

## EFRAG SECRETARIAT PAPER FOR PUBLIC MEETING

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International Accounting Standards Board  
30 Cannon Street  
London EC4M 6XH, United Kingdom

XX December 2015

Dear Mr Hoogervorst,

### **Re: Exposure Draft ED/2015/3 *Conceptual Framework for Financial Reporting***

The revision of the Conceptual Framework is subject to close scrutiny by all European interests with stakes in the EU IFRS policy. In the past decade of development of IFRS, the IASB due process has repeatedly led to hot debate on the same fundamental issues, including the objectives of financial reporting, the measurement of assets and liabilities and the reporting of performance. The efficiency of the IASB standard-setting process and the confidence that Europe needs to have in the standard-setting process it has entrusted to the IASB will be significantly enhanced when these issues are resolved. Whilst the Conceptual Framework is not subject to the EU endorsement process, it needs to be of such quality that it could meet political approval.

In this context EFRAG expressed satisfaction in its response to the IASB Discussion Paper on the Conceptual Framework that the IASB had undertaken a comprehensive revision of the Conceptual Framework, decided to focus on financial statements, and adopted a pragmatic approach with the objective of providing a solution to identified problems. From EFRAG's perspective this approach continues to be the right approach. EFRAG is aware that some other constituencies have called for the Conceptual Framework to be more aspirational in nature, and have exercised influence to set aside guidance that well illustrated the accounting model that was currently implemented in IFRS. From EFRAG's point of view, the result is a set back from the approach in the Discussion Paper, even though the analysis of measurement bases is significantly improved, and has led EFRAG to be concerned that the Conceptual Framework as developed in the Exposure Draft will not provide the clarity that is deemed necessary.

Having said that, EFRAG is pleased to note that the IASB has been responsive to some of EFRAG's requests, in particular in its reconsideration of the objectives and qualitative characteristics of financial reporting. Good progress has been made in giving more prominence to the objective of stewardship and the re-introduction of prudence. We are nevertheless of the view that more needs to be done in those areas. EFRAG is not convinced that information that is relevant to support decisions to buy, hold and sell, and to support the assessment of stewardship are in all circumstances the same. On prudence, EFRAG agrees with most of the developments made in the Basis for

Conclusions. However, EFRAG does not agree with the concluding remarks, and hence not with what the Conceptual Framework would say on prudence, were it to be finalised on the basis proposed.

Furthermore, although EFRAG appreciates that measurement uncertainty affects the usefulness of accounting information, EFRAG does not believe it does so by reducing the relevance of the information provided. Measurement uncertainty affects faithful representation (or reliability). EFRAG urges the IASB to clarify this by acknowledging the trade-off between relevance and faithful representation (or reliability). In this regard the IASB should also explain when measurement uncertainty would result in information not being faithfully representative (or reliable). The revision of the Conceptual Framework is the ideal opportunity for this. EFRAG notes that it agrees with most of the IASB's Basis for Conclusions on this issue. The Conceptual Framework should also be clear that uncertainty plays a role in both recognition and measurement.

Finally, the Exposure Draft does not provide the expected guidance on how to select a measurement basis or a conceptual foundation for the reporting of performance, including what should be reported in profit or loss and when. EFRAG assesses that these issues are interrelated and related with the objective of financial reporting. As indicated above, these are among the areas which have created the most contentious discussions and misunderstandings in the past: European expectations would not be met and public confidence in the standard setting process may be harmed if it would leave the members of the IASB without robust guidance on such critical areas of financial reporting. EFRAG considers that the business model is one of the factors that should be taken into account when developing the principles on these issues in the Conceptual Framework.

EFRAG therefore expects that the next round of deliberations will contribute to filling the need for guidance in these areas. This may require a second exposure draft. This possible outcome, and the consequent delay in concluding the project, should not prevent the IASB from satisfying the legitimate expectations of jurisdictions which have adopted IFRS. Whilst we support the IASB's ambition of issuing a revised framework without lingering, we consider that a high quality outcome is more important than a high speed outcome.

Whether the inconsistencies in current Standards on the distinction between equity and liabilities can be considered in any second exposure draft or in a later amendment to the Conceptual Framework may depend on when the separate project on this issue is finalised. EFRAG, however, notes that it is important to solve the inconsistencies within Standards and to amend the Conceptual Framework, to reflect the outcome of this project that is running in parallel with the broader Conceptual Framework revision.

Detailed analysis and responses to the questions in the ED are set out in the Appendix 1. Appendix 2 includes an assessment of the extent to which the guidance included in the ED assists in determining the unit of account.

If you would like to discuss our comments further, please do not hesitate to contact the EFRAG Secretariat or me.

Yours sincerely,

Roger Marshall

**Acting President of the EFRAG Board**

## APPENDIX 1

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CHAPTERS 1 AND 2 THE OBJECTIVE OF GENERAL PURPOSE FINANCIAL REPORTING AND THE QUALITATIVE CHARACTERISTICS OF USEFUL FINANCIAL INFORMATION

**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?

*Question 1 (a) - Stewardship*

**EFRAG's response**

**EFRAG welcomes the greater prominence given to the assessment of management's stewardship of the entity's resources in the description of the objective of financial reporting in the ED. EFRAG remains concerned, however, that the objective of assessing management's stewardship remains subsumed in a general objective of providing useful information to support decisions involving buying, selling or holding equity and debt instruments, and providing or settling loans and other forms of credit.**

- 2 EFRAG thinks that providing information that is useful for assessing stewardship is as important as providing information to assess the prospects for future net cash inflows to an entity. EFRAG accordingly agrees with paragraph 1.3 of the ED that existing and potential investors, lenders and other creditors need information to help them assess both the prospects for future net cash inflows to an entity and management's stewardship of the entity's resources.
- 3 However, the ED presents the assessment of stewardship as an element in the decision to buy, sell or hold equity and debt instruments. Although the ED in paragraph 1.22 mentions that information about management's discharge of its responsibilities is useful for decisions by existing investors, lenders and other creditors who have the right to vote on or otherwise influence management's actions, it appears to limit the provision of such information to usefulness for decisions on whether to buy, sell or hold equity and debt instruments. It also ignores the information needs of potential investors, lenders and other creditors and users of financial statements other than those identified as primary users.
- 4 The ED does not include much guidance on the implications for standard setting of the objective of providing information useful for assessing the management's stewardship. EFRAG considers that assessing management's stewardship is about assessing how efficiently and effectively the entity's management and governing board have discharged their responsibilities for managing the assets and liabilities of an entity. The necessary information should be both forward-looking and

backward-looking as EFRAG considers that stewardship is both about how the management has positioned the entity for the future and what the management has done in a given period.

- 5 EFRAG believes that existing investors could need information for the assessment of stewardship that would supplement the information useful for decisions on buying, selling or holding equity and debt instruments. EFRAG disagrees with the Basis for Conclusions (paragraph BC1.10) that information about management's stewardship is solely part of the information used to make decisions about whether to buy, sell or hold an investment.
- 6 EFRAG is of the view that, in some circumstances, an investor would not consider selling an investment in an entity, but would need information to support decisions about the quality of the management of the entity, including decisions about whether the management should be retained or replaced.
- 7 There would be a very significant overlap between providing information useful for buying, holding and selling decisions and information useful for assessing stewardship because:
  - (a) Information prepared for the purpose of assessing stewardship necessarily includes information on the financial position at the end of the period: that information will be influenced by projections of the future. For example, the carrying amount of assets is written down to the amount that can be recovered in the future; and
  - (b) The most relevant basis for an assessment of the future is often an analysis of past events.
- 8 However, in order to assess what the management has done in a given period, the transactions actually entered into by an entity have to be transparently reported. For example, it would be relevant to compare any investment measured at current value with the price paid.
- 9 To meet the objective of providing information for the assessment of stewardship, financial statements should report on past transactions and events and the information should focus on having confirmatory value.
- 10 EFRAG notes that one way of responding to its concern could be to identify the assessment of stewardship as an objective in its own right. This would involve replacing the focus in the definition of the objective of financial reporting on information useful for "decisions involving buying, selling or holding equity and debt instruments, and providing or settling loans and other forms of credit" with a more general objective of providing decision useful information for the different types of users identified in the ED. Decision-useful information would then be described as information needed for both decisions based on the assessment of management's stewardship on the one hand and decisions to buy, sell or hold decisions on the other. Indeed, there may be cases where information is only relevant to one of these objectives. The IASB should also eliminate paragraph BC1.10 from its Basis for Conclusions as this appears to justify that providing information necessary for decisions based on the assessment of stewardship should not be an objective in its own right.
- 11 The ED defines users as those existing and potential investors, lenders and other creditors who must rely on general purpose financial reports for much of the financial information they need. This excludes, for example, the management of the entity. Management, however, can be expected to have extensive knowledge of information that would be useful to depict the financial position and performance of entities. Accordingly, if preparers consider that the information resulting from a Standard is useful for them, it could indicate that information resulting from a Standard is useful for users. Similarly, if preparers do not believe that a Standard

results in useful information then this could indicate that the information would not be useful for existing and potential investors, lenders and other creditors.

Question 1 (b) - Prudence

**EFRAG's response**

**EFRAG welcomes the IASB's decision to re-introduce prudence into the Conceptual Framework, and with the judgement of the IASB in the Basis for Conclusions that prudence may lead to asymmetry in the recognition of assets/income and liability/expenses without introducing any undesirable bias in financial reporting. These conclusions should, however, be made clearer and be acknowledged in the Conceptual Framework itself. Also, prudence should not be made subservient to neutrality. Finally, when the Conceptual Framework explains prudence, the focus should be on how it affects standard-setting rather than suggesting it only affects the behaviour of preparers of financial statements.**

- 12 EFRAG agrees that prudence should be reintroduced into the Conceptual Framework, however, EFRAG disagrees with how prudence is considered in paragraph 2.18 of the ED. The paragraphs below explain:
- (a) What EFRAG thinks prudence is;
  - (b) What EFRAG thinks about asymmetric prudence;
  - (c) How EFRAG considers the relationship between prudence and neutrality;
  - (d) EFRAG's view of the role of prudence in the Conceptual Framework; and
  - (e) How EFRAG thinks prudence should be explained in the Conceptual Framework.

What EFRAG thinks prudence is

- 13 EFRAG notes that before the 2010 revision of the Conceptual Framework prudence was described as:
- [T]he inclusion of a degree of caution in the exercise of the judgements needed in making the estimates required under conditions of uncertainty, such that assets or income are not overstated and liabilities or expenses are not understated. However, the exercise of prudence does not allow, for example the creation of hidden reserves or excessive provisions, the deliberate understatement of assets or income, or the deliberate overstatement of liabilities or expenses, because the financial statements would not be neutral and, therefore, not have the quality of reliability.
- 14 EFRAG would agree with the pre-2010 Conceptual Framework that prudence should not allow for hidden reserves, excessive provisions or deliberate understatements of assets and the deliberate overstatement of liabilities. On the other hand, in case of uncertainty, EFRAG thinks that it may sometimes in standard-setting be useful to require more certainty before recognising income than before recognising expenses.
- 15 As explained in its comment letter in response to the DP, EFRAG considers that prudence represents a degree of caution that generally recognises downside risks and strongly questions whether upside potential inherent in uncertain future events should be recognised. This would mean that when the IASB is setting Standards, it could sometimes set thresholds for recognising losses lower than the thresholds for recognising gains. Currently, many Standards include such different thresholds.
- 16 The manner in which EFRAG considers prudence should not stop the use of fair value measurement in appropriate circumstances or the recognition of fair value gains in financial statements.

What EFRAG thinks about asymmetric prudence

- 17 In its basis for conclusions (paragraphs BC2.1 to BC2.15), the IASB considers two possible aspects of prudence, 'cautious prudence' and 'asymmetric prudence'. The Basis for Conclusions mentions that the IASB disagrees that asymmetric prudence is a necessary characteristic of useful financial information. However, accounting policies that treat gains and losses asymmetrically could be selected in accordance with the proposals in the ED if their selection is intended to result in relevant information that faithfully represents what it purports to represent. EFRAG agrees with this. However, EFRAG does not think that the fact that asymmetric prudence should only be applied in some cases would call for a rejection of the term as is done in paragraph BC2.15 of the Basis for Conclusions. Instead EFRAG thinks that the Conceptual Framework should include a discussion similar to the discussion included in paragraphs BC2.13 – BC2.14 of the Basis for Conclusions.

