
Preface

The Financial Accounting and Reporting Special Interest Group (FARSIG) is a special interest group of the British Accounting and Finance Association (BAFA). Its technical committee is charged with commenting on discussion papers and exposure drafts issued by standard setters on issues relating to financial accounting and reporting. Its views represent those of its members and not those of BAFA.

BAFA is the representative body for UK accounting academics and others interested in the study of accounting and finance in the UK. FARSIG is BAFA’s designated group specialising in issues relating to financial reporting. This response has been formulated by Mark Clatworthy, Mike Jones, Tony Miller, David Oldroyd, Mike Page, Ken Peasnell, Ioannis Tsalavoutas, Pauline Weetman and Geoff Whittington and has been approved by the FARSIG Technical Committee.

We have necessarily been sparing with the literature we have cited in this response and if you need any supportive academic references we will be happy to supply them.

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1 Edited by David Oldroyd, Chair FARSIG Technical Committee
Section 1 – Introduction

First, we welcome the decision of the IASB to press ahead with the Conceptual Framework project despite the withdrawal of FASB. This shows a commitment to a principle-based approach to accounting standards and is to be commended.

However, revision of the CF has taken a long time in coming given that the framework that it will replace was produced in 1989. Since then the corpus of international accounting standards has expanded considerably. Most of these relate to important issues of general applicability, and revisiting the whole body will be a daunting task. In view of the breadth of coverage of existing standards we would encourage the Board to undertake a thorough review, notwithstanding the reluctance they express in paragraph 1.22.

Answers to specific question

(a) The primary purpose of assisting the IASB ‘by identifying concepts that it will use consistently when developing and revising IFRSs’ appears too narrow. Surely the primary purpose of a Conceptual Framework is to produce a coherent, consistent and comprehensive framework for financial reporting. A subset of this is to guide the IASB in their standard setting.

(b) There appears to be a conflict in the notion that there may be occasions when it is necessary to depart from the Conceptual Framework in the development of an accounting standard given that most IFRSs are of general applicability. If the Conceptual Framework were sound then there should be no need to depart from it. If departure proved necessary, it would imply that the CF was itself in need of review. Given the time it takes to revise CFs then in practice this may be the only pragmatic way forward. However, it does not appear to be a conceptually coherent way of dealing with issues.
Section 2 – Elements of Financial Statements

We view the proposed revised definitions as an improvement over the existing definitions. They are clearer and less cumbersome. Introducing a separate definition of an economic resource enhances the clarity and succinctness of the definitions and the separation of the definition of assets and liabilities from the recognition criteria is now clearer.

We agree that the definitions of assets and liabilities should not retain the notion that an inflow or outflow is ‘expected’. We also agree that the recognition criteria should not set a probability threshold, nor should the reference to probability be retained in the recognition criteria. The proposed changes should reduce any confusion surrounding assets and/or liabilities being defined as a mathematical expectation, which can lead to significant verifiability and measurement problems. In particular,
the probability threshold need only apply in cases where observable measurement is unavailable anyway, and the academic literature shows that in the presence of asymmetric payoffs, agents often employ probabilistic definitions and thresholds opportunistically due to interdependencies in the tasks of assessing probabilities and payoffs.

It is not clear, however, that disputes over assets’ and liabilities’ capabilities will not arise in cases where the likelihood of producing inflows or outflows of economic resources is low.

As noted in the DP, more difficulties would arise from attempts to define elements for statements of profit or loss and OCI than statement of cash flows and statement of changes in equity. It would be highly beneficial to users to define profits because there is a strong demand from users. However, as noted elsewhere in this response, producing a satisfactory definition is conceptually challenging and previous attempts have not proved successful. As noted by Barker (2004), although persistence (or degree of ‘recurrence’) is usually what determines the relevance of profits, ascertaining a satisfactory basis for classification is impossible. We therefore agree that the provision of presentation guidance is a sensible approach in the absence of a satisfactory conceptual set of definitions.

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Section 4 – Recognition and Derecognition

The IASB’s proposal to redefine assets and liabilities in such a way as to remove the word ‘probable’ entails a change to the existing recognition criteria, which also depend on the word ‘probable’; the word has caused considerable debate and confusion. It is now proposed that all resources (implicitly items capable of producing cash flows/economic benefits) should be classed as assets and similarly for liabilities. Under this philosophy it is consistent to propose that all assets should be recognised, perhaps with limited exceptions. It is the discussion of the exceptions which takes up most of Section 4 for both recognition and derecognition. The subsection devoted to recognition is somewhat devoid of examples, whereas there are examples in the derecognition section.

Removal of ‘probable’ from the recognition criteria creates a simplification and should help users evaluate and compare financial statements since they no longer need to ask whether there are items of low probability of economic benefit or loss that have been omitted, but which might have a substantial impact on the entity. However inclusion of a resource that has a low probability of economic benefit intensifies measurement problems. For example it is difficult to tell whether such an asset is impaired: the economic value is sensitive to small errors in probability estimates and to the correlation of benefits or losses with other items’ returns.

Relevance and the cost constraint

At §4.9 and §4.26, it is concluded that ‘relevance’ can be used as a kind of escape clause to avoid recognising difficult items. Information about items can be relevant for both resource allocation and accountability reasons and for both income statement and balance sheet purposes: a wider a set of items may need to be recognised to fulfil these requirements than the balance sheet approach based on resource allocation decisions alone might suggest. For example, the convoluted reasoning for recognising external goodwill but not internal goodwill is less convincing than the consideration that external goodwill is recognised because it makes management accountable for the resources laid out to acquire the new entity, whereas recognising internally generated goodwill and intangibles would reduce accountability by increasing management’s opportunity for accounting manipulations.

