EFRAG
European Financial Reporting Advisory Group

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Draft Comment Letter

Comments should be submitted by 31 December 2013 to commentletters@efrag.org

26 September 2013

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

Dear Sir/Madam,

Re: *A Review of the Conceptual Framework for Financial Reporting*

On behalf of the European Financial Reporting Advisory Group (EFRAG), I am writing to comment on the Discussion Paper *A Review of the Conceptual Framework for Financial Reporting* (the 'DP').

EFRAG welcomes that the IASB has initiated a project on improving its Conceptual Framework. European constituents, including EFRAG, have over the years repeatedly called for this revision to take place, before any fundamental change to the underlying IFRS accounting model would be made. The view that the Conceptual Framework was the most important project the IASB should undertake culminated in the response to the 2011 agenda consultation. We therefore agree with the high priority the IASB has given to this project and with the aim of completing the project within a few years. We appreciate the work that the IASB has done in analysing areas that have proven problematic in the past and we support the practical approach taken in the project. We also agree with explicitly limiting the scope of the project to financial statements.

While we broadly agree with the issues selected for the DP, we do not agree with all of the proposed solutions and think that some of the issues should be addressed on a more conceptual basis. This may partly be because it seems to us that many of the principles proposed have been generated from requirements in current Standards without their justification being debated conceptually. The revised Conceptual Framework should be based on the understanding of how clear objectives of financial reporting should be met in practice.

Our detailed comments and responses to the questions in the DP are set out in Appendix 1. In the following paragraphs we would like provide some high-level comments in relation to:

- Amending Chapters 1 and 3 of the existing Conceptual Framework
- The role of the business model in financial reporting
- Elements of financial statements and recognition
- Distinction between liability and equity elements
- Disclosure
- Implications on existing Standards of amending the Conceptual Framework

Amending Chapters 1 and 3 of the existing Conceptual Framework

The DP proposes not to undertake a fundamental reconsideration of the chapters of the Conceptual Framework that were published in 2010. Accordingly, the IASB will only make changes to these chapters if work on the rest of the Conceptual Framework highlights areas that need clarifying or amending. We disagree with this approach as we do not support how the existing chapters are dealing with stewardship, reliability and prudence.

The existing Chapter 1 seems to state that providing information to help existing and potential investors assess the prospects for future net cash inflows is the primary objective of financial reporting. Providing information that is useful for assessing stewardship is in our view equally essential. The assessment of stewardship is important as, contrary to what is reflected in the existing Conceptual Framework, the same information may not be the most useful for considering stewardship and evaluating prospects for future cash flows. We believe that this trade-off and a balance between the two objectives should be properly reflected in Chapter 1 of the existing Conceptual Framework.

When the Conceptual Framework was amended in 2010, the term 'reliability' was replaced by 'faithful representation'. We disagree with this change. To meet the objective of providing useful information we think that 'reliability' should replace 'faithful representation' as a fundamental qualitative characteristic. The Conceptual Framework describes 'faithful representation' as something that can be achieved by disclosures whereas it was acknowledged before the 2010 amendment that there could be a trade-off in recognised amounts between relevance and reliability. Furthermore, we think that verifiability should form part of reliability instead of just being considered an enhancing, albeit unnecessary, qualitative characteristic.

Similarly, we believe that the concept of prudence should be reintroduced and explained in the Conceptual Framework. Prudence is clearly reflected both in Standards in force today and those being developed. We therefore believe that it is essential to articulate the concept of prudence clearly in the Conceptual Framework in order to ensure that it is applied consistently across both current and future Standards. In our view, 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.

The role of the business model in financial reporting

We appreciate that the DP presents the preliminary views that financial statements can be made more relevant if the IASB considers how an entity conducts its business activities. We agree with this and think it is important that no standard ends up preventing entities from reflecting their business models. We therefore also welcome the approach to measurement proposed in the DP, which we believe forms a sound basis to have an entity's business model being reflected in measurement.

However, measurement cannot be considered in isolation. In order to achieve useful performance reporting, it is essential to consider how remeasurements are presented in the financial statements. For example, information may be most useful if some non-operational items are measured at a current value, but only if those remeasurements are presented in other comprehensive income.

In relation to a general discussion on what is best presented in profit or loss and what is best included in other comprehensive income, we think that the Conceptual Framework should not artificially limit the IASB's possibilities for defining the primary performance to be reflected in profit or loss.

Elements of financial statements and recognition

As noted above, we appreciate that the DP is dealing with issues that have been identified to result in problems. We also agree with the DP that the current definitions of assets and liabilities are interpreted inconsistently. We therefore appreciate that the IASB is trying to address this issue and we generally agree with the proposed new definitions. However, in order to ensure that the proposed definitions are interpreted in a consistent manner, we recommend that the IASB tests this.

Although we generally support the proposed definitions, we think that constructive obligations are defined too narrowly in the proposal. We do not agree with the DP that a constructive obligation only exists when an entity has a duty or responsibility to another party or parties that will benefit from the entity fulfilling its duty or responsibility. We favour an approach for liabilities where an obligation is present when it has arisen from past events and is practically unconditional. We acknowledge though that the notion of practical ability should be supported by appropriate guidance, as it means different things to different people. We also think that determining existence uncertainty of a liability is not necessarily helpful when there is evidence that a net outflow arising from past events is practically unavoidable.

We agree with the proposed definition of an asset but note that it may result in more assets being identified than under some interpretations of the current definition. We question whether it will be useful to recognise all these assets. The DP suggests that the Conceptual Framework should state that the IASB might decide on a standards level that assets (or liabilities) should not (or need not) be recognised when this would provide information that is not sufficiently relevant or when no measure would result in a faithful representation. We have not yet reached a decision on whether we think these criteria are appropriate, or the Conceptual Framework should include explicit probability thresholds for filtering what assets and liabilities to recognise. We are of the view though that uncertainty has a distinct impact on relevance and reliability, and that certain conditions of uncertainty may lead to non-recognition.

Distinction between liability and equity elements

Another issue that the IASB has rightly identified as causing problems in practice is the distinction between liability and equity elements. We therefore welcome that the DP addresses this issue. We do, however, not support the proposals in the DP in relation to ‘wealth transfers’ to reflect changes in rights and obligations that may be settled by transfer of an entity’s equity instruments. Wealth transfers are described as being akin to contributions of equity by one class of equity and equal distributions of equity to other classes. These rights and obligations could relate to an entity’s trading, borrowing and investing activities and we think it would be inappropriate for them to be described as transactions with owners instead of being reflected in comprehensive income.

Disclosure

There is a strong consensus in the financial community that disclosures in the notes to the financial statements have become unwieldy; the increasing length of the notes has done little to improve the quality of information, and may have even decreased it because of information overload. We therefore appreciate that the IASB is addressing disclosures in the DP. We also think that the proposals included in the DP are pointing in the right direction and acknowledge that the IASB will also address the issue in other projects. However, we think that the Conceptual Framework could go further than proposed in the DP in order to provide some guidance that could introduce some discipline on the issues in relation to the IASB’s standard setting. The EFRAG, ANC and FRC Discussion Paper *Towards a Disclosure Framework for the Notes* and related feedback statements should be useful to this purpose. For example, it could be specified what types of risks are relevant to provide information about.

Implications on existing Standards of amending the Conceptual Framework

The DP proposes that in rare cases, in order to meet the overall objective of financial reporting, the IASB may decide to issue a new or revised Standard that conflicts with an aspect of the revised Conceptual Framework. If this happens the IASB should describe the departure from the Conceptual Framework, and the reasons for that departure, in the Basis for Conclusions on that Standard.

We agree with this, but note that it is likely that the principles of the revised Conceptual Framework will conflict with some requirements in existing IFRS. We believe that these conflicts should be identified at the level of the exposure draft, so that constituents have a clearer understanding of the possible outcomes of the proposed changes. Unsupportable conflicts would be natural candidates for projects to be considered as part of the IASB's agenda consultations. In addition, some clear guidance has to be set on how the revised Conceptual Framework should be used, or not used, by the Interpretation Committee.

Although amending the Conceptual Framework will not have any immediate consequences for how financial statements are prepared, it should accordingly have implications in the long-term.

If you would like to discuss our comments further, please do not hesitate to contact Rasmus Sommer, Benjamin Reilly, Ales Novak or me.

Yours faithfully,

Françoise Flores

EFRAG Chairman

APPENDIX 1

SECTION 1 INTRODUCTION

Question 1

Paragraphs 1.25–1.33 of the DP [which are summarised below in paragraphs 1 to 6] set out the proposed purpose and status of the Conceptual Framework. The IASB's preliminary views are that:

(a) the primary purpose of the revised Conceptual Framework is to assist the IASB by identifying concepts that it will use consistently when developing and revising IFRSs; and

(b) in rare cases, in order to meet the overall objective of financial reporting, the IASB may decide to issue a new or revised Standard that conflicts with an aspect of the Conceptual Framework. If this happens the IASB would describe the departure from the Conceptual Framework, and the reasons for that departure, in the Basis for Conclusions on that Standard.

Do you agree with these preliminary views? Why or why not?

Notes to constituents

1 *The current Conceptual Framework includes a list of possible uses of the Conceptual Framework. The IASB believes that a long list of possible uses is unhelpful when developing a revised Conceptual Framework. Instead the DP proposes that the primary purpose of the revised Conceptual Framework is to assist the IASB by identifying concepts that it will use consistently when developing and revising Standards. The IASB believes that focusing on the needs of the IASB when setting Standards will help to provide better targeted concepts. Some aspects of the Conceptual Framework are therefore intended only for the IASB's use as it develops new or revised Standards.*

2 *However, the IASB also acknowledges that the Conceptual Framework plays an important role in helping parties other than the IASB (for example, preparers, auditors, regulators and users of financial statements). The DP therefore proposes that the revised Conceptual Framework should state that it may also assist parties other than the IASB to:*

(a) *understand and interpret existing IFRSs; and*

(b) *develop accounting policies when no Standard or Interpretation specifically applies to a particular transaction or event.*

3 *Where the IASB does not intend other parties to use a particular aspect of the Conceptual Framework it will make that clear.*

4 *The DP does not propose to change the fact that the Conceptual Framework is not an IFRS and does not override any specific standard. The DP notes that because the Conceptual Framework will guide the IASB when it develops and revises Standards, the number of conflicts between specific Standards and the revised Conceptual Framework should diminish over time.*

5 *However, the DP also notes that the IASB would not be prohibited from issuing an IFRS that could conflict with the Conceptual Framework in order to meet the overall objectives of financial reporting. In the limited number of cases where there would be a conflict, the IASB should describe the departure from the Conceptual Framework, and the reasons for it, in the accompanying Basis for Conclusions.*

6 *The DP also proposes that the Conceptual Framework would not be static, but the IASB will review it from time to time in the light of the experience of working with it.*

EFRAG's response

EFRAG generally agrees with the proposal on the purpose and status of the Conceptual Framework, but does not understand why parts of the Conceptual Framework should be for the IASB's use only. EFRAG agrees with the proposal that the IASB could introduce requirements in Standards that could conflict with the Conceptual Framework, but EFRAG believes that future conflicts as well as existing conflicts should be identified and explained.

