the likelihood of future cash flows. Such requirements are inconsistent with the existing *Conceptual Framework* recognition criteria, but are possible outcomes of the proposed new *Conceptual Framework* recognition criteria. (As noted in paragraph BCE.4, the IASB has not attempted to predict what judgements it would now make if it were to set requirements in existing Standards applying the concepts now proposed.)

BCE.24 The IASB emphasises that its intention in this project is to provide a coherent basis for developing future Standards, not to eliminate existing inconsistencies. In fact, as discussed in paragraphs BCE.7–BCE.21, the IASB acknowledges that the proposals in the Exposure Draft would create some new inconsistencies. Nevertheless, some concepts in recent Standards-level projects reflect the IASB's most developed thinking on these matters, and that thinking also flows into the proposals in the Exposure Draft. It is not the IASB's intention to legitimise existing Standards or practice.

Transition and effective date

BCE.25 As noted in the Discussion Paper, the IASB will start using the revised *Conceptual Framework* immediately once it is published. The revised *Conceptual Framework* will supersede the previous version.

BCE.26 Some respondents asked the IASB to provide transition guidance for:

(a) the Interpretations Committee to help it interpret Standards developed under an earlier version of the *Conceptual Framework*; and

(b) entities that develop and apply an accounting policy in accordance with the *Conceptual Framework* when no Standard applies to a particular transaction or when they have to choose between accounting policy options permitted by a Standard.

BCE.27 The IASB concluded that there is no need to include in the revised *Conceptual Framework* any transition guidance for the Interpretations Committee. To avoid having several co-existing versions of the *Conceptual Framework*, the Interpretations Committee will start using the revised *Conceptual Framework* immediately after it is published. When the Interpretations Committee is faced with inconsistencies between a Standard (including those developed on the basis of the existing *Conceptual Framework*) and the concepts in the revised *Conceptual Framework*, it is required by the *IASB and IFRS Interpretations Committee Due Process Handbook* to refer the issue to the IASB.[22]

BCE.28 The IASB considered how entities should account for changes in accounting policies resulting from the revision of the *Conceptual Framework*. In particular, the IASB discussed:

(a) whether to allow entities not to change their existing accounting policy. It rejected this approach because it could result in financial statements prepared on the basis of concepts that were inconsistent with the revised *Conceptual Framework*.

22 See paragraph 7.8 of the *IASB and IFRS Interpretations Committee Due Process Handbook*.

(b) whether to require prospective application of the revised *Conceptual Framework*. It rejected this approach because it would compromise the comparability of financial statements.

BCE.29 Consequently, the IASB proposes that entities should account for any changes in accounting policy arising from an application of the revised *Conceptual Framework* retrospectively in accordance with IAS 8, subject to the impracticability provisions set out in that Standard.

BCE.30 To avoid having several co-existing versions of the *Conceptual Framework*, the IASB proposes replacing references to the *Framework for the Preparation and Presentation of Financial Statements* in existing Standards with references to the *Conceptual Framework for Financial Reporting*. To achieve this, the IASB has issued a separate Exposure Draft *Updating References to the Conceptual Framework*.

BCE.31 The replacement of those references within two Standards—IAS 1 and IAS 8—will achieve transition to the revised *Conceptual Framework* for entities that use the *Conceptual Framework* to develop accounting policies. The two Standards will set the effective date for the paragraphs containing those references. The IASB proposes to set an effective date that will allow a transition period of approximately 18 months between the issue of the revised *Conceptual Framework* and its effective date for entities. This would allow entities time to review the effects of the revised concepts on their accounting policies and prepare for retrospective application of the changes. In addition, the IASB proposes to permit early application for entities that would not find it difficult to start applying the revised *Conceptual Framework* immediately.

Appendix

> This appendix reproduces the Basis for Conclusions on Chapter 1: *The objective of general purpose financial reporting* and Chapter 3: *Qualitative characteristics of useful financial information* of the existing *Conceptual Framework*.
>
> The Exposure Draft proposes a number of changes to these Chapters (including renumbering Chapter 3 as Chapter 2). These changes are discussed in paragraphs BC1.1–BC2.33 of the Basis for Conclusions on the Exposure Draft.
>
> Footnotes have been added to this appendix to enable readers to better understand how the changes proposed in the Exposure Draft affect the decisions made when these Chapters were originally developed.

Basis for Conclusions on Chapter 1: *The objective of general purpose financial reporting*

This Basis for Conclusions accompanies, but is not part of, Chapter 1.

Introduction

BC1.1 This Basis for Conclusions summarises considerations of the International Accounting Standards Board in reaching the conclusions in Chapter 1 *The objective of general purpose financial reporting*. It includes reasons for accepting some alternatives and rejecting others. Individual Board members gave greater weight to some factors than to others.

BC1.2 The Board developed this chapter jointly with the US Financial Accounting Standards Board (FASB). Consequently, this Basis for Conclusions also includes some references to the FASB's literature.

Background

BC1.3 The Board began the process of developing the objective of financial reporting by reviewing its own framework and concepts as well as those of other standard-setters. In July 2006 the Board published for public comment a discussion paper on this topic. That same paper was also published by the FASB. The Board and the FASB received 179 responses. In its redeliberations of the issues on this topic, the Board considered all of the comments received and information gained from other outreach initiatives. In May 2008 the Board and the FASB jointly published an exposure draft. The boards received 142 responses. The Board reconsidered all of the issues on this topic. This document is the result of those reconsiderations.

General purpose financial reporting

BC1.4 Consistently with the Board's responsibilities, the *Conceptual Framework* establishes an objective of financial reporting and not just of financial statements. Financial statements are a central part of financial reporting, and most of the issues that the Board addresses involve financial statements. Although the scope of FASB Concepts Statement No. 1 *Objectives of Financial*

Reporting by Business Enterprises was financial reporting, the other FASB concepts statements focused on financial statements. The scope of the Board's *Framework for the Preparation and Presentation of Financial Statements*, which was published by the Board's predecessor body in 1989 (hereinafter called *Framework* (1989)), dealt with financial statements only. Therefore, for both boards the scope of the *Conceptual Framework* is broader.[23]

BC1.5 Some constituents suggested that advances in technology may make general purpose financial reporting obsolete. New technologies, for example the use of eXtensible Business Reporting Language (XBRL), may make it practicable in the future for reporting entities either to prepare or to make available the information necessary for different users to assemble different financial reports to meet their individual information needs.

BC1.6 To provide different reports for different users, or to make available all of the information that users would need to assemble their own custom-designed reports, would be expensive. Requiring users of financial information to assemble their own reports might also be unreasonable, because many users would need to have a greater understanding of accounting than they have now. Therefore, the Board concluded that for now a general purpose financial report is still the most efficient and effective way to meet the information needs of a variety of users.

BC1.7 In the discussion paper, the Board used the term *general purpose external financial reporting*. External was intended to convey that internal users such as management were not the intended beneficiaries for general purpose financial reporting as established by the Board. During redeliberations, the Board concluded that this term was redundant. Therefore, Chapter 1 uses *general purpose financial reporting*.

Financial reporting of the reporting entity

BC1.8 Some respondents to the exposure draft said that the reporting entity is not separate from its equity investors or a subset of those equity investors. This view has its roots in the days when most businesses were sole proprietorships and partnerships that were managed by their owners who had unlimited liability for the debts incurred in the course of the business. Over time, the separation between businesses and their owners has grown. The vast majority of today's businesses have legal substance separate from their owners by virtue of their legal form of organisation, numerous investors with limited legal liability and professional managers separate from the owners. Consequently, the Board concluded that financial reports should reflect that separation by accounting for the entity (and its economic resources and claims) rather than its primary users and their interests in the reporting entity.[24]

23 Note for readers of the Exposure Draft: with the exception of Chapters 1 and 2, the Exposure Draft *Conceptual Framework for Financial Reporting* focuses on financial statements instead of financial reports (see paragraph BCIN.22).