How EFRAG considers the relationship between prudence and neutrality

- 18 EFRAG also agrees with the ED that both neutrality and prudence are necessary components of faithful representation. As both need to be met and neutrality calls for the absence of any bias, prudence cannot have the effect that some describe as necessarily entangled with it, that is the intended understatement of assets or overstatement of liabilities that is contrary to transparent and faithful financial reporting. EFRAG agrees that prudence does not lead to making choices such as those described in paragraph BC2.14. When prudence applies, caution exercised by the standard setter may nevertheless result in asymmetric outcomes in how assets and liabilities are accounted for, for the reasons stated in paragraph BC2.5.
- 19 Prudence and neutrality contribute together – on the same footing – to faithfully representative information and prudence cannot be said to 'support' neutrality. Rather they provide together an equilibrium. EFRAG notes that all of the above is consistent with the manner in which prudence was described in the pre-2010 Conceptual Framework.
- 20 The type of prudence that EFRAG accordingly thinks should be reflected in the Conceptual Framework would not support neutrality. Neither would it be inconsistent with neutrality. According to the current Conceptual Framework, a neutral depiction is without bias in the selection or presentation of financial information. A neutral depiction is not slanted, weighted, emphasised, de-emphasised or otherwise manipulated to increase the probability that financial information will be received favourably or unfavourably by users.

EFRAG's view of the role of prudence in the Conceptual Framework

- 21 EFRAG acknowledges that in the pre-2010 Conceptual Framework, prudence was explained in a manner that was directed towards preparers of financial statements. EFRAG, however, considers that the status of the Conceptual Framework makes it a less effective tool for affecting the behaviour of preparers than guidance in Standards.
- 22 Accordingly, EFRAG thinks that the description of prudence in the Conceptual Framework should be directed more towards how the IASB should use it in standard-setting. Addressing prudence in standard-setting rather than leaving it to individual preparers would, in the view of EFRAG, result in a more consistent application. The Conceptual Framework should thus include directions in order for 'asymmetric prudence' to be reflected in Standards on a consistent basis. 'A consistent basis' in this regard would not mean that there should generally be different thresholds for assets/income and liabilities/expenses but it would mean that when such thresholds are introduced they are introduced for similar circumstances and in a similar manner.

- 23 EFRAG therefore supports paragraph BC2.9(b) of the Basis for Conclusions that clearly identifies a role of prudence in standard-setting, that is, it does not limit prudence to having a role in how estimates are prepared. EFRAG, however, does not believe that prudence in standard-setting is necessarily limited to counteracting any bias by management in the preparation of financial statements. Prudence has a role to play in standard-setting to set requirements that consider the inter-relationship between conditions of uncertainty and faithfully represented information, i.e. leading to useful information.

How EFRAG thinks prudence should be explained in the Conceptual Framework

- 24 Even though the Basis for Conclusions is in its developments consistent with how EFRAG perceives the role of prudence, EFRAG disagrees with the concluding statements and with how it is finally dealt with in the ED which:

- (a) Fails to acknowledge the possibility of asymmetric outcomes;
- (b) Makes neutrality trump prudence; and
- (c) Seems to focus on how financial statements are prepared and not on how standards are set.

- 25 EFRAG suggests building on the content of the Basis for Conclusions to provide for a meaningful re-introduction of prudence in the Conceptual Framework along the following lines:

A neutral depiction is without bias in the definition and application of accounting policies and the selection and presentation of financial information. A neutral depiction is not slanted, weighted, emphasised, de-emphasised or otherwise manipulated to increase the probability that financial information will be received favourably or unfavourably by users. As a result neutral representation cannot allow for the deliberate understatement, or overstatement, of assets and income and liabilities and expenses.

Providing relevant information that faithfully represents what it purports to represent requires the exercise of prudence. Prudence is the exercise of caution when making judgements under conditions of uncertainty. It helps the IASB develop rigorous standards and practitioners determine reasonable estimates. It may result under some circumstances in accounting policies that treat income and expenses asymmetrically, however only when this is intended to result in relevant information that faithfully represents what it purports to represent. Under these circumstances prudence is not contrary to neutrality, it supplements neutrality in providing useful information.

- 26 The Basis for Conclusions could remain virtually unchanged, except that the conclusions reached under 'cautious prudence' and 'asymmetric prudence' would have to be modified to lead to the above outcome, taking into account all of EFRAG's comments.

*Question 1 (c) – Substance over form*

**EFRAG's response**

**EFRAG welcomes the IASB's decision to reintroduce 'substance over form' but considers that the IASB should revisit the drafting and explain the distinction between 'legal substance' and 'legal form'.**

- 27 EFRAG welcomes the IASB's decision to reintroduce 'substance over form' as a necessary component of faithful representation. EFRAG agrees with the pre-2010 Conceptual Framework that if information is to represent faithfully the transactions and other events that it purports to represent, it is necessary that they are accounted for and presented in accordance with their substance and economic reality and not merely their form or appearance.



- 28 EFRAG would, however, suggest that the drafting is revisited, so as to eliminate any possible misinterpretation that legal arrangements should be disregarded and the economic substance of transactions considered independently. EFRAG does not think legal arrangements should be disregarded. Legal aspects will often play an important role in assessing what rights and obligations an entity has, and hence are the basis for analysing the economic substance of arrangements, i.e. their 'legal substance'. They should thus be considered unless the legal form would not represent the economic substance.
- 29 Clarity on this account is necessary. Often opposition to accounting requirements arises because they would generate different outcomes in different countries for transactions in the same economic sector, the reason being that legal frameworks vary from jurisdiction to jurisdiction. What constituents may regard as the same 'economic' transactions have different economic substance, the differences in the legal requirements making the economic substance different.

*Question 1 (d) – Measurement uncertainty*

**EFRAG's response**

**EFRAG appreciates that measurement uncertainty affects the usefulness of accounting information, but disagrees that measurement uncertainty should be an element of 'relevance'. The Conceptual Framework should acknowledge the trade-off between relevance and faithful representation (or reliability), with measurement uncertainty being included in 'faithful representation' (or reliability). In EFRAG's view, the Conceptual Framework should provide the opportunity of gaining a better understanding of what the boundary of a faithfully representative (or reliable) measurement should be.. Further, it should be clear that uncertainty plays a role in both recognition and measurement.**

- 30 In EFRAG's view, the IASB's proposal on 'measurement uncertainty' cannot be considered as an isolated change. It is closely related to the effectiveness in applying the fundamental qualitative characteristics, the notion of what a faithfully representative (or reliable) measurement is and the elimination of the probability recognition criterion.
- 31 In the following paragraphs EFRAG refers to 'faithful representation'. However, EFRAG can also see benefits in reverting to the term 'reliability'. For EFRAG, the term chosen is, however, secondary to what the term represents and how the concept is used. In the following paragraphs, EFRAG therefore focuses on these issues.

Effectiveness in applying the fundamental characteristics

- 32 EFRAG agrees with paragraph 2.20 of the ED that states that "information must be both relevant and faithfully represented if it is to be useful".
- 33 By including measurement uncertainty in the notion of relevance, it becomes difficult for EFRAG to see any difference between 'useful' and 'relevant'. EFRAG understands that the IASB considers that if the measurement uncertainty is high, users may not find the resulting information relevant and that there is a trade-off between the level of measurement uncertainty and other factors that make information relevant (paragraph BC2.24 of the Basis for Conclusions). However, if relevance is interpreted as broadly as this, it could also be argued that information is not relevant if, for example, it does not represent faithfully what it purports to represent. It would thus be difficult to understand why 'relevance' and 'faithful representation' should be considered as different elements instead of considering whether information is useful more directly.

- 34 In the view of EFRAG, considering ‘relevance’ and ‘faithful representation’ (including measurement uncertainty) as two separate and key components of ‘useful’ as in the pre-2010 Conceptual Framework, better describes the two-step approach and trade-off when deciding that certain items should not be recognised in the financial statements (but disclosed in the notes). In the pre-2010 Conceptual Framework, what is now faithful representation should not be considered when assessing whether information was relevant. For example, information about a claim for damages under a legal action that may be material to the entity is relevant information, regardless of the level of measurement uncertainty, for assessing the prospects for future net cash inflows to an entity. However, as stated in the pre-2010 Conceptual Framework, the information may be “so unreliable in nature or representation [what is now termed ‘faithful representation’] that its recognition may be potentially misleading”, and therefore recognising any amount of the claim in the statement of financial position may not result in faithfully representative information. In such a case the relevance of the information commands that information be disclosed.
- 35 EFRAG also notes that completeness, freedom from error, neutrality and prudence have important roles to play in handling measurement uncertainty, and that they are all part of ‘faithful representation’. It may be worth emphasising that, in EFRAG’s view, promoting the trade-off between faithful representation and relevance is not intended to support the choice of the lowest level of uncertainty possible in the measurement, as in a great number of circumstances this would undoubtedly not lead to useful information.

Notion of a faithfully representative measurement

- 36 EFRAG agrees with the statement in paragraph 2.12 of the ED that “the use of estimates is an essential part of the preparation of financial information”. The use of estimates should therefore not be unduly restricted.
- 37 EFRAG, however, disagrees with the idea that any number could qualify as a faithfully represented estimate, provided that “the reporting entity has properly applied an appropriate process, properly described the estimate and explained any uncertainties that significantly affect the estimate” as is stated in paragraph 2.20 of the ED. Faithful representation cannot be limited, in EFRAG’s view, to strict compliance with a computation process and disclosures. An estimate will represent what it purports to represent, provided the link between the economic reality that is considered and the estimate that is provided can be identified. EFRAG therefore believes that *in addition* to the above some link is required between, on the one hand, the choice of inputs, assumptions, models, sources of data, on which the estimate is built and, on the other, the economic reality that the information “purports to represent”. EFRAG fully accepts, for example, that a model that is acknowledged by market practice is a basis for a faithful representation of the price of a complex derivative. Clarifying that this link must exist and be identifiable would not put into question the bulk of the current IFRS practice. It may, however, have the merit of setting some boundary between what should be accepted as faithfully representative, that is, what users can ‘depend upon’ and what they should not.

Elimination of the probability recognition criterion

- 38 Uncertainty does not only play a role in relation to measurement. It plays a role in recognition as well.
- 39 Notwithstanding this, EFRAG supported at the DP stage the elimination of the probability recognition criterion for the following reasons:
- (a) Current IFRS clearly demonstrate that the definition of probability recognition thresholds has to be a standards level decision. Despite the single probability threshold set in the current Conceptual Framework, IFRS reflect a great diversity in probability recognition thresholds. EFRAG has not heard anybody

claim that a probability recognition threshold should govern the recognition of financial instruments, for example. In contrast, when amendments to IAS 37 were discussed a few years ago, the elimination of the probability recognition threshold was one of the very contentious issues debated; and

- (b) Setting relevance and faithful representation as recognition criteria was in EFRAG's view sufficient to determine, at standards level, whether a probability recognition threshold was needed.

- 40 In the ED relevance and faithful representation continue to be proposed as recognition criteria and EFRAG remains supportive of this. EFRAG agrees with the IASB that the existence uncertainty and the level of probability of a flow of economic benefits have a role to play in assessing whether an information would be useful.
- 41 EFRAG therefore believes that a reference to uncertainty that is limited to measurement in relation to the discussion of relevance in the chapter dealing with qualitative characteristics may bring confusion about where and how uncertainty should play a role in financial reporting.