7 EFRAG thinks that it is important that the IASB has a Conceptual Framework to guide its standard setting activities. EFRAG believes that for financial reporting information to be useful, the guidance under which financial reports are based should be founded on some general principles. Guidance that is not based on articulated general principles could be inconsistent and could result in financial reporting information not being understandable and comparable.

8 EFRAG agrees that the IASB, in a limited number of cases, would have to issue an IFRS that conflicts with the Conceptual Framework. For example, in order to produce the most useful information it may be necessary to recognise a liability for deferred income although such item would not meet the definition of a liability. EFRAG agrees that departures from the Conceptual Framework should be explained in the Basis for Conclusions to the relevant standard or amendment. However, as departures from the Conceptual Framework could indicate deficiencies with the principles, the IASB should in addition to explaining the departure, investigate whether changes should be made to the Conceptual Framework.

9 Conflicts between Standards and the Conceptual Framework will not only arise as the IASB develops new or revised Standards. It is likely that the principles of the revised Conceptual Framework will conflict with some requirements in existing IFRS. EFRAG believes that identification of these conflicts to the extent possible and assessing whether the conflicts should be removed or kept in order to meet the overall objectives of financial reporting should be a priority of the IASB. Unsupportable conflicts would be natural candidates for projects to be considered as part of the IASB's agenda consultations.

10 Identification of the conflicts between existing requirements and the revised Conceptual Framework may also be relevant when it comes to interpreting existing Standards developed under the current or an older version of the Conceptual Framework. When specific requirements conflict with the revised Conceptual Framework, the IASB will need to provide clarification as to what the procedure would be when the IFRS Interpretations Committee or others interpret that requirement. In these cases it may not be appropriate to draw upon the revised Conceptual Framework for guidance, but to base the interpretation on the principles that drove the development of the requirement[1].

11 When it comes to using the Conceptual Framework to interpret standards, EFRAG does not understand why the DP proposes to limit the use of parts of the Conceptual Framework to the IASB.

12 The DP proposes that some parts of the Conceptual Framework could only be used by the IASB. For example, it is intended that only the IASB should/could use the proposed guidance on when an item of income or expense could be presented in OCI. EFRAG understands that the IASB, by this restriction, tries to reflect the requirement of paragraph 88 of IAS 1, which states that an entity shall recognise all items of income

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[1] According to paragraph 7.8 of the IASB and IFRS Interpretations Committee Due Process Handbook, interpretations of the IFRS Interpretations Committee must not change or conflict with IFRSs or the Conceptual Framework. If the Interpretations Committee concludes that the requirements of an IFRS differ from the Conceptual Framework, it obtains direction from the IASB before developing the Interpretation further.

and expense in a period in profit or loss unless an IFRS requires or permits otherwise. In other words, an entity is only allowed and required to recognise items of income and expense in OCI in the specific cases where the IASB has decided on that in a Standard.

13 EFRAG does not understand why it is necessary to limit the use of parts of the Conceptual Framework to the IASB in order to avoid the Conceptual Framework being used to override requirements in Standards. IAS 1 clearly specifies that only in the extremely rare circumstances in which management concludes that compliance with a requirement in an IFRS would be so misleading that it would conflict with the objective of financial statements, the entity can and shall depart from that requirement if the relevant regulatory framework requires, or otherwise does not prohibit, such a departure. EFRAG therefore believes that all parts of the Conceptual Framework could be useful for preparers or the IFRS Interpretations Committee in the absence of an IFRS that specifically applies to a transaction, another event or condition. Limiting the use of parts of the Conceptual Framework to the IASB may confuse constituents, result in the Conceptual Framework being less understandable and may result in inconsistencies.

SECTION 2 ELEMENTS OF FINANCIAL STATEMENTS

Question 2

The definitions of an asset and a liability are discussed in paragraphs 2.6–2.16 of the DP [which are summarised below in paragraphs 14 to 15]. The IASB proposes the following definitions:

(a) an asset is a present economic resource controlled by the entity as a result of past events.

(b) a liability is a present obligation of the entity to transfer an economic resource as a result of past events.

(c) an economic resource is a right, or other source of value, that is capable of producing economic benefits.

Do you agree with these definitions? Why or why not? If you do not agree, what changes do you suggest, and why?

Notes to constituents

14 *Currently an asset is defined as a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity. A liability is defined as a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits. The IASB is proposing to amend these definitions to:*

(a) *confirming more explicitly that:*

(i) *an asset is a resource (rather than the inflow of economic benefits that the resource may generate);*

(ii) *a liability is an obligation (rather than the outflow of economic benefits that the obligation may generate);*

(iii) *an asset must be capable of generating inflows of economic benefits. Those inflows need not be certain. The probability of those inflows need not reach any minimum threshold before the underlying resource meets the definition of an asset;*

(iv) *a liability must be capable of generating outflows of economic benefits. Those outflows need not be certain. Their probability need not reach any* *minimum threshold before the underlying obligation meets the definition of a liability.*

(b) *adding to the guidance supporting the definitions of assets and liabilities, to clarify various matters that have caused difficulties when revising or providing Interpretations for particular Standards (see Section 3).*

15 The DP proposes to define an asset (of an entity) as a present economic resource controlled by the entity as a result of past events. A liability (of an entity) is proposed to be defined as a present obligation of the entity to transfer an economic resource as a result of past events. Finally, an economic resource is proposed to be defined as a right, or other source of value, that is capable of producing economic benefits.

EFRAG's response

EFRAG believes that the proposed definitions may be easier to understand than the current ones. EFRAG is currently split on whether the definition of an economic resource should be amended to specify that the right, or other source of value, should be capable of producing economic benefits to the entity.

16 EFRAG notes that some would consider the changes made to the definitions of an asset and a liability to be more than just clarifications as stated in the DP. In any case, as the current definitions have been interpreted differently, the proposed changes may have an impact on what users of the Conceptual Framework consider to be assets and liabilities. EFRAG considers that many items will meet the proposed definition of an asset – and perhaps items that some people would not consider to meet the current definition. Items such as a workforce and an improved market position (resulting from marketing efforts) seem to meet the proposed definition of an asset.

17 EFRAG believes that the proposed definitions may result in more consistent interpretations than the current ones, as EFRAG thinks that the proposed definitions are easier to understand. EFRAG welcomes the changes in this respect. For example, EFRAG considers that under the proposed definitions a reduction in future outflows would meet the definition of an asset. This is less evident under the current definition as it refers to economic benefits to flow to an entity.

18 Although EFRAG believes the proposed definitions are easier to understand, we think that it should be further tested whether the proposed definitions are generally interpreted consistently or ambiguous wording in one area is just replaced by ambiguity in another area. For example, the test should ensure that replacing 'expected' in the definition of an asset with 'capable' in the definition of a resource does not just move a problem. EFRAG acknowledges that the DP includes some examples of items that meet the definitions of an asset and a liability and further examples of what an economic resource is. However, before publishing an exposure draft, EFRAG considers that the IASB should publish for comments a list of items it considers would meet the proposed definitions of an asset or a liability to test the consistency of interpretations. The IASB could in this regard consider the list of items assessed in the EFRAG/ANC staff paper on the definition of an asset published in 2010.

19 EFRAG agrees with the proposals that the definition of an asset (and a liability) should include the link to the entity. That is, the items defined should be assets and liabilities of an entity. We do not think it would be efficient first to define assets and liabilities without such a link and then establish the link to the entity afterwards. Accordingly, EFRAG does not think that fish in the open sea should meet the definition of an asset. Only when they are caught they are assets of a particular entity. For assets the link between the economic resource and the entity is established in the DP by stating that the economic resource should be "controlled by the entity". For liabilities the link is established by stating that a liability is a present obligation "of the entity".

Question to constituents

20 EFRAG has discussed whether an economic resource should be defined as a right, or other source of value, that is capable of producing economic benefits *to the entity*. That is, whether ‘to the entity’ should be added to the proposed definition of an economic resource included in the DP. EFRAG has not reached a consensus on this issue. This draft comment letter therefore sets out two different views of the members of the EFRAG Technical Expert Group (EFRAG TEG members) and asks constituents for their comments.

View 1 – ‘to the entity’ should be added to the proposed definition of an economic resource

21 Some EFRAG TEG members believe that an economic resource is a right, or other source of value, that is capable of producing economic benefits *to the entity*. They note that shares in an entity are capable of producing economic benefits to others than the entity itself. Accordingly, if it is not specified that the economic benefits should flow to the entity, own shares would, in their view, meet the definition of an asset of the entity. They do not expect this is the intention of the IASB.

22 These EFRAG TEG members also note that assets managed by a third party, for example a discretionary trust, might be considered to be an asset of that third party if it were not specified that the economic benefits should flow to the entity. They do not think that it would result in useful information if the third party should recognise assets it is only managing on behalf of others.

View 2 – ‘to the entity’ should not be added to the proposed definition of an economic resource

23 Other EFRAG TEG members believe that it would be redundant to add ‘to the entity’ to the proposed definition of an economic resource. They note that the definition of control already includes the link to the entity.

24 The proposed definition of control states that an entity controls an economic resource if it has the present ability to direct the use of the economic resource so as to obtain the economic benefits that flow from it. Therefore, in the case of a discretionary trust, the third party does not control the assets, as the trust only manages the assets without obtaining the economic benefits that flow from them. The economic resources provided by the investors should accordingly not be considered assets of the trust.