24 Note for readers of the Exposure Draft: Chapter 3 of the Exposure Draft *Conceptual Framework for Financial Reporting* discusses the reporting entity and the perspective of financial statements (see paragraphs BC3.9–BC3.22).

Primary users

BC1.9 The objective of financial reporting in paragraph OB2 refers to existing and potential investors, lenders and other creditors. The description of the primary users in paragraph OB5 refers to existing and potential investors, lenders and other creditors who cannot require reporting entities to provide information directly to them. Paragraph OB10 states that 'regulators and members of the public other than investors, lenders and other creditors' may find information in general purpose financial reports useful but clearly states that those are not the parties to whom general purpose financial reports are primarily directed.

BC1.10 Paragraph 9 of the *Framework* (1989) stated that users included 'present and potential investors, employees, lenders, suppliers and other trade creditors' (and later added advisers in the discussion of investors' needs), all of which are intended to be encompassed by the phrase in paragraph OB2. Paragraph 9 of the *Framework* (1989) also included a list of other potential users such as customers, governments and their agencies, and the public, which is similar to the list in paragraph OB10 of those who may be interested in financial reports but are not primary users.

BC1.11 Paragraph 10 of the *Framework* (1989) stated that 'as investors are providers of risk capital to the entity, the provision of financial statements that meet their needs will also meet most of the needs of other users that financial statements can satisfy', which might have been read to narrow the focus to investors only. However, paragraph 12 explicitly stated that the objective of financial statements is to provide information 'that is useful to a wide range of users in making economic decisions.' Thus, the *Framework* (1989) focused on investors' needs as representative of the needs of a wide range of users but did not explicitly identify a group of primary users.

BC1.12 FASB Concepts Statement 1 referred to 'present and potential investors and creditors and other users in making rational investment, credit, and similar decisions' (paragraph 34). It also stated that 'major groups of investors are equity securityholders and debt securityholders' and 'major groups of creditors are suppliers of goods and services who extend credit, customers and employees with claims, lending institutions, individual lenders, and debt securityholders' (paragraph 35). One difference in emphasis from the *Framework* (1989), which emphasised providers of risk capital, is that Concepts Statement 1 referred to 'both those who desire safety of investment and those who are willing to accept risk to obtain high rates of return' (paragraph 35). However, like the *Framework* (1989), Concepts Statement 1 stated that the terms investors and creditors 'also may comprehend security analysts and advisors, brokers, lawyers, regulatory agencies, and others who advise or represent the interests of investors and creditors or who otherwise are interested in how investors and creditors are faring' (paragraph 35).

BC1.13 Paragraphs OB3, OB5 and OB10 differ from the *Framework* (1989) and Concepts Statement 1 for two reasons—to eliminate differences between the *Framework* and Concepts Statement 1 and to be more direct by focusing on users making decisions about providing resources (but not to exclude advisers). The reasons are discussed in paragraphs BC1.15–BC1.24.

Should there be a primary user group?

BC1.14 The discussion paper and the exposure draft proposed identifying a group of primary users of financial reports. Some respondents to the exposure draft said that other users who have not provided, and are not considering providing, resources to the entity, use financial reports for a variety of reasons. The Board sympathised with their information needs but concluded that without a defined group of primary users, the *Conceptual Framework* would risk becoming unduly abstract or vague.

Why are existing and potential investors, lenders and other creditors considered the primary users?

BC1.15 Some respondents to the discussion paper and the exposure draft suggested that the primary user group should be limited to existing shareholders or the controlling entity's majority shareholders. Others said that the primary users should be existing shareholders and creditors, and that financial reports should focus on their needs.

BC1.16 The reasons why the Board concluded that the primary user group should be the existing and potential investors, lenders and other creditors of a reporting entity are:

(a) Existing and potential investors, lenders and other creditors have the most critical and immediate need for the information in financial reports and many cannot require the entity to provide the information to them directly.

(b) The Board's and the FASB's responsibilities require them to focus on the needs of participants in capital markets, which include not only existing investors but also potential investors and existing and potential lenders and other creditors.

(c) Information that meets the needs of the specified primary users is likely to meet the needs of users both in jurisdictions with a corporate governance model defined in the context of shareholders and those with a corporate governance model defined in the context of all types of stakeholders.

BC1.17 Some respondents expressed the view that the specified primary user group was too broad and that it would result in too much information in the financial reports. However, *too much* is a subjective judgement. In developing financial reporting requirements that meet the objective of financial reporting, the boards will rely on the qualitative characteristics of, and the cost constraint on, useful financial information to provide discipline to avoid providing too much information.[25]

25 Note for readers of the Exposure Draft: the Basis for Conclusions on the Exposure Draft *Conceptual Framework for Financial Reporting* includes an additional discussion of primary users (see paragraphs BCIN.35–BCIN.43 and BC1.11–BC1.13).

Should there be a hierarchy of users?

BC1.18 Some respondents to the exposure draft who supported the composition of the primary user group also recommended that the Board should establish a hierarchy of primary users because investors, lenders and other creditors have different information needs. However, the Board observed that individual users may have information needs and desires that are different from, and possibly conflict with, those of other users with the same type of interest in the reporting entity. General purpose financial reports are intended to provide common information to users and cannot accommodate every request for information. The Board will seek the information set that is intended to meet the needs of the maximum number of users in cost-beneficial ways.

Information needs of other users who are not within the primary user group

Management's information needs

BC1.19 Some constituents questioned the interaction between general purpose financial reporting and management's needs. The Board stated that some of the information directed to the primary users is likely to meet some of management's needs but not all of them. However, management has the ability to access additional financial information, and consequently, general purpose financial reporting need not be explicitly directed to management.

Regulators' information needs

BC1.20 Some constituents said that maintaining financial stability in capital markets (the stability of a country's or region's economy or financial systems) should be an objective of financial reporting. They stated that financial reporting should focus on the needs of regulators and fiscal policy decision-makers who are responsible for maintaining financial stability.

BC1.21 Other constituents opposed establishing an objective to maintain financial stability. They said that financial statements should present the economic reality of the reporting entity with as little bias as possible, but that such a presentation is not necessarily inconsistent with a financial stability objective. By presenting economic reality, financial statements could lead to more informed decision-making and thereby support financial stability even if that is not the primary aim.[26]

BC1.22 However, advocates of a financial stability objective had a different outcome in mind. They did not encourage the Board to require reporting entities to provide information for use by regulators and fiscal policy decision-makers. Instead, they recommended that the Board consider the consequences of new financial reporting standards for the stability of the world's economies and financial

26 One group expressing that view was the Financial Crisis Advisory Group (FCAG). The FCAG comprised approximately 20 senior leaders with broad experience in international financial markets and an interest in the transparency of financial reporting information. The FCAG was formed in 2009 to advise the Board and the FASB about the standard-setting implications of the financial crisis and of potential changes in the global regulatory environment.

systems and, at least at times, assign greater weight to that objective than to the information needs of investors, lenders and other creditors.

BC1.23 The Board acknowledged that the interests of investors, lenders and other creditors often overlap with those of regulators. However, expanding the objective of financial reporting to include maintaining financial stability could at times create conflicts between the objectives that the Board is not well-equipped to resolve. For example, some may take the view that the best way to maintain financial stability is to require entities not to report, or to delay reporting, some changes in asset or liability values. That requirement would almost certainly result in depriving investors, lenders and other creditors of information that they need. The only way to avoid conflicts would be to eliminate or de-emphasise the existing objective of providing information to investors, lenders and other creditors. The Board concluded that eliminating that objective would be inconsistent with its basic mission, which is to serve the information needs of participants in capital markets. The Board also noted that providing relevant and faithfully represented financial information can improve users' confidence in the information, and thus contribute to promoting financial stability.

Usefulness for making decisions

BC1.24 Both the Board's and the FASB's previous frameworks focused on providing information that is useful in making economic decisions as the fundamental objective of financial reporting. Those frameworks also stated that financial information that is useful in making economic decisions would also be helpful in assessing how management has fulfilled its stewardship responsibility.

BC1.25 The discussion paper that led to Chapter 1 stated that the objective of financial reporting should focus on resource allocation decisions. Although most respondents to the discussion paper agreed that providing useful information for decision-making was the appropriate objective, they said that investors, lenders and other creditors make other decisions that are aided by financial reporting information in addition to resource allocation decisions. For example, shareholders who vote on whether to retain directors or replace them, and on how members of management should be remunerated for their services, need information on which to base their decisions. Shareholders' decision-making process may include evaluating how management of the entity performed against management in competing entities in similar circumstances.

BC1.26 The Board agreed with these respondents and noted that, in most cases, information designed for resource allocation decisions would also be useful for assessing management's performance. Therefore, in the exposure draft leading to Chapter 1, the Board proposed that the objective of financial reporting is to provide financial information about the reporting entity that is useful to present and potential investors, lenders and other creditors in making decisions in their capacity as capital providers. The exposure draft also described the role financial statements can have in supporting decisions related to the stewardship of an entity's resources.

BC1.27 The exposure draft discussed the *Objective of Financial Reporting* and *Decision-usefulness* in separate sections. The Board combined those two sections in Chapter 1 because usefulness in making decisions is the objective of financial reporting. Consequently, both sections addressed the same points and provided more detail than was necessary. Combining those two sections resulted in eliminating the separate subsections on usefulness in assessing cash flow prospects and usefulness in assessing stewardship. The Board did not intend to imply that assessing prospects for future cash flow or assessing the quality of management's stewardship is more important than the other. Both are important for making decisions about providing resources to an entity, and information about stewardship is also important for resource providers who have the ability to vote on, or otherwise influence, management's actions.

BC1.28 The Board decided not to use the term *stewardship* in the chapter because there would be difficulties in translating it into other languages. Instead, the Board described what stewardship encapsulates. Accordingly, the objective of financial reporting acknowledges that users make resource allocation decisions as well as decisions as to whether management has made efficient and effective use of the resources provided.[27]

The objective of financial reporting for different types of entities

BC1.29 The Board also considered whether the objective of general purpose financial reporting should differ for different types of entities. Possibilities include:

(a) smaller entities versus larger entities;

(b) entities with listed (publicly traded) debt or equity financial instruments versus those without such instruments; and

(c) closely held entities versus those with widely dispersed ownership.

BC1.30 External users of financial reporting have similar objectives, irrespective of the type of entities in which they invest. Therefore, the Board concluded that the objective of general purpose financial reports is the same for all entities. However, cost constraints and differences in activities among entities may sometimes lead the Board to permit or require differences in reporting for different types of entities.

27 Note for readers of the Exposure Draft: the Exposure Draft *Conceptual Framework for Financial Reporting* proposes to increase the prominence of stewardship within the overall objective of financial reporting (see paragraphs 1.3–1.4, 1.15, 1.20 and 1.22–1.23 of the Exposure Draft and paragraphs BC1.6–BC1.10 of the related Basis for Conclusions).

Information about a reporting entity's resources, claims against the entity and changes in resources and claims

The significance of information about financial performance

BC1.31 A long-standing assertion by many constituents is that a reporting entity's financial performance as represented by comprehensive income and its components is the most important information.[28] Concepts Statement 1 (paragraph 43) stated:

> The primary focus of financial reporting is information about an enterprise's performance provided by measures of comprehensive income and its components. Investors, creditors, and others who are concerned with assessing the prospects for enterprise net cash inflows are especially interested in that information.

In contrast, the *Framework* (1989) considered information on the reporting entity's financial position and financial performance of equal importance.

BC1.32 To be useful for decision-making, financial reports must provide information about a reporting entity's economic resources and claims, and the change during a period in economic resources and claims. A reporting entity cannot provide reasonably complete information about its financial performance (as represented by comprehensive income, profit or loss or other similar terms) without identifying and measuring its economic resources and the claims. Consequently, the Board concluded that to designate one type of information as the primary focus of financial reporting would be inappropriate.

BC1.33 In discussing the financial position of an entity, the exposure draft referred to *economic resources and claims on them*. The chapter uses the phrase *economic resources of the reporting entity and the claims against the reporting entity* (see paragraph OB12). The reason for the change is that in many cases, claims against an entity are not claims on specific resources. In addition, many claims will be satisfied using resources that will result from future net cash inflows. Thus, while all claims are claims against the entity, not all are claims against the entity's existing resources.

Financial position and solvency

BC1.34 Some constituents have suggested that the main purpose of the statement of financial position should be to provide information that helps assess the reporting entity's solvency. The question is not whether information provided in the financial reports should be helpful in assessing solvency; clearly, it should. Assessing solvency is of interest to investors, lenders and other creditors, and the objective of general purpose financial reporting is to provide information that is useful to them for making decisions.

BC1.35 However, some have suggested that the statement of financial position should be directed towards the information needs of lenders, other creditors and

28 Concepts Statement 1 referred to *earnings and its components*. However, FASB Concepts Statement No. 6 *Elements of Financial Statements* substituted the term *comprehensive income* for the term *earnings*. The latter term is reserved for a component of comprehensive income.

regulators, possibly to the detriment of investors and other users. To do so would be inconsistent with the objective of serving the common information needs of the primary user group. Therefore, the Board rejected the notion of directing the statement of financial position (or any other particular financial statement) towards the needs of a particular subset of users.

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Chapter 3: *Qualitative characteristics of useful financial information*

This Basis for Conclusions accompanies, but is not part of, Chapter 3.

Introduction

BC3.1 This Basis for Conclusions summarises considerations of the Board in reaching the conclusions in Chapter 3 *Qualitative characteristics of useful financial information*. It includes reasons for accepting some alternatives and rejecting others. Individual Board members gave greater weight to some factors than to others.

BC3.2 The Board developed the chapter jointly with the US Financial Accounting Standards Board (FASB). Consequently, this Basis for Conclusions also includes some references to the FASB's literature.

Background

BC3.3 The Board began the process of developing the qualitative characteristics of useful financial information by reviewing its own framework and concepts as well as those of other standard-setters. In July 2006 the Board published for public comment a discussion paper on this topic. That same paper was also published by the FASB. The Board and the FASB received 179 responses. In its redeliberations of the issues on this topic, the Board considered all of the comments received and information gained from other outreach initiatives. In May 2008 the Board and the FASB jointly published an exposure draft. The boards received 142 responses. The Board reconsidered all of the issues. This document is the result of those reconsiderations.

The objective of financial reporting and the qualitative characteristics of useful financial information

BC3.4 Alternatives are available for all aspects of financial reporting, including recognition, derecognition, measurement, classification, presentation and disclosure. When developing financial reporting standards, the Board will choose the alternative that goes furthest towards achieving the objective of financial reporting. Providers of financial information will also have to choose among the alternatives if there are no applicable standards available, or if application of a particular standard requires judgements or options, to achieve the objective of financial reporting.

BC3.5 Chapter 1 specifies that the objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity. The decision-makers on which this *Conceptual Framework* focuses are existing and potential investors, lenders and other creditors.

BC3.6 That objective by itself leaves a great deal to judgement and provides little guidance on how to exercise that judgement. Chapter 3 describes the first step in making the judgements needed to apply that objective. It identifies and describes the qualitative characteristics that financial information should have if it is to meet the objective of financial reporting. It also discusses cost, which is a pervasive constraint on financial reporting.

BC3.7 Subsequent chapters will use the qualitative characteristics to help guide choices about recognition, measurement and the other aspects of financial reporting.

Fundamental and enhancing qualitative characteristics

BC3.8 Chapter 3 distinguishes between the fundamental qualitative characteristics that are the most critical and the enhancing qualitative characteristics that are less critical but still highly desirable. The discussion paper did not explicitly distinguish between those qualitative characteristics. The Board made the distinction later because of confusion among respondents to the discussion paper about how the qualitative characteristics relate to each other.