The IASB suggests uncertainty in measurement can make recognition of an item irrelevant (§4.9a). This has always been a specious argument and it is time to dispense with it. A more persuasive argument is that it is precisely the most uncertain measurements about which users need the most information. The traditional answer to uncertainty has been prudence in measurement, which, properly applied, has considerable merits for risk averse users and accountability purposes. Uncertainty about future benefit flows is a measurement problem, not a recognition one.
A different problem is uncertainty about the existence of an asset or liability. For example, how is a potential liability arising from litigation to be treated? At this point it is hard not to look at a probability criterion (which §4.26b implicitly reintroduces). At a conceptual framework level it is probably best to defer decisions to individual standards.

Another potential relevance problem that is noted is production of information that is incomplete or not understandable (§4.9b). The obvious answer is to produce complete information in an understandable form, not to omit the item. Failure to recognise an item implicitly measures it at zero, which is even less use for resource allocation decisions or accountability than a measurement that is incomplete or hard to understand.

**Faithful representation**

In its discussion of faithful representation as it pertains to recognition, the DP cites the characterisation of the concept as ‘complete, neutral and free from error’. The DP fails to take the opportunity to clarify that ‘neutrality’ relates to neutrality as between interested parties. In particular neutrality should not be interpreted to mean that measurements should be statistically unbiased. Frequently biased estimates will be preferable to unbiased estimates particularly where users are risk averse or the biased estimate is more precise. ‘Faithful representation’, as characterised, omits important features of reliability.

**Non-existence of measurements that provide faithful representation (paradoxical items)**

Part (b) of Question 8 contemplates the possibility that there may be no faithful representation of an item and changes in it and implies such items should not be recognised. As no examples are linked to this idea it is unclear what kinds of items this is supposed to refer to. There are some potential items where existence or measurement may be affected by recognition or the valuation placed upon them. Example (1), consider a contract that contains a clause that states that any disclosure of the contract or investments taken to fulfil it will vitiate the contract. A contract to undertake an ethically dubious investment in a secrecy regime might contain such a clause. If the contract is recognised it ceases to exist (or at least the investment becomes valueless); alternatively if it is not recognised the investment is valuable. Example (2), consider a (substantial but not crippling) liability that if disclosed at its full amount will cause a fall in the credit status of the entity resulting in a fall in the value of the liability. If the liability is not disclosed at its full amount, the credit status of the entity will not be impaired and the liability will have its full value. There may be no valuation that is consistent with the outcomes, because recognition and measurement affect outcomes. Having put forward these perhaps somewhat strained examples, they seem to us sufficiently unusual to be left to individual standards or interpretations to deal with.
Control or risk and rewards approach to derecognition

The difference between these approaches becomes apparent when risks become high relative to the expected value of an item. It is again helpful to distinguish between existence problems and measurement problems. Consider an item that is attached to an uncertain set of future cash flows. If all of the cash flows are positive the item is an asset, if they are all negative it is a liability. What if the cash flows in future periods have probability distributions that include both positive and negative amounts? One solution available under the old conceptual framework is to say the item is too difficult and to fail to recognise it on grounds of measurement uncertainty – an unfortunate consequence of confusing the existence and measurement problems. The continuance of this problem is likely because of the way the DP allows ‘faithful representation’ to be used to sweep highly uncertain items ‘under the carpet’.

An alternative solution is to break the resource up into different components and to recognise and measure each separately. Under current rules it is possible, in some circumstances, to recognise and measure the relatively certain bits and ignore the rest, which is clearly unsatisfactory and is one of the concerns of proponents of a ‘stickiness’ approach. Accounting solutions that encourage entities to undertake artificial transactions in order to hide risks are clearly undesirable from both a resource allocation and an accountability perspective. This is again a situation which prudence, in the form of asymmetry of recognition and measurement, can help to solve. In the analysis of example 4.1 it is taken as a given that the value of the guarantee is its fair value, that is to say, by undertaking the transaction a revaluation is triggered even for components of resources that pre-existed and are retained. This need not be the case even under the control approach. It may be the case that items derived by carving up existing items should be measured at a cost-derived basis rather than at fair value. Such a solution could lead to accounting becoming more ‘decision neutral’ in the sense of not providing incentives for management to undertake transactions which are not economically beneficial.
In our view the proposal to recognise all assets and liabilities is an improvement on the current framework. We agree that there may be limited exceptions that should be defined by individual standards. We have reservations about the potential reasons for not recognizing an element identified in the discussion paper.

Paragraph 4.9 of the DP suggests that items might fail to be recognised if information about them is not relevant to users’ decisions or the cost of recognition is excessive. Three circumstances where the relevance test is failed are identified as uncertainty of estimates, information that is incomplete or which is hard to understand. None of these reasons should prevent recognition of an element. Uncertainty of estimates should be dealt with by additional disclosure. Incomplete or hard to understand information should be dealt with by clarification and additional disclosure. This is not to say that there are not knotty problems, but these need to be dealt with on a standard by standard basis.

There does exist a problem when there is uncertainty about the existence of an element, and it is hard to avoid some kind of probability test in these situations. We think the conceptual framework should make a clear distinction between existence uncertainty and measurement uncertainty and acknowledge that a probability criterion is needed in the case of existence uncertainty, but not measurement uncertainty. Historically prudence has been used in these situations – using asymmetric criteria for the recognition of assets and liabilities. There is no reason not to continue to solve the problem in this way and to require a higher probability of existence for the recognition of assets than for liabilities. There have been attempts to appeal to standards of evidence or verification as a recognition criterion, which confuses the underlying issue, which is the probability of the existence of an item. While evidence can show the probability of existence is high, lack of evidence does not necessarily mean probability of existence is low. Strength of evidence is an auditing problem.