25 EFRAG TEG members in favour of View 2 also note that adding ‘to the entity’ to the proposed definition of an economic resource could have unintended consequences for when a liability would be identified. In addition, items benefiting society in general, rather than the entity, might not meet the definition of an economic resource if ‘to the entity’ would be added.

Question

26 Which, if any, of the views presented above do you support, and why? If you do not support any of the views, what is your view on the proposed definition of an economic resource included in the DP?

Question 3

Whether uncertainty should play any role in the definitions of an asset and a liability, and in the recognition criteria for assets and liabilities, is discussed in paragraphs 2.17–2.36 of the DP [which are summarised below in paragraphs 27 to 29]. The IASB’s preliminary views are that:

(a) the definitions of assets and liabilities should not retain the notion that an inflow or outflow is 'expected'. An asset must be capable of producing economic benefits. A liability must be capable of resulting in a transfer of economic resources.

(b) the Conceptual Framework should not set a probability threshold for the rare cases in which it is uncertain whether an asset or a liability exists. If there could be significant uncertainty about whether a particular type of asset or liability exists, the IASB would decide how to deal with that uncertainty when it develops or revises a Standard on that type of asset or liability.

(c) the recognition criteria should not retain the existing reference to probability.

Do you agree? Why or why not? If you do not agree, what do you suggest, and why?

Notes to constituents

27 The DP discusses whether uncertainty should play any role in the definitions of an asset and a liability and in the recognition criteria for assets and liabilities. The DP presents the view that the definitions of assets and liabilities should not retain the notion that an inflow or outflow is 'expected'. Instead it explains that an asset must be capable of producing economic benefits and a liability must be capable of resulting in a transfer of economic resources. The DP also presents the view that the Conceptual Framework should not include any recognition threshold regarding the probability of future inflows or outflows.

28 When discussing uncertainty, the DP distinguishes between:

(a) *Uncertainty about whether an asset or liability exists. Such uncertainty exists in the case of litigation where it is uncertain whether an entity has committed an act that would require it to pay damages or a fine.*

(b) *Uncertainty about whether an asset or liability will result in any inflow or outflow. Outcome uncertainty refers to cases where the asset or the liability exists, but the outcome is uncertain. For example, in case of a lottery ticket, the holder has an asset (the ticket) but does not know whether it will win in the draw.*

29 The DP presents different views for including recognition thresholds for both types of uncertainty but on balance it is in favour of the view presented above. However, the DP also states that:

(a) *if there is significant uncertainty about whether an asset or a liability exists, the IASB would decide when developing or revising an IFRS how to deal with that uncertainty; and*

(b) *uncertainty may make some rights or obligations so difficult to measure that recognising them might result in information that is not relevant (see below regarding recognition).*

EFRAG's response

EFRAG thinks that the definitions of assets and liabilities should not include probability thresholds. (EFRAG's comments in relation to probability thresholds for recognition of assets and liabilities are provided below in relation to the questions on recognition).

30 EFRAG agrees with the DP that there should not be any probability thresholds in the definition of an asset or of a liability.

31 EFRAG agrees with the DP that it is possible to distinguish between uncertainty in relation to existence and uncertainty in relation to outcome. However, in practice EFRAG thinks that there can be cases where it is difficult to distinguish between the two types of uncertainties. In our view, for example, existence uncertainty is not just something that exists in rare cases as stated in paragraph 2.20 of the DP. One of the

reasons why it may be difficult to distinguish between the two types of uncertainty is that it is unclear what the unit of account to consider should be. For example, if tax authorities disagree with an entity that a part of revenue is not tax free as the entity has claimed, it is not clear whether the uncertainty relates to the outcome of the total tax liability or to existence of a tax liability for the particular revenue.

32 Distinguishing between the different types of uncertainty may, however, be unnecessary in relation to the definition and recognition of assets and liabilities as it may not affect the usefulness of financial statements. EFRAG thus questions that it will affect financial statement users' decisions to know that the probability of an outflow is very low because of uncertainty about the existence rather than uncertainty about the outcome. In any case, the user would probably benefit more from a description of the uncertainty.

Question to constituents

33 Do you think it is useful to distinguish between existence uncertainty and outcome uncertainty? Please explain.

34 Do you agree with the DP that existence uncertainty is rare?

Question 4

Elements for the statement(s) of profit or loss and OCI (income and expense), statement of cash flows (cash receipts and cash payments) and statement of changes in equity (contributions to equity, distributions of equity and transfers between classes of equity) are briefly discussed in paragraphs 2.37–2.52 of the DP [which are summarised below in paragraphs 35 to 40].

Do you have any comments on these items? Would it be helpful for the Conceptual Framework to identify them as elements of financial statements?

Notes to constituents

35 The DP proposes that the Conceptual Framework should include definitions of: cash receipts, cash payments, contributions to equity, distribution of equity, and transfers between classes of equity. However, the DP does not propose any definitions as it does not foresee great difficulties in developing such definitions.

36 The DP notes that profit or loss, total OCI and total comprehensive income are not elements of financial statements. They are subtotals or totals derived by summing items of income or expense.

37 The existing Conceptual Framework defines income and expenses based on changes in assets and liabilities.

38 The DP discusses whether the Conceptual Framework should define different types of income or expense to differentiate:

(a) *revenue from gains, and expenses from losses; and*

(b) *income and expense reported in profit or loss from income and expense reported in OCI.*

39 The DP, however, concludes that distinguishing revenue from gains and expenses from losses would be best carried out in a project to review Standards on financial statement presentation and not in a project to revise the Conceptual Framework.

40 Similarly the DP proposes that the Conceptual Framework should not include definitions to differentiate income and expense reported in profit or loss from income and expense reported in OCI. The DP concludes that there are disadvantages to using *definitions to distinguish income and expense reported in OCI from income and expense reported in profit or loss, rather than relying on presentation guidance as*

(a) *definitions may not be a clear way to implement an approach that states when an item could be reported in OCI;*

(b) *defining one set of elements for use in profit or loss and a separate set of elements for OCI may not be straightforward, particularly if the IASB decides that an entity should report in OCI only a component of a change in the carrying amount of an asset or a liability rather than the entire change.*

EFRAG's response

EFRAG supports that income and expenses are defined on the basis of changes in assets and liabilities. EFRAG believes it would be useful to define contributions to equity, distributions of equity and transfers between classes of equity. However, EFRAG does not see any particular benefits in defining cash receipts and cash payments. Instead the IASB should consider what the statement of cash flows should communicate.

41 EFRAG believes that no primary financial statement should have primacy over the other primary statements. This means that the statement of financial position should not have primacy over the statement(s) of profit or loss and other comprehensive income. EFRAG is aware that some believe that defining income and expenses based on changes in assets and liabilities results in the statement(s) of profit or loss and other comprehensive income being secondary to the statement of financial position. EFRAG does not share this view as further explained in the Bulletin on the asset/liability approach, which EFRAG has issued together 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)[2]. Defining income and expenses based on changes in assets and liabilities does not conflict with the objective of producing useful performance figures and it does not mean that the statement of financial position is more important than the statement(s) of profit or loss and other comprehensive income.

42 EFRAG therefore agrees that income and expenses are defined on the basis of changes in assets and liabilities. EFRAG notes that in many cases focusing on changes in assets and liabilities provides greater clarity for the development of accounting standards. This is, for example, the case when allocating income and expenses to a reporting period. An alternative approach where income and expenses were not derived from changes in assets and liabilities, but where allocation of income and expenses would be based on a matching approach would, in the view of EFRAG, not result in direct guidance that could be used to determine in what period a transaction or event would relate.

43 EFRAG believes it would be useful to define contributions to equity, distributions of equity and transfers between classes of equity instruments. EFRAG notes that it is currently not always clear whether, for example, certain transactions with shareholders should be considered equity transactions or not.

44 On the other hand, EFRAG does not see any particular benefits in defining cash receipts and cash payments. Instead EFRAG thinks the IASB should consider what the statement of cash flows should communicate. In 2010, EFRAG performed outreach activities in relation to the staff draft of the exposure draft *Financial Statement Presentation*. Feedback from these activities suggested that cash flow statements, as currently defined, are of little value to the users of the financial statements of financial

[2] Not all the partners issuing the Bulletin share the preliminary view of EFRAG on this issue. The different views are explained in the Bulletin.

institutions including insurance entities. The IASB may therefore need to reflect, on a conceptual level, on what information should be conveyed in these statements, including whether the information presented should be the same for all types of entities.

45 EFRAG's comments in relation to income and expense reported in profit or loss versus income and expense reported in OCI are provided in response to the questions relating to Section 8 of the DP.

SECTION 3 ADDITIONAL GUIDANCE TO SUPPORT THE ASSET AND LIABILITY DEFINITIONS

Question 5

Constructive obligations are discussed in paragraphs 3.39–3.62 of the DP [which are summarised below in paragraphs 46 to 50]. The discussion considers the possibility of narrowing the definition of a liability to include only obligations that are enforceable by legal or equivalent means. However, the IASB tentatively favours retaining the existing definition, which encompasses both legal and constructive obligations – and adding more guidance to help distinguish constructive obligations from economic compulsion. The guidance would clarify the matters listed in paragraph 3.50 of the DP [which is summarised below in paragraph 49].

Do you agree with this preliminary view? Why or why not?

Notes to constituents

46 The DP notes that under current IFRS it can be difficult to judge whether and to what extent an entity's past practices are sufficient to have created a valid expectation among other parties that the entity will accept specific responsibilities. In addition, it can be difficult to distinguish constructive obligations from a situation in which an entity is economically compelled to take a particular course of action in the future and guidance on whether to consider economic compulsion when assessing whether a liability exists may not be consistent.

47 In addition to providing more guidance on obligations that are conditional on future events, the DP proposes two solutions to deal with the issues. The first solution is to limit obligations to those that another party could enforce against the entity. Any requirement for an obligation to be enforceable by legal or equivalent means would refer to the mechanism that creates an obligation. It would not affect the assessment of when that obligation arises. The second solution is to include more guidance to support the definition of a constructive obligation.