#### Conclusion

- 42 For the reasons explained above, EFRAG disagrees with the proposal to assess measurement uncertainty as part of relevance. EFRAG could fear that measurement uncertainty would not be genuinely considered by the IASB if it is to be considered in relation to 'relevance'. For example, it seems difficult to argue that information about a claim for damages under a legal action would not be capable of making a difference in a decision even if it is subject to a high level of measurement uncertainty.
- 43 Furthermore, reaching an appropriate trade-off between relevance and faithful representation to optimise the usefulness of information is a well-established and well-understood notion in Europe. In EFRAG's view it is therefore important that this trade-off is not eliminated or disguised in the IFRS Conceptual Framework.
- 44 It is also important, in EFRAG's view, that the IASB reaches a common understanding with its constituents of what constitutes a faithfully representative measurement, with the revision of the Conceptual Framework being the opportunity to clarify the boundaries of estimates. The impact of measurement uncertainty on recognition and the choice of a measurement basis should be further developed in the relevant sections of the Conceptual Framework.

#### *Question 1 (e) – Relevance and faithful representation*

<b>EFRAG supports the Conceptual Framework continuing to identify relevance and faithful representation as the two fundamental qualitative characteristics of useful financial information.</b>
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- 45 EFRAG considers that the Conceptual Framework should continue to identify relevance and faithful representation as the two fundamental qualitative characteristics of useful financial information. This is evidenced by our discussions above where EFRAG emphasises the importance of properly representing these characteristics. In EFRAG's view, the enhancing qualitative characteristics play a subordinate role and are not subject to the same need of trade-off that is integral to relevance and faithful representation.

CHAPTER 3 FINANCIAL STATEMENTS AND REPORTING ENTITIES

**The reporting entity**

**Question 2 – Description and boundary of a reporting entity**

Do you agree with:

- (a) the proposed description of a reporting entity in paragraphs 3.11–3.12 of the ED; and
- (b) the discussion of the boundary of a reporting entity in paragraphs 3.13–3.25 of the ED?

Why or why not?

**EFRAG's response**

**EFRAG generally agrees that a reporting entity is not necessarily a legal entity and that an entity can prepare both individual and consolidated financial statements. However, EFRAG disagrees with including a statement in the Conceptual Framework that consolidated financial statements are more likely to provide useful information to users of financial statements than unconsolidated financial statements without acknowledging the circumstances where this may not be the case. Finally, EFRAG considers that it would be beneficial to have further explained in the Conceptual Framework what the implications of the entity approach are.**

- 46 EFRAG agrees that a reporting entity is not necessarily a legal entity. It can comprise a portion of an entity, or two or more entities. EFRAG also agrees that entities can prepare both individual and consolidated financial statements.
- 47 It appears from the ED that 'control' would determine whether an entity is a subsidiary/parent of another entity. This is in accordance with the current requirements in IFRS 10 *Consolidated Financial Statements*. The ED does not provide further guidance on what 'control' is. Such guidance is currently provided in IFRS 10.
- 48 EFRAG thinks that it could have been useful to explain in the Conceptual Framework why control – exclusive control – is the underlying principle to the definition of the reporting entity. EFRAG is, however, not urging that this is done at this juncture.
- 49 EFRAG thinks that it is an improvement compared with the current Conceptual Framework that the ED acknowledges that unconsolidated financial statements can provide useful information. Different users have different needs. EFRAG, for example, considers that some lenders may be more interested in the separate financial statements of the borrowing entity (and the interest that it controls) than in the consolidated financial statements of the whole group. Similarly, non-controlling interests would probably find consolidated financial statements of the controlling interest less useful than financial statements of the one entity in which they are holding an interest (and any controlled subsidiaries). In addition, equity investors (whether or not they are non-controlling interests at a group level) are more likely to find the information about the ability to meet expectations about future dividends in separate financial statements. EFRAG therefore disagrees with including a statement in the Conceptual Framework that consolidated financial statements are more likely to provide useful information to users of financial statements than unconsolidated financial statements without acknowledging the circumstances where this may not be the case.

- 50 The ED states that financial statements should be prepared from the perspective of the reporting entity as a whole instead of from the perspective of any particular group of investors, lenders or other creditors. There seems to be different views on the consequences of this<sup>1</sup>. Accordingly, EFRAG considers that it would be beneficial to have this further explained in the Conceptual Framework. EFRAG considers that the non-controlling interest in a subsidiary of a parent entity is less interested in the group financial statements of the parent entity as this includes assets, liabilities and profits to which it has no rights or obligations. It seems, on the other hand, that the shareholders of the parent company could benefit from consolidated financial statements. EFRAG considers that the likely users of particular types of financial statements has to be taken into account when preparing Standards. Furthermore EFRAG thinks that for some types of information a proprietary approach would be more useful than the entity approach suggested. This could, for example, be the case for information to assess the management's stewardship. The IASB's equity/liability project may result in more insight of when it would be useful to provide some information from a proprietary perspective. EFRAG would expect that this project would lead to amendments to the Conceptual Framework, including guidance on when it would be useful to deviate from the entity approach in specific standards.
- 51 Paragraph 3.16 of the ED states:  
For financial statements to give a faithful representation of the economic activities of the reporting entity, they need to describe the set of economic activities included within the reporting entity.
- 52 EFRAG understands that the paragraph has been included to reflect the concept of completeness. However, the paragraph could be read as a disclosure requirement. EFRAG therefore recommends that the purpose of this paragraph is clarified.
- 53 EFRAG also notes that the references to 'direct control' and 'indirect control' are used differently from how the terms are often used. 'Direct control' is often used when an entity controls another entity directly whereas 'indirect control' is used when an entity controls another entity through a third entity. To avoid confusion, EFRAG would recommend the IASB to consider whether the issue could be explained differently.
- 54 Based on the suggested guidance provided in the ED, EFRAG is uncertain about how to deal with financial statements that are neither, consolidated nor combined or individual financial statements. An example could be the financial statements of a part of an entity ('carve-out financial statements') that would be required by local authorities. EFRAG considers that it should be clarified whether such financial statements could be considered IFRS financial statements according to the Conceptual Framework.
- 55 Finally, EFRAG think that the guidance included in the ED that it is necessary to disclose in the unconsolidated financial statements how users may obtain the consolidated financial statements is a too specific requirement for the Conceptual Framework.

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<sup>1</sup> See for example Mourik, C. van. 2014. The Equity Theories and the IASB Conceptual Framework. *Accounting in Europe*. Vol. 11, Issue 2.

CHAPTER 4 THE ELEMENTS OF FINANCIAL STATEMENTS

**Definitions of elements**

**Question 3 – Definitions of elements**

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?

**EFRAG's response**

**EFRAG tentatively agrees with defining:**

- (a) **An asset as a present economic resource controlled by the entity as a result of past events;**
- (b) **An economic resource as a right that has the potential to produce economic benefits;**
- (c) **A liability as a present obligation of the entity to transfer an economic resource as a result of past events;**
- (d) **Equity as the residual interest in the assets of the entity after deducting all its liabilities;**
- (e) **Income as increases in assets or decreases in liabilities that result in increases in equity, other than those relating to contributions from holders of equity claims; and**
- (f) **Expenses as decreases assets or increases in liabilities that result in decreases in equity, other than those relating to distributions to holders of equity claims.**

**EFRAG will provide its final comments on the definitions separately, after EFRAG has considered the responses to its questionnaire on the proposed definitions of assets and liabilities.**

**EFRAG disagrees with:**

- (a) **Removing the description of revenue; and**
- (b) **Stating that if one party has a liability another party has an asset.**

56 EFRAG tentatively agrees with the proposed definitions of assets and liabilities as they seem easier to understand than the current definitions. EFRAG, however, tentatively considers that:

- (a) Similar to the proposals included in the Discussion Paper preceding the ED, it should be specified that the definition of an asset (a liability) is, in fact, the definition of an asset (liability) *of an entity*.

- (b) The definition of a liability does not need to refer to 'past event'. The additional guidance on when a liability is present states that in order for an entity to have a present obligation to transfer an economic resource, the obligation must have arisen from past events. The reference to the 'past event' is thus already included in definition by requiring that the obligation is present.
- 57 EFRAG will provide its final comments on the definitions separately. Before finalising its views on the proposed definitions, EFRAG will consider responses received on a questionnaire issued on the proposed new definitions. The questionnaire asks constituents whether various items would meet the different aspects of the proposed definitions. Contrary to what the IASB expects (paragraph BC4.17), EFRAG assesses that, for example, the change of 'expected' to 'having the potential to' could result in constituents interpreting the proposed definitions differently from the current definitions.
- 58 EFRAG disagrees with removing the description of revenue. EFRAG is concerned that removing the description of revenue could indicate that profit or loss and OCI is less important than indicated by the current version of the Conceptual Framework. EFRAG has an opposite view. EFRAG believes that the statement(s) of financial performance and the statement of financial position are equally important.
- 59 Although EFRAG considers that the statement(s) of financial performance and the statement of financial position are equally important, EFRAG thinks that it is reasonable to define income and expenses on the basis of changes in assets and liabilities. Defining income and expenses based on changes in assets and liabilities does not mean that the statement of financial position is more important than the statement(s) of financial performance. EFRAG thinks that the asset/liability approach has some merits compared to a matching approach. First it ensures that the statement of financial position only represents rights and obligations to future in- and out-flows. In contrast a pure matching approach generates deferrals that cannot be linked to economic phenomena. Second it brings discipline - and therefore enhances the faithful representation of information - in the income statement. This is because the matching approach does not provide any reliable anchor to decide the period to which a transaction relates. For these reasons EFRAG believes that the asset and liability approach leads to more robust and consistent financial reporting.
- 60 However, the IASB should consider situations where Standards would not result in useful matching of expenses with related income. In those cases, the IASB should carefully assess whether the information provided would be relevant.
- 61 In relation to the removal of the term 'ordinary activity', EFRAG notes that the term has been used in IFRS 15 *Revenue from Contracts with Customers* to define the transactions within the scope of IFRS 15. IFRS 15 deals with contracts with customers and defines a customer as a party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration.
- 62 EFRAG notes that some respondents to the Exposure Draft resulting in IFRS 15, asked the IASB to clarify the meaning of ordinary activities. However, the IASB decided not to provide additional requirements, because the notion of ordinary activities was derived from the definition of revenue in the Conceptual Framework. In order to provide clarity on what is considered 'ordinary' and within the scope of IFRS 15, EFRAG thinks that the removal of the term from the Conceptual Framework should lead the IASB to consider explaining the term better on a standards level.
- 63 EFRAG disagrees with the proposal that the Conceptual Framework should state that if one party has a liability, another party or parties has an asset. EFRAG has considered an example where an entity (Entity A) has announced, initiated and is

committed to a restructuring (for example, because it could not continue as a going concern without it). Entity A knows that as part of the restructuring, it will have expenses to some kind of legal advisors, but it has not yet decided what advisors to use.

- 64 In this case EFRAG believes that Entity A should recognise a liability for the costs related to the restructuring. EFRAG thinks, however, that the requirement that another party should have an asset could result in no liability being recognised for the legal costs.
- 65 EFRAG acknowledges that one interpretation of the requirement could be that all legal advisors in the world would jointly control the economic resource that is caused by the fact that Entity A will have expenses to legal advisors. All the legal advisors in the world would then be the party that has an asset. In that case, there would not be a problem with recognising a liability for the restructuring.
- 66 However, other arguments could be made against such an interpretation. For example, with an unidentifiable sub-group rather than 'society at large':
- (a) The definition of an asset states that an asset is something controlled by an entity, all the legal advisors in the world is not 'an entity' – and hence they cannot have an asset.
  - (b) All the legal advisors in the world is not a defined group and accordingly cannot be considered as a 'party'.
- 67 EFRAG is therefore uncertain about what interpretation the IASB would make when setting Standards in the future.
- 68 EFRAG could also be concerned about implications of considering that an asset, for example, is shared by all legal advisors in the world. Would any legal advisor have a share of this asset, and accordingly another type of asset? If this is the case, would the result be that entities would have to consider possible future contracts as assets? EFRAG would not support such a development.
- 69 The Basis for Conclusions accompanying the ED (paragraph BC4.78) states that the IASB thinks that making the general point that if one party has a liability another party has an asset would help people to apply the definitions. EFRAG, on the other hand, is concerned that it could result in unintended consequences, and accordingly disagrees with including such a statement in the Conceptual Framework.
- 70 EFRAG agrees with the ED that in principle a physical object consists of different rights and that these different rights can be regarded as separate assets. EFRAG also agrees with the ED that in many cases, the set of rights arising from legal ownership of a physical object should be accounted for as a single item. As further explained in relation to the proposed guidance on the unit of account, EFRAG is, however, concerned that the guidance on the unit of account is not sufficiently clear that such an outcome would result.
- 71 The ED does not deal with the inconsistencies in current Standards on the distinction between equity and liabilities. EFRAG agrees with the IASB that it may be useful to deal with this issue in a project running in parallel with the broader Conceptual Framework revision. EFRAG, however, notes that it is important to solve the inconsistencies and to amend the Conceptual Framework to reflect the outcome of the separate project on this issue.