BC3.9 Some respondents to the exposure draft stated that all of the qualitative characteristics should be considered equal, and that the distinction between fundamental and enhancing qualitative characteristics was arbitrary. Others said that the most important qualitative characteristic differs depending on the circumstances; therefore, differentiating qualitative characteristics was not appropriate.

BC3.10 The Board does not agree that the distinction is arbitrary. Financial information without the two fundamental qualitative characteristics of relevance and faithful representation is not useful, and it cannot be made useful by being more comparable, verifiable, timely or understandable. However, financial information that is relevant and faithfully represented may still be useful even if it does not have any of the enhancing qualitative characteristics.

Fundamental qualitative characteristics

Relevance

BC3.11 It is self-evident that financial information is useful for making a decision only if it is capable of making a difference in that decision. *Relevance* is the term used in the *Conceptual Framework* to describe that capability. It is a fundamental qualitative characteristic of useful financial information.

BC3.12 The definition of relevance in the *Conceptual Framework* is consistent with the definition in FASB Concepts Statement No. 2 *Qualitative Characteristics of Accounting Information*. The *Framework* (1989) definition of relevance was that information is relevant only if it actually makes a difference in users' decisions. However, users consider a variety of information from many sources, and the extent to which a decision is affected by information about a particular economic phenomenon is difficult, if not impossible, to determine, even after the fact.

BC3.13 In contrast, whether information is *capable* of making a difference in a decision (relevance as defined in the *Conceptual Framework*) can be determined. One of the primary purposes of publishing exposure drafts and other due process documents is to seek the views of users on whether information that would be required by proposed financial reporting standards is capable of making a difference in their decisions. The Board also assesses relevance by meeting users to discuss proposed standards, potential agenda decisions, effects on reported information of applying recently implemented standards and other matters.

Predictive and confirmatory value

BC3.14 Many decisions by investors, lenders and other creditors are based on implicit or explicit predictions about the amount and timing of the return on an equity investment, loan or other credit instrument. Consequently, information is capable of making a difference in one of those decisions only if it will help users to make new predictions, confirm or correct prior predictions or both (which is the definition of predictive or confirmatory value).

BC3.15 The *Framework* (1989) identified predictive value and confirmatory value as components of relevance, and Concepts Statement 2 referred to predictive value and feedback value. The Board concluded that confirmatory value and feedback value were intended to have the same meaning. The Board and the FASB agreed that both boards would use the same term (confirmatory value) to avoid giving the impression that the two frameworks were intended to be different.

The difference between predictive value and related statistical terms

BC3.16 Predictive value, as used in the *Conceptual Framework*, is not the same as predictability and persistence as used in statistics. Information has predictive value if it can be used in making predictions about the eventual outcomes of past or current events. In contrast, statisticians use predictability to refer to the accuracy with which it is possible to foretell the next number in a series and persistence to refer to the tendency of a series of numbers to continue to change as it has changed in the past.

Materiality

BC3.17 Concepts Statement 2 and the *Framework* (1989) discussed materiality and defined it similarly. Concepts Statement 2 described materiality as a constraint on financial reporting that can be considered only together with the qualitative characteristics, especially relevance and faithful representation. The *Framework* (1989), on the other hand, discussed materiality as an aspect of relevance and did not indicate that materiality has a role in relation to the other qualitative characteristics.

BC3.18 The discussion paper and the exposure draft proposed that materiality is a pervasive constraint in financial reporting because it is pertinent to all of the qualitative characteristics. However, some respondents to the exposure draft agreed that although materiality is pervasive, it is not a constraint on a reporting entity's ability to report information. Rather, materiality is an aspect of relevance, because immaterial information does not affect a user's decision. Furthermore, a standard-setter does not consider materiality when developing standards because it is an entity-specific consideration. The boards agreed with those views and concluded that materiality is an aspect of relevance that applies at the individual entity level.[29]

Faithful representation

BC3.19 The discussion of faithful representation in Chapter 3 differs from that in the previous frameworks in two significant ways. First, it uses the term *faithful representation* instead of the term *reliability*. Second, substance over form, prudence (conservatism) and verifiability, which were aspects of reliability in Concepts Statement 2 or the *Framework* (1989), are not considered aspects of faithful representation. Substance over form and prudence were removed for the reasons described in paragraphs BC3.26–BC3.29. Verifiability is now described as an enhancing qualitative characteristic rather than as part of this fundamental qualitative characteristic (see paragraphs 3.34–3.36).

Replacement of the term reliability

BC3.20 Concepts Statement 2 and the *Framework* (1989) used the term *reliability* to describe what is now called faithful representation.

BC3.21 Concepts Statement 2 listed representational faithfulness, verifiability and neutrality as aspects of reliability and discussed completeness as part of representational faithfulness.

BC3.22 The *Framework* (1989) said:

> Information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully that which it either purports to represent or could reasonably be expected to represent.

The *Framework* (1989) also discussed substance over form, neutrality, prudence and completeness as aspects of faithful representation.

BC3.23 Unfortunately, neither framework clearly conveyed the meaning of reliability. The comments of respondents to numerous proposed standards indicated a lack of a common understanding of the term *reliability*. Some focused on *verifiability* or *free from material error* to the virtual exclusion of faithful representation. Others focused more on faithful representation, perhaps combined with neutrality. Some apparently think that reliability refers primarily to precision.

BC3.24 Because attempts to explain what reliability was intended to mean in this context have proved unsuccessful, the Board sought a different term that would more clearly convey the intended meaning. The term *faithful representation*, the faithful depiction in financial reports of economic phenomena, was the result of that search. That term encompasses the main characteristics that the previous frameworks included as aspects of reliability.

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29 Note for readers of the Exposure Draft: the Exposure Draft *Conceptual Framework for Financial Reporting* proposes to clarify that the reference to users in the discussion of materiality is to the primary users of general purpose financial reports (see paragraph 2.11 of the Exposure Draft and paragraphs BC2.28–BC2.31 of the related Basis for Conclusions).

BC3.25 Many respondents to the discussion paper and the exposure draft opposed the Board's preliminary decision to replace *reliability* with *faithful representation*. Some said that the Board could have better explained what reliable means rather than replacing the term. However, many respondents who made those comments assigned a different meaning to reliability from what the Board meant. In particular, many respondents' descriptions of reliability more closely resembled the Board's notion of verifiability than its notion of reliability. Those comments led the Board to affirm its decision to replace the term *reliability* with *faithful representation*.[30]

Substance over form

BC3.26 Substance over form is not considered a separate component of faithful representation because it would be redundant. Faithful representation means that financial information represents the substance of an economic phenomenon rather than merely representing its legal form. Representing a legal form that differs from the economic substance of the underlying economic phenomenon could not result in a faithful representation.[31]

Prudence (conservatism) and neutrality

BC3.27 Chapter 3 does not include prudence or conservatism as an aspect of faithful representation because including either would be inconsistent with neutrality. Some respondents to the discussion paper and exposure draft disagreed with that view. They said that the framework should include conservatism, prudence or both. They said that bias should not always be assumed to be undesirable, especially in circumstances when bias, in their view, produces information that is more relevant to some users.

BC3.28 Deliberately reflecting conservative estimates of assets, liabilities, income or equity has sometimes been considered desirable to counteract the effects of some management estimates that have been perceived as excessively optimistic. However, even with the prohibitions against deliberate misstatement that appear in the existing frameworks, an admonition to be prudent is likely to lead to a bias. Understating assets or overstating liabilities in one period frequently leads to overstating financial performance in later periods—a result that cannot be described as prudent or neutral.[32]

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30 Note for readers of the Exposure Draft: the Basis for Conclusions on the Exposure Draft *Conceptual Framework for Financial Reporting* explains why the IASB reaffirmed its 2010 decision not to use the term 'reliability' as a label for the qualitative characteristic called 'faithful representation'. In addition, the Exposure Draft proposes to clarify how measurement uncertainty affects the relevance of an estimate (see paragraphs 2.12–2.13 of the Exposure Draft and paragraphs BC2.21–BC2.25 of the related Basis for Conclusions).