48 The view presented in the DP is that the second approach is preferable.

49 The DP suggests that additional guidance could be to specify that in order to have a constructive obligation:

(a) *an entity must have a duty or responsibility to another party. It is not sufficient that an entity will be economically compelled to act in its own best interests or in the best interests of its shareholders. It is not necessary to know the identity of the party or parties to whom the obligation is owed – indeed the obligation may be to the public at large;*

(b) *the other party must be one who would benefit from the entity fulfilling its duty or responsibility or suffer loss or harm if the entity fails to fulfil its duty or responsibility; and*

(c) *as a result of the entity's past actions, the other party can reasonably rely on the entity to discharge its duty or responsibility.*

50 A result of the suggested approach would be that the current guidance in IAS 37 on constructive obligations to restructure may not be in accordance with the revised

Conceptual Framework as the entity in these cases may not have an obligation to others and is not bound by its plan.

EFRAG's response

EFRAG agrees with the DP that the IASB should retain the existing definition of a liability which encompasses both legal and constructive obligations. However, EFRAG thinks that constructive obligations should be defined broader than what is proposed in the DP.

51 EFRAG agrees that the IASB should retain the existing definition of a liability which encompasses both legal and constructive obligations. EFRAG agrees with the arguments presented in the DP that excluding some constructive obligation could provide less relevant information to users of financial statements about the entity's future cash flows relating to past activities. In addition, EFRAG considers that excluding some constructive obligations would not result in a faithful representation.

52 However, EFRAG does not agree with the DP on how to consider constructive obligations. EFRAG agrees that a constructive obligation exists in cases where the criteria in paragraph 3.50 of the DP [summarised in paragraph 49 above] are met. However, EFRAG considers that constructive obligations could also arise in other circumstances where the entity has no realistic alternative than to incur future costs (that are not outweighed by accompanying benefits). For example, if an entity has no realistic alternative to a restructuring plan, obligations following from this plan should be recognised as liabilities. Guidance on when an entity would have no realistic alternative would follow the guidance proposed in paragraph 3.79 of the DP [summarised in paragraph 60 below] on when an obligation is practically unconditional. Accordingly, an entity may not have realistic alternatives, if the alternative would involve the entity ceasing to operate as a going concern, significantly curtailing operations or leaving specific markets.

Question 6

The meaning of 'present' in the definition of a liability is discussed in paragraphs 3.63–3.97 of the DP. A present obligation arises from past events. An obligation can be viewed as having arisen from past events if the amount of the liability will be determined by reference to benefits received, or activities conducted, by the entity before the end of the reporting period. However, it is unclear whether such past events are sufficient to create a present obligation if any requirement to transfer an economic resource remains conditional on the entity's future actions. Three different views on which the IASB could develop guidance for the *Conceptual Framework* are put forward:

(a) View 1: a present obligation must have arisen from past events and be strictly unconditional. An entity does not have a present obligation if it could, at least in theory, avoid the transfer through its future actions.

(b) View 2: a present obligation must have arisen from past events and be practically unconditional. An obligation is practically unconditional if the entity does not have the practical ability to avoid the transfer through its future actions.

(c) View 3: a present obligation must have arisen from past events, but may be conditional on the entity's future actions.

The IASB has tentatively rejected View 1. However, it has not reached a preliminary view in favour of View 2 or View 3.

Which of these views (or any other view on when a present obligation comes into existence) do you support? Please give reasons.

Notes to constituents

53 The DP notes that to identify a liability it is necessary to distinguish between present obligations and possible future obligations. A present obligation must have arisen 'as a result of past events'.

54 Difficulties are encountered in practice because it is unclear whether particular past events are sufficient to create a present obligation to transfer an economic resource if such a transfer remains conditional on future events that have not occurred, or on further actions that the entity has not taken, by the reporting date.

55 The IASB proposes to state in the Conceptual Framework that when these future events are outside of the control of an entity, the unconditional 'stand-ready obligations' to transfer resources, if specified future event occurs, are present obligations that meet the definition of a liability.

56 The DP presents three views to determine whether a present obligation exists in the case where these future events are within the control of an entity:

(a) *A present obligation must have arisen from past events and be strictly unconditional.*

(b) *A present obligation must have arisen from past events and be practically unconditional.*

(c) *A present obligation must have arisen from past events but may be conditional on the entity's future actions.*

57 Under the first approach no liability is recognised until the obligation is unconditional.

58 The second approach would identify as liabilities all obligations to transfer an economic resource that:

(a) *Have arisen as a result of past events, i.e. that will be measured by reference to benefits received, or activities conducted, by the entity before the end of the reporting period; and*

(b) *The entity has no practical ability to avoid through its future actions.*

59 A liability can be viewed as having arisen from past events if the amount of the liability will be determined by reference to benefits received, or activities conducted, by the entity before the end of the reporting period. Activities conducted by the entity could include, for example, making sales, earning profits or even operating on a particular date – the important fact is that the amount of the liability is determined by reference to that activity.

60 The DP notes that the assessment of whether an entity has the practical ability to avoid any remaining conditions would require judgement. Guidance might be needed (possibly in individual Standards) to identify the types of condition that an entity might not have the practical ability to avoid. Arguably, these conditions might include, for example, conditions that the entity could avoid only by ceasing to operate as a going concern, significantly curtailing operations or leaving specific markets. An entity might have no practical ability to avoid some future operating costs, such as the following month's employee salaries. However, these future costs do not give rise to a liability at the reporting date if the amount of the obligation is determined solely by reference to future receipts or activities.

61 Under the third approach an entity would have a liability if, on meeting the further conditions specified, it will be required to:

(a) *Transfer an economic resource that it would not have been required to transfer without the past receipt or activity; or*

(b) *Exchange economic resources with another party on more onerous terms than would have been required without the past receipt or activity.*

62 *The IASB has tentatively rejected the first approach. However, it has not reached a preliminary view in favour of the second or third approach.*

EFRAG's response

EFRAG thinks that a present obligation must have arisen from past events and be practically unconditional. However, the term 'past events' should be described differently than suggested in the DP in cases where the entity does not receive direct benefits from incurring an obligation.

63 The DP includes some examples illustrating the outcome of the three views presented on how to determine whether a present obligation exists. EFRAG is in favour of an approach that will result in the same outcomes as those that are illustrated for the second approach. EFRAG considers that the first approach would sometimes identify liabilities too late. This is, for example, the case when a levy is based on the entity's revenue in one year, but where the obligation only becomes unconditional if the entity is still in the business on a certain date the following year. On the other hand, EFRAG thinks that approach three would probably result in too many liabilities being identified. For example, if an entity has promised its employees a total bonus of CU100 and if the entity would have a profit of CU100,000 in year ten from now, EFRAG understands that approach three would result in an obligation being identified even when the entity needs to grow considerably in order to meet the goal in ten years. EFRAG, however, notes that it had some difficulties in understanding the third approach proposed in the DP, and would recommend that this approach be explained further.

64 EFRAG notes that under the second approach whether or not an obligation exists depends on how the amount of the obligation is determined. Accordingly, if:

(a) In Jurisdiction A, a particular utility is required to pay a levy of two percent of its revenue of year 20x1 if it is in business on 1 April 20x2, EFRAG interprets the proposal in a manner that would result in a liability for the utility in Jurisdiction A from January 20x1 when the utility starts generating revenue.

(b) In Jurisdiction B, a particular utility is required to pay a levy of a 'fixed' amount announced on 1 April 20x1 if it is in business on 1 April 20x2, EFRAG interprets that no liability should be recognised until 1 April 20x2 as the amount of the liability is not directly linked to the entities performance (although the government may consider the performance of the utilities when determining the size of the levy this is not known).

65 EFRAG believes that reflecting the scenarios differently does make sense as it could be expected that there is some rationale behind how the jurisdictions in the examples above calculate the levies.

66 Unfortunately, the DP is not clear on what benefits received or activities conducted by an entity would result in a liability. For example, if a utility in Jurisdiction C is required to pay an amount on 1 April 20x2 that is determined based on various parameters such as: the average number of customers over the past ten years; the increase in revenue from 20x0 to 20x1; the estimated increase in customer over the following ten years; and the average asset balance of the past five years. It is not apparent from the DP whether the utility should recognise a liability from the start date of the calculation of the average number of customers. Paragraph 3.66 of the DP [summarised in paragraph 59 above], states that activities conducted by the entity include that the entity is operating on a particular date. The fact that the entity has customers on a particular date could indicate that it has been operating.

67 Paragraph 3.66 of the DP [summarised in paragraph 59 above] does, however, not seem particularly clear. It can even be read as an acceptance of different interpretations of the second approach suggested in the DP, as it states "a liability can be viewed…". In the view of EFRAG the IASB would have to specify in a clearer

manner how the second approach should be understood by, for example, stating that "a liability should be viewed…".

68 In the view of EFRAG, the IASB should also further clarify when an obligation is practically unconditional. The IASB could, among other things, consider referring to its discussions about economic compulsion and explain how practicality interacts with the going concern assumption.

Question 7

Do you have comments on any of the other guidance proposed in this section of the DP to support the asset and liability definitions?

Notes to constituents

69 In addition to constructive obligations and the meaning of 'present' in the definition of a liability, the additional guidance to support the asset and liability definitions consider:

(a) *the meaning of 'economic resource';*

(b) *the meaning of 'control';*

(c) *the meaning of 'transfer an economic resource';*

(d) *reporting the substance of contractual rights and contractual obligations; and*

(e) *executory contracts.*

The meaning of 'economic resource'

70 According to the DP, economic resources may take various forms such as: enforceable rights established by contract, law or similar means; rights arising from a constructive obligation of another party; and other sources of value if they are capable of generating economic benefits.

71 The guidance would clarify that economic benefits derived from an asset are the potential cash flows that can be obtained directly or indirectly in many ways. In addition it would clarify that, for a physical object, such as an item of property, plant and equipment, the economic resource is not the underlying object but a right (or set of rights) to obtain the economic benefits generated by the physical object. In many cases, an entity treats all of the rights it holds as a single asset. Nevertheless, an entity would treat some of the rights as one or more separate assets if such a separation produces information that is relevant to users of financial statements and provides a faithful representation of the entity's resources, at a cost that does not exceed the benefits of doing so. The unit of account will determine whether a contract is viewed as giving rise to a single net right or net obligation, or to one or more separate rights and obligations.

