24 December 2013

Our ref: ICAEW Rep 179/13

Ms Françoise Flores
Chairman
EFRAG
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Dear Françoise

A Review of the Conceptual Framework for Financial Reporting: draft EFRAG comment letter

ICAEW is pleased to respond to your request for comments on EFRAG's draft comment letter dated 26 September 2013 on the IASB discussion paper *A Review of the Conceptual Framework for Financial Reporting*.

Please contact me should you wish to discuss any of the points raised in the attached response.

Yours sincerely

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ICAEW REPRESENTATION

A REVIEW OF THE CONCEPTUAL FRAMEWORK FOR FINANCIAL REPORTING: DRAFT EFRAG COMMENT LETTER

Memorandum of comment submitted in December 2013 by ICAEW, in response to the draft EFRAG comment letter dated 26 September 2013 on the IASB discussion paper *A Review of the Conceptual Framework for Financial Reporting* published in July 2013

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INTRODUCTION

1. ICAEW welcomes the opportunity to comment on the draft European Financial Reporting Advisory Group (EFRAG) comment letter, dated 26 September 2013, on the discussion paper *A Review of the Conceptual Framework for Financial Reporting* published by the International Accounting Standards Board (IASB) in July 2013.

WHO WE ARE

2. ICAEW is a world-leading professional accountancy body. We operate under a Royal Charter, working in the public interest. ICAEW's regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the UK Financial Reporting Council. We provide leadership and practical support to over 140,000 member chartered accountants in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained.

3. ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.

4. The Financial Reporting Faculty is recognised internationally as a leading authority on financial reporting. The faculty's Financial Reporting Committee is responsible for formulating ICAEW policy on financial reporting issues, and makes submissions to standard setters and other external bodies. The faculty also provides an extensive range of services to its members, providing practical assistance in dealing with common financial reporting problems.

MAJOR POINTS

Status of comments

5. We are currently finalising our comments to the IASB on the discussion paper (DP), and our comments below reflect our current draft response to the IASB. While we do not expect any major changes at this stage, it is possible that the views expressed below will vary to some extent from those submitted in due course to the IASB.

Support for the initiative

6. Like EFRAG, we welcome the DP. We do not in general agree with EFRAG's comment that:

> 'some of the issues should be addressed on a more conceptual basis. This may partly be because it seems to us that many of the principles proposed have been generated from requirements in current Standards without their justification being debated conceptually.'

It seems to us that some of the weaker parts of the DP are where the issues are discussed conceptually without the concepts being tested against the requirements in existing standards, which have usually been discussed and thought through more thoroughly than the proposals in the DP.

Amending Chapters 1 and 3 of the existing conceptual framework

7. Like EFRAG, we would like to see some changes to Chapters 1 and 3 of the 2010 conceptual framework, but we do not seek such extensive changes as EFRAG proposes.

8. On stewardship, we believe that it is very important that it is well-understood that financial reporting does have a dual primary role, and that the provision of information to a company's owners to facilitate their control of its management is a legitimate objective of reporting under

IFRS. We believe that confirmation of this can be secured without major changes by clarifying the intention of paragraph OB4 in the 2010 framework.

9. We do not object to the retention of 'faithful representation' as a qualitative characteristic, and we do not believe that it is necessary to reinstate 'reliability'. We do not agree with the classification of qualitative characteristics into 'fundamental' and 'enhancing' ones, but we believe that if this distinction is retained, 'verifiability' should be classified as a fundamental qualitative characteristic.

10. We agree with EFRAG that 'prudence' should be reinstated in the framework, but only with its meaning clarified. As EFRAG points out, 'Prudence is clearly reflected both in Standards in force today and those being developed', and we believe that this is appropriate. Prudence in financial reporting can mean different things to different people, and this could lead to an understanding of the term that would in our view be entirely inconsistent with transparent financial reporting and that could result in most 'imprudent' financial reporting, if for example it results in standard setters allowing profit to be artificially depressed in one period, only for it to be artificially enhanced in the next, distorting trends over time. Moreover, if preparers were required to follow such a principle, it could lead to manipulation of profit for potentially short-term gains. But we believe that it should be possible to refer to prudence in the conceptual framework in an appropriately precise way that would achieve the desired objective and leave neutrality as a concept in place and not undermined.

The role of the business model in financial reporting

11. We agree that financial statements can be made more relevant if the IASB considers, when developing or revising standards, how a company conducts its business activities. Unlike EFRAG, though, we do not think that 'the approach to measurement proposed in the DP … forms a sound basis to have an entity's business model being reflected in measurement'.

12. On asset measurement, the DP attempts to reflect the business model by making a distinction between whether the asset contributes to cash flows by being used or by being sold. This approach does not really work as it would, for example, imply that manufacturers' finished goods and retailers' inventories should be measured at a current exit price, while investment properties should be measured at cost. We do not believe that there is any simple rule that will provide a comprehensive answer to how different assets should be measured. But other business-model-based considerations that should be taken into account include whether, on the one hand, the asset forms part of a process of transformation and inputs and outputs are sold in different markets or, on the other hand, the asset is not transformed by the business and is bought and sold in the same markets.

