
20 October 2015

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

Email: commentletters@ifrs.org

Dear Mr Hoogervorst


I am grateful for the opportunity to provide feedback on the above Exposure Draft. The feedback is given in my own capacity and do not reflect the positions of my employer or other organizations that I am associated with.

The invitation to comment on the conceptual framework ED (ED/2015/3) consists of 18 questions but I only comment on selected ones. The following pages are the questions which I have a comment, and then my two cents worth. I use the following abbreviation on documents I consulted in the coming pages: the Basis of Conclusion of the (current) Conceptual Framework 2010 (CF2010BC), Conceptual Framework 2010 (CF2010), the Basis of Conclusion of the Exposure Draft 2015 for Conceptual Framework (EDCF2015BC), the Exposure Draft 2015 for Conceptual Framework (EDCF2015). Research papers are reference along the way at the footnote. Thank you.

Yours sincerely

Tan Boon Seng (Dr)
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Question 1—Proposed changes to Chapters 1 and 2

Do you support the proposals:

(a) to give more prominence, within the objective of financial reporting, to the importance of providing information needed to assess management’s stewardship of the entity’s resources;

(b) to reintroduce an explicit reference to the notion of prudence (described as caution when making judgements under conditions of uncertainty) and to state that prudence is important in achieving neutrality;

(c) to state explicitly that a faithful representation represents the substance of an economic phenomenon instead of merely representing its legal form;

(d) to clarify that measurement uncertainty is one factor that can make financial information less relevant, and that there is a trade-off between the level of measurement uncertainty and other factors that make information relevant; and

(e) to continue to identify relevance and faithful representation as the two fundamental qualitative characteristics of useful financial information?

Why or why not?

(a) The term stewardship is not reinstated, but there is an expansion to explain the importance of “how efficiently and effectively the entity’s management and governing board have discharged their responsibilities to use the entity’s resources” so that capital providers (existing and potential shareholders, lenders and other creditors) can assess an entity’s prospects for future net cash inflows (CF2010: OB3), which is IASB’s idea of stewardship without using the term. This appears to be an opportunity for IASB to emphasize the importance of neutrality of accounting information, which is desirable for both monitoring and capital allocation decisions. I support the proposal in this narrow sense. I am mindful that many users will be disappointed that other aspects of stewardship are not part of the objective of financial reporting, e.g. use of accounting information in managerial contracts to motivate good governance, which will require that accounting information is asymmetrically prudence according to accounting research. I suspect that this other aspects are the reasons the term stewardship is not mentioned.

(b) The concept of prudence is in the 1989 IASB Conceptual Framework, removed in the 2010 version, and this EDCF2015 is asking if an explicit reference to prudence should be made under the condition of stating that prudence is neutral. Many accountants will welcome reinstating prudence because it has been the foundation of accounting for a long time. However, most will disagree with the condition that prudence is neutral, e.g. see Finnegan’s alternative view (EDCF2010BC: AV16). IASB invented the concept of cautious prudence to distinguish it from asymmetric prudence which is what accounting researchers understand as conservatism – that losses are recognized on a timelier basis than gains, with less need for verification. Then IASB in CF2015BC at BC2.14 (d) states that “The selection of neutral accounting policies ... does not require the recognition of all assets and liabilities” After which IASB sits on the fence for measurement at BC5.45 ( ...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) and BC5.76 (...the Conceptual Framework neither requires nor prohibits setting different levels of tolerable measurement uncertainty for assets and liabilities) and deferring decisions to standard level.