The meaning of 'control'

72 The DP proposes that an entity controls an economic resource if it has the present ability to direct the use of the economic resource so as to obtain the economic benefits that flow from it.

73 The DP includes further guidance to clarify the definition of control.

74 The proposed definition of a liability specifies that the obligation must be an obligation of the entity. In other words, the entity must be the party that is bound by the obligation. This feature of the definition corresponds to the fact that the proposed definition of an asset specifies that the entity must be the party that controls the asset.

75 The DP states that if a liability exists for one party, an asset always exists for another party or parties, except perhaps for some obligations to clean up damage to the environment. However, for some assets, such as rights over physical objects, no corresponding liability exists.

The meaning of 'transfer of an economic resource'

76 The DP specifies that an obligation to transfer an economic resource may result in an entity paying cash, transferring assets other than cash, granting a right to use an asset, rendering services or standing ready to make a payment on the occurrence of a future event that is outside the entity's control.

77 An obligation that requires an entity to provide economic resources only if, at the same time or earlier, the entity expects to receive economic resources of equal or greater value does not give rise to a present obligation to transfer an economic resource. This is also the case for an obligation that an entity is permitted (or required) to fulfil by issuing its own equity instruments.

Reporting the substance of contractual rights and contractual obligations

78 The existing Conceptual Framework gives limited further guidance on assessing the substance of contractual rights and obligations. However, several Standards give guidance for specific types of transaction. The IASB proposes to add the underlying principles of this guidance to the Conceptual Framework. The Conceptual Framework could state that:

(a) *An entity should report the substance of a contract. In some cases, the legal form of a contract is an important part of the substance of the contract. In other cases, the legal form is only a minor part of the substance of the contract.*

(b) *A group or series of contracts that achieves, or is designed to achieve, an overall commercial effect should be viewed as a whole. One situation in which this treatment may be particularly important is if rights or obligations in one contract entirely negate obligations or rights in another contract.*

(c) *Conversely, if a single contract contains two or more sets of rights and obligations that would all have been identical if they had been created through more than one legal document, the entity may need to account for the different sets of rights as if they were separate contracts.*

(d) *All terms – whether explicit or implied – should be taken into consideration. Implied terms could include, for example, obligations imposed by statute, such as statutory warranty obligations imposed on entities that enter into contracts for the sale of goods to customers.*

(e) *Terms that have no commercial substance should be disregarded. A term has no commercial substance if it has no discernible effect on the economics of the contract. Terms that have no commercial substance could include, for example:*

  (i) *terms that bind neither party; and*

  (ii) *rights (including options) that the holder will not have the practical ability to exercise.*

(f) *If, after disregarding options with no commercial substance, an option holder has only one remaining option, that option is in substance a requirement.*

79 There have been a significant number of requests to the IFRS Interpretations Committee on the role economic compulsion should take in determining whether an instrument contains an obligation to transfer an economic resource (and is therefore a liability).

80 Problems often relate to contracts where an entity has no contractual obligation to pay an annual dividend to the holder of an instrument issued by the entity, and no contractual obligation ever to redeem the financial instrument. However, if the entity does not pay dividend of a specified amount to the holders of the instrument it cannot pay any dividend to its ordinary shareholders. In addition, the entity could have an option to redeem the financial instrument at a specified future date. If it does not *redeem the financial instrument on that date, the dividend 'steps up' to an amount that would give a cost of finance higher than the issuer would otherwise have to incur.*

81 The IASB thinks that, even if the option not to redeem the financial instrument has some commercial substance, the overall substance of some such financial instruments might still be that of a liability, not equity. Although economic compulsion does not in itself create an obligation in the absence of a contract or other legal mechanism, it might be appropriate to take economic compulsion or significant economic incentives into account when determining whether a contractual claim against the entity is a liability or part of equity. However, the IASB thinks that it should consider any further requirements or guidance on this matter in the context of specific transactions, i.e. when developing or revising particular Standards, rather than in the Conceptual Framework. Hence, it proposes to limit the guidance in the Conceptual Framework to widely applicable principles, such as those set out in paragraph 78 above.

Executory contracts

82 The current Conceptual Framework states that in practice, obligations under contracts that are equally proportionately unperformed (for example, liabilities for inventory ordered but not yet received) are generally not recognised as liabilities in the financial statements. However, such obligations may meet the definition of liabilities and, provided the recognition criteria are met in the particular circumstances, may qualify for recognition.

83 The IASB thinks it could improve this guidance by explaining the nature of the rights and obligations that arise under executory contracts and other forward contracts and why those rights and obligations might not be recognised as an asset or a liability. It proposes to clarify that in principle, a net asset or a net liability arises under an executory contract if the contract is enforceable. However, if the contract was priced on arm's length terms, the initial measurement of that contract would typically be zero because the rights of one party have the same value as its obligations to the other party. Accordingly, it is usually the case that neither party recognises a net asset or a net liability at contract inception. After contract inception, one or both parties may need to recognise its asset or liability, depending on the measurement basis applied. The nature of the purchaser's rights and obligations under an executory contract or other forward contract may depend on the circumstances:

(a) *In some cases, the purchaser might have a single net right or net obligation to exchange the underlying asset and the purchase price simultaneously. Often, that net right or net obligation would be measured at zero.*

(b) *In other cases, the purchaser might have a separate gross right to receive the asset and a separate gross obligation to pay the purchase price. In practice, such rights and obligations are sometimes offset.*

EFRAG's response

EFRAG supports the additional guidance. However, it notes that the definition of control may be different from how some currently interpret the term. In addition EFRAG considers that the Conceptual Framework should provide additional guidance on when economic compulsion should be considered when distinguishing between equity and liability.

84 EFRAG supports the additional guidance to be included in the Conceptual Framework to explain the meaning of: 'economic resource'; 'control'; and 'transfer an economic resource'. It also supports the guidance provided on executory contracts.

85 However, EFRAG notes that some currently interpret 'control' in a different manner than what is proposed in the DP. Some are currently placing more emphasis on legal ownership, possession and ability to sell a resource rather than the ability to obtain the

benefits from it. For these, the change may therefore result in different types of assets being identified.

86 The DP only considers economic compulsion inside a contractual arrangement. EFRAG does not generally support economic compulsion outside a contractual arrangement being considered a relevant factor when determining whether an entity has an obligation to deliver an economic resource and therefore recognises a liability. However, EFRAG believes that economic compulsion has a different role to play when it is part of a contractual arrangement.

87 As it appears from paragraph 3.108 of the DP (see the first sentence of paragraph 81 above), the IASB considers that even when an option not to redeem a financial instrument has some commercial substance, the overall substance of some financial instruments might still be that of a liability, not equity. The IASB's proposal that a contractual option should only be ignored if it 'lacks commercial substance' may therefore not be appropriate.

88 EFRAG considers that in the cases where an entity can only avoid redeeming a financial instrument by transferring an asset, liability or equity instrument that it would not have otherwise done, a liability exists. EFRAG considers that this could be formulated as a principle that could be included in the Conceptual Framework. We do not support the suggestion of the DP only to deal with the issue at a standards level.

89 Similarly, EFRAG considers that a cumulative dividend blocker often should result in an instrument being a liability. In most cases, however, EFRAG thinks that this would also be the result of considering the commercial substance of an option specifying that if an entity would not pay any amount to the holder of a particular instrument every year, it would not be allowed to pay any dividend to ordinary shareholders (until it would have paid the amount (eventually accumulated) to the holder of the financial instrument). EFRAG considers that profit oriented entities will generally not be established without an intention of providing returns (in the form of dividends) to the ordinary shareholders and therefore an option to not make a contractual payment, subject to a cumulative dividend block, would not have commercial substance.

SECTION 4 RECOGNITION AND DERECOGNITION

Question 8

Paragraphs 4.1–4.27 of the DP [which are summarised below in paragraphs 90 to 96] discuss recognition criteria. In the IASB's preliminary view, an entity should recognise all its assets and liabilities, unless the IASB decides when developing or revising a particular standard that an entity need not, or should not, recognise an asset or a liability because:

(a) recognising the asset (or the liability) would provide users of financial statements with information that is not relevant, or is not sufficiently relevant to justify the cost; or

(b) no measure of the asset (or the liability) would result in a faithful representation of both the asset (or the liability) and the changes in the asset (or the liability),even if all necessary descriptions and explanations are disclosed.

Do you agree? Why or why not? If you do not agree, what changes do you suggest, and why?

Notes to constituents

90 The existing Conceptual Framework states that an entity recognises an item that meets the definition of an element if:

(a) *it is probable that any future economic benefit associated with the item will flow to or from the entity; and*

(b) *the item has a cost or value that can be measured with reliability.*

91 In addition, as with all other aspects of the existing Conceptual Framework, the cost constraint applies.

92 The IASB believes that it should delete references to probability from the recognition criteria in the Conceptual Framework.

93 In the IASB's preliminary view, the Conceptual Framework should (only) state that the IASB might decide in developing or revising particular Standards that an entity need not, or should not, recognise an asset or a liability:

(a) *if recognising the asset (or the liability) would provide users of financial statements with information that is not relevant, or not sufficiently relevant to justify the cost; or*

(b) *if no measure of the asset (or the liability) would result in a faithful representation of the asset (or the liability) and of changes in the asset (or the liability), even if all necessary descriptions and explanations are disclosed.*

94 Additional guidance could suggest that the following could indicate that recognition would not result in relevant information:

(a) *If the range of possible outcomes is extremely wide and the likelihood of each outcome is exceptionally difficult to estimate.*

(b) *If an asset (or a liability) exists, but there is only a low probability that an inflow (or outflow) of economic benefits will result.*

(c) *If identifying the resource or obligation is unusually difficult.*

(d) *If measuring a resource or obligation requires unusually difficult or exceptionally subjective allocations of cash flows that do not relate solely to the item being measured.*

(e) *If recognising an asset is not necessary to meet the objective of financial reporting (the DP notes that this is the case for internally generated goodwill).*

95 To provide relevant information to users of financial statements, the IASB may need to require disclosure about unrecognised assets or unrecognised liabilities, including perhaps disclosure about the factors, specified by the IASB, that led the IASB to conclude that recognition is not appropriate for those assets or liabilities.

96 However, the IASB acknowledge that the failure to recognise an asset or a liability is not rectified by disclosure of the accounting policies used nor by the notes or explanatory material.

97 The DP identifies no need for recognition criteria relating to the enhancing characteristics of comparability, verifiability, timeliness and understandability.

EFRAG's response

EFRAG agrees with the DP that relevance and faithful representation should be considered when deciding on recognition of assets and liabilities. EFRAG has not reached a consensus on whether the Conceptual Framework should include probability thresholds in relation to recognition.

98 EFRAG agrees with the DP that in deciding whether an asset or liability should be recognised, relevance and faithful representation should be considered. In other words, an item that would meet the definition of an asset or a liability should not automatically be recognised. Consistent with the preliminary views expressed in the Bulletin *Reliability of financial information*[3] and EFRAG's comment letter on the research paper

[3] This Bulletin was issued by EFRAG, ANC, OIC, DRSC and FRC in April 2013.

Toward a Measurement Framework for Financial Reporting by Profit-Oriented Entities, issued by the Canadian Institute of Chartered Accountants in 2012, EFRAG does not think that disclosures can compensate for large margins of errors in measurement, i.e. for the unreliability of measurement.

Questions to constituents

99 EFRAG has not reached a consensus on whether the Conceptual Framework should include probability thresholds related to the probability of inflows and outflows ('probability thresholds'). This draft comment letter therefore sets out two different views of EFRAG TEG members and asks constituents for their comments.

View 1 – Probability thresholds should be included in the Conceptual Framework

100 Supporters of View 1 think that the Conceptual Framework should include explicit probability thresholds. They agree with the DP that if recognising items does not produce relevant and reliable information, recognition should not take place. They also acknowledge that recognition criteria could be introduced on a standards level (instead of in the Conceptual Framework) as suggested by the DP based on relevance and faithful representation. However, they do not think this is the best solution because:

(a) It would enhance consistency amongst Standards to have a common set of recognition criteria.

(b) It would be difficult on a standards level to argue that it would not be relevant to recognise an item that would meet the definition of an asset or a liability. Therefore, although the DP mentions that a low probability of an inflow or outflow may indicate that recognising an asset or liability would not be relevant, the role of this indicator may be minor.

(c) The role of Conceptual Framework is also to provide guidance when issues are not dealt with in specific Standards. It would thus be helpful if the Conceptual Framework could provide guidance, in the form of probability thresholds, on when it would not be relevant to recognise an item.

101 While supporters of View 1 think that the Conceptual Framework should include recognition criteria, they do not think that the criteria should be the same for all items. They consider that the following three-step approach should be considered when recognising assets and liabilities:

(a) First, it should be considered whether the main component of the asset or liability represents an outcome risk or is linked to an item that represents an outcome risk. If this is the case, then no probability threshold related to uncertainty should apply. The main component of an asset or liability represents an outcome risk if the item has no value on its own but increases or reduces the holder's exposure to a certain risk. In most cases, the holder has to pay for such an item if it reduces the holders' exposure to a certain risk (e.g. an insurance or an option). However, in some cases, such as in the case of a lottery ticket, the holder pays for an increased risk exposure.

(b) If the main component of the asset or liability is not an outcome risk, then it should be assessed how reliable/verifiable the probabilities related to various outcomes can be determined. If the probabilities related to various outcomes can be determined with a high degree of reliability/verifiability, then assets and liabilities should only be recognised if it is more likely than not that an expected inflow or outflow will happen.

(c) If the probabilities related to various outcomes cannot be determined with a high degree of reliability/verifiability, then liabilities should be recognised unless the probability of an outflow is remote and an asset should be recognised when the probability of an inflow is virtually certain.

The three steps are further explained in the following paragraphs.

Step 1

102 Some transactions are entered into for the purpose of obtaining or reducing/eliminating exposure to a certain risk. This is, for example, the case when an entity purchases or sells a lottery ticket, an insurance contract and a financial derivative. In these items, the risk component is the main feature.

103 In other cases uncertainty about outcome arises as the entity is carrying out activities (this is, for example, the case for court cases, uncertainty about collectability of receivables and uncertainty about whether a deferred tax loss can be utilised in future periods) or because the entity is acquiring or issuing assets and liabilities where uncertainty about outcome is a component, but not the only main component (e.g. property, plant and equipment and bonds).

104 The supporters of View 1 think that for items where the entity is transferring or receiving resources for items that mainly consist of an element related to the uncertainty of the outcome (those mentioned in paragraph 102 above) there should be no probability threshold regarding the uncertainty of the outcome. Assets and liabilities closely linked to such an item should also be recognised without considering any probability thresholds. A close link, for example, exists between a hedging instrument and the item containing the hedged risk.

Step 2 and step 3

105 In all other cases, there should be a probability threshold related to the uncertainty of outcome. For prudential reasons the threshold should be higher for assets than for liabilities.

106 Assets should be recognised when it is virtually certain that they will result in an inflow of economic resources or when it is virtually certain that the probability of an inflow is more likely than not. The latter means that for an asset to be recognised it should be possible to make reasonably estimates about the likelihood that an inflow will occur, and the probability of an inflow to occur should be more likely than not.

107 Liabilities should not be recognised if the likelihood of an outflow is remote and when it is virtually certain that the probability is less likely than not.

108 Supporters of View 1 consider that these criteria reflect that when it is possible to make good estimates about the probabilities related to possible inflows and outflows, the probability thresholds for assets and liabilities are the same. However, when it is difficult to estimate the probabilities, caution has to be exercised.

109 Supporters of View 1 considers that there can be cases where guidance in a specific Standard may conflict with the recognition criteria. This would be acceptable. The recognition criteria should only provide the basis or rebuttable presumption for how probability threshold should be set.

View 2 – The Conceptual Framework should not include probability thresholds

110 Supporters of View 2 agree with the tentative view of the IASB that the Conceptual Framework should not include explicit probability thresholds relating to outcome and existence uncertainty. However, two different arguments are presented in support of that view.

111 Some EFRAG TEG members support the arguments of View 1 for including probability thresholds in the Conceptual Framework. These EFRAG TEG members, however, think it would be difficult to establish probability thresholds that would work for all types of assets and liabilities. These members are particularly concerned about the probability threshold for liabilities suggested in paragraphs 104 and 107 above, as they think these criteria could result in some liabilities that are currently recognised, not being recognised.

112 As these EFRAG TEG members think that it would be difficult (or even impossible) to set appropriate probability thresholds in the Conceptual Framework, they support the proposal of the IASB not to include them in the Conceptual Framework.

113 Other EFRAG TEG members note that when deciding on a standards level what assets and liabilities should be recognised, the conclusion should be driven by the objective of providing relevant and reliable information. In some cases, as with some financial derivatives, it may always be considered to result in the most relevant information to recognise these even if the outcome probability is very low. In other cases, for example in relation to assets resulting from litigations, it may make sense to have a high probability threshold. There may also be situations where, it would make sense to have higher thresholds for assets than for liabilities but in other situations this may not result in the most relevant information. For example, where assets and liabilities are interlinked.

114 These EFRAG TEG members believe that introducing explicit probability thresholds in the Conceptual Framework may reduce the flexibility to prepare Standards that result in the most relevant and reliable information being provided and may prevent that an entity's business model is reflected.

115 Supporters of View 2 thinks that the Conceptual Framework should include indicators for when not recognising assets and liabilities would be beneficial from a relevance and/or reliability point of view, although no probability thresholds should be included in the Conceptual Framework. These criteria should not only apply to the IASB when setting its Standards, but also to entities looking for guidance on issues not covered in specific Standards.

Question

116 Which, if any, of the views presented above do you support, and why? If you do not support any of the views, what is your view on the proposal included in the DP on recognition?

117 In accordance with the view expressed in response to Question 1, EFRAG thinks that it should be possible for the IASB to decide on a standards level that certain items should be recognised as assets or liabilities even when they do not meet the definitions of such. However, such a departure from the Conceptual Framework has to be explicitly justified.

Question 9

In the IASB's preliminary view, as set out in paragraphs 4.28–4.51 of the DP [which are summarised below in paragraphs 118 to 126], an entity should derecognise an asset or a liability when it no longer meets the recognition criteria. (This is the control approach described in paragraph 4.36(a)). However, if the entity retains a component of an asset or a liability, the IASB should determine when developing or revising particular Standards how the entity would best portray the changes that resulted from the transaction. Possible approaches include:

(a) enhanced disclosure;

(b) presenting any rights or obligations retained on a line item different from the line item that was used for the original rights or obligations, to highlight the greater concentration of risk; or

(c) continuing to recognise the original asset or liability and treating the proceeds received or paid for the transfer as a loan received or granted.

Do you agree? Why or why not? If you do not agree, what changes do you suggest, and why?

Notes to constituents

118 The existing Conceptual Framework does not define derecognition and does not describe when derecognition should occur.

119 The DP notes that derecognition has the following consequences:

(a) *The entity no longer recognises a previously recognised asset or liability;*

(b) *The entity may need to recognise other assets and liabilities that result from the transaction or other event that gave rise to the derecognition; and*

(c) *Income or expense may arise from the derecognition of the previous asset or liability and the recognition of any new asset or liability.*

120 The DP states that the aim of accounting requirements for a transaction that may result in derecognition should be to represent faithfully both:

(a) *the resources and obligations remaining after the transaction; and*

(b) *the changes in the resources and obligations as a result of the transaction.*

121 Achieving that twin aim is difficult if the entity retains a component that exposes the entity disproportionately to the remaining risks or rewards arising from the previously recognised asset or liability. The DP states that there are two approaches to derecognition in such cases:

(a) *a control approach: derecognition is simply the mirror image of recognition. This implies that the derecognition criteria for an asset would focus on the control of the asset (rather than on legal ownership or on risks and rewards) and the derecognition criteria for a liability would focus on whether the entity still has the liability.*

(b) *a risk-and-rewards approach: an entity should continue to recognise an asset or a liability until it is no longer exposed to most of the risks and rewards generated by that asset or liability, even if the remaining asset (or liability) would not qualify for recognition if acquired (or incurred) separately at the date when the entity disposed of the other components. Thus, whether an entity recognises an asset or a liability depends, in some circumstances, on whether the entity previously recognised that asset or liability.*

122 The IASB is concerned that:

(a) *in some cases derecognition based on the control approach could result in smaller amounts in the statement of financial position, even though the entity is still exposed to risks of similar magnitude.*

(b) *in some cases, derecognition produces a gain or loss that would not arise at that time if the entity treated the cash received as arising from a financing transaction.*

123 The DP considers the following two approaches to account for derecognition when a transaction eliminates some but not all of the rights and obligations contained in an asset (or a liability):

(a) *Full derecognition: derecognise the entire asset (or liability) and recognise the retained component as a new asset (or liability).*

(b) *Partial derecognition: continue to recognise the retained component and derecognise the component that is not retained.*

124 The DP notes that it is likely that the IASB would need to decide whether to apply a full derecognition approach or a partial derecognition approach when it develops or revises particular Standards, because that decision depends on the unit of account which is proposed to be decided on a standards level.

125 One other factor to be considered under a partial derecognition model is whether the component retained should be regarded as continuing to be a component of the *original asset, or whether its character has changed so much that it should be regarded as an entirely new asset.*

126 If the entity retains a component of an asset or the liability, the DP notes that the IASB should determine, when developing or revising particular Standards, how the entity would best portray the changes that resulted from the transaction. Possible approaches include:

(a) *enhanced disclosure;*

(b) *presenting any rights or obligations retained on a line item different from the line item that was used for the original rights or obligations, to highlight the greater concentration of risk; or*

(c) *continuing to recognise the original asset or liability, and treating the proceeds received or paid for the transfer as a loan received or granted.*

EFRAG's response

EFRAG supports the proposals included in the DP, but thinks guidance should be provided on the difference between a modification of an asset or liability and derecognition of an asset or liability and recognition of another.

127 EFRAG agrees with the DP that in most cases an asset or a liability should be derecognised when it no longer meets the recognition criteria (or no longer exists), or is no longer an asset or a liability of the entity. However, there may be cases where another approach may result in more useful information. EFRAG therefore also agrees with the DP that when the entity retains a component of an asset or a liability, the IASB should determine, when developing or revising particular Standards, how the entity would best portray the changes that resulted from the transaction.

128 However, EFRAG considers that the IASB should develop on a Conceptual Framework level principles that could be used to distinguish modifications from derecognition of one asset or one liability and recognition of another asset or liability.

SECTION 5 DEFINITION OF EQUITY AND DISTINCTION BETWEEN LIABILITY AND EQUITY ELEMENTS

Question 10

The definition of equity, the measurement and presentation of different classes of equity, and how to distinguish liabilities from equity instruments are discussed in paragraphs 5.1-5.59 of the DP. In the IASB's preliminary view:

(a) the Conceptual Framework should retain the existing definition of equity as the residual interest in the assets of the entity after deducting all its liabilities.

(b) the Conceptual Framework should state that the IASB should use the definition of a liability to distinguish liabilities from equity instruments. Two consequences of this are:

  (i) obligations to issue equity instruments are not liabilities; and

  (ii) obligations that will arise only on liquidation of the reporting entity are not liabilities (see paragraph 3.89(a) of the DP).

(c) an entity should:

  (i) at the end of each reporting period update the measure of each class of equity claim. The IASB would determine when developing or revising particular Standards whether that measure would be a direct measure or an allocation of total equity.

  (ii) recognise updates to those measures in the statement of changes in equity as a transfer of wealth between classes of equity claim.

(d) if an entity has issued no equity instruments, it may be appropriate to treat the most subordinated class of instruments as if it were an equity claim, with suitable disclosure. Identifying whether to use such an approach, and if so, when, would still be a decision for the IASB to take in developing or revising particular Standards.

Do you agree? Why or why not? If you do not agree, what changes do you suggest and why?

129 EFRAG has responded to each of the sub-questions to Question 10 individually in the paragraphs below.

130 Generally, EFRAG notes that at least one item on the statement of financial position cannot be directly measured, but is instead the residual (balancing figure) of all other items. This is currently equity, and the DP proposes retaining this.

131 In current IFRS, the owners of the entity are currently identified as 'holders of instruments classed as equity'[4]. Consequently, the current Conceptual Framework specifies income and expense in relation to changes in equity. Any increases (decreases) in equity, other than those relating to contributions from (distributions to) equity participants are defined as income (expense).

132 A change in the definition of equity therefore also has consequences for performance reporting.

The definition of equity – part (a) of IASB question

Notes to constituents

133 The IASB proposes retaining a definition of equity as the residual interest in the assets of the entity after deducting all of its liabilities.

134 In particular, total equity is equal to total assets, less total liabilities, as recognised and measured in the financial statements and does not depict the value of the entity.

[4] IAS 1 *Presentation of Financial Statements*, paragraph 7.

EFRAG's response

EFRAG supports retaining a split between equity and liability claims and equity being the residual claim on the entity that is not directly remeasured.

135 EFRAG notes that the notion of equity as a residual is important because at least one element cannot be directly measured. For the statement of financial position to balance, this element is the residual of all of the other elements.

136 In current IFRS, this residual element is equity and the residual nature is the reason why once something has been recognised in equity it is generally not directly remeasured. Although the carrying values of some parts of equity, for example non-controlling interest, are updated, this is not a direct remeasurement: it simply reflects changes in the part of the residual (assets less liabilities) owned by non-controlling interests.

137 EFRAG believes that, in this context, the notion of residual has two important and distinct meanings as:

(a) The part of the statement of financial position which is not directly remeasured; and

(b) A claim on the entity which is not an obligation to deliver an economic resource.

138 In respect of (a) EFRAG, in general, supports the notion of equity as the element of the financial statements that is not directly remeasured, but does not believe defining it as such is entirely consistent with some of the IASB's proposals, especially those with respect to the remeasurement of some equity claims. The effect of the IASB's proposals is that only some equity claims (i.e. primary equity claims – as discussed later) are considered residual. EFRAG has a number of concerns regarding those proposals, which are set out later in this comment letter.

139 In relation to (b) EFRAG does not believe that a definition of equity as the residual interest in the assets of the entity after deducting all of its liabilities is particularly helpful, merely a repetition of the accounting identity for the statement of financial position: assets equal liabilities plus equity. Current IFRS defines equity as a claim where there is no obligation to transfer economic resources. Alternative definitions of equity and liability could also be satisfied by this equation (for example, a liability could be defined as a claim that reduces the resources available for distribution to equity).

Does the statement of financial position need to be split between equity and liabilities?

140 The claims on an entity have numerous characteristics, including maturity (or lack of), rights to contribute to decision-making, ability to absorb losses and fixed versus variable return. There is no limit to how such characteristics could be combined in a single instrument. Therefore some believe that any split between equity and liabilities based on characteristics of an instrument portrays no more information on the nature of the claim than the chosen criteria.

141 EFRAG is aware of suggestions that the statement of financial position should depict and describe these various claims as a continuum rather than a split between equities and liabilities (described variously as a 'no-split' or 'claims' approach). Under such an approach, the statement of financial position would not be split between liabilities and equity, but would instead list the claims on the entity's assets and disclose the characteristics of each claim in the notes. Any distinction between the different types of capital provided to an entity would be at the discretion of the user of the financial statements who could then make his/her own definition of equity according to his/her specific user needs.

142 However, at least one type of claim cannot be remeasured directly without remeasuring the entire entity[5]. If there were to be a class of claims that were not remeasured, then this would, implicitly, be accepting that some claims are different to others. It would be a liability/equity distinction, even if not called by that name.

143 Given that at least one category of claims cannot be remeasured directly, EFRAG supports explicitly splitting the claims side of the statement of financial position between liabilities and equity, and the retention of a definition of equity as the residual (in this sense) being retained. However, EFRAG notes that this definition of a residual is not consistent with the proposals in the DP for direct remeasurement of equity claims: under the proposals only primary equity claims are a residual.

Distinguishing between equity and liabilities

Notes to constituents

144 The IASB is proposing that, consistent with current IFRS, the distinction between equity instruments and liabilities is based on the characteristics of the instruments and that an instrument with the same characteristics be classified consistently across entities. An equity instrument would therefore be a claim on the entity that is not a liability. This approach means that instruments with the same characteristics are classified consistently as equity or liabilities. The owners of the entity would be determined by those who hold instruments classified as equity. This could be seen as being consistent with an entity perspective to financial reporting.

145 An alternative approach is to identify equity as the class of instruments that are held by owners in their capacity as owners, no matter what characteristics the instrument has. The IASB call this the 'Narrow Equity Approach', and propose that the class of instruments is identified as being the most residual instrument issued by the entity. This could be seen as being consistent with a proprietary perspective to financial reporting.

EFRAG's response

Before deciding on specific requirements for identifying equity, EFRAG believes it is important to decide if this is being done from an entity or proprietary perspective to financial reporting.

146 EFRAG believes that there are two basic approaches to determining how equity (as the residual claim on an entity) is defined:

(a) Equity can be determined as the instruments held by the owners of the entity, and any claim that reduces the returns to these is a liability; or

(b) Equity can be determined based on the characteristics of the instruments issued by an entity.

147 These two approaches could be seen as being consistent with a proprietary and entity perspective to financial reporting respectively.

<u>A proprietary perspective – the instruments held by the entity's owners are equity</u>

148 If financial statements are being prepared from the proprietary perspective, it appears necessary to identify the instruments that convey an ownership interest and proceed from there: such instruments are equity, and all other claims are liabilities. One way of doing this is set out as the *Narrow Equity Approach* in the DP. We note that the FASB Preliminary Views document *Financial Instruments with Characteristics of Equity* (FICE) started from a basis of identifying an instrument that conveyed a 'basic ownership interest.'

[5] Based on the statement in paragraph OB7 of the Conceptual Framework that the purpose of financial reporting is not to show the value of a reporting entity. Without this restriction all claims could be directly measured and something else, such as internally generated goodwill, could be the residual.

149 EFRAG believes that an approach to distinguishing between liabilities and equity on the basis of ownership interest as equity has a number of attractive features. For example, it would provide a conceptual basis to solving classification problems that have arisen in relation to a number of instruments, including puttable shares, non-controlling interests and puts/forwards over own equity.

150 However, if such an approach to distinguishing liabilities and equity were to be taken, instruments with the same characteristics could be classified differently by different entities, reducing comparability. Some of the roles equity has traditionally been perceived as fulfilling, including as a buffer against losses by holders of less-subordinated claims (such as bond-holders), would also not necessarily be compatible with a notion of equity based on a proprietary approach. As noted in the DP, if such a distinction between equity and liability were to be adopted, it would also require a subsequent change to the definition of a liability.

151 EFRAG also believes that such an approach would raise significant issues in relation to relevance with respect to some corporate structures, for example entities in which the basic ownership instrument is a demand deposit.

152 Within such an approach, there remain a number of significant unanswered questions on how to identify what instruments contain an ownership interest. EFRAG does not believe an approach based on limiting this to the 'most residual' instrument – as suggested in the DP – of an entity is appropriate, because:

(a) The instrument that is most residual may change depending on other instruments (including those issued later);

(b) Different instruments may be the most residual depending on how residual is defined, particularly whether it is defined with respect to participation in ongoing returns, subordination or participation on liquidation; and

(c) It is unclear how the concept of residual interest applies in a group context, given the potential extent of structural subordination. For example, in the case of the insolvency of the parent of a group, equity holders in subsidiaries may have a higher claim on underlying net assets than the creditors of the parent (who would merely have a claim on the shares held by the parent).

153 One potential way of avoiding these difficulties would be to allow entities a free choice of which instrument is designated as the basic ownership instrument.

154 If only a basic ownership instrument were defined as equity there would be some instruments that, despite not imposing any obligation on the entity to transfer an economic resource, would be labelled as liabilities. As liabilities are measured directly, these instruments would be directly measured (on a basis such as at fair value) and changes in the carrying value taken through comprehensive income.

155 Therefore, the following would be the result:

(a) Shares in subsidiaries held by non-controlling interest would be recognised as liabilities, the carrying value updated at each reporting date and changes in this carrying value taken through comprehensive income;

(b) Other classes of ownership instruments (such as other classes or types of shares including perpetual interest bearing, deferred or preference shares; or the interests of limited partners) would be recognised as liabilities, the carrying value updated at each reporting date, and changes in this carrying value taken through comprehensive income.

156 EFRAG is not convinced that this would provide meaningful information to users of financial statements, but believes it would be consistent with an approach in which equity is determined by reference to the class of instruments held by owners.

157 During the FICE project two possible approaches were explored that would result in equity being defined wider than the basic ownership instrument. These, the *ownership-*

settlement approach and the *revised expected outcomes* approach were not pursued further, partially due to the level of complexity required to determine whether any particular instrument was equity.

158 These difficulties were in a US GAAP context of identifying equity in a single legal framework. EFRAG believes that identifying appropriate principles to distinguish which instruments are ownership instruments would be even more difficult in IFRS given that these principles would need to apply across a wide range of legal and regulatory systems.

159 As such, EFRAG believes further work would be required to identify principles that could be used, in the context of a proprietary perspective, to identify what instruments, other than a basic ownership instrument, would also be classified as equity.

<u>An entity perspective to identifying equity</u>

160 An alternative basis to distinguish between equity and liabilities is to distinguish based on the characteristics of the instruments issued, an approach which may be considered to be consistent with an entity perspective.

161 There are a number of characteristics that could be used, including control, the presence or absence of an obligation to deliver economic resources and loss absorption. Although the DP suggests using presence, or absence, of an obligation to issue economic resources as the distinguishing factor EFRAG believes that using other characteristics would be similarly consistent with an entity perspective: deciding upon an entity perspective to distinguishing equity does not necessarily lead to the suggestions set out in the DP.

162 An approach of distinguishing between equity and liability instruments based on the presence, or absence, of an obligation to deliver economic resources, as is basically the case in current IFRS and the approach suggested by the DP, has a number of advantages. These advantages include:

(a) Consistency with the current and proposed definitions of a liability in that an instrument would not be able to be both simultaneously a liability and equity[6];

(b) Relative simplicity;

(c) Consistency with the accounting identity of assets equalling liabilities plus equity;

(d) Consistent depiction of an entity's leverage;

(e) Consistency with a view of equity as a 'buffer' that protects holders of less subordinated claims from loss; and

(f) Comparable application across a broad range of instruments and legal/regulatory environments.

163 However, EFRAG believes that there could be other, perhaps more appropriate characteristics, used to distinguish between equity and liabilities. In particular, EFRAG notes that the current requirements have led to financial reporting that many believe is counter-intuitive for a number of instruments. These instruments include:

(a) Puttable shares;

(b) Derivatives over own equity including NCI Puts; and

(c) Instruments that require an entity to distribute an amount based on a proportion of profit or revenue.

164 The 2008 Proactive Accounting Activities in Europe (PAAinE) Discussion Paper *Distinguishing Between Liabilities and Equity* identified a loss absorption approach as

[6] However, a single legal contract could contain multiple financial instruments, and thus require separate recognition of each component.

one way to distinguish based on the characteristics of instruments. Although this approach was more complex than the current approach in IFRS and did not depict an entity's leverage EFRAG believes that it better depicted the ownership structures of the wide range of entities required to report under IFRS in Europe. As such it, and other similar approaches, should be investigated further.

165 However, in the absence of widespread agreement on another distinguishing characteristic, EFRAG supports the presence – or absence – of an obligation as being an appropriate basis to distinguish between equity and liabilities.

166 This support is expressed solely on the basis of lack of a better defining characteristic, and EFRAG believes that relying solely on this characteristic does not always result in appropriate classification of the basic ownership instruments in some corporate structures common across Europe, including partnerships and other structures involving puttable instruments. EFRAG believes that it is important that the Conceptual Framework contains appropriate guidance for the development of Standards that would result in useful information for users, including the holders of these ownership instruments.

167 EFRAG has therefore identified two important factors that it believes should be included in the Conceptual Framework to assist in producing Standards that result in useful information:

(a) The logic expressed in IFRIC 2 *Members' Shares in Co-operative Entities and Similar Instruments* should be repeated at the conceptual level. IFRIC 2 states that, in determining whether an obligation exists, an entity must consider all of the terms and conditions of a financial instrument, including relevant local laws, regulations and the entity's governing charter. EFRAG supports this and believes that it is important guidance for determining whether an obligation exists and is enforceable. As such, this or similar guidance should be included in the Conceptual Framework.

(b) The Conceptual Framework should acknowledge the important role of basic ownership instruments, even within the context of financial reporting where equity is defined based on the characteristics of instruments and should lead to the development of Standards that acknowledge the importance of these instruments. One way in which this could be done would be through disclosure. For example, a future revised standard on the presentation of financial statements could contain an optional disclosure of a statement of financial position and statement(s) of profit or loss and other comprehensive income where the distinction between equity (as the class of claims not directly remeasured) and liabilities was on the basis of what the entity chose to identify as its basic ownership instruments. These may be similar to those currently contained in Examples 7 and 8 of IAS 32 *Financial Instruments*.

168 This would result in the presentation of information from the perspective of the holders of these basic ownership instruments that would have the status of GAAP, but also preserve the comparability and principles-based financial reporting of the primary statements. If such an approach were taken, it would be important that the XBRL taxonomy reflected this.

169 EFRAG also believes that the ideas being developed in the *Financial Statements Presentation* project (for example separating the operating performance of an entity from its financing activities) were highly relevant to this discussion, and that the content of the final Conceptual Framework should not limit future developments in this area.

Obligations to issue equity instruments

Notes to constituents

170 The DP informally describes two categories of equity:

(a) *Primary equity claims; and*

(b) *Secondary equity claims.*

171 Primary equity claims would be those equity claims that contain a right to share in distributions in equity, either during the life of an entity or on liquidation.

172 Secondary equity claims would be contractual arrangements that result in the entity being obliged to deliver, or have a contractual right to receive, other equity instruments (which could be either primary or secondary equity claims).

173 In IFRS there is currently no conceptual guidance on how obligations to deliver equity instruments (a secondary equity claim) should be classified. IFRS 2 Share-based Payment requires that obligations to deliver shares where the obligation derives from the receipt of goods or services be classified as equity, even when the number of shares to be delivered varies, based on value of the shares or otherwise. IAS 32 Financial Instruments: Presentation *requires an obligation to deliver equity shares to be classified as a liability, unless a fixed number of equity shares will be exchanged for a fixed amount of cash (which may be zero), in which case the obligation to deliver is classified as an equity instrument.*

174 In the DP, the IASB proposes that all such contractual rights and obligations, including forwards and options over equity instruments and share-options issued in exchange for goods and services, be classified as equity. Contractual arrangements where an entity has the right to choose whether to settle in equity instruments or by exchange of an economic resource would also be classified as equity (subject to the contractual option to settle in equity having commercial substance, as discussed earlier in this letter).

175 The IASB believes that this will better show the cash leverage of the entity, which is of particular importance to non-equity providers of capital.

176 An entitlement to receive an equity instrument (for example a physically settled purchased call option) would not be classified as an asset because, if and when an entity receives the share on settlement, that share would not be an asset, but a reduction in equity. This means that a right to receive an equity instrument would be presented similarly to how treasury shares are currently and changes in the measurement of this right presented as a 'wealth transfer'.

EFRAG's response

EFRAG believes that primary and secondary equity claims are fundamentally different, and that the Conceptual Framework should reflect this. In particular, it would be inappropriate for holders of secondary equity claims to be described as the owners of an entity.

177 EFRAG agrees that classifying as equity all obligations that an entity may choose to settle with equity instruments could provide important information on the cash leverage of an entity. Although an entity may choose to satisfy such obligations by purchasing shares in the open market (rather than issuing new ones), that is a separate transaction and it is appropriate that it be accounted for as such.

178 EFRAG does not believe, however, that an obligation that the entity can satisfy by delivering an equity instrument is economically or contractually the same as an equity instrument that does not contain any obligation and notes that the requirements in IAS 32 to classify most obligations to deliver own equity as liabilities appear to have been driven by a desire to avoid entities structuring transactions to obtain a particular treatment in comprehensive income rