

EFRAG STAFF PAPER FOR PUBLIC MEETING

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Objective

- 1 The objective of this paper is to advise the Board of the current status of the IASB's Conceptual Framework project and to seek any preliminary views that members of the Board may have.

Current Status of the IASB's Conceptual Framework project

- 2 The IASB is undertaking a project to update its Conceptual Framework. This project is limited to updating the Conceptual Framework for shortcomings in terms of areas covered and guidance required, and to bring it more in line with the IASB's current thinking. It is not a fundamental review.
- 3 The IASB issued the Discussion Paper *A Review of the Conceptual Framework for Financial Reporting* in July 2013 with comments due by 14 January 2014. EFRAG developed a very detailed comment letter after extensive consultation, including the issuance of Bulletins exploring various issues.
- 4 The IASB's work plan published on 27 January 2015 notes that the IASB will issue an Exposure Draft in Q1 2015 (which is expected to be late in March).
- 5 EFRAG TEG has been considering the extent to which, based on discussions by the IASB, the issues raised by EFRAG in its comment letter on the Discussion Paper have been addressed, and whether new issues have arisen. This paper summarises some of EFRAG TEG's main issues of concern that are likely to be raised in the advice relating to the Exposure Draft from EFRAG TEG to the EFRAG Board. However, as EFRAG TEG's discussions have only been based on published tentative decisions of the IASB and not on a final Exposure Draft, the comments included in this paper only represent initial views that have not been formally approved by EFRAG TEG. Some of the views expressed in this paper may accordingly be modified in the advice EFRAG TEG will finally provide the EFRAG Board.

Main issues

- 6 The overall concern which is reflected in the specific issues discussed below is that the proposals included in the Exposure Draft will not provide clear directions for how to deal with various issues. It could be argued that the review of the Conceptual Framework accordingly will be harmless. On the other hand, it could be argued that given the time and resources that have been and will be allocated to the project, guidance that could result in more effective standard setting in the future should result. In particular, it does not appear that the revised Conceptual Framework is likely to resolve areas of controversy including the accounting for emissions trading, macro hedging and rate-regulated activities.

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- 7 The detailed issues of concern are:
- (a) Recognition of assets and liabilities;
 - (b) Business model;
 - (c) Selection of a basis for measurement;
 - (d) Presentation in the statement of comprehensive income – profit or loss and OCI; and
 - (e) Other issues.

Recognition of assets and liabilities

- 8 In its comment letter, EFRAG agreed with the Discussion Paper that in deciding whether an asset or liability should be recognised, relevance and faithful representation should be considered. EFRAG, however, disagreed with the implicit assumption of the Discussion Paper that an entity should recognise all its assets and liabilities.
- 9 It is expected that the Exposure Draft will not establish criteria that govern the recognition of an asset or liability in all circumstances. The Exposure Draft will instead describe factors to consider in deciding whether to recognise an asset or liability. Those factors would include whether the resulting information would be relevant and provide a faithful representation, and the costs of providing information relative to the benefits. Information might not be relevant if, for example, it is uncertain whether the asset or liability exists, if it is unlikely that future flows of economic benefits will occur or if there is very significant measurement uncertainty associated with the item.
- 10 EFRAG TEG is awaiting the final wording of the Exposure Draft. However, EFRAG TEG is concerned that it may not provide criteria for recognition that are sufficient to avoid an explicit or implicit assumption that all items that meet the definitions of assets and liability should be recognised. Having, as a starting point that all assets and liabilities should be recognised could result in increased complexity, higher costs for preparers and less transparency.
- 11 EFRAG TEG is also concerned that the Exposure Draft may not acknowledge that if a measurement is subject to a high degree of measurement uncertainty and another measurement may not be sufficiently reliable or relevant, it should be considered not to recognise an item but only provide disclosure about it.
- 12 It is expected that the Exposure Draft will state that the combined right and obligation included in an enforceable executory contract would constitute a single asset or liability. EFRAG TEG is concerned that unless the Exposure Draft includes some additional specific wording, the result could be that executory contracts should be recognised in the future.

Business model

- 13 The Discussion Paper presented the view that financial statements can be made more relevant if the IASB considers how an entity conducts its business activities when the IASB develops new or revised Standards. The way in which an entity conducts its business activities was considered in the measurement, presentation and disclosure and statement of financial performance sections of the Discussion Paper.

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- 14 The Discussion Paper did not define the business model concept.
- 15 In its comment letter, EFRAG believed that the business model notion should be referred to in IASB's financial reporting requirements on a systematic basis and thus be part of the IASB's Conceptual Framework. EFRAG agreed that the entity's business model should play a role in relation to recognition, measurement, presentation and disclosures.
- 16 The IASB has tentatively decided that the ED should not provide a single overarching description of how the nature of an entity's business activities would affect standard setting. Instead, the IASB should describe, for each area affected, how consideration of an entity's business activities would affect standard setting. The IASB has also indicated that the nature of an entity's business activities is likely to affect measurement, the unit of account, the distinction between profit or loss and OCI, and presentation and disclosure. It is less likely to affect other areas covered by the Conceptual Framework.
- 17 The IASB has also decided not to use the term 'business model' (as constituents put different meanings to this term), but instead refer to 'business activities'.
- 18 Finally, the IASB has decided that the Conceptual Framework can provide appropriate guidance for setting standards that could cover long-term investments without any specific consideration of relevant issues.

Selection of a basis for measurement

- 19 In its comment letter, EFRAG supported the view expressed in the Discussion Paper that the measurement should depend on how an asset contributes to future cash flows and how the entity will settle or otherwise fulfil a liability. This was considered to provide the most relevant information.
- 20 However, EFRAG did not share the view that a change of measurement basis subsequent to the initial recognition considerably reduces the understandability of financial reporting and EFRAG also thought that limiting the number of measurement bases could conflict with the objective of financial reporting.
- 21 The IASB has generally supported the views expressed by EFRAG, except that:
 - (a) the Exposure Draft may not provide sufficient guidance on when to use entity-specific versus market-based measurement bases and entry versus exit prices; and
 - (b) the measurement basis on initial recognition should be consistent with the measurement basis subsequently, and a change in measurement basis should only be allowed if such a change increases the relevance of the information provided.

Presentation in the statement of comprehensive income – profit or loss and OCI

- 22 The Discussion Paper proposed that items of income and expense should be presented in a way that would make the components of the entity's returns, and the variability of those returns, understandable. EFRAG recommended that the Conceptual Framework should provide a definition of what profit or loss was intended to depict, so that its meaning was clear. Specifically, EFRAG believed that the business model should play a role in defining primary performance and thus which items of income and expense should go to profit or loss and which into OCI.
- 23 The Exposure Draft is expected to propose that:

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- (a) profit or loss is the primary source of information about an entity's performance for the period and to emphasise that profit or loss is not the only source of such information.
 - (b) there is a rebuttable presumption that all items of income and expense should be included in profit or loss unless the IASB concludes in a particular Standard that including that item in OCI would enhance the relevance of profit or loss as the primary source of information about an entity's performance for the period; and
 - (c) the presumption that items of income and expense should be included in profit or loss (rather than in OCI) cannot be rebutted for items of income and expense that arise when cost-based measures are used for assets and liabilities.
- 24 However, the IASB is not expected to provide guidance as to the meaning of 'relevance' in the context of this decision. Discussions of EFRAG TEG indicate that EFRAG TEG may be concerned that this would result in a rebuttable presumption that all changes in assets and liabilities should be reflected in profit or loss. EFRAG TEG considers that it would be more fruitful to establish more generally what information should be provided by profit or loss and other comprehensive income. Whether items reported in other comprehensive income should be recycled could then also be derived from the described purposes of these statements.

Other issues

- 25 The IASB had decided not to revisit Chapter 1 and Chapter 3 of the Conceptual Framework that it published in 2010. Issues that EFRAG, in its comment letter, recommended should be revisited relate to reliability and prudence.

Reliability

- 26 In its comment letter EFRAG thought that the term 'faithful representation' should be replaced with the term 'reliability'. 'Reliability' should be defined in the same way it was in Conceptual Framework before 2010 and mean that information:
- (a) Should be free from material error and bias;
 - (b) Can be depended upon by users to represent faithfully that which it either purport to represent or could reasonably be expected to represent. This also means that transactions and other events are accounted for and presented in accordance with their substance and economic reality and not merely their legal form;
 - (c) Is prepared under the exercise of prudence; and
 - (d) Is complete.
- 27 The IASB has tentatively decided not to replace 'faithful representation' with 'reliability'. However, the IASB would consider whether it would be possible to give greater prominence to the idea that if the level of uncertainty associated with an estimate is sufficiently large, that estimate might not provide *relevant* (as distinct from reliable) information.

Prudence

- 28 EFRAG noted in its comment letter that prudence, although widely accepted as a concept, had different meanings to different people. EFRAG viewed prudence as a degree of caution which generally recognises downside risks and not upside potential inherent in uncertain future events.

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- 29 As such a prudence filter within the Conceptual Framework should operate in setting Standards for recognition or measurement – it should not relate to disclosure as the uncertainties/risks could be described at least qualitatively if not quantitatively.
- 30 EFRAG thought that prudence was clearly reflected in Standards in force. EFRAG therefore believed that it was essential to include a clearly articulated concept of prudence in the Conceptual Framework in order to ensure that it is applied consistently across the Standards (both current and future).
- 31 The IASB has tentatively decided to reintroduce prudence as the exercise of caution when making judgements under conditions of uncertainty. It would be explained that the exercise of prudence is consistent with neutrality and should not allow the overstatement or understatement of assets, liabilities, income or expenses. Based on the IASB staff papers for the IASB May 2014 meeting, this discussion does not seem to include a reference to possible asymmetry in recognition (as in the paper prepared by Roger Marshall and Andrew Lennard of the FRC). It is the view of EFRAG TEG that the Conceptual Framework should acknowledge that the criteria for recognising an asset should not necessarily mirror the criteria for recognising a liability. EFRAG TEG does not consider such asymmetry to be in conflict with neutrality. EFRAG TEG notes that the current Conceptual Framework describes a neutral depiction as being not slanted, weighed, emphasised, de-emphasised or otherwise manipulated to increase the probability that financial information will be received favourably or unfavourably by users. EFRAG TEG does not think that the asymmetry implicit in requirements that, for example, require a higher level of certainty for recognising internally generated intangible assets than for provisions are designed to increase the probability that financial information will be received (un)favourably by users.

Questions for EFRAG Board

- 32 Subject to the final form of the IASB's Exposure Draft, do you consider that these issues should be addressed in the draft comment letter? If so, do you have any tentative views?
- 33 Are you aware of any other major issues that should be considered in the draft comment letter?