## Present obligation

### Question 4 – Present obligation

Do you agree with the proposed description of a present obligation and the proposed guidance to support that description? Why or why not?

## EFRAG's response

**EFRAG generally agrees with how the ED describes a 'present obligation' and a constructive obligation. However, EFRAG is concerned that the guidance is not sufficiently clear.**

- 72 EFRAG agrees with the ED that obligations need not be legally enforceable, but also arise when the entity has no practical ability to avoid transferring an economic resource.
- 73 EFRAG also agrees with paragraph 4.31 of the ED that an entity has a present obligation to transfer an economic resource if:
- (a) The entity has no practical ability to avoid the transfer; and
  - (b) The obligation has arisen from past events; in other words, the entity has received the economic benefits, or conducted the activities, that establish the extent of its obligation.
- 74 Although EFRAG welcomes guidance on when a past event has arisen, it considers that the wording of the guidance needs to be amended, as it does not appear sufficiently clear. For example, a levy a utility will have to pay on 1 April 2x12 can be based on various parameters such as: the average number of customers over the past ten years; change in revenue from 2x10 to 2x11; the estimated increase in customers over the following ten years; and the average asset balance of the past five years. It is not apparent from the ED what factors the utility should consider in determining when to start recognising a liability, which could be from the start date of the calculation of the average number of customers (i.e. from 2x02).
- 75 EFRAG will provide its final comments on the guidance on when an obligation is present separately when it has considered the responses received on the questionnaire mentioned above in paragraph 57.

## Other guidance on the elements

### Question 5 – Other guidance on the elements

Do you have any comments on the proposed guidance?

Do you believe that additional guidance is needed? If so, please specify what that guidance should include.

## EFRAG's response

**EFRAG is uncertain about the outcome of the guidance proposed on executory contracts. EFRAG does not think the discussion on the unit of account provides sufficient guidance for the IASB and EFRAG thinks that the unit of account for measurement decisions and recognition decisions should generally be the same.**

*Executory contracts*

- 76 Under current practice, executory contracts are normally not recognised when the rights and obligations have equal value, or the rights have a value greater than that of the obligations. EFRAG considers this approach provides useful information. EFRAG is uncertain whether this would be the outcome of the guidance proposed in the ED.
- 77 The guidance included in the ED states that an executory contract is either an asset or a liability. Whether the asset or the liability is included in the financial statements depends on both:
- (a) The recognition criteria; and
  - (b) The measurement basis adopted for the contract.
- 78 EFRAG is unsure about what the outcome of the recognition criteria would be for executory contracts. From paragraph BC4.92 of the Basis for Conclusions, it seems as if measurement at cost at both initial recognition and subsequently is the way to avoid executory contracts being recognised. EFRAG, however, considers that selecting a measurement basis for the purpose of avoiding recognition is a way to escape from a problem. It is not a solution to the problem.
- 79 EFRAG does not support different measurement bases for executory contracts at initial recognition and subsequently. Different measurement bases may be appropriate when the contract ceases to be executory and the underlying assets and liabilities are recognised separately. However, in EFRAG's view, confusion will arise from using different measurement bases during the executory phase. If the IASB retains this possibility in the final Conceptual Framework, it would also need to establish whether the different bases are applied to the contract as a whole or the assets and liabilities incorporated in the contract.

*The unit of account*

- 80 EFRAG agrees with the ED that the unit of account is the group of rights, the group of obligations or the group of rights and obligations, to which recognition and measurement requirements are applied. EFRAG therefore finds it inconsistent that the ED also states that a unit of account is selected for an asset or a liability after considering how recognition and measurement will apply, not only to that asset or liability, but also to the related income and expenses. EFRAG considers that the unit of account should be established in conjunction with developing recognition and measurement guidance for that unit of account.
- 81 In the view of EFRAG, the Conceptual Framework should specify that the unit of account when considering recognition should be the same as when considering measurement. This does not mean that EFRAG considers that the unit of account for measurement should always be the same as for recognition. However, if the IASB when setting Standards were to depart from this principle, the basis for conclusions accompanying the Standard has to explain why different units of accounts were chosen.
- 82 In order to examine whether the guidance on unit of account proposed in the ED is likely to be useful for standard-setting, EFRAG has applied the proposed guidance to selected items. EFRAG has then assessed whether the guidance is helpful when deciding on the unit of account. The tentative results of EFRAG's initial assessment are published in Appendix 2 to this comment letter. They indicate that the guidance included in the ED does not seem to provide clear directions on how to determine the unit of account.

CHAPTER 5 RECOGNITION AND DERECOGNITION

**Recognition**

**Question 6 – Recognition criteria**

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?

**EFRAG's response**

**EFRAG broadly agrees with the guidance on recognition. However, in some areas EFRAG is concerned that the guidance proposed is insufficient to ensure consistent standard-setting in the future.**

- 83 EFRAG broadly agrees with the guidance on recognition. However, it considers that the guidance could be improved in some areas.
- 84 EFRAG considers that it should appear clearer that the alternative to recognition is disclosure rather than completely omitting assets and liabilities from the financial statements.
- 85 As noted in relation to Question 1, EFRAG thinks that measurement uncertainty relates to whether information is faithfully represented rather than whether it is relevant. It seems from the ED, that recognising assets and liabilities would be relevant unless:
- (a) It is unclear whether the asset or liability exists (existence uncertainty) or is separable from goodwill;
  - (b) There is a low probability of an inflow or outflow of economic benefits; or
  - (c) The level of measurement uncertainty is so high that the resulting information has little relevance and no other relevant measure is available or can be obtained.
- 86 The ED does, however, not provide any substantive guidance on when recognising an asset where there is existence uncertainty or a low probability of an inflow or an outflow would not result in relevant information. EFRAG considers that it is difficult to assess the impact of the guidance if it were to be used for standard-setting. EFRAG accordingly believes that future IASB members may place emphasis on different parts of the guidance. Accordingly, consistency in future standard-setting may be impaired.
- 87 Although EFRAG considers that the Conceptual Framework should include more substantive guidance on how uncertainty affects recognition, it would not necessarily have to include this guidance in the chapter on recognition. Uncertainty is dealt with in several parts of the ED, and it might be clearer if the issue is addressed in a single place.
- 88 EFRAG does not support the inclusion of a probability recognition threshold in the revised Conceptual Framework. However, EFRAG considers that the Conceptual Framework could usefully acknowledge that such a threshold would be useful in particular Standards.
- 89 EFRAG is supportive of stating in the Conceptual Framework that, if recognising all changes in assets and liabilities is not possible, it may be necessary not to recognise any changes, even if they provide relevant information about the individual asset or liability affected. This would avoid an accounting mismatch, rather than requiring further remeasurements to ameliorate the accounting mismatch. However, EFRAG considers that it would be helpful if the Conceptual Framework would provide guidance on when different assets and liabilities should be considered together. In

this regard, EFRAG thinks that the entity's business model would have a role to play.

- 90 EFRAG notes that the guidance on recognition explicitly mentions that items should only be recognised if the information results in benefits exceeding the cost of providing that information (paragraph 5.9(c) of the ED). As the cost constraint is a general constraint, EFRAG does not consider it beneficial to mention it explicitly in relation to recognition. This could give the impression that the constraint does not apply unless specifically mentioned.

## **Derecognition**

### **Question 7 – Derecognition**

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?

## **EFRAG's response**

### **EFRAG agrees with the guidance on derecognition.**

- 91 EFRAG agrees with the ED that the aim of derecognition is both to depict faithfully an entity's financial position resulting from a transaction or event and income or expenses resulting from that transaction or event.
- 92 As the ED acknowledges, it may sometimes be difficult to achieve this aim and lists alternative ways to achieve the aims. Although the ED does not provide any directions on when a different alternative should be considered, EFRAG considers that the guidance is sufficient for the Conceptual Framework.

CHAPTER 6 MEASUREMENT

**Measurement bases**

**Question 8 – Measurement bases**

Has the IASB:

- (a) correctly identified the measurement bases that should be described in the Conceptual Framework? If not, which measurement bases would you include and why?
- (b) properly described the information provided by each of the measurement bases, and their advantages and disadvantages? If not, how would you describe the information provided by each measurement basis, and its advantages and disadvantages?

**EFRAG's response**

**EFRAG broadly agrees with the categorisation proposed in the ED. EFRAG also broadly agrees with the ED's description of the information provided by each of the measurement bases. EFRAG welcomes the descriptions as their inclusion would improve the Conceptual Framework. However, the ED does not consider the possible use of market-consistent measurement bases other than fair value. Such measurement bases could be useful in circumstances where an entry market, and not an exit market, is relevant or when own credit risk changes are deemed irrelevant.**

- 93 EFRAG welcomes the proposal in the ED to include a description in the Conceptual Framework of the information provided by each measurement basis. The guidance on measurement in the current Conceptual Framework is clearly insufficient.

*Identification of measurement bases*

- 94 The Discussion Paper *A Review of the Conceptual Framework for Financial Reporting* grouped measurements into three categories:
- (a) Cost-based measurements;
  - (b) Current market prices including fair value; and
  - (c) Other cash-flow-based measurements.
- 95 EFRAG considered that cash-flow-based measurements could be used to estimate a current value or cost. EFRAG accordingly thought that it was unclear which measurement attribute cash-flow-based measurements were aiming to achieve.
- 96 EFRAG therefore agrees with the ED that cash-flow-based measurement techniques are normally used to implement a historical cost, a current value measurement basis or a partly updated measurement basis (a customised measurement basis). EFRAG accordingly agrees that cash-flow-based measurement techniques should not be considered as a separate measurement category.
- 97 EFRAG also agrees that, in principle, it makes sense to categorise measurement bases as either historical cost or current value. EFRAG acknowledges that the IASB may choose to customise measurement bases by updating only some of the factors that could be updated when measuring at fair value or value in use and fulfilment value. EFRAG agrees with the ED, that when this is done, the IASB should explain the reasons for the customisation in the Basis for Conclusions accompanying the Standard. In addition, EFRAG considers that the IASB would need to determine whether the customised measurement basis should be considered as representing historical cost or current value in order to 'fit' with the categorisation suggested.

- 98 Sometimes it may be difficult to categorise a customised measurement basis as either 'historical cost' or 'current value', for example, when a measurement basis is partly updated as a result of applying hedge accounting. EFRAG could accordingly see the benefits of creating a third category of measurement bases for these partly updated measurements. A benefit of introducing a third category for partly updated measurements would be that the Conceptual Framework in that case would have to provide guidance on how to decide what part of a measurement basis should be updated, and when<sup>2</sup>.
- 99 EFRAG also notes that after introducing the category of historical cost in paragraph 6.6 of the ED, its application is further (and differently) explained in paragraphs 6.7 and 6.9 of the ED to each of non-financial and financial assets and liabilities. Some elements of those applications involve what might be regarded as derived from current measures (such as updated cash flows). In addition, currency translation is not discussed at all and again presently both historical and current exchange rates are used for items which traditionally are regarded as at 'historical cost'. EFRAG therefore believes it would be better if the conceptual basis for these various components was explicitly discussed and justified rather than being assumed as incorporated into the overall broad category of 'historical cost'.
- 100 EFRAG disagrees with the statement included in the ED that initially cost and fair value of a financial asset are the same if transaction costs are excluded from cost. EFRAG notes that that an entity, for various reasons, may want to sell or acquire an asset at a price that is different from fair value. Further, as noted below, fair value may be market-specific and the cost of an asset may not represent the fair value of that asset in the market in which it will be deployed. EFRAG also notes that cost and fair value may not be the same in non-exchange transactions, such as donations of goods.