31 Note for readers of the Exposure Draft: the Exposure Draft *Conceptual Framework for Financial Reporting* proposes to make an explicit reference to substance over form in the discussion of faithful representation (see paragraph 2.14 of the Exposure Draft and paragraphs BC2.18–BC2.20 of the related Basis for Conclusions).

32 Note for readers of the Exposure Draft: the Exposure Draft *Conceptual Framework for Financial Reporting* proposes to reintroduce a reference to prudence in the *Conceptual Framework* and describe prudence as the exercise of caution when making judgements under conditions of uncertainty (see paragraph 2.18 of the Exposure Draft and paragraphs BC2.1–BC2.17 of the related Basis for Conclusions).

BC3.29 Other respondents to the exposure draft said that neutrality is impossible to achieve. In their view, relevant information must have purpose, and information with a purpose is not neutral. In other words, because financial reporting is a tool to influence decision-making, it cannot be neutral. Obviously, reported financial information is expected to influence the actions of users of that information, and the mere fact that many users take similar actions on the basis of reported information does not demonstrate a lack of neutrality. The Board does not attempt to encourage or predict specific actions of users. If financial information is biased in a way that encourages users to take or avoid predetermined actions, that information is not neutral.

Can faithful representation be empirically measured?

BC3.30 Empirical accounting researchers have accumulated considerable evidence supporting relevant and faithfully represented financial information through correlation with changes in the market prices of entities' equity or debt instruments. However, such studies have not provided techniques for empirically measuring faithful representation apart from relevance.

BC3.31 Both previous frameworks discussed the desirability of providing statistical information about how faithfully a financial measure is represented. That would not be unprecedented. Other statistical information is sometimes reflected in financial reports. For example, some entities disclose value at risk from derivative financial instruments and similar positions. The Board expects that the use of statistical concepts for financial reporting in some situations will continue to be important. Unfortunately, the boards have not identified any way to quantify the faithfulness of the representations in a financial report.

Enhancing qualitative characteristics

Comparability

BC3.32 Comparability was an important concept in both the *Framework* (1989) and Concepts Statement 2, but the two previous frameworks disagreed on its importance. The *Framework* (1989) stated that comparability is as important as relevance and faithful representation.[33] Concepts Statement 2 described comparability as a quality of the relationship between two or more pieces of information that, although important, is secondary to relevance and faithful representation.

BC3.33 Relevant and faithfully represented information is most useful if it can be readily compared with similar information reported by other entities and by the same entity in other periods. One of the most important reasons that financial reporting standards are needed is to increase the comparability of reported financial information. However, even if it is not readily comparable, relevant and faithfully represented information is still useful. Comparable information, however, is not useful if it is not relevant and may mislead if it is not faithfully

33 The term *reliability* was used instead of *faithful representation*, but the meaning was intended to be similar.

represented. Therefore, *comparability* is considered an enhancing qualitative characteristic instead of a fundamental qualitative characteristic.

Verifiability

BC3.34 Verifiable information can be used with confidence. Lack of verifiability does not necessarily render information useless, but users are likely to be more cautious because there is a greater risk that the information does not faithfully represent what it purports to represent.

BC3.35 The *Framework* (1989) did not explicitly include verifiability as an aspect of reliability, but Concepts Statement 2 did. However, the two frameworks are not as different as it might appear because the definition of reliability in the *Framework* (1989) contained the phrase *and can be depended upon by users*, which implies that users need assurance on the information.

BC3.36 The discussion paper stated that reported financial information should be verifiable to assure users that it is free from material error and bias and can be depended on to represent what it purports to represent. Therefore, verifiability was considered an aspect of faithful representation. Some respondents pointed out that including verifiability as an aspect of faithful representation could result in excluding information that is not readily verifiable. Those respondents recognised that many forward-looking estimates that are very important in providing relevant financial information (for example, expected cash flows, useful lives and salvage values) cannot be directly verified. However, excluding information about those estimates would make the financial reports much less useful. The Board agreed and repositioned verifiability as an enhancing qualitative characteristic, very desirable but not necessarily required.

Timeliness

BC3.37 The *Framework* (1989) discussed timeliness as a constraint that could rob information of relevance. Concepts Statement 2 described timeliness as an aspect of relevance. However, the substance of timeliness as discussed in the two previous frameworks was essentially the same.

BC3.38 The discussion paper described timeliness as an aspect of relevance. However, some respondents pointed out that timeliness is not part of relevance in the same sense that predictive and confirmatory value are. The Board was persuaded that timeliness is different from the other components of relevance.

BC3.39 Timeliness is very desirable, but it is not as critical as relevance and faithful representation. Timely information is useful only if it is relevant and faithfully represented. In contrast, relevant and faithfully represented information may still be useful (especially for confirmatory purposes) even if it is not reported in as timely a manner as would be desirable.

Understandability

BC3.40 Both the *Framework* (1989) and Concepts Statement 2 included understandability, a qualitative characteristic that enables users to comprehend the information and therefore make it useful for making decisions. Both frameworks also similarly described that for financial information to be understandable, users should have a reasonable degree of financial knowledge and a willingness to study the information with reasonable diligence.

BC3.41 Despite those discussions of understandability and users' responsibilities for understanding financial reports, misunderstanding persists. For example, some have expressed the view that a new accounting method should not be implemented because some users might not understand it, even though the new accounting method would result in reporting financial information that is useful for decision-making. They imply that understandability is more important than relevance.

BC3.42 If understandability considerations were fundamental, it might be appropriate to avoid reporting information about very complicated things even if the information is relevant and faithfully represented. Classifying understandability as an enhancing qualitative characteristic is intended to indicate that information that is difficult to understand should be presented and explained as clearly as possible.[34]

BC3.43 To clarify another frequently misunderstood point, the *Conceptual Framework* explains that users are responsible for *actually* studying reported financial information with reasonable diligence rather than only being *willing* to do so (which was the statement in the previous frameworks). In addition, the *Conceptual Framework* states that users may need to seek the aid of advisers to understand economic phenomena that are particularly complex.

Qualitative characteristics not included

BC3.44 *Transparency*, *high quality*, *internal consistency*, *true and fair view or fair presentation* and *credibility* have been suggested as desirable qualitative characteristics of financial information. However, transparency, high quality, internal consistency, true and fair view or fair presentation are different words to describe information that has the qualitative characteristics of relevance and representational faithfulness enhanced by comparability, verifiability, timeliness and understandability. Credibility is similar but also implies trustworthiness of a reporting entity's management.

BC3.45 Interested parties sometimes suggested other criteria for standard-setting decisions, and the Board has at times cited some of those criteria as part of the rationale for some decisions. Those criteria include simplicity, operationality, practicability or practicality, and acceptability.

BC3.46 Those criteria are not qualitative characteristics. Instead, they are part of the overall weighing of benefits and costs of providing useful financial information. For example, a simpler method may be less costly to apply than a more complex method. In some circumstances, a simpler method may result in information that is essentially the same as, but somewhat less precise than, information produced by a more complex method. In that situation, a standard-setter would

34 Note for readers of the Exposure Draft: the Basis for Conclusions on the Exposure Draft *Conceptual Framework for Financial Reporting* explains why the IASB reaffirmed its 2010 decision not to elevate understandability from an enhancing qualitative characteristic to a fundamental qualitative characteristic (see paragraphs BC2.26–BC2.27).

include the decrease in faithful representation and the decrease in implementation cost in weighing benefits against costs.

The cost constraint on useful financial reporting

BC3.47 Cost is a pervasive constraint that standard-setters, as well as providers and users of financial information, should keep in mind when considering the benefits of a possible new financial reporting requirement.[35] Cost is not a qualitative characteristic of information. It is a characteristic of the process used to provide the information.

BC3.48 The Board has attempted and continues to attempt to develop more structured methods of obtaining information about the cost of gathering and processing the information that proposed standards would require entities to provide. The primary method used is to request interested parties, sometimes formally (such as by field tests and questionnaires), to submit cost and benefit information for a specific proposal that is quantified to the extent feasible. Those requests have resulted in helpful information and have led directly to changes to proposed requirements to reduce the costs without significantly reducing the related benefits.

35 Note for readers of the Exposure Draft: the Basis for Conclusions on the Exposure Draft *Conceptual Framework for Financial Reporting* notes that the cost constraint plays a particularly important role in some aspects of financial reporting and hence the Exposure Draft incudes a discussion of the cost constraint in those areas (see paragraph BC2.33).

Alternative views on the *Conceptual Framework* Exposure Draft

AV1 Mr Cooper, Mr Finnegan and Ms Lloyd voted against the publication of the Exposure Draft:

(a) Mr Cooper and Mr Finnegan voted against the publication for the reasons given in paragraphs AV2–AV7;

(b) Ms Lloyd and Mr Finnegan voted against publication for the reasons given in paragraphs AV8–AV14; and

(c) Mr Finnegan also voted against publication for the reasons given in paragraphs AV15–AV34.

Alternative view of Stephen Cooper and Patrick Finnegan

AV2 Mr Cooper and Mr Finnegan voted against the publication of the Exposure Draft because they do not believe that Chapter 7 of the proposed *Conceptual Framework* provides an adequate basis for the IASB to make decisions about the presentation of income and expenses, and in particular on what amounts should be reported in OCI and whether and when they should be subsequently reclassified to profit or loss (recycled). They consider that the Exposure Draft represents a missed opportunity to identify a conceptual basis for the use of OCI, with the IASB effectively being in no better position than it is now in determining how it should be used. Mr Cooper and Mr Finnegan also disagree with the combination of a lack of discipline in the use of OCI with the rebuttable presumption that items are reclassified to profit and loss. They are concerned that this would lead to the use of an arbitrary basis for the reclassification of some OCI amounts.

AV3 Mr Cooper and Mr Finnegan agree that performance reporting, the presentation of different types of income and expenses and the use of OCI are key issues in financial reporting and that it is important that the *Conceptual Framework* provides a foundation for related Standards-level decisions. However, they believe that the proposals in the Exposure Draft lack that conceptual basis. Identifying the statement of profit or loss as the primary source of information about financial performance, but without actually defining financial performance or specifying the characteristics of income and expenses that require their presentation in OCI, will leave the IASB in effectively the same position that it is now. In addition, the approach to recycling provides little guidance, because there are no specific reasons presented that would rebut the presumption that recycling takes place (other than the reference to relevance).

AV4 Mr Cooper and Mr Finnegan think that the conceptual foundation for performance reporting should be based on principles of separate presentation of income and expenses with different characteristics, including, for example, different degrees of persistence and different predictive values, and principles of disaggregation or splitting of items of income and expenses to highlight components that have different characteristics. In general, such disaggregation should be done within profit or loss, either on the face of the statement or in the notes. However, Mr Cooper and Mr Finnegan acknowledge that there may be some circumstances in which disaggregation may be best done by recognising some components of income and expenses in OCI and not in profit or loss. Nevertheless, they believe that the *Conceptual Framework* should restrict the use of this approach (unless the IASB chooses to depart from the *Conceptual Framework*) more than the Exposure Draft proposes.

AV5 Mr Cooper and Mr Finnegan think that the principle governing the disaggregation of a component of income or expenses referred to in paragraph AV4 should result in an amount recognised outside profit or loss, but only if doing so enhances the relevance of the information in the statement of profit or loss in that reporting period. Moreover, they think that this must also hold true for all other periods that may be affected, including periods covered by any potential recycling, and also in aggregate over several periods, including the life of the transaction concerned. To achieve this, the basis of disaggregation should result in a net zero accumulated amount in OCI over the life of a transaction or in aggregate over the life of economically linked transactions. If the cumulative amount in OCI is not zero, then the relevance of the information in the statement of profit or loss is reduced on a cumulative basis, because some items of income and expenses would be entirely omitted from the statement of profit or loss and so the depiction of financial performance in that statement would not be complete. They also believe that the principle they outline would obviate the need to consider explicit reclassification of OCI items (because the disaggregation should naturally result in zero cumulative OCI over the life of the relevant transactions) and would therefore remove a source of complexity and confusion for users of financial statements.

AV6 Mr Cooper and Mr Finnegan consider that this principle would, in effect, restrict the use of OCI to a limited number of cases in which either (1) a different measurement basis (which, as noted in paragraph BC7.49, should be a meaningful measure and not just an accumulation of amounts recognised in the statement of profit or loss) is judged appropriate for measuring income and expenses in profit or loss, compared with that best suited to the measurement of the asset or the liability in the statement of financial position; or (2) there is a mismatch in the recognition basis for different but economically related transactions. These are two of the three situations for use of OCI envisaged in the Discussion Paper. Mr Cooper and Mr Finnegan believe that further work to develop a conceptual basis for OCI should have built on these.

AV7 Mr Cooper and Mr Finnegan think that the proposals in the Exposure Draft would likely result in a much wider use of OCI than they have outlined in paragraphs AV5–AV6. For these additional items it is proposed that there should be a presumption that reclassification (recycling) takes place. Mr Cooper and Mr Finnegan consider that if the IASB does decide that remeasurements other than those described in paragraph AV6 can be presented in OCI, they should not be subsequently reclassified. To do so would create items in profit or loss that do not meet the definition of income and expenses, that are confusing for investors and that distort profit or loss in the period of reclassification. As a result, Mr Cooper and Mr Finnegan think that these other remeasurements are best dealt with in profit or loss, with appropriate presentation to emphasise their different characteristics, and not in OCI.

Alternative view of Suzanne Lloyd and Patrick Finnegan

AV8 Ms Lloyd and Mr Finnegan voted against the publication of the Exposure Draft because they disagree with the limited nature of the changes proposed to the definition of a liability (see paragraphs BCIN.25 and BC4.93–BC4.103). Ms Lloyd and Mr Finnegan agree that the definition of a liability should be used to distinguish between liabilities and equity. However, Ms Lloyd and Mr Finnegan believe that the IASB should have more fully considered changes to the definition of a liability to address the classification of claims against an entity as liabilities or equity. Ms Lloyd and Mr Finnegan think that the Exposure Draft should have included either:

(a) the IASB's conclusion that the definition of a liability that is being proposed is suitable for distinguishing between liabilities and equity; or

(b) additional changes to the definition of a liability that would make it suitable for such a purpose.

AV9 The objective of the *Conceptual Framework* project is to improve financial reporting by providing a more complete, clear and updated set of concepts. Ms Lloyd and Mr Finnegan believe that the distinction between liabilities and equity is an issue that:

(a) is not adequately addressed or explained in the current *Conceptual Framework*; and

(b) is fundamental to reporting the effects of financial instruments with characteristics of both debt and equity.

AV10 Ms Lloyd and Mr Finnegan believe that the lack of adequate concepts in the current *Conceptual Framework* is evidenced both by inconsistent application of the existing definitions of equity and liability in Standards and in inconsistencies between these definitions in the *Conceptual Framework* and in Standards. In particular, this is the case for more complex financial instruments that have characteristics of both liabilities and equity. For example, the classification of a financial instrument differs between IFRS 2 *Share-based Payments* and IAS 32 *Financial Instruments: Presentation* if the entity has an obligation to deliver a variable number of equity instruments equal to a specified amount (ie if it uses its own shares as 'currency' to settle the instrument). IAS 32 also includes a limited-scope exception from the definition of a liability for some puttable instruments that represent a residual interest in the entity.

AV11 As a result of responses to the recent financial crisis and to continuing financial innovation, increasingly complex financial instruments with characteristics of both debt and equity have been, and are continuing to be, created. Ms Lloyd and Mr Finnegan believe that there is a need to more fully consider how to classify such financial instruments to meet the information needs of investors, lenders and other creditors and to consider whether the existing definitions of equity and liability meet those information needs. Ms Lloyd and Mr Finnegan acknowledge that additional information can be provided through alternative presentation and disclosure requirements, and welcome further development of such requirements. However, Ms Lloyd and Mr Finnegan believe that the classification of claims as liabilities or equity has a fundamental effect on the reporting of an entity's financial position and financial performance. For financial performance in particular, classification is particularly important, because the definitions of income and expenses only include changes in claims if they are classified as liabilities.