The cost constraint is a valid consideration for immaterial items but is likely to be a measurement problem rather than a recognition problem.
It is correct that, in principle, there may be some items that no measure can capture. The only reason we can see for this is because the existence (or value) of an item may be endogenous with whether it is recognised or not (or the amount at which it is measured). It would be valuable for the conceptual framework to acknowledge that recognition, or measurement, can result in changes to the existence or values of underlying items and future cash flows.

There may be a problem of self-negating recognition such that if an item is recognised, it ceases to exist or becomes valueless, but if the item is not recognised it continues to exist. See above for examples of such ‘paradoxical’ items. We can only comment that, in our experience, such items are rare, and that this can give rise to non-existence of equilibrium values or multiple equilibrium values. Having said that, it is probably best to leave the issue to individual standards were problems to arise in practice.

We agree both that the control approach is preferable, inter alia because it makes derecognition symmetrical with recognition, and that it is necessary to deal with particular problems through development of individual accounting standards and interpretations. However, where interests are retained it does not follow that a new item valued at fair value has been created. Measurement of items retained can be ‘sticky’ in a way that potentially includes both prudent and cost-based measures with the objective of greatly reducing incentives for undertaking transactions for cosmetic effects.

Useful tests of appropriate treatments include asking the questions, ‘How would the acquiring entity treat the item acquired?’ and ‘How would this transaction be treated if the same economic effect were accomplished by other means – acquiring or writing an option, say?’ For derecognition accountability and income statement effects need to be taken into account as well as resource allocation decisions.
Section 5 – Definition of Equity and Distinction between Liabilities and Equity Instruments

Definition of liabilities and equity

This part of the DP deals with an area where the existing CF has been particularly ill-suited to deal with major innovations in business practice that have taken place in the past 40 years. As the appendices make clear, there are an amazing variety and complexity of financial arrangements and financial instruments that businesses can and do employ, many of which blur the traditional distinction between debt and equity. The existing approach takes a narrow view of what is meant by a liability, classifying any financial claim not meeting the definition as equity. This has posed particular problems for accounting for employee stock options, the use of which has expanded enormously since the CF was originally promulgated. The option is currently treated very differently, depending on whether it is to be settled (if...
exercised) by the issuance of shares, when it is classified as equity, or by paying cash equal to the difference between the market value of the shares at exercise date and the strike price of the option, when it is treated as a liability. In the case of cash-settled options, the expense is adjusted through time as the value of the liability is updated, with all expenses being reversed in cases where the option expires out of the money. In the case of options settled by the issuance of shares, no such adjustment takes place.

These and myriad other problems led the IASB, as part of its convergence exercise with the FASB, to issue a DP in 2008 explicitly focused on the issue of how to deal with financial instruments that have characteristics similar to equity. That DP considered a number of other approaches, one of which was to reverse the reasoning, defining current shareholders as equity and all other financial claims as liabilities. The current DP limits its attention to these two polar opposite definitional approaches. The 2008 DP considered a number of other approaches, one of which was to take the ‘reassessed expected outcomes’ (REO) approach, which would classify as equity any claim (or component of a claim) whose fair value changes in the same direction as current equity. Finance theory predicts that the REO approach would lead to both cash and share-settled employee stock options being treated as equity. The problem with the REO approach is that it implicitly uses two polar opposites—a narrow approach to equity (e.g. current shares in issue) and a narrow approach to liabilities (e.g. interest-paying bonds)—and classifies a claim as equity or debt where it falls on this spectrum. The current DP rejects this and a number of other approaches in favour of first defining what is meant by a liability and treating all other claims as equity.

**Updating measures of equity**

None of this would matter very much were it not for the effect classification can have on the measurement of income. As equity is defined as a residual, it is not usually revalued in the light of new information in the way that liabilities are (at least at time of extinguishment). The proposals in the DP address this in an interesting and imaginative way. The proposal is that the entity should, at the end of each reporting period, update the measure of each class of equity claim. How this is to be done is rightly left to particular standards. However, by making this proposal the DP has addressed one particularly troublesome feature of the existing CF.

The DP proposes that any such updating appears in the statement of changes in equity as a transfer of wealth between classes of equity claim. This proposal has some distinct advantages. Many users will want to track such wealth transfers. For example, equity investors have an interest in being able to monitor the dilution of their interest that occurs with share-settled employee stock options. However, as currently phrased, this might be unintentionally inhibiting to the development of particular standards.

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5 For evidence consistent with the prediction that share-settled options are more akin to current equity than to (straight) debt instruments, see M. E. Barth, L. D. Hodder and S. R. Stubben, ‘Financial reporting for employee stock options: liabilities or equity?’ Review of Accounting Studies, 18 (3), pp. 642-682.

6 For further comment on this, particularly, in the context of accounting for employee stock options, see K. V. Peasnell, ‘Discussion of “Financial reporting for employee stock options: liabilities or equity”’ Review of Accounting Studies, 18 (3), pp. 683-691.
Using employee stock options again as an example, the rationale for recognising share-settled employee stock options as giving rise to an expense is that such contracts can be viewed as a forward purchase of services. The cost of such services cannot be reliably determined until the services have been rendered, i.e. the vesting rather than the grant date. It ought therefore to be possible to update the recognition of the expense throughout the vesting period. Doing so would provide a better (cumulative) picture of operating performance than would be obtained if all such value changes were required to be shown in the statement of changes in equity.
Section 6 – Measurement

The DP reaches the sensible conclusion that the conceptual framework should not attempt to prescribe a single, universal method of measurement. Rather, it proposes that the method of measurement should be selected at standards level on the basis of which method best meets the objectives of the conceptual framework in that particular case. This conclusion is consistent with much academic research, both theoretical and empirical, which has demonstrated the potential usefulness of different measures in different circumstances and for different purposes.