IASB view of prudence is that it is consistent with the objective of financial reporting stated in EDCF2015 at 1.2 (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). Conceptually prudence is neutral, but there is flexibility at the standard level, which in practice means that prudence is not neutral. This problem arises to a large extent because of the use of accounting information for contracting in practice even though the objective of financial reporting does not include contracting in the conceptual framework (see IASB Charter, paragraphs 44-45 at http://goo.gl/bKo8FU). For example, the use of neutral P/L to monitor manager’s performance is sensible, but bonus payment should not be based on neutral P/L. Managers have private information about the quality of accounting information. There is an inherent risk that manager may opportunistically report a higher net income to obtain higher bonus, hence reducing the credibility of the information reported to shareholders. Furthermore, once excessive bonus is given, subsequent recovery is impractical because managers have limited tenure and limited liabilities for business decisions. Such practical considerations will be flagged when standards are set (since IASB sits on the fence) producing non-neutral standards in practice. A recent research paper elaborates the implication of contracting in the setting of accounting standards in detail. Furthermore, several of the existing accounting standards advocate essentially conservative treatment where assets/income are understated and liabilities/expenses are overstated—e.g., revaluation surplus hits OCI but deficit hits P/L under FRS 16, unrealized losses but not gains on inventories are recognized under FRS 2, contingent assets are recognized only if absolute certain while contingent liabilities are recognized if probable under FRS 37.

Introducing prudence explicitly in the conceptual framework makes salient the inconsistency between the framework and existing standards. As the concept of faithful representation already includes neutrality, is it really important to introduce the prudence concept explicitly in the framework? Therefore, I do not support reintroducing a specific reference to prudence.

(c) The FASB Statement of Financial Accounting Concepts No. 2, Qualitative Characteristics of Accounting Information, ¶160, 1980 already noted the redundancy of “substance over form” defined as “...presented in accordance with their economic reality and not merely their legal form ...” Furthermore, implementing “substance over form” can involve substantial judgement with little consensus. For example, the cut off in the remaining economic life of a lease asset for distinguishing between operating and capital lease in IAS17 are different for Germany (70%), US (75%) and France (90%). Yet the economics of leasing should not be

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different across countries – the difference arises from judgement producing the legal form. Therefore I do not support the proposal to state explicitly substance over form.

(d) I support this clarification as there is concern in the comment letters to the Discussion Paper about the disappearance of the trade-off between reliability and relevance in the Conceptual Framework.

(e) Reliability in the 1989 conceptual framework is replaced by faithful representation in CF2010 without the “prudence” and “substance over form” elements in reliability. Given our answers in (b) and (c), I support the proposal.

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<th>Question 3—Definitions of elements</th>
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| Do you agree with the proposed definitions of elements (excluding issues relating to the distinction between liabilities and equity):
  (a) an asset, and the related definition of an economic resource;
  (b) a liability;
  (c) equity;
  (d) income; and
  (e) expenses? 
| Why or why not? If you disagree with the proposed definitions, what alternative definitions do you suggest and why? |

(a) The key difference in the definition of an asset between the CF2010 and EDCF2015 are the removal of “from which future economic benefits are expected to flow to the entity” and the introduction of a separate definition of economic resource. I agree with the removal of the “...expected to flow ...” clause because the uncertainty (such as probability threshold) is better dealt with at recognition and measurement rather than at the definition. The definition of economic resource as rights is a step in the right direction to help accountant think about economic substance (in terms of property rights) over legal form (in terms of legal ownership). I therefore agree with the definition.

(b) I agree with the definition for liability for reasons given in (a) for asset (about the removal of the “...expected to flow ...” clause) and Q4 for the description of present obligation.

(c) I agree with defining equity as a residue of claims. Economic resource controlled by the reporting entity is its assets which belong, either to party within the entity as equity, or outside the entity as liability. A problem arises when the party is not clearly within or outside the entity, but this issue is supposedly addressed by the Financial Instruments with Characteristics of Equity research project.

(d) and (e) I agree with defining the income and expense as the change in asset and liability. It is logical to first define asset, then define the other “stock” accounts, and then the “flow” accounts. This can avoid some difficult judgement in matching income and expense.

<table>
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<th>Question 4—Present obligation</th>
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<tr>
<td>Do you agree with the proposed description of a present obligation and the proposed guidance to support that description? Why or why not?</td>
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The proposed description of a present obligation is a middle ground – between mandating enforceability (View 1) and no requirement for enforceability (View 3) – which I agree is a better economic representation of business reality than either of the views (all three views are used in current IFRSs). The case of constructive obligation (EDCF2015: 4.34) discussed in EDCF2015BC: BC4.67-4.69 is a good example that the middle ground is more useful. I agree with the proposed description and guidance.

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<th>Question 6—Recognition criteria</th>
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<td>Do you agree with the proposed approach to recognition? Why or why not? If you do not agree, what changes do you suggest and why?</td>
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Recognition in CF2010 was based on probability of inflow/outflow of economics benefit and measurement reliability (with the associated problems). EDCF2015 is moving towards criteria based on relevance, faithful representation and cost. I see this as a step towards principle based accounting, and a step forward for the profession (accountants can no longer be bean counters and have to exercise a lot more judgment based on accounting principles) with the associated costs and benefits⁴. Therefore, I agree with the general approach and note that a lot of guidelines need to be provided, especially on the criterion "benefits exceeding the cost of providing that information". For example, should brand equity be recognized as asset? Investor do value it (with other things like quality of management team) paying a price above net tangible asset, and it is possible to hire a valuation consultant to measure it. The areas highlighted in EDCF205:5.13(a) existence uncertainty/separable from goodwill, (b) low probability of inflow/outflow and (c) high measurement uncertainty, will also need a lot of guidelines, probably at the standard level.

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<th>Question 7—Derecognition</th>
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<tr>
<td>Do you agree with the proposed discussion of derecognition? Why or why not? If you do not agree, what changes do you suggest and why?</td>
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I agree with IASB that the control approach and risk-reward approach are valid, and they usually give the same answer. In the cases that they do not, BC5.50 suggest that the principle of faithful representation prevails to decide the way forward. I think that this is a stronger position compared to stating that the control approach is better because recognition is defined using control.


Question 8—Measurement bases

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<th>Has the IASB:</th>
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<td>(a) The bases of measurement identified are historical and current values (consisting of fair value and value in use). Deprival/relief measurement base is excluded because, as stated in BC6.18(c) of EDCF2015BC, it is too complex and not accepted in some jurisdictions. I agree with the bases identified for practical reasons (no good if there is jurisdictions not accepting the deprival value basis) rather than conceptual basis (deprival value is conceptually superior to fair value in some situation for revenue and liability recognition, see <a href="http://papers.ssrn.com/sol3/papers.cfm?abstract_id=913363">http://papers.ssrn.com/sol3/papers.cfm?abstract_id=913363</a>)</td>
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<td>(b) I agree with the description and stated advantage/disadvantage, and I find Table 6.1 of EDCF2015 a useful summary.</td>
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IAASB has basically used the principles of relevance and faithful representation as the basis to choose a measurement base and elaborate the considerations in EDCF2015 at 6.48-6.73. I agree with IASB’s approach.

Question 9—Factors to consider when selecting a measurement basis

| Has the IASB correctly identified the factors to consider when selecting a measurement basis? If not, what factors would you consider and why? |

The point in EDCF2015BC:BC6.68 is to emphasize relevance and faithful representation as the basis for measurement, and if need be multiple bases can be used as elaborated in EDCF2015:6.74-6.77. I agree with the rationale and the approach.

Question 10—More than one relevant measurement basis

| Do you agree with the approach discussed in paragraphs 6.74–6.77 and BC6.68? Why or why not? |

The objective of GPFS (EDCF2015:1.2 or CF2010:OB1) and consequently objective of financial statements (EDCF2015: 3.4, 7.2) is narrowly focused on the providers of capital but accounting information is more widely used (e.g. in other areas of contracting) in practice. This narrow focus allows IASB to have an internally consistent conceptual framework, which is often not consistent with the standards that accommodate the use of accounting information for contracting.
I agree with the scope of financial statements (EDCF2015: 7.2-7.7) and the use of presentation and disclosure as communication tools (EDCF2015: 7.8-7.18). I believe that IASB Disclosure Initiatives will probably add many details later to 7.8-7.18 or make references from there.