*Description of the information provided by each of the measurement bases*

- 101 EFRAG broadly agrees with the description in the ED (paragraphs 6.4 – 6.47) of the information provided by each of the measurement bases: historical cost; fair value; value in use and fulfilment value. EFRAG, however, notes that 'current value' in the ED is only represented by exit-market-based measurements: fair value; value in use and fulfilment value. EFRAG thinks that the ED should also have described current input-market measures.
- 102 The Basis for Conclusions (paragraph BC6.18) notes that the IASB thinks that there is often little difference between entry and exit values in the same market, except for transaction costs.
- 103 While EFRAG perhaps could agree that there is often little difference between entry and exit values in the same market, EFRAG thinks that it is important to consider that the same market may not always be relevant from the perspective of an entity. A retailer will frequently buy its products in a wholesale market with professional participants and sell the products in a retail market on an 'item by item' basis with final consumers. If there were identical prices in these two markets, the retailer would not make any profit.
- 104 For a particular asset, it could be argued that the most useful measurement would be one that reflects how much an entity should pay to acquire the asset at the balance sheet date as it was when it was originally acquired. This could provide information about the costs of replacing the asset. Although such a measure should

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<sup>2</sup> Such an approach has been suggested by the Accounting Standards Board of Japan and described in the paper *Identification, Description and Classification of Measurement Bases* presented at the March 2015 meeting of the Accounting Standards Advisory Forum (ASAF).

be categorised as a current value, it does not seem possible to categorise it as either fair value or value in use according to the ED.

- 105 The ED describes fair value as the price that would be received to sell an asset in an orderly transaction between market participants at the measurement date. The fair value would in the case of a retailer depend on whether the retailer would sell the asset in the market it was bought or in the market where it is going to be sold. The selling price in the market in which it is sold would not reflect the price the entity would pay to acquire the asset. However, paragraph 6.26 of the ED states that fair value does not include transaction costs. The current value for the particular asset mentioned above would include transaction costs. In addition, if the entity has further developed the asset, the selling price of the asset would not reflect the current price of the asset in its original condition. Accordingly, even if the fair value in the input market (and not the exit market) was considered, 'fair value' could not capture the most useful measurement in the particular example. In addition, the ED describes that fair value reflects estimates of future cash flows (paragraph 6.23(a)) and has predictive value, because it reflects expectations about the amount, timing and uncertainty of the cash flows. The fair value (the selling price) of the particular asset in the input market would in the case of the retailer not be an estimate of future cash flows of the retailer, as the retailer would not sell the asset in the input market.
- 106 EFRAG would thus consider that the Conceptual Framework should include market-consistent measurement bases for the cases where an entry market would be relevant. Currently, the only market-consistent measurement basis that is described is fair value, which is based on an exit market.
- 107 EFRAG notes that current cost is very briefly presented in paragraph 6.18 under 'historical cost'. In EFRAG's view, 'current cost' does not meet the description of 'historical cost'.
- 108 In addition to providing guidance on the use of entry-market based measurements, EFRAG thinks that the Conceptual Framework should provide guidance on when own credit risk changes are relevant. This issue seems to be the subject of some debate.

### **Selection of a measurement basis**

#### **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?

**EFRAG's response**

**In EFRAG's view the Conceptual Framework should include guidance on:**

- (a) How to select measurement bases that are useful for reporting both the financial position and the performance of the entity;**
- (b) When to select between market-consistent and entity-specific measurement bases; and**
- (c) When customisation of measurement bases could be useful.**

**In the view of EFRAG, the mere mention in the ED of factors to be taken into account when selecting a measurement basis without much other sense of direction is insufficient. However, the IASB could usefully build on the description of different measurement bases to determine the necessary guidance, distinguishing clearly between what is useful to the statement of financial position on the one hand and to the statement(s) of financial performance on the other.**

109 The ED seems to state that the factors to consider when determining a measurement basis are the qualitative characteristics of useful financial information. To the extent that EFRAG agrees with the qualitative characteristics of useful financial information (see paragraphs 2 – 45 above), EFRAG does not disagree with such a statement. On the other hand, EFRAG does not think that such a statement is sufficient to ensure discipline and consistency in future standard-setting.

110 EFRAG acknowledges that the ED does more than just stating that the qualitative characteristics of useful financial information should be considered when determining a measurement basis. The ED includes a discussion of factors that can affect the various qualitative characteristics. However, the ED is deficient in the following ways:

- (a) The ED does not describe how different measurement bases are linked with the factors to be considered when deciding on a measurement basis.
- (b) The ED states that when selecting a measurement basis, it is important to consider what information that measurement basis will provide in both the statement of financial position and the statement(s) of financial performance. EFRAG agrees with this, but it notes that the ED does not further describe what information meets the qualitative characteristics from the perspectives of the statement of financial position and the statement(s) financial performance. In the view of EFRAG, the discussion in the ED seems to be focused on how to meet the qualitative characteristics for the statement of financial position, as the references in the ED are to assets and liabilities rather than to income and expenses. EFRAG disagrees with this primary focus. EFRAG further notes that:
  - (i) The ED proposes that circumstances in which different measurement bases for the measurement in the financial position and in the statement(s) of financial performance would be rare (paragraph 6.75); and
  - (ii) The Basis for Conclusions notes that the statement of profit or loss should be as inclusive as possible (paragraph BC7.42).

When the statement of profit or loss should be as inclusive as possible, assets and liabilities cannot be measured at a current value without including the changes in the current value in profit or loss. Statement (ii) thus reinforces what is said in (i) that different measurement bases for the measurement in the financial position and in the statement(s) of financial performance would be rare. Given the lack of sufficient guidance on what performance is and/or



what profit or loss represents, EFRAG considers such a statement to be premature.

EFRAG could envisage that there could be situations where the most useful information about an entity's financial position would be provided by measuring assets and liabilities at a current value in the statement of financial position, but where the presentation of the performance of the entity would be most useful if changes in the current value were reflected in OCI.

- (c) The factors the ED considers may point in different directions. The ED states that the relative importance of each of the factors will depend upon facts and circumstances. However, the ED does not provide any guidance on what circumstances would mean that one factor is more important than another factor – for example, when an entity-specific or a market-based measurement would be more useful or when the focus should be on how an asset or a liability contributes to future cash flows or the characteristics of the asset or the liability. There is also no guidance on how to customise measurement bases. It follows that the discussion in the ED does not seem to guide the selection of a measurement basis other than in specific situations.
- (d) EFRAG disagrees with the guidance on internally constructed assets. EFRAG disagrees with the statement in paragraph 6.73 of the ED that the information provided could be useful for assessing the cost-effectiveness of the construction, as EFRAG does not believe it is relevant to suggest that an entity earns money from 'transacting' with itself. In addition, EFRAG agrees that for unique or custom-made assets it could be difficult to find a fair value, the risk of income recognised not being faithfully represented would therefore exist in such circumstances.

111 EFRAG assesses that the issues mentioned above in (a) – (c) could be dealt with by:

- (a) Distinguishing between the statement of financial position and the statement of profit or loss;
- (b) Incorporating some of the guidance included in the description of measurement bases into the guidance on factors to consider when selecting a measurement basis; and
- (c) Including some directions in the guidance, as is done for specific cases in paragraphs 6.64 - 6.71 of the ED.

### Multiple measurement bases

#### **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?

#### **EFRAG's response**

**EFRAG considers it premature to consider the use of different measurement bases as an exception.**

112 EFRAG agrees that in some cases the relevance of the information provided in the statement of financial position and the statement of profit or loss is enhanced by using different measurement bases for the statement of financial position and the statement of profit or loss. That is, EFRAG considers that there may be cases where it would be useful to analyse income and expenses arising from a chosen measurement basis into their component parts in profit or loss and OCI. EFRAG

also agrees with paragraph 6.76 of the ED that the cases where it would enhance relevance would depend on the business model of the entity. However, EFRAG considers that the statements in the ED should be supplemented by guidance on when it would be relevant to separate income and expenses between profit or loss and OCI. EFRAG thinks this would depend on the objective of the statement of profit or loss. As explained above, EFRAG does not think this objective has been sufficiently developed in the ED. Until this has been done, EFRAG thinks it is premature to state that the use of different measurement bases in the statement of profit or loss and the statement of financial position should be an exception.

- 113 EFRAG further observes that the choice of measurement bases is not only relevant from the perspective of the statement of financial position and the statement of profit or loss. It could also be relevant in some circumstances to provide information using a second measurement basis in the notes to the financial statements.

CHAPTER 7 PRESENTATION AND DISCLOSURE

**Scope of financial statements**

**Question 11 – Objective and scope of financial statements and communication**

Do you have any comments on the discussion of the objective and scope of financial statements, and on the use of presentation and disclosure as communication tools?

**EFRAG's response**

**EFRAG agrees with the proposals included in the ED on the objective and scope of financial statements and communication, which are consistent with its past proposals on the 'Disclosure Framework'. However, the IASB should consider how to distinguish between presentation and disclosure.**

- 114 EFRAG agrees with the proposals included in the ED on the scope of financial statements.
- 115 It was suggested in the DP that the term 'presentation' attracts different meanings. It was also suggested in the DP that the term meant the disclosure of financial information on the face of an entity's primary financial statements.
- 116 EFRAG notes, that contrary to the DP, the ED does not try to define primary financial statements. It is therefore unclear what the difference is between presentation and disclosure.
- 117 EFRAG is aware that the IASB has not defined financial performance. Accordingly, EFRAG does not know what the IASB has in mind when using the term. EFRAG, however, understands that many users of financial statements also consider the statement of cash flows to provide useful information about an entity's performance. It is therefore unclear why the statement of cash flows is not considered in the description of financial performance.
- 118 EFRAG agrees with the ED that it may be necessary to include information about transactions or events that have occurred after the end of a reporting period in the financial statements in order to meet the objective of financial statements. EFRAG thinks it would be useful for the Conceptual Framework to provide further guidance on when it would be useful to include such information. This guidance could include when events and transactions occurring after the end of a reporting period should affect the information reported for that period (i.e. adjusting and non-adjusting events).
- 119 Finally, EFRAG suggests the IASB to consider whether the description about the content and components of financial statements were better placed in Chapter 3 of the Conceptual Framework.

**Description of the statement of profit or loss**

**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.

**EFRAG's response**

**EFRAG supports the description of the statement of profit or loss proposed in the ED. It however recommends that the IASB provide some basis to ensure that all constituents have a common understanding of the 'return on an entity's economic resources' that should be depicted.**

- 120 EFRAG agrees with the ED that the purpose of the statement of profit or loss is to:
- (a) Depict the return that an entity has made on its economic resources during the period; and
  - (b) Provide information that is helpful in assessing prospects for future cash flows and in assessing management's stewardship of the entity's resources.
- 121 EFRAG also agrees that income and expenses included in the statement of profit or loss are the primary source of information about an entity's performance for the period.
- 122 EFRAG, however, notes that people will likely have different interpretations of what 'return that an entity has made on its economic resources' would mean. Some may, for example, consider that it mean that profit can only be recognised after capital has been maintained. Others may consider that it refers to a return on investment measure.
- 123 EFRAG accordingly considers that it is necessary to provide further clarity on what is meant. EFRAG notes that profit or loss is very commonly relied on, and it is necessary to have robust guidance on which income and expenses are reported in profit or loss and which income and expenses are reported in OCI.
- 124 EFRAG believes that to meet the objective of general purpose financial reporting it is useful to consider how to measure assets and liabilities for the purpose of depicting an entity's performance and financial position in accordance with its business model. If it would be useful to measure assets and liabilities differently for the purpose of depicting profit or loss and financial position, the difference should be reported in OCI.