However, despite reaching this broadly sensible conclusion, the DP is not very clear or convincing in its arguments and, in this respect, fails to advance our understanding of the issues. Two issues in particular require clarification: first, the classification and definition of alternative measurement methods, and second, the criteria for choosing between those methods.

Classification and definition of alternative measurement bases

The existing conceptual framework (1989) lists four types of measurement basis:

1. Historical cost.
2. Current cost.
3. Realisable value (settlement value for liabilities).
4. Present value (discounted cash flows).

The DP (§6.37) proposes three types of measurement basis:

1. Cost-based methods.
2. Current market prices.
3. Other cash-flow-based measures.

The DP’s approach reduces the four existing categories to three and, in doing so, adds unnecessary confusion to the subsequent discussion. It eliminates the current cost category, and it is not at all clear which heading now includes current (or replacement) cost.

The DP’s discussion of ‘cost-based measures’ (§6.38) has only a cursory description of historical cost (a separate item in the current framework) and §6.41-2 refer to the possibility of updating historical cost for subsequent price changes, which would turn it into a form of current cost. The subsequent discussion of current cost and deprival value in this section diverts attention from historical cost and is effectively a discussion (again, cursory) of current values. Deprival value, which is dismissed abruptly here, provides a systematic means of selecting one of the current value bases.
(2 to 4 above) listed in the IASB’s existing framework. We believe that a much more thorough and intelligible discussion of deprival value is required. The statement in footnote 52, that current cost and capital maintenance should be considered in relation to accounting for high inflation, is inappropriate. Individual prices can change drastically in the absence of inflation, which is why large oil companies, such as BP, provide a measure of profit based on valuing stocks consumed at replacement cost.

The following category, Market Prices, could include current or replacement costs, because these are based on market prices, albeit including some transaction costs that might be precluded by a narrow definition of price. This category explicitly includes fair values, which are defined in IFRS 13 as selling prices, sometimes known as exit values, but purchase prices, which are entry values, are mentioned only briefly (§6.49) in the discussion. A clear distinction between the properties of exit and entry prices and a discussion of the treatment of transaction costs is necessary in order to understand the potential role of current market prices in measurement.

Criteria for choosing measurement methods

The rejection of a universal single measurement basis is welcome but creates a need for clear criteria for the selection of measurement methods to suit specific cases. These criteria are derived from other sections of the revised framework and are deficient in the following respects:

1. The rejection of stewardship, or accountability, as one of the two primary objectives (together with relevance to investment decisions) leads to a natural emphasis on the prediction of the future (‘how an asset or liability of that type will contribute to the entity’s future cash flows’, §6.16) rather than the reporting of past transactions and events, which are more relevant to stewardship. This leads to a bias in favour of current values rather than historical cost. It also leads to an apparent rejection of prudence in measurement, which is well described in the 1989 framework, and which is a consequence of the information asymmetry that creates the need for accountability. In practice, prudence permeates IFRS, notably in the application of asymmetric impairment tests.

2. The substitution of representational faithfulness for reliability has destroyed the clear trade-off between relevance and reliability that existed in the previous framework. The concept of representational faithfulness suffers from ambiguity about the role of reliability, because it seems to combine elements of relevance and reliability. A manifestation of the consequent loss of the trade-off between relevance and reliability is the statement: ‘A highly uncertain estimate will be faithfully represented if it is properly described (for example, not as a market price but as a highly uncertain estimate of a market price)’ (§6.34). This seems to imply that some information is so ‘representationally faithful’ that it should be reported even if it is extremely unreliable.

3. Both the revised framework and its predecessor take what is sometimes called a balance sheet approach, i.e. they concentrate on the balance sheet as the
foundation of double-entry accounting and on assets and liabilities (with equity as a residual) as the basic building blocks of the balance sheet. There is no denying the importance of the balance sheet but extensive academic research has demonstrated that earnings measures are a major determinant of share prices and therefore of great interest to investors. However, the DP has hardly any discussion of what measurements should be applied to income statement items or in what circumstances (if any) they should differ from those applied to assets and liabilities. The neglect of capital maintenance in the DP is a related symptom of the neglect of income measurement: capital maintenance is a critical component of the measurement of income or gain.

Answers to specific questions

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<th>Question 11</th>
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<td>How the objective of financial reporting and the qualitative characteristics of useful financial information affect measurement is discussed in paragraphs 6.6-6.35. The IASB’s preliminary views are that:</td>
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<tr>
<td>(a) the objective of measurement is to contribute to the faithful representation of relevant information about:</td>
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<td>(i) the resources of the entity, claims against the entity and changes in resources and claims; and</td>
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<td>(ii) how efficiently and effectively the entity’s management and governing board have discharged their responsibilities to use the entity’s resources.</td>
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<td>(b) a single measurement basis for all assets and liabilities may not provide the most relevant information for users of financial statements;</td>
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<td>(c) when selecting the measurement to use for a particular item, the IASB should consider what information that measurement will produce in both the statement of financial position and the statement(s) of profit or loss and OCI;</td>
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<td>(d) the relevance of a particular measurement will depend on how investors, creditors and other lenders are likely to assess how an asset or a liability of that type will contribute to future cash flows. Consequently, the selection of a measurement:</td>
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<td>(i) for a particular asset should depend on how that asset contributes to future cash flows; and</td>
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<td>(ii) for a particular liability should depend on how the entity will settle or fulfill that liability.</td>
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<td>(e) the number of different measurements used should be the smallest number necessary to provide relevant information. Unnecessary measurement changes should be avoided and necessary measurement changes should be explained; and</td>
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<td>(f) the benefits of a particular measurement to users of financial statements need to be sufficient to justify the cost.</td>
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Do you agree with these preliminary views? Why or why not? If you disagree, what alternative approach to deciding how to measure an asset or a liability would you support?