**Question 12—Description of the statement of profit or loss**

Do you support the proposed description of the statement of profit or loss? Why or why not?

If you think that the Conceptual Framework should provide a definition of profit or loss, please explain why it is necessary and provide your suggestion for that definition.

Q12-Q14 relate to presenting financial performance stated in 7.19–7.27 (of EDCF2015) on the basis of BC7.24–BC7.57 (of EDCF2015BC). These sections are extremely convoluted, but essentially say this: Financial performance is presented in the statement of financial performance which has two parts (the parts can be two sections or two statements) – P/L and OCI – and is the summary statistics of all the recognized and measured income and expense for the period. All these income and expense flow to P/L unless rebutted by IASB (IAS1 preclude preparers to use the rebuttal). There are two cases when rebuttal cannot be used (the underlying asset/liability is measured in historical cost, or the income/expense affect the carrying value of the asset/liability measured in current cost) which will always result in flowing to P/L. Flowing to OCI occurs the rebuttal is used, i.e. when IASB thinks it is more decision useful (relevance) or it is not the second case stated earlier (7.25 give the example of mix measurement base). Even if the income/expense flows to OCI in the current period, it can be recycled to P/L if IASB thinks it is decision useful (relevance) to do so (7.26 and 7.27).

The IASB has already implicitly defined the statement of profit or loss – it is the part of the statement of financial performance that contains the sub-total for P/L – but somehow refuses to make the definition explicit. I speculate that this is a move to encourage the one statement format, while allowing the two statement format, and give closure to that controversy. I support the approach in this EDCF2015 for practical consideration.

**Question 13—Reporting items of income or expenses in other comprehensive income**

Do you agree with the proposals on the use of other comprehensive income? Do you think that they provide useful guidance to the IASB for future decisions about the use of other comprehensive income? Why or why not?

If you disagree, what alternative do you suggest and why?

I neither agree nor disagree because I have yet to understand why IASB finds it decision useful (relevance) for capital provider to have P/L distinct from OCI. In fact, IASB has not defined OCI directly: it is just whatever income/expense that does not flow to P/L. This EDCF2015 is a step forward to spell out what will not be included in OCI (7.23-7.24) but remains conceptually incomplete. It leaves the decision to IASB Board to determine what is to be included using the criterion that it will be decision-useful to capital provider to do so, which is operationally very vague.
IASB could consider the result from a research paper\(^5\) to nail down the concept of OCI. Essentially, under perfect financial market (the Modigliani-Miller Proposition 1 (MM1) assumption of zero tax and bankruptcy cost), the valuation of the firm is dependent only on business activity and not on financing activity, i.e. re-measurement of financial asset is irrelevant to performance and should not flow to P/L. Therefore, P/L is a clean surplus, and OCI a dirty surplus (investing jargons), where only the clean surplus is decision-useful for capital allocation under MM1 assumption. This arrangement is also useful from a stewardship perspective. Management are accountable for the performance arising from business activities while shareholders can still obtain their investment performance inclusive of the volatility arising from the financial asset the firm is holding. In the real world that deviates from MM1 assumption, investment analyst can decide how much of the dirty surplus to include in the adjustment, and presenting financial performance in two parts is decision-useful. However, whether IASB is thinking about this concept or something else needs to be directly articulated.

I neither agree nor disagree. The root cause is that OCI is not directly defined, which makes the basis to recycle very vague. If OCI is just re-measurement, then there appears to be no basis to recycle to P/L. If OCI is something more general, then it has to be articulate first before discussing about recycling. There is no point to discuss reclassification (which is what recycle means) without first establishing directly what the classification is.

The analysis is to scope out inconsistency of existing standards with EDCF2015, in particular the propose action for IAS21, IFRIC 21, IAS1 and IAS8, and propose that the EDCF2015 is immediately effective when issued. I agree with the analysis.

IASB has wisely avoided the term “business model” which has varied interpretations and has instead directly incorporate the effect of business activities into relevant parts of the conceptual framework (unit of account, measurement, presentation and disclosure) as a contextual factor. I agree with the approach.