**Items in profit or loss**

**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?

**EFRAG's response**

**EFRAG disagrees with the IASB's proposal that profit or loss should be "as inclusive as possible". The proposal can be expected to gradually label 'profit or loss' what is labelled today 'comprehensive income', i.e. include (almost) all current value adjustments. As European stakeholders have been vocal in the past requesting that "profit or loss" be retained as a primary measure of performance, the IASB's proposals are likely not to meet their expectations.**

- 125 EFRAG notes that paragraph BC7.42 of the Basis for Conclusions states that excluding income and expenses from the statement of profit or loss without compelling reasons could undermine the usefulness of that statement. That is, the statement of profit or loss should be as inclusive as possible.

- 126 Based on paragraph BC7.42 of the ED, it seems as if the IASB may be proposing that changes in the current value of assets and liabilities should be reported in profit or loss. This would mean that profit or loss should include those items that are currently reported in OCI (including current value adjustments) unless there are compelling reasons for including them in OCI (or the measurement of the items are changed). EFRAG would disagree with this.
- 127 EFRAG considers that there could be situations where, for the purpose of the statement of financial position, it could be useful to measure certain assets or liabilities at a current value (e.g. fair value changes), but for the purpose of performance reporting, the changes in the fair value should be reported in OCI.
- 128 For example, it may be worthwhile to consider whether fair value changes for long-term investments (e.g. some investment properties) should be reflected in profit or loss (before the investment is sold) even when the most useful information for the statement of financial position will result from measuring the investment at fair value. If the fair value changes were to be recognised in OCI and the accumulated fair value changes are reported in profit or loss when the investment is sold, there would not be any amount related to the investment that would be 'stuck' in OCI.

## Recycling

### Question 14 – Recycling

Do you agree that the Conceptual Framework should include the rebuttable presumption described above? Why or why not?

If you disagree, what do you propose instead and why?

## EFRAG's response

**EFRAG believes that the principle (rather than a rebuttable presumption) should be set that no income and expense should be permanently excluded from the statement of profit or loss. As with other principles, the IASB could choose to depart from it when setting a specific Standard if the rationale for doing so is explained.**

- 129 EFRAG agrees with the ED the statement of profit or loss is the primary statement of an entity's performance. It is at the moment, however, not clear what "performance" is. EFRAG considers that the business model is one of the key factors to determine what performance is. In other words, it should be considered how profit or loss could reflect how an entity is generating profit and cash flows based on its business model(s).
- 130 It could be that the further deliberations on what performance is, would result in some changes in current value that are reflected in the statement of financial position not being reported in the statement of profit or loss. Instead, these changes would be reported in OCI. If this income and expense would subsequently be relevant to reporting performance, they should be recycled to profit or loss. That is, these income and expenses are included in profit or loss at a later date than the date the changes in the measurement of related assets and liabilities are reflected in the statement of financial position.
- 131 Based on how EFRAG considers profit or loss, items reported in OCI should in principle be recycled. EFRAG thus agrees with paragraph BC7.54 that
- [i]f the amounts included in the statement of profit or loss are the primary source of information about an entity's financial performance for the period, it follows that the

cumulative amounts included over time in that statement should also be as complete as possible. Hence, not income and expense should be excluded from the statement of profit or loss permanently, unless there is a compelling reason to do so.

- 132 EFRAG, however, thinks that the principle-based explanation provided in the Basis for Conclusions is much better than what could be considered to be a rules based rebuttable presumption in the ED. EFRAG therefore thinks that the explanation provided in the Basis for Conclusions should be included in the Conceptual Framework instead of the rebuttable presumption.

OTHER ISSUES

**Effects of the proposed changes to the Conceptual Framework**

**Question 15 - Effects of the proposed changes to the Conceptual Framework**

Do you agree with the analysis in paragraphs BCE.1–BCE.31 of the ED? Should the IASB consider any other effects of the proposals in the Exposure Draft?

**EFRAG's response**

**EFRAG agrees with the proposed status of the Conceptual Framework. As the Conceptual Framework does not provide clear directions for future standard-setting activity, the effect analysis is not very helpful.**

133 As EFRAG observes above, the guidance included in the ED is insufficient to provide clear directions for future standard-setting on important issues. EFRAG is, accordingly, not surprised to see that the only a few effects of the proposals have been identified.

**Business activities**

**Question 16 – Business activities**

Do you agree with the proposed approach to business activities? Why or why not?

**EFRAG's response**

**EFRAG welcomes the acknowledgement of the role the business model should play in measurement, in selecting different measurement bases for the statement of financial position and the statement of profit or loss, and in determining the unit of account. However, in EFRAG's view the proposed Conceptual Framework would limit the role of the business model in measurement without stating why and how it would be limited, and does not consider the role it could play in recognition. Furthermore EFRAG thinks that the term 'business model' that has been introduced with IFRS 9 could be retained and included in the Conceptual Framework and appropriately described for financial reporting purposes.**

134 EFRAG thinks that the term 'business model' that has been introduced with IFRS 9 *Financial Instruments* could be retained and described for financial reporting purposes. Paragraph BCIN.31 of the Basis for Conclusions notes that the term 'business activities' has been used in the ED as the term 'business model' is used with different meanings by various organisations. Instead of replacing the term, EFRAG thinks that the Conceptual Framework could describe the term the IASB introduced with IFRS 9 for financial reporting purposes.

135 In the Bulletin *The role of the business model in financial reporting*<sup>3</sup>, EFRAG presented the view that the business model should play a role in financial reporting. EFRAG was not convinced by the arguments of those who oppose that view, as EFRAG believes that financial statements that are consistent with other parts of corporate financial reporting are likely to support the most effective communication between management and investors and provide more useful information.

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<sup>3</sup> The Bulletin was prepared in cooperation with the French Autorité des Normes Comptables (ANC), the Accounting Standards Committee of Germany (ASCG), the Organismo Italiano di Contabilità (OIC) and the UK Financial Reporting Council (FRC).

- 136 EFRAG agrees that the business model should be one of the factors that should be considered when selecting a measurement basis, determining the unit of account, deciding what items should be reported in profit or loss and when making decisions on presentation and disclosure. EFRAG, however, believes that the Conceptual Framework should better reflect how the business model would play a role in relation to these topics. The ED does little more than stating that, when making decisions related to the topics mentioned, the business model should be considered.
- 137 In addition to playing a role in relation to measurement, the unit of account, the distinction between profit or loss and OCI, and presentation and disclosure, EFRAG thinks that the business model plays a role in relation to recognition. In current Standards some executory contracts are recognised while others are not. For example, a contract to buy or sell a non-financial item that can be settled net in cash should be recognised except if it is entered into and continues to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements. EFRAG therefore thinks that the business model should also be discussed in relation to relevance in the guidance for recognition to be included in the Conceptual Framework.

### Long-term investment

#### Question 17 – Long-term investment

Do you agree with the IASB's conclusions on long-term investment? Why or why not?

#### EFRAG's response

**As indicated in many of its responses above, EFRAG recommends that the *Conceptual Framework* include additional guidance on the unit of account, measurement and presentation. In the absence of such guidance at present, EFRAG considers that the *Conceptual Framework* does not provide sufficient guidance on how to reflect long-term investment business models.**

**Where financial statements genuinely provide information that is necessary to make decisions to buy, hold and sell and to assess the stewardship of management, EFRAG believes that it is not necessary to differentiate among investors on the basis of their investment horizon.**

- 138 In the view of EFRAG, the *Conceptual Framework* would contain sufficient guidance to define at standards level requirements taking into account the specificities of a long term investment business model, if the IASB developed more guidance as requested by EFRAG in the above answers.
- 139 As explained above, EFRAG considers that the Conceptual Framework should rely more on the business model when considering measurement and what changes in current value should be reported in OCI. For this purpose, it could be useful to group different business models into some general categories which might include a long-term investment category.
- 140 Whether the Conceptual Framework includes sufficient guidance to ensure that IFRS provide useful information to investors having a long-term objective is a different question. EFRAG believes that if financial statements provide useful information to make decisions to buy, hold and sell and to assess stewardship of management, all investors' needs are fulfilled, without the need to differentiate them by their horizon of investment.



**Additional issues**

- 141 EFRAG notes that the ED, for example, in paragraph 5.7 states that “the purpose of financial statements is not to show the value of the entity and, therefore, not all assets and liabilities are recognised”. EFRAG thinks that this could imply that if you would recognise all assets and liabilities you would show the value of an entity. EFRAG would disagree with this, and would therefore suggest the IASB word the sentence differently.

## Appendix 2

### Unit of Account

- 1 This Appendix on the unit of account has been prepared to support EFRAG's assessment of whether the guidance included in the Exposure Draft *Conceptual Framework for Financial Reporting* (the ED) is sufficient to provide directions for future Standards on what the unit of account should be.

#### Applying the IASB proposals to specific situations

##### *Situations analysed*

- 2 To examine whether the guidance provided in the ED provides sufficient directions for future standard-setting, EFRAG has considered the outcome of applying the proposal to some issues where the unit of account has raised concerns, and sometimes been heavily debated, in the past.
- 3 The issues have been grouped into the following categories:
  - (a) Situations where a bundle of rights and obligations has been acquired in one transaction but the rights and obligations would have to be accounted for as smaller groups of rights and obligations. An example is when an entity acquires an asset in one transaction (e.g. nuclear power plant or building), but for accounting purposes would have to unbundle this asset and account for rights and obligations related to each of the unbundled items separately. This situation will be illustrated by an **item of property, plant and equipment (PPE) held for use** (Case A).
  - (b) Situations where one unit of account is used for recognition, but the fact that the item is part of a portfolio is taken into account when measuring it (and when assessing whether any probability thresholds are met in relation to recognition). This situation will be illustrated by **warranties related to products sold** (Case B).
  - (c) Situations where one unit of account is used for recognition but a smaller unit of account is used for measurement. This situation will be illustrated by **investments in subsidiaries, associates and joint ventures** (Case C).
  - (d) Situations where rights and obligations are unbundled and bundled based on the activity they relate to. This situation will be illustrated by a **subsidiary of an investment entity** (Case D).
- 4 Paragraphs 4.57 – 4.63 of the ED includes guidance on the unit of account. When examining the outcome of the guidance only paragraphs 4.62 – 4.63 have been considered.
- 5 Paragraphs 4.57 – 4.60 note that:
  - (a) The unit of account is the group of rights, the group of obligations or the group of rights and obligations, to which recognition and measurement requirements are applied;
  - (b) A unit of account is selected after considering how recognition and measurement will apply to the asset or liability and the related income and expenses;
  - (c) One unit of account may be appropriate for recognition while another unit of account may be appropriate for measurement;
  - (d) Separable rights and obligations may be included in a single unit of account.
- 6 Paragraph 4.61 provides a list of possible units of account and paragraphs 4.62 – 4.63 set out the objective in selecting a unit of account and provide list of factors to

consider when determining the unit of account. More specifically, the factors that drive the identification of the unit of account are:

- (a) The information provided about the resulting asset, liability, income and expenses must be relevant;
- (b) The asset, liability, income and expenses recognised must faithfully represent the substance of the transaction from which they have arisen; and
- (c) The cost of providing the information for that unit of account must not exceed the benefits.

7 When examining the outcome of the guidance, EFRAG has only considered paragraphs 4.62 – 4.63 of the ED, which focus on the factors to consider when determining the unit of account.

#### *Summary of findings*

8 The situations analysed below indicate that the guidance included in the ED does not clearly point in a specific direction when considering significant unit of account issues in standard-setting.

9 Although the ED acknowledges that it may be appropriate in some cases to select one unit of account for recognition and one other for measurement, the guidance provided in the ED is similar for recognition and measurement. It is therefore unclear how the unit of account could be different for recognition and measurement.

10 The ED notes that the unit of account is the group of rights and/or obligations, to which recognition and measurement requirements are applied. Thus, before deciding on recognition and measurement requirements an entity needs to decide the unit of account to be used. However, according to the ED, when determining the unit of account, the measurement of assets and liabilities should be taken into consideration. The guidance could thus seem circular.