We are broadly in agreement with these preliminary views, for reasons given above. However, the detailed text of the DP does not argue coherently in support of these
views. We also have specific reservations about 11 (d). Namely, we do not believe that contribution to the entity’s future cash flows (§6.16) should be the sole criterion (see our comments on accountability) and we do not believe that measurement should focus exclusively on assets and liabilities (see our comments on the ‘balance sheet approach’) as is implied by (d) in apparent contradiction of (c).

We agree with the broad sentiment that measurement of an asset should reflect its contribution to the value of the business of the entity. However, we disagree with the concentration solely on the contribution of an asset to future cash flows and the consequent absence of discussion of accountability, as indicated in our earlier comments. Also, we do not agree with the DP’s categorisation of measurement bases, which entails the grouping together of current costs and historical costs, which have different properties and potential uses. We also believe that a more thorough discussion of deprival value is required, emphasising its potential contribution towards choosing between different current value methods. Finally, the concentration on assets and liabilities, excluding considerations of profit measurement, indicates an unduly narrow ‘balance sheet’ approach to measurement.
The comments made with respect to assets (Question 12) also apply with respect to liabilities. One approach that deserves consideration is to develop a systematic algorithm for choosing between alternative current value measures on the basis of the economic consequences of the various methods of discharging the obligation that are available to the entity. Relief value, which is the deprival value concept applied to liabilities rather than assets, might provide a starting point for developing such an approach.

Paragraph 6.19 deals with the specific case of financial instruments, especially derivatives, which have volatile and uncertain returns. It does not raise new matters of principle and the issue should be dealt with at standards level rather than in the conceptual framework.

The issue is essentially a practical one: Are market-based measures more reliable than cash flow based measures? It should be noted that, consistent with §6.57, ‘cash flows’
encompasses all value flows. Moreover, market values will be based on estimates of future cash flows (in this broader sense), so the question is really whether the accountant or the market place is best qualified to make the estimate.

Our further comments appear in the introductory sections above.
Section 7 – Presentation and Disclosure

IAS 1 *Presentation of Financial Statements* considers notes comprising a summary of significant accounting policies and other explanatory information as part of a complete set of financial statements (§10). Additionally, in line with the spirit of a principles-based accounting standard, the majority of the remaining standards consist of a section entitled presentation and/or disclosures. These sections usually outline individual disclosure requirements, whereas the existing Conceptual Framework does not contain guidance on the issue of presentation and disclosure of information that could or should accompany the primary financial statements. The absence of such guidance results in an inconsistency compared to the guidance provided for other matters (e.g., recognition and measurement). Thus, we consider the IASB’s decision to augment the Conceptual Framework with a section dedicated to these issues a necessary step forward. This will contribute to the completeness of the CF and could result in the improvement of individual standards and the overall framework for financial reporting.
Answers to specific questions

The Discussion Paper indicates that the IASB plans to carry out other work on disclosure which will lead to the amendment of some standards. For this reason it is noted that the discussion presented in Section 7 ‘deals with only some aspects of disclosure’ (§7.8). However, given that this is a work in progress, there is no clear indication of how this parallel work complements the proposed Section provided in the DP. This results in the discussion in this Section being somewhat incomplete or, in some cases, contradictory. Our responses to Q17 and Q18 below are indicative of that matter.

We agree with the IASB’s preliminary views about the scope and content of guidance that should be included in the Conceptual Framework on presentation in the primary financial statements. With regard to classification and aggregation, §7.28 appears to be sufficient and as a consequence, §7.27 appears to be somewhat redundant. If standards require particular items to be presented in the primary financial statements
(assuming they are material to an entity; see below discussion about materiality (Q17)), it is at the entity’s own discretion to decide presentation of additional line items, subtotals and totals in their primary financial statements based on their individual facts and circumstances. Nevertheless, the phraseology of these two paragraphs implies that often it would be acceptable or expected that the items presented in companies’ primary financial statements should be determined by the companies themselves rather than the guidance in specific standards.

We also agree with the IASB’s preliminary views about the scope and content of guidance that should be included in the CF on disclosure in the notes to the financial statements, and with the statement in §7.37 that information about management’s view of the entity’s performance, position and progress in the context of its stated plans and strategies for achieving those plans belongs outside the financial statements e.g., in management commentary. However, in this regard we would recommend that the CF should explicitly seek for, and promote consistency between the information presented outside the financial statements and the information presented in the notes to the financial statements. As an example, information on the assumptions used during the impairment testing process should be in line with the entity’s stated plans and strategies outlined in the management commentary.

Although materiality is an integral aspect of relevance, one of the two fundamental qualitative characteristics, guidance on how it is to be applied – especially with regard to disclosures – is scarce. Thus, we welcome the IASB’s intention to proceed with the provision of such guidance. And, in principle, we agree with the approach of developing additional guidance outside the CF. However, how and where the additional guidance will be developed is not discussed in a coherent and explicit way in the detailed text of the DP. §7.46 states that the IASB is considering providing additional material on the application of materiality by amending its standards or (emphasis added) by providing educational material. §7.7 – §7.8, inter alia, point to the reader the Disclosure Forum Feedback Statement (DFFS) published by the IASB in May 2013. The IASB’s response to the feedback received on the disclosure problem explicitly states that ‘if any additional guidance is developed it would be at the Standards-level’ (DFFS: p.16). We would support the development of guidance at the standards-level in particular. This would be in line with one of the designated roles of the CF: to include principles which would help the IASB in developing each standard (in this case, specific disclosure requirements in each standard).

The DP recommends paragraph QC11 of Chapter 3 of the existing CF to stay as it is. This states the concept of materiality, which we agree needs no change. However, this

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7 http://go.ifrs.org/Disclosure-Forum-Feedback-Statement-PDF
paragraph also adds that ‘the Board cannot specify a uniform quantitative threshold for materiality or predetermine what could be material in a particular situation.’ This is because information relates to the context of an individual entity’s financial report. Although this is true when referring to all disclosures in general, we believe that if the IASB proceeds with the development of additional guidance on materiality at the standards-level, there are many areas where specific thresholds could be applied (e.g., impairment testing required disclosures, business combinations required disclosures, employee benefit required disclosures). In fact, §7.46 of the DP indicates that ‘an entity would need to assess the materiality of each disclosure requirement individually’. And, §7.48 adds that ‘the IASB should provide guidance that enables an entity to determine whether the specified information would be material in the context of an entity’s financial statements.’ Provision of such guidance at the standards-level would assist firms in their assessment of materiality and would also act as a safeguard for the users. We note that significant effort for reaching consensus on the specific thresholds is needed. However, we also note and welcome the IASB’s acknowledgment that ‘it is important that users, preparers, the IASB, auditors and regulators have a shared view of materiality’ (DFFS: p.16). We believe that input from all these parties could contribute to the development of such a view. Under the current approach, it is preparers along with auditors who ultimately are in control of determining what is material and what is not.

In line with our view that the CF should include principles that would help the IASB in developing new standards or improving existing ones, we agree that communication principles should be part of this effort as well. These could form the foundations for developing the presentation and disclosure requirements of particular standards, and specific guidance on materiality in particular at the standard-level (see response to the previous question).

However, we believe that there is scope for improvement in the communication principles proposed, particularly with regard to some of the wording used and the connotation this carries. Specifically, the principles proposed are presented as ‘guidance on the form and communication aspects of disclosure and presentation requirements’ (emphasis added) (§7.47). Given the wording in individual standards (e.g., ‘in meeting that objective an entity shall disclose …’) and given the lists of disclosure requirements that follow, one understands that these principles should promote the improvement of expected disclosures (i.e., requirements).\(^8\) However,

\(^8\) It is well documented that the word ‘requirements’ as well as the wording ‘a company shall disclose’ lead many preparers and auditors to view these items as minimum requirements that must be presented in all circumstances, if applicable to a firm (see DFFS: p.17). This has also led to the
§7.49 indicates that these lists of requirements are to be seen effectively as ‘…disclosure guidance in Standards…’ which would assist in meeting the objective of financial reporting to provide useful information to financial statement users. Based on this, §7.50 and all sub-paragraphs (a-f) refer to the IASB developing disclosure guidance in IFRSs. The exception is the last sentence in §7.50 which states that the IASB should consider the proposed communication principles when it sets disclosure requirements. The interchangeable use of this wording (disclosure guidance vs. requirements) appears to be somewhat confusing especially because the one does prompt readers to the issue of ‘compliance with specific requirements of Standards’ as opposed to ‘a form of communication guided by Standards’ (§7.49). We feel that focusing on the latter would be a step forward, providing that specific guidance at the standard-level is developed and that the wording in the Conceptual Framework is clear and consistent.

As far as the individual principles proposed are concerned, the principle stated in §7.50(f) is very relevant to, and follows on from the principle stated in §7.50(a). In order to improve coherence, we recommend including (f) in the list of principles after (a). Further, the principle stated in §7.50(f) indicates that individual standards will continue to incorporate some disclosures that are required and some that are permitted. This seems somewhat inconsistent with the objective of moving away from the connotation of ‘compliance with specific requirements of Standards’ (see earlier discussion). We agree with the principles stated in §7.50(b-e). These can be applied to all disclosures (permitted or required).

Section 8 – Presentation in the Statement of Comprehensive Income – Profit or Loss and Other Comprehensive Income

We agree that the Conceptual Framework should require a total or subtotal for profit or loss. However we comment further in this response on the issues to be considered in defining how the total or subtotal is determined and described in a manner that achieves comparability, consistency and usefulness in decision making.

The Discussion Paper states that it does not seek to define or directly describe profit (§8.35). It proposes to treat profit or loss as the default category after OCI has been separated out within the total comprehensive income for the period. It seems strange for a conceptual framework of accounting to be unable to define a concept such as ‘profit’ when it is acknowledged to be viewed as a useful performance measure (§8.19).

However a review of text books on accounting theory and the writings of leading thinkers that now form part of accounting history would indicate that the definition of profit has been agonised over repeatedly and there seems little likelihood that an agreed definition is any more likely to emerge today. Hatfield (1927) and Solomons (1960) are historical examples of academic writers pointing to the problems of

9 Henry Rand Hatfield, a leading academic writer whose contributions extended across two world wars and the turbulent inter-war years challenged the accountancy profession to define ‘profit’ as technical term comparable to terminology of physical sciences or engineering.

But one finds a state of actual confusion in this fundamental matter. Net earnings, net income, gross profits, profits, net profits? I have tried for years to find the proper term to be used and the exact connotations of each of the terms just quoted. I have appealed to academic writers, both economists and accountants, and I find only confusion. I have turned to the courts, and found in their decisions a confusion overwhelmingly ludicrous. If one sees the word ‘profits’ in a textbook he may still be left in doubt.”


10 David Solomons commented:

Just as Hicks was led to the conclusion that income was not an effective tool of economic analysis, so it seems to me that we are led to the conclusion that periodic income is not an effective tool of
defining profit and questioning the usefulness of ever completing the search for a definition.

If the solution cannot be found in economic or accounting theory then paragraph 8.19 points to the need for empirical investigation as a means of establishing which indicators of an entity’s performance are useful. The conceptual framework could draw on evidence from published research, although care would be needed to ensure that the findings were sufficiently broad internationally.  

Richard Barker has reviewed approaches to reporting profit in a way that distinguishes operating activities from financial activities. He contrasts the work of Feltham and Ohlson (1995), where financing activity is defined by nature, and the work of Penman (2006), where financing activity is defined by function. We note that the Discussion Paper does not refer to this aspect of the debate on measurement or presentation of profit but the concept of relating profit to performance would lead into a discussion of how users of accounting information are given the information to permit operating performance to be distinguished from financial performance.

Empirical research in accounting tends to draw on the information that is made available through databases, in order to obtain a sufficiently large and representative sample. Some researchers in accounting and finance have based their investigations on total comprehensive income (‘clean surplus’). Other researchers have focused on reported earnings and components of earnings, when investigating such issues as earnings management or predictive value. The models of earnings management most frequently tested relate to use, or misuse, of accruals in working capital and depreciation. Recycling could be seen as another form of earnings management

financial planning or control. This conclusion seems to accord ill with the fact that income measurement has long been a central theme of accounting and the main preoccupation of the accounting profession. Yet this fact need not impress us. The practice of medicine one consisted largely of blood-letting.’

He concluded by predicting that the next 25 years would subsequently be seen to have been the twilight of income measurement.


An example of international comparisons is seen in:

A useful explanation of the use of clean surplus profit is to be found in:

A test on UK data is provided by:
(including ‘real earnings management’ when the reporting entity can choose the timing of the transaction that triggers the recycling action). See further comments in answer to Question 20.

We note that the IASB, in its 2012 Feedback Statement on the Agenda Consultation indicated a willingness to engage with academic research. (p.16 of the December 2012 statement), stating: ‘The focus on establishing a more structured and formal research capability will make it easier for the IASB to gain access to the wealth of expertise and information that exists in the research community.’ We encourage the IASB to commission and draw upon international academic research that tests the IASB’s assertions in paragraphs 8.19 and 8.20, against the counterviews set out in paragraph 8.21, to provide a foundation for the approach proposed in the Discussion Paper.

We agree that the Conceptual Framework should permit or require recycling as discussed in paragraphs 8.23 to 8.26, and we agree with the supporting arguments set out in paragraph 8.24. The Discussion Paper indicates in paragraph 8.19 that users from all sectors incorporate profit or loss in their analyses. It is a logical extension of that observation to channel substantially all profits and losses eventually through the measure of profit used in decision making. However paragraph 8.26 seems to be cautious in specifying which, if any, OCI items would be recycled. Reading paragraph 8.26 with Principle 3 of paragraph 8.83 suggests that the IASB may in future be reluctant to permit recycling.

The Discussion Paper notes in paragraph 8.26(e) that recycling could be seen as another form of earnings management. We note that academic empirical research has found evidence of earnings management in many contexts and in many regulatory regimes. Academic research uses the term ‘real earnings management’ when the reporting entity can choose the timing of the transaction that triggers the recycling. Research into the nature and extent of such recycling would require the availability of good quality data, where the recycled element of profit in any year can be identified separately in the primary financial statements. Empirical research using large datasets requires researchers to draw on databases of financial information. Those databases tend to focus on the primary financial statements rather than the notes to the accounts. Hence the effects of recycling need to be explicit in the primary financial statements.
We support principles 1 and 2 of Approach 2B in preference to Approach 2A, as a pragmatic approach. It recognises decisions previously made in setting specific standards, where consultation has confirmed that the needs of decision-makers were best served by the treatment prescribed. We find principle 3 is described in wording that seems to imply a high level of non-recycling, so that the result is a mixture of a generous extension of Principles 1 and 2 of Approach 2A for inclusion in OCI, together with a very limited scope for reversal out of OCI as Principle 3, coming close to Approach 1.

We find the word ‘transitory’ is a rather contradictory word to describe the characteristics listed in §8.88. The normal meaning of the word ‘transitory’ has a sense of short-term, short-lived, Condition §8.88(a) makes the long-term an essential condition and the reversal stipulated in condition §8.88(b) has an implicit sense of longevity. Condition §8.88(c) is not related to the short-term or long-term nature of the item; it is an observation about relevance to decision-making.

Paragraph 8.82 explains that Approach 2B allows a broader view of the application of Principles 1 and 2. Disaggregation could take place without needing to arise from a clearly describable measure of the related asset or liability. We would expect that if the measure is not clearly describable then there should be a clearly describable characteristic of the asset or liability that has an economic meaning.

The wording of Principle 3 in paragraph 8.83 seems to discourage recycling, by its emphasis on ‘…when, and only when…’ If that is interpreted as constituting 99% certainty then recycling could become the exception for OCI items. It would be helpful to have more indication of how strictly the IASB intends to apply this condition. We would prefer an approach that says ‘recycle as a default, unless …’

Other comments on Section 8

IASB as sole arbiter

Para 8.36 restricts the use of OCI to categories permitted or required by IFRS. Entities would not be allowed to use OCI by analogy. This appears to be unnecessarily restrictive. If the Conceptual Framework is sufficiently robust to guide the IASB in its determination of what constitutes OCI, then it should be able to sustain an argument by analogy where a transaction or event falls outside existing IFRS.
**Prohibition of recycling**

Paragraph 8.29 states that if recycling were prohibited there would be no need for the Conceptual Framework to define profit or loss. That seems illogical as there would nevertheless have to be criteria for inclusion of items in OCI. The profit or loss would still be a default category as described in §8.36. Principles 1 and 2 of Approach 2A could be applied equally to Approach 1. The only change would be in Principle 3, which would be written as ‘no recycling’.
Section 9.2-9.22 – Chapter 1 and Chapter 3 of the Existing Conceptual Framework

Paragraphs 9.2 to 9.3 of the Discussion Paper are indicative of IASB’s apparent belief that the rejection of stewardship as a primary reporting objective, or accountability, to give it its PAAinE term,17 will not make any ‘significant’ difference to the rest of the CF. This was mirrored in the deliberations leading up to the publication of Chapters 1 and 3 of the new CF.18 Paragraphs 9.5 to 9.9 of the DP reiterate the view that the ‘concept of stewardship’ is not compromised by subsuming it wholly within a decision-facilitating focus. Whilst we accept that stewardship information can play a decision-facilitating role, we do not agree that this is its main purpose. The missing element is the motivational and control aspects of accounting information – i.e. information for influencing the decisions of agents as opposed to facilitating the investment decisions of capital providers. This constitutes a second valuable conceptual role performed by financial reporting that is supported by a large body of research, and should not be ignored.

As far as differences for the CF go, the first point to note is that the qualitative characteristics that give information its value do not map precisely onto each other for these two distinct reporting roles. First, the strict emphasis on timeliness in the decision-facilitating focus is, if not absent, considerably weakened in the decision-influencing one. Timeliness should be paramount to the CF given its adopted decision-facilitating objective since information cannot be decision-relevant if it is received too late as by definition it will by then have lost its potential to change decisions. It is therefore surprising that the CF regards timeliness as a secondary characteristic of useful information given the primacy of the decision-facilitating objective. Valuable decision-influencing information, on the other hand, can be genuinely ex post; its production can follow the decisions it influences, through its incentive properties without reducing that value. Agents take better decisions not because they have more relevant information but because they are motivated by the prospect of future performance evaluation.

Faithful representation and two of its components, freedom from error and verifiability, probably enhance the value of both kinds of information. However, verifiability takes on a more potent role in influencing the decisions of agents than in

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facilitating decisions by capital providers, because it makes for a more effective contracting variable for the design of agent rewards. If stewardship/accountability were reintroduced as a primary reporting objective, verifiability would assume a greater significance in the CF than is currently the case. Paragraph 4.14(c) of the DP characterises verifiability as ‘very desirable, but not necessarily required’, whereas Chapter 3 of the CF dispenses with the related qualitative characteristic of reliability altogether. Clearly there are significant implications in these rankings for the recognition and measurement of the components of financial statements. For example, accountability would provide an alternative criterion to resource allocation in choosing the measurement basis; and to argue that eliminating stewardship as a primary reporting objective makes no conceptual difference as IASB appear to be saying in §9.2-9.3 is specious.

If the benefits of stewardship/accountability are not recognised, the knock on effect in terms of accounting disclosures is that the scope of analysis for the CF’s cost-benefit test is incomplete. Chapter 3 of the CF makes it clear that decisions regarding specific disclosures should be governed by a cost-benefit test, with benefits everywhere defined in terms of investment decisions (§QC35, OB2).

**Answers to specific question**

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<th>Question 22</th>
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<tr>
<td><strong>Chapters 1 and 3 of the existing Conceptual Framework</strong></td>
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<tr>
<td>Paragraphs 9.2–9.22 address the chapters of the existing Conceptual Framework that were published in 2010 and how those chapters treat the concepts of stewardship, reliability and prudence. The IASB will make changes to those chapters if work on the rest of the Conceptual Framework highlights areas that need clarifying or amending. However, the IASB does not intend to fundamentally reconsider the content of those chapters. Do you agree with this approach? Please explain your reasons. If you believe that the IASB should consider changes to those chapters (including how those chapters treat the concepts of stewardship, reliability and prudence), please explain those changes and the reasons for them, and please explain as precisely as possible how they would affect the rest of the Conceptual Framework.</td>
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In the light of the above, we do not agree that Chapters 1 and 3 should remain unchanged in terms of the specified objectives of financial reporting and the concomitant characteristics of what constitutes useful information. We argue for public policy on financial reporting to explicitly recognise the distinct benefits of financial reporting information for influencing the behaviour of agents as well as facilitating the investment decisions of capital providers. Undoubtedly, the problem of regulating financial reporting is difficult to solve when there are two potentially conflicting informational roles to be served. Yet simply ignoring one of the roles for information does not effectively solve the regulator’s problem.
Section 9.49-9.50 – Proposed Approach to Capital Maintenance

The opening sentence of paragraph 9.49 asserts: ‘The IASB notes that the concepts of capital maintenance are probably most relevant for entities operating in high inflation economies’. This is quite breath-taking in its dismissal of all that has been written in accounting theory on concepts of income and concepts of capital maintenance.¹⁹

In the light of such enormous dismissal of all prior thinking on the subject, paragraph 9.50 comes as something of a relief to find that the IASB will leave the existing descriptions and discussion of the concepts of capital maintenance in the revised Conceptual Framework largely unchanged. We suggest that the IASB should leave them wholly unchanged and most certainly should not equate the principles of capital maintenance with the revision of IAS 29.

Paragraph 4.65 of the existing Conceptual Framework states: ‘At the present time, it is not the intention of the Board to prescribe a particular model other than in exceptional circumstances, such as for those entities reporting in the currency of a hyperinflationary economy.’ The wording of paragraph 9.49 of the Discussion Paper implies that the IASB sees the exceptional circumstances of hyperinflation as the only case for acknowledging the existence of the concept of capital maintenance.

The wording of paragraphs 4.57 to 4.65 of the existing framework document serve at least to retain awareness of the relationship of capital maintenance to measurement of profit and valuation of assets and liabilities. Each time we make a valuation decision

¹⁹ The following are examples of writings by founding members of the IASB:
or a profit calculation, we imply a concept of capital maintenance. While it may be a task too much for the IASB at this time to delve deeper into concepts of capital maintenance, dismissing them as relevant only to IAS 29 is a disservice to the international accounting community.