AV12 Ms Lloyd and Mr Finnegan believe the *Conceptual Framework*'s definition of a liability and, as a consequence, of equity, need to be reconsidered in the light of these issues. In particular, Ms Lloyd and Mr Finnegan believe that the *Conceptual Framework* should more fully address whether and why the definition of a liability should or should not include:

(a) an obligation to deliver a variable number of equity instruments equal to a specified amount (ie when an entity uses its own shares as 'currency'); and

(b) an obligation to transfer a variable amount of cash or other economic resources equal to the value of an equity instrument.

AV13 Ms Lloyd and Mr Finnegan therefore disagree with the decision not to address the distinction between liabilities and equity in the Exposure Draft. They believe that, in failing to consider this, a fundamental conceptual issue for the classification of financial instruments is not addressed. Without reconsidering this distinction, including the effect on an entity's financial performance, Ms Lloyd and Mr Finnegan believe that the *Conceptual Framework* will fail to achieve the stated objective of 'assist[ing] the IASB to develop the Standards' when the issues at the Standards level relate to financial instruments that have characteristics of both liabilities and equity.

AV14 Ms Lloyd and Mr Finnegan acknowledge that the IASB has decided to consider the distinction between liabilities and equity in the Financial Instruments with Characteristics of Equity research project. However, the *Conceptual Framework* is intended to provide a basis for developing and revising Standards and Ms Lloyd and Mr Finnegan therefore believe that this analysis is better placed in the *Conceptual Framework* project. The research project is primarily a Standards-level project. A Standards-level project should ideally be based on applying or making considered departures from the *Conceptual Framework*, instead of being used to develop concepts that may subsequently be considered as changes to the *Conceptual Framework*. In addition, Ms Lloyd and Mr Finnegan believe that it will be more difficult to consider fundamental changes to the distinction between liabilities and equity in the research project than in the *Conceptual Framework* project. This is because the *Conceptual Framework* project will not necessarily result in subsequent changes at a Standards level and the research project is largely intended to focus on current application questions that have arisen in relation to IAS 32. Thus, by undertaking the analysis of the distinction between liabilities and equity in the *Conceptual Framework* project, it could be more aspirational and have a broader focus. Ms Lloyd and Mr Finnegan are also concerned that by considering this issue within the context of the research project, there will be a detrimental effect on the timeliness with which the IASB will be able to consider potential revisions or interpretations of existing Standards that deal with the distinction between liabilities and equity.

Alternative view of Patrick Finnegan

AV15 In addition to the reasons outlined above, Mr Finnegan voted against the publication of the Exposure Draft because he:

(a) disagrees with the decision to reintroduce an explicit reference to the notion of prudence in the *Conceptual Framework*;

(b) disagrees with the discussion of historical cost and current value measurement; and

(c) believes that the IASB has both a duty and an opportunity to spend more time developing concepts in the areas of:

(i) reporting financial performance; and

(ii) presentation and disclosure.

Prudence

AV16 Mr Finnegan disagrees with the decision to reintroduce an explicit reference to the notion of prudence in the *Conceptual Framework* to support the meaning of neutrality, ie a lack of bias in the selection or presentation of financial information. He believes that financial information possessing the characteristic of neutrality is already free from bias. Mr Finnegan thinks that if prudence is included in the *Conceptual Framework* or any Standard, it would introduce bias and would create confusion in the minds of many preparers about whether or how it should be applied. Even though the Exposure Draft attempts to make it clear that prudence is consistent with neutrality, Mr Finnegan disagrees that prudence (the exercise of caution) is consistent with neutrality. He believes the use of that term within the *Conceptual Framework* could result in:

(a) Standards designed to produce weighted outcomes.

(b) preparers being cautious by understating assets and overstating liabilities or being cautious in communicating bad news and hence overstating assets and understating liabilities. Such actions have the potential to confuse investors and lower their confidence in financial reporting.

Measurement

AV17 The Exposure Draft describes two principal categories of measurement bases—historical cost and current value—along with the perceived advantages and disadvantages of both. Mr Finnegan disagrees with those descriptions and believes that the application of such guidance will lead to a biased selection of the use of historical cost over current value. Mr Finnegan believes:

(a) current value information will always be more relevant than historical cost information (see paragraphs AV18–AV19);

(b) current value information maximises the enhancing qualitative characteristics to a greater extent compared with historical cost information and is not inherently more costly than historical cost information (see paragraphs AV20–AV22); and

(c) the Exposure Draft's proposed approach to guiding the selection of a measurement basis:

   (i) is flawed (see paragraph AV23);

   (ii) will perpetuate the variety of measurement bases in current IFRS, to the detriment of investors (see paragraphs AV24–AV25); and

   (iii) creates a bias for the use of historical cost measurement (see paragraph AV26).

Relevance

AV18 Mr Finnegan believes that current value measurement reflects the most relevant information about an asset or a liability and, hence, should have primacy in the statement of financial position and the statement(s) of financial performance. That belief is based on the view, and is supported by empirical evidence, that the changes in variables included in current values, such as changes in interest rates, price of credit and other market variables, result in information with greater predictive value compared with historical cost measures that do not include such changes.

AV19 Chapter 1 of the *Conceptual Framework* states that to make decisions about providing resources to an entity, users of financial statements assess both the prospects for future net cash inflows to an entity and also management's stewardship of the entity's resources. To do this, they need measures of assets, liabilities, income and expenses that capture the amount, timing and uncertainty of those net cash inflows. Current value measures do that more effectively than historical cost measures. Moreover, the use of historical cost provides more motivation and opportunity to manipulate profit or loss by realising income or expenses when desired compared with current value measurement.

Enhancing qualitative characteristics and cost

AV20 Mr Finnegan believes that current value information maximises the qualitative characteristics of comparability, timeliness and understandability to a greater extent than does historical cost information, and is at least as verifiable as historical cost information. In addition, he does not believe that historical cost measures are in many situations simpler and less expensive to provide than information using current measurement bases, as asserted in paragraph 6.15 of the Exposure Draft.

AV21 Mr Finnegan observes that both historical cost and current value measures are often based on market values at initial recognition. Consequently, at initial recognition, both historical cost and current values will be equally verifiable for a particular item, depending on whether verification is a direct observation or an indirect verification through an estimation technique. However, following initial recognition, historical cost requires preparers to make a number of subjective judgements that are involved in the process of estimating useful lives, salvage values or impairment. These judgements are no more verifiable than the estimates of current values. Furthermore, the process of including such judgements can make historical cost measures complex and difficult to understand; for example, amortised cost as required under IFRS 9 *Financial Instruments*.

AV22 When making comparisons between companies, historical cost amounts are rarely, if ever, comparable because they are recognised and adjusted at different dates, including some dates in the distant past. This can significantly distort the carrying amounts of the assets and the timing of the recognition of income and expenses from these assets. Collectively, this can significantly distort the reporting of real economic margins of an entity.

Selection of a measurement basis

AV23 One of the criteria proposed in the Exposure Draft for consideration when selecting a measurement basis deals with the characteristics of an asset or a liability; for example, the nature or extent of the expected variability of an asset or a liability's cash flows or the sensitivity of the value of an asset or a liability to changes in market forces. This criterion will not meet the objectives of financial reporting consistently because even a simple asset, for example, a government bond, may experience significant negative changes in value, which cannot be foreseen by management. In such circumstances, historical cost measurement would significantly overstate an entity's financial position, solvency and liquidity until management decides whether and by how much the asset has been impaired.

AV24 Another factor in selecting a measurement basis is how an asset or a liability contributes to future cash flows, which, in turn, depends in part on the nature of the business activities conducted by the entity. Mr Finnegan thinks this factor allows management intent to affect measurement. He thinks that how management intends to use an asset or realise its value may be inconsistent and be an unreliable indicator of the prospects of future net cash flows. Management's intentions about the way it intends to realise value are not static. Determining measurement attributes based on such intentions and assumptions introduces the potential for management bias, which can cause financial information to be less relevant and less faithfully represented compared to when it is consistently measured at current value.

AV25 Furthermore, there are numerous possible outcomes to the application of historical cost measurement. For example, the use of historical cost as described in the Exposure Draft can result in amounts for assets that reflect the effects of different estimates of consumption, different estimates of cash flows, different discount rates or different estimates of impairment. If this much judgement is warranted, it should focus instead on current value estimates.

AV26 The use of current value measures is linked to the presentation of income and expenses (see paragraphs AV29–AV33). Mr Finnegan thinks that the rebuttable presumption that changes in current value measure must be recognised in profit or loss unless they do not enhance the relevance of the information in profit or loss will create a barrier to the use of current value measure.

Summary of views on measurement

AV27 Mr Finnegan accepts that IASB members and many stakeholders believe that both historical cost measurement and current value measurement have a predictive ability and value relevance for investors. He acknowledges that there are circumstances in which the use of historical cost measurement would produce a result that would be materially consistent with the result produced by the use of current value measurement. For example, this would be the case when assets are consumed or converted to cash shortly after being recognised. However, Mr Finnegan believes that current value measures would be more relevant for financial statement analysis and that financial statement analysis would be easier for users if all assets and liabilities were measured using a consistent approach. Moreover, he also believes that the debate about whether historical cost provides more relevant information, that is, information less subject to measurement uncertainty compared to current value, is unlikely to be resolved on the basis of the way in which the revised *Conceptual Framework* is drafted.

AV28 Mr Finnegan is also concerned that many of the decisions regarding how to subsequently measure an asset or a liability after initial recognition derive from trying to deal with the concern about volatility in reported profit or loss, and are not based on whether the measure provides information with the qualitative characteristics as proposed in the *Conceptual Framework*. The fact is that economic volatility exists in business and managers regularly make decisions to engage in transactions that subject their businesses to this volatility. If this is the case, then Mr Finnegan believes that it seems entirely appropriate to report that volatility in the financial statements.

Reporting financial performance

AV29 Mr Finnegan believes that the principal challenge to using current value measurement more widely and consistently across IFRS is the concern raised by some stakeholders that its use will create volatility in reported profit or loss and, as a result, profit or loss will be less reliable. That concern has been raised during the IASB's deliberations in such areas as accounting for post-employment benefits, financial instruments, liabilities and equity, insurance contracts, revenue recognition and biological assets.

AV30 Mr Finnegan believes that the root of the debate between historical cost and current value lies in the existing focus of preparers and users on the use of a single statistic—profit or loss—to reflect performance for that period. When profit or loss is measured using current values, or even a mix of current values and historical costs, as proposed in the Exposure Draft, opponents of current value measurement argue that it results in financial performance that is less reliable and predictable than historical cost measurement. Mr Finnegan believes that in the Exposure Draft the IASB is not advancing the concepts needed to improve the quality of financial information for investors.

AV31 Mr Finnegan believes that the current impasse on the use of current value or historical cost could be better addressed if the Exposure Draft more clearly defined the purpose and use of other comprehensive income. As discussed in paragraph BC7.1, respondents to the IASB's Agenda Consultation 2011 identified the reporting of financial performance, including the use of OCI and reclassification of items from OCI, as a priority topic that the IASB should address.

AV32 According to paragraph 1.15 of the Exposure Draft (paragraph OB15 of the existing *Conceptual Framework*), changes in a reporting entity's economic resources and claims are a result of that entity's financial performance and other events and transactions such as issuing debt or equity instruments. Mr Finnegan believes that this statement implies that financial performance must be evaluated as including all changes in the total net assets, exclusive of transactions with holders of equity claims. Without greater clarity about why and how other comprehensive income is used, the emphasis on profit or loss as a primary source of information about performance has the potential to create a confusing picture of performance for investors.

AV33 As stated, Mr Finnegan believes that investors need to receive timely information about the changes in recognised assets and liabilities measured at current value. He believes that presentation through the use of OCI is an effective (albeit not necessarily an optimal) means of delivering such information, which the IASB has used in many areas. The IASB's current and proposed use of OCI has been primarily to report unrealised gains or losses resulting from remeasurements of assets and liabilities that were measured at fair value or other current value in the statement of financial position. Mr Finnegan believes that this provides useful information and communicates information about the characteristics of assets and liabilities in a more objective and timely way compared to the use of historical cost supplemented by the disclosure of current value information (see paragraphs 6.74–6.77 of the Exposure Draft).

Presentation and disclosure

AV34 Mr Finnegan believes the Exposure Draft's discussion of principles for presentation and disclosure should be changed as follows to address two critical areas of financial reporting that require improvement:

(a) *disaggregation*—Mr Finnegan believes that the *Conceptual Framework* should discuss the usefulness of financial information from the perspective of disaggregated information, not aggregated information. The financial statements issued by most entities report information that summarises a large volume of detail, as noted by paragraph 7.15 of the Exposure Draft. Such summarised information cannot provide the essential information necessary for an investor's understanding of financial performance (or financial position). Moreover, a significant amount of effort is expended by investors when analysing and using financial statements to identify, adjust and possibly remove amounts of income and expenses from reported financial performance to estimate 'sustainable' or 'normalised' performance. Mr Finnegan believes that, to address investors' needs, the *Conceptual Framework* should emphasise the importance of providing information in a way that highlights the effects of different economic attributes, different measurement bases and different trends. In particular, the *Conceptual Framework* should establish principles that would result in Standards specifying appropriate levels of disaggregation, with clear links between amounts recognised in the statements of financial position and financial performance and amounts presented and disclosed elsewhere in the financial statements.

(b) *relationships between assets, liabilities, income and expenses with cash flows*—Mr Finnegan believes that the disclosure principles in the *Conceptual Framework* should set an objective for all Standards to include a requirement for the disclosure of entity-specific information that shows or explains changes in assets and liabilities attributable to cash and non-cash changes for all assets and liabilities presented in the statement of financial position. One way of achieving this disclosure objective would be to provide reconciliations for all assets and liabilities, but the simple disclosure of cash and non-cash changes could also satisfy the objective. This would address the frequently heard call for improving the quality (or relevance) of disclosures in financial statements.

Table of Concordance

This table shows how the contents of the *Conceptual Framework for Financial Reporting* (2010) and the Exposure Draft *Conceptual Framework for Financial Reporting* correspond. Paragraphs are treated as corresponding if they broadly address the same matter even though the guidance may differ.

***Conceptual Framework* (2010) paragraphs**	**Exposure Draft paragraphs**
Introduction	Introduction
OB1–OB3 (Chapter 1)	1.1–1.3
OB4	1.4, 1.22–1.23
OB5–OB21	1.5–1.21
QC1–QC11 (Chapter 3)	2.1–2.11
QC12–QC15	2.14–2.17, 2.19
QC16–QC17	2.12–2.13, 2.20
QC18–QC39	2.21–2.42
4.1	3.10
4.2	4.2–4.3
4.3	7.10
4.4	4.3–4.4
4.5	5.7, 5.17–5.19
4.6	4.53–4.56
4.7	None
4.8–4.14	4.5–4.23
4.15–4.19	4.24–4.39
4.20–4.23	4.43–4.47
4.24	4.3, 7.22
4.25–4.35	4.48–4.52
4.36	8.10
4.37–4.53	5.1–5.24
4.46	4.40–4.42
4.54–4.56	6.1–6.80
4.57–4.65	8.1–8.9

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***Conceptual Framework* (2010) paragraphs**	**Exposure Draft paragraphs**
None	2.18, 3.1–3.9, 3.11–3.25, 4.1, 4.57–4.63, 5.25–5.36, 7.1–7.9, 7.11–7.21, 7.23–7.27, A1–A9

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