#### **Case A: An item of PPE held for use**

##### *The issue*

11 Different parts of an item of PPE may need to be replaced over time. The choice of the unit of account could influence how the replacement of parts should be accounted for and the length of the depreciation period(s) of the asset(s).

12 Currently IAS 16 *Property, Plant and Equipment* requires each part of an item of PPE with a cost that is significant in relation to the total cost of the item to be depreciated separately (paragraph 43 of IAS 16).

##### *Possible units of account*

13 When considering how to account for a piece of PPE (e.g. a nuclear power plant or a building) possible unit of accounts include, but are not limited to:

- (a) Each single right that could be identified (e.g. a right to use (a part of) a physical asset);
- (b) The combination of a set of rights over an equipment or a single part of the equipment (and treat them as a single unit of account) that:
  - (i) Could be purchased separately;
  - (ii) Was purchased separately by the entity;
  - (iii) Is capable of producing a usable output;
  - (iv) Is capable of producing an output the entity is selling; and
- (c) Group of single parts with similar useful lives and usage patterns.

Guidance in the ED when considering an item of PPE

- 14 The left column in the table below presents the guidance provided in the ED on how to determine the unit of account. The right column includes an assessment of what unit of account the guidance would result in for the accounting for a PPE, more specifically a nuclear power plant and building.
- 15 The text of the ED refers to 'a group of rights and obligations'. In the analysis below, it is assumed that the guidance also applies to 'a group of rights' only.

**Relevance**

Treating a group of rights and obligations as a single unit of account may provide relevant information to users if, for example, those rights and obligations:

- cannot (or are unlikely to) be the subject of separate transactions;

The rights related to a nuclear reactor constructed for a particular acquirer are usually not subject of separate transactions. Similarly, the different rights over a building are unlikely to be the subject of separate transactions. Therefore, it seems that **the unit of account would be each equipment that could be purchased separately such as a nuclear reactor or building (i.e. combining a set of rights into a single asset that can be subject of a separate transaction could provide relevant information).**

Perhaps, an exception could be said to occur when an asset is leased. In these cases the rights to use an asset for a given period may be transferred directly from a seller to the lessee, but other rights may simultaneously be transferred directly to the lessor. In this case, there is also the question of whether the unit of account of the obligation to pay rentals in a lease and unit of account of the right-of-use asset should be, to some extent, related as the rights and obligations arise in the same contract and do not normally exist independently of each other.

Another exception might be if a piece of PPE acquired could be divided into several physical parts. In the case of the building, it could, for example, be considered that all the rights related to the central heating and all the rights related to main building could be acquired separately. Thus, **the unit of account would be each single part of the equipment that could be purchased separately (i.e. the combination of rights over a single part of an asset that can be subject of a separate transaction).**

Finally, the rights over an elevator can be subject of a separate transaction if sold as

a spare part. In this case, **the unit of account would be each single part of the equipment that could be purchased separately (i.e. the combination of rights over a single part of an asset that can be subject of a separate transaction).**

- 
- cannot (or are unlikely to) expire in different patterns;

In many cases, the rights related to an acquired physical item of PPE would not expire at different points in time (an exception may be a lease agreement). For example, the right to use a building would usually expire at the same time as the right to sell the building.

This example would accordingly result in the **unit of account would be each equipment over which there is legal ownership (i.e. unit of account being the combination of rights and/or obligations embodied in the physical asset).**

However, the depreciation pattern of the different rights related to a physical asset such as a building may differ (e.g. roof and central heating). The example would, accordingly, suggest that the **unit of account should be the physical parts of the physical assets expire in similar patterns (i.e. the unit of account is the group of single parts with similar useful lives and usage patterns).**

- 
- are used together in the context of the business activities conducted by the entity to produce cash flows and are measured by reference to the estimates of their interdependent future cash flows;

In many cases, the different rights over an item of PPE that is capable of producing an output that the entity is selling are used together in the business activities conducted by the entity to produce cash flows.

Whether this group of rights will be measured together (e.g. entire nuclear power plant or a building) depends on the unit of account chosen in Standards.

Currently, the requirements in IAS 36 *Impairment of Assets* may result in the rights related to an entire nuclear power plant or building being measured by reference to the estimate of the interdependent future cash flows.

Depending on measurement requirements, the **unit of account could therefore be each equipment or single part that is capable of producing an output the entity is selling (i.e. the combination of rights over a nuclear power plant or a building).**

- 
- have similar economic characteristics and risks. Rights and obligations with

The rights related to a physical piece of PPE may often have similar economic

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different characteristics and risks are likely to have different implications for the prospects for future net cash inflows to an entity and so may need to be separated.

characteristics and risks. This may apply to the rights related to a nuclear power plant or a building.

### Faithful representation

To achieve a faithful representation it may be necessary to:

- treat the rights or obligations arising from different sources as a single unit of account or
- to separate the rights or obligations arising from a single source.

Moreover, to provide a faithful representation of unrelated rights and obligations, it may be necessary to recognise and measure them separately.

Generally, accounting for a group of rights over an item of PPE as a single unit of account would result in a faithful representation. That is, an entity would group the different rights arising from a single source (e.g. contract) and treat them as a single unit of account.

However, the examples do not seem to provide indicators of when it may be necessary to separate or group the rights or obligations arising from a single source.

### The cost constraint

Costs of providing the information for that unit of account must not exceed the benefits. In general, the costs associated with recognising and measuring assets, liabilities, income and expenses increase as the size of the unit of account decreases.

Generally, the cost constraint would push towards considering the highest group level of rights – or big groups of physical objects as the unit of account. It would, however, not necessarily prohibit that physical objects that expires in similar patterns could be considered the unit of account (**i.e. group of single parts with similar useful lives and usage patterns**).

### Transfer part of an asset

If an entity transfers part of an asset or part of a liability, the unit of account may change at that time so that the transferred component and the retained component become separate units of account.

It can happen that part of a physical object is replaced.

When this happens, if the unit of account is the combination of a set of rights over an asset (e.g. a car) the replacement parts (e.g. tyres) may become a separate unit of account and the retained component becomes a separate unit of account.

- 16 Based on the assessment above, it appears as if each single right that could be identified in relation to a physical item of PPE would not be identified as the unit of account under the proposed guidance.
- 17 The list of factors included in the ED seems to indicate that a possible unit of account could be the following, as described in paragraph 13 above:
- (a) the combination of a set of rights over an equipment or a single part of the equipment that:
    - (i) is capable of being subject to a separate transaction (see paragraph 19 (a) below);
    - (ii) was purchased separately by the entity (see paragraph 19 (a) below);
    - (iii) is capable of producing an output the entity is selling (a cash generating unit in accordance with IAS 36) (see paragraph 19 (b) below); or

- (b) A subgroup of rights over an item of PPE embodied in a physical part of a piece of PPE, that is parts with similar useful lives and usage patterns.
- 18 However, if the unit of account is the combination of all rights over an asset (e.g. a car), then over time as parts of the asset are replaced (e.g. tyres), the replacing parts would be considered as separate units of account and the retained component becomes a separate unit of account.
- 19 In addition to indicating that the directions included in the ED would not point in only one direction, this example on PPE also showed that:
- (a) Whether rights and obligations are unlikely to be the subject of separate transactions depends on which type of transactions one has to consider. One could consider all types of transactions, where every screw could sold separately; or one could consider transactions with the similar purpose to that being considered (i.e. acquire a fully operative asset and not its individual components).
  - (b) How the unit of account would be determined would depend on how an asset or liability is measured. However, how an asset or liability is measured seem also to depend on the unit of account chosen for measurement.

### **Case B: Warranties for products sold**

#### *The issue*

- 20 An entity may sell some products and provide a related guarantee. Each time the entity sells a product it also incurs a liability related to the guarantee. It is unlikely that a particular guarantee will result in an outflow. However, it is also unlikely that none of the guarantees will result in an outflow. When measuring the liability (and when considering any recognition thresholds related to the probability of an outflow) it may therefore matter whether each guarantee is considered separately or it is taken into account that the entity has a portfolio of guarantees.
- 21 Currently, in accordance with IFRS 15 *Revenue from Contracts with Customers*, if a customer has the option to purchase a warranty separately, the warranty is a distinct service as the entity promises to provide the service to the customer in addition to the product. In those circumstances, an entity accounts for the promised warranty as a performance obligation (that is the warranty is measured based on the stand-alone selling price).
- 22 However, if a customer does not have the option to purchase a warranty separately and it only provides the customer with assurance that the related product will function as the parties intended because it complies with agreed-upon specifications, an entity shall account for the warranty in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. The amount should accordingly reflect the best estimate of the expenditure required to settle the present obligation at the end of the reporting period.

#### *Possible units of account*

- 23 When considering how to measure guarantee liabilities possible unit of accounts include, but are not limited to:
- (a) Each single obligation that could be identified; and
  - (b) Groups or subgroups of similar obligations.

#### *Guidance in the ED when considering warranties for products sold that are not considered separate performance obligations*

- 24 The left column in the table below presents the guidance provided in the ED on how to determine the unit of account. The right column includes an assessment of what unit of account the guidance would result in relation to the accounting for warranties for products sold.

- 25 The text of the ED refers to ‘a group of rights and obligations’. In the analysis below, it is assumed that the guidance also applies to ‘a group of obligations’ only.

### Relevance

Treating a group of rights and obligations as a single unit of account may provide relevant information to users if, for example, those rights and obligations:

- cannot (or are unlikely to) be the subject of a separate transaction;
- cannot (or are unlikely to) expire in different patterns;
- are used together in the context of the business activities conducted by the entity to produce cash flows and are measured by reference to the estimates of their interdependent future cash flows;
- have similar economic characteristics and risks. Rights and obligations with different characteristics and risks are likely to have different implications for the prospects for future net cash inflows to an entity and so may need to be separated.

Each warranty is likely to be the subject of a separate transaction. Each warranty is ‘sold’ when the entity sells a product and the entity is likely to settle its obligations with each individual customer.

This example would accordingly point in the direction that **each warranty should be considered separately for measurement and recognition (i.e. the unit of account is each single obligation that could be identified)**.

In this specific case, each obligation to repair a product so that it will function in accordance with the agreed-upon specifications may expire at different points in time (i.e. the entity may have to settle each obligation at various points in time). This example would accordingly result in **each warranty being different considered as a single unit of account for measurement and recognition (i.e. the unit of account is each single obligation that could be identified)**.

This example does not seem to provide directions for what the unit of account for warranties should be.

Warranties related to the same product would have similar economic characteristics and risks. Warranties related to very different types of products could have very different risks.

This example would thus result in **warranties being grouped according to economic characteristics and risks and these groups are considered the unit of account for measurement and recognition (i.e. the unit of account is a group or a subgroup of similar obligations)**.

### Faithful representation

To achieve a faithful representation it may be necessary to:

It is assessed that it would not result in a faithful representation to measure warranty



- treat the rights or obligations arising from different sources as a single unit of account or
- to separate the rights or obligations arising from a single source.

Moreover, to provide a faithful representation of unrelated rights and obligations, it may be necessary to recognise and measure them separately.

liabilities at zero (not recognising the liability) if it is unlikely that a particular guarantee will result in an outflow but, at the same time, it is unlikely that none of the guarantees will result in an outflow.

On the one hand, it could be argued that it would result in a faithful representation to recognise and measure each warranty individually as long as each warranty (if there are many of them) are measured at an expected value **(thus, the unit of account is each single obligation that could be identified)**.

On the other hand it could be argued that if the choice of measurement basis should depend on how many warranties an entity has, recognition and measurement would de facto be carried out on a portfolio level. **(i.e. the unit of account is a group or a subgroup of similar obligations).**

#### The cost constraint

Costs of providing the information for that unit of account must not exceed the benefits. In general, the costs associated with recognising and measuring assets, liabilities, income and expenses increase as the size of the unit of account decreases.

Generally, the cost constraint would push towards considering the highest group level of obligations as the unit of account. It would, however, not necessarily prohibit that each warranty could be considered the unit of account.

#### Transfer part of an asset

If an entity transfers part of an asset or part of a liability, the unit of account may change at that time so that the transferred component and the retained component become separate units of account.

For the particular examination, this guidance is assessed not to be relevant.

- 26 Based on the assessment above, it appears as if the ED could both indicate that a possible unit of account could be (a) or (b) in paragraph 23 above.
- 27 In addition to indicating that the directions included in the ED would not point in only one direction, the example on warranties also showed that:
- (a) Although the ED mentions that it in some cases may be appropriate to select one unit of account for recognition and a different unit of account for measurement, the ED includes no further guidance on this.
  - (b) When the selection of a measurement basis has to be based on the number of similar items to be measured, it is not clear what the unit of account is. On the one hand, it could be argued that each single item is the unit of account measured at, for example, expected value. On the other hand, it could be argued that the group of similar items is the unit of account measured at, for example, the most likely amount.

### Case C: Investments in subsidiaries, associates and joint ventures

#### The issue

- 28 An entity may acquire a considerable number of equity instruments in another entity. In these cases, the price of the total number of equity instruments may be higher than the fair value of a single equity instrument in the other entity as the entity would

have to pay some type of a control premium. For measurement and recognition, the issue could be whether the unit of account is each equity instrument the entity has purchased or the group of equity instruments the entity has purchased. This could affect whether a control premium would have to be recognised as an expense immediately.

- 29 Currently, IAS 28 *Investments in Associates and Joint Ventures* (as amended in 2011) prescribes the accounting for investments in associates and joint ventures. IAS 27 *Separate Financial Statements* also prescribes the accounting for investments in subsidiaries, jointly ventures and associates, but taking into account the perspective of the users of separate financial statements (the focus is upon the performance of the assets as investments). Although both IAS 27 and IAS 28 relate the accounting to an “investment”, neither IAS 27 nor IAS 28 make a reference to the unit of account. When measuring investments at fair value, IFRS 13 states that a control premium when measuring the fair value of a controlling interest is not permitted in a fair value measurement. On the other hand IFRS 3 *Business Combinations* requires the control premium to be taken into account when determining the fair value of a non-controlling interest in an acquiree.

*Possible units of account*

- 30 When considering how to account for an interest in an subsidiary (in separate financial statements), joint venture and associate (in separate and consolidated financial statements) possible units of account include:
- (a) Combination of rights over all the individual financial instruments that are included within the investments (i.e. there is only one investment and account for the investment as a single unit of account);
  - (b) A subgroup of rights over the individual financial instruments that are included within the investment (i.e. different portions of an investment);
  - (c) Each individual financial instrument that are included within the investment (i.e. combination of rights over a single financial instrument); or
  - (d) Each right included in each individual financial instrument.

*Guidance in the ED on the unit of account for investments*

- 31 The left column in the table below presents the guidance provided in the ED on how to determine the unit of account. The right column includes an assessment of what unit of account the guidance would result in relation to the accounting for a listed subsidiary that is being measured at fair value in separate financial statements.
- 32 The text of the ED refers to ‘a group of rights and obligations’. In the analysis below, it is assumed that the guidance also applies to ‘a group of rights’ only.

**Relevance**

Treating a group of rights and obligations as a single unit of account may provide relevant information to users if, for example, those rights and obligations:

- cannot (or are unlikely to) be the subject of a separate transaction;

The rights related to the individual financial instruments that make up the investment in a subsidiary can be subject of separate transactions (i.e. the parent may sell part of its investment in a subsidiary). In some cases, the different rights related to an equity instrument (e.g. right to receive dividend and right to vote at the general assembly) could also be the subject of a

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|--|---|
| <ul style="list-style-type: none"> <li>▪ cannot (or are unlikely to) expire in different patterns;</li> </ul>  | <p>separate transaction. The example would accordingly point in the direction that the <b>unit of account should be each individual financial instrument that could be identified or each right within such a financial instrument.</b></p> <p>The rights related to an interest in another entity do normally not expire in different patterns (but some could). <b>The example would accordingly point in the direction that the unit of account should be the entire investment.</b></p>   |
| <ul style="list-style-type: none"> <li>▪ are used together in the context of the business activities conducted by the entity to produce cash flows and are measured by reference to the estimates of their interdependent future cash flows;</li> </ul>  | <p>In most cases, the different rights over an investment in a subsidiary, that is capable of generating cash flows to the parent, are used together in the business activities conducted by the parent (e.g. decisions about dividends or other distributions). Therefore, this example would <b>point in the direction that all the individual financial instruments that are included within the investment should be considered as a single unit of account.</b></p>  |
| <ul style="list-style-type: none"> <li>▪ have similar economic characteristics and risks. Rights and obligations with different characteristics and risks are likely to have different implications for the prospects for future net cash inflows to an entity and so may need to be separated.</li> </ul> | <p>A parent may own different types of financial instruments in a subsidiary (e.g. ordinary shares, preference shares). There may be different economic characteristics and risks related to these. <b>Thus, the example would point in the directions that similar types of financial instruments in a subsidiary should be considered as a single unit of account (i.e. a subgroup of rights over the individual financial instruments that are included within the investment for which there are similar economic characteristics and risks).</b></p> |

### Faithful representation

To achieve a faithful representation it may be necessary to:

- treat the rights or obligations arising from different sources as a single unit of account or
- to separate the rights or obligations arising from a single source.

Moreover, to provide a faithful representation of unrelated rights and obligations, it may be necessary to recognise and measure them separately.

Current IFRS indicates that both considering the entire investment in another entity as the unit of account and considering each financial instrument as the unit of account would result in a faithful representation.

### The cost constraint

Costs of providing the information for that unit of account must not exceed the benefits. In general, the costs associated

Generally, the cost constraint would push towards considering the highest group level of rights. However, in this specific case, the

with recognising and measuring assets, liabilities, income and expenses increase as the size of the unit of account decreases.

mathematical product  $P \times Q$  (i.e. sum of the individual financial instruments) to measure the fair value of an investment in a subsidiary, quoted in an active market may be the simplest and less costly method to measure the investment. Considering each right related to a financial instrument will likely be the most costly, but the **guidance would not point in a specific direction on whether individual financial instruments or groups of financial instruments should be considered as the unit of account.**

#### Transfer part of an asset

If an entity transfers part of an asset or part of a liability, the unit of account may change at that time so that the transferred component and the retained component become separate units of account.

A parent may decide to sell part of its investment in a subsidiary. The guidance suggests that if the unit of account has been the group of financial instruments in the subsidiary, this would continue to be the case even if the investment should no longer be considered a subsidiary or an associate.

- 33 Based on the assessment above, it appears as if the ED could provide arguments in favour of all the possibilities listed above in paragraph 30.

#### Case D: A subsidiary meeting the definition of an investment entity and additionally providing investment-related services

##### *The issue*

- 34 A subsidiary can have different activities. How to account for a subsidiary may depend on its activities. The question is whether the subsidiary is the unit of account or different activities of the subsidiary can be considered the unit of account. The choice of the unit of account could impact whether, for example, part of a subsidiary could be measured at fair value while another part is consolidated.
- 35 Currently, the issue is relevant for investment entities. In December 2014 the IASB issued an amendment to IFRS 10, IFRS 12 and IAS 28: *Investment Entities: Applying the Consolidation Exception* where it clarified that an investment entity shall measure at fair value through profit or loss all its subsidiaries that are themselves investment entities and provide services that relate to the parent's investment activities.
- 36 If the subsidiary is not an investment entity, the investment entity parent assesses whether the main activities undertaken by the subsidiary support the core investment activities of the parent. If so, the subsidiary's activities are considered to be an extension of the parent's core investing activities and the subsidiary would be consolidated.

##### *Possible units of account*

- 37 When considering how an investment entity should account for subsidiaries that have investing activities and provide services that relate to the parent's investment entities, possible units of account include, but are not limited to:
- (a) A combination of all the rights and obligations related to the subsidiary; or
  - (b) A subgroup of rights and obligations that are related to a particular activity of a subsidiary.

Guidance in the ED on the unit of account for subsidiaries

- 38 The left column in the table below presents the guidance provided in the ED on how to determine the unit of account. The right column includes an assessment of whether the guidance would point towards (a) or (b) of paragraph 37. In the examination, the focus is not on the rights held by a parent entity that provides control of a subsidiary. These rights are considered above in paragraphs 28 - 33. The focus of this examination is whether the rights and obligations of a subsidiary should be considered as one unit of account or more unit of accounts.

**Relevance**

Treating a group of rights and obligations as a single unit of account may provide relevant information to users if, for example, those rights and obligations:

- cannot (or are unlikely to) be the subject of a separate transaction;

A subsidiary, in consolidated financial statements, consists of many rights and obligations. Many of these can be subject to a separate transaction. For example, it is common practice for a group to change its structure by making, for example, a spin-off or selling a part of a subsidiary (e.g. a business within a subsidiary). This example would accordingly mean that an **entity should not treat all its rights over a subsidiary as a single unit of account. Instead, the unit of account should be a subgroup of rights and obligations that are related to a particular activity of a subsidiary.**
- cannot (or are unlikely to) expire in different patterns;

Whereas the rights that gives control of a subsidiary would generally expire in similar patterns, the rights and obligations of a subsidiary will generally expire at different points in time. Thus, the example seems to suggest that **the rights and obligations of a subsidiary should not be treated as a single unit of account. Instead, the unit of account should be a subgroup of rights and obligations that are related to a particular activity of a subsidiary.**
- are used together in the context of the business activities conducted by the entity to produce cash flows and are measured by reference to the estimates of their interdependent future cash flows;

In this example, it is difficult to assess whether the different components of the subsidiary that are capable of engaging different business activities are in fact used together in the context of the business activities. It would depend on facts and circumstances. Nonetheless, different business components (e.g. core investing activities and investment-related services) may be mutually dependent and benefit from synergies between them. If so, this example would suggest that **an**

**entity should treat all its rights over a subsidiary as a single unit of account.**

- have similar economic characteristics and risks. Rights and obligations with different characteristics and risks are likely to have different implications for the prospects for future net cash inflows to an entity and so may need to be separated.

Although the different business components may be mutually dependent and benefit from synergies between them, ‘core investing activities’ and ‘investment related services’ have different economic characteristics and risks. Thus, this example seems to suggest that **an entity should not treat all its rights over a subsidiary as a single unit of account (i.e. the unit of account is the combination of all the rights and obligations related to the subsidiary)**

**Faithful representation**

To achieve a faithful representation it may be necessary to:

- treat the rights or obligations arising from different sources as a single unit of account or
- to separate the rights or obligations arising from a single source.

Moreover, to provide a faithful representation of unrelated rights and obligations, it may be necessary to recognise and measure them separately.

While this guidance might not explicitly point in the direction that all rights and obligations of a subsidiary should be considered separately for presenting them in the consolidated financial statements, the guidance would not seem to require that the rights and obligations should all be bundled.

**The cost constraint**

Costs of providing the information for that unit of account must not exceed the benefits. In general, the costs associated with recognising and measuring assets, liabilities, income and expenses increase as the size of the unit of account decreases.

Generally, the cost constraint would push towards considering the highest group level of rights – or big groups of physical objects as the unit of account. It would, however, not necessarily prohibit an entity to consider each component of the subsidiary that is capable of engaging different business activities as a different unit of account.

**Transfer part of an asset**

If an entity transfers part of an asset or part of a liability, the unit of account may change at that time so that the transferred component and the retained component become separate units of account.

An investment entity may decide to sell part of its investment in a subsidiary. Still, the unit of account after the sale would depend on the unit of account chosen by the entity before the sale and the retained interest in the subsidiary.

- 39 Although one of the examples above would suggest that the **subsidiary should be considered as one unit of account**, the proposed guidance seems generally to suggest that groups of rights and obligations within a subsidiary can be considered the unit of account. This is not reflected in the December 2014 amendment, but is reflected in the normal consolidation guidance.