13. On liability measurement, we think that, contrary to the proposals in the DP, there are a number of liabilities that will be settled according to their terms – eg, defined benefit pension obligations – where a 'cost-based' measurement will not be appropriate.

Elements of financial statements and recognition

14. Like EFRAG, we agree with the DP's proposed definition of an asset. We believe, though, that the proposed definition of a liability may be too narrow, and that this leads to the type of problem identified by EFRAG regarding constructive obligations. We suggest that it might be necessary to define liabilities as including two categories: (i) present obligations and (ii) other amounts arising from recognised expenses. Our suggestions on this point are not fully developed and they would need further work by the IASB. But we believe that, unless an approach along the lines that we suggest is adopted, there is a risk that either:

- in order to comply with the DP's definition of 'liability', significant expenses would not be recognised in the relevant accounting period; or
- in order to recognise expenses in the relevant accounting period, significant liabilities that do not comply with the DP's definition would be recognised in accounts.

Distinction between liability and equity elements

15. We are generally supportive of the DP's proposals on the definition of equity and the distinction between liability and equity elements, but we share EFRAG's concern about the DP's proposals in relation to 'wealth transfers'. While some updating of equity in total, and potentially of different classes of equity, will follow logically from changes in net assets reported in the accounts, we are not clear what beyond this the IASB intends or why remeasurements of all individual classes of equity would be worthwhile.

Disclosure

16. We are generally content with the DP's proposals on disclosure. We note that EFRAG believes that the guidance in the framework 'could go further than proposed in the DP', but in our view the proposals in the DP seem reasonable.

Implications for existing standards of amending the conceptual framework

17. As we see it, the conceptual framework will set out guidance for the IASB, which will include a number of potentially conflicting considerations (eg, costs v benefits, relevance v verifiability, what would provide the most useful information in the balance sheet versus what would provide the most useful information in the income statement). What may appear to be conflicts with the framework in particular standards may well therefore be no more than instances of one consideration under the framework outweighing another. We doubt whether a supposed conflict would ever be sufficient reason by itself to merit an immediate revision to a standard. And any such proposed review of a standard should be subject to consultation by the IASB on whether it would be worthwhile to add the project to its agenda at that time, in preference to other potential projects.

RESPONSES TO SPECIFIC QUESTIONS

18. In commenting on EFRAG's draft responses to specific questions, we do not repeat the points made above.

Question 2: Definition of an asset

19. We do not think that it is necessary to add 'to the entity' to the proposed definition of an economic resource as the additional words would be redundant.

Question 3: Existence uncertainty and outcome uncertainty

20. We believe that it is probably useful to distinguish in principle between existence uncertainty and outcome uncertainty, but have no views on the frequency with which existence uncertainty is likely to arise.

Question 4: Defining income and expenses

21. We doubt whether it is helpful to define income and expenses entirely on the basis of changes in assets and liabilities as this approach appears to give priority to the statement of financial position. In our view the income statement should be given equal priority, and this might mean that, for example, some liabilities are recognised because it is desirable to charge the corresponding expense in the income statement. We also think that, to the extent that income and expenses are defined in terms of changes to the balance sheet, this should be done in terms of increases or decreases in equity rather than changes in assets and liabilities.

Question 5: Definition of a liability

22. As noted above, we believe that the proposed definition of a liability is probably too narrow.

Question 6: Present obligation

23. EFRAG's view that a present obligation must be practically unconditional would reinforce, in our view, the argument for a definition of liabilities that goes beyond 'present obligations'.

Question 8: Probability thresholds for recognition

24. We have no objection to the removal of probability thresholds in relation to recognition, and we note that DP4.26(a) and (b) provide a basis for guidance on recognition decisions by the IASB in conditions of uncertainty.

Questions 11-13: Measurement of assets and liabilities

25. As noted above, we do not entirely agree with the DP's proposals on measurement. Indeed we believe that this part of the DP needs a good deal more work before the exposure draft stage.

Question 19: Profit or loss

26. We believe that it is important for the conceptual framework to explain the **objective** of presenting profit or loss. We do not envisage that this will yield a hard-and-fast rule for what should be recognised in profit or loss and what should be recognised in other comprehensive income (OCI), but it should set out principles that will be taken into account by the IASB in making decisions on this issue.

Question 20: Recycling

27. We do not agree with recycling except for fair value gains or losses on effective hedges, which should be recycled when the hedged transaction is recognised in profit or loss. In general, we believe that recycling results in a less useful measure of profit or loss, which – to the extent that recycled amounts are included – gives neither a good indication of performance during the year nor a helpful indication of repeatable profit.

Question 23: Role of the business model

28. We support the role that business models already have in financial reporting and believe that they should continue to have such a role. At present this role is largely implicit. We are not sure how much will be gained by making the role more explicit or systematic, as we suspect it may lead to demands for 'business model' to be defined and to extensive arguments on matters that are currently accepted without dispute.

Question 26: Capital maintenance

29. We believe that the conceptual framework should recognise that IFRS is based on a financial capital maintenance concept, rather than give the impression that the question is an open one, which in practice it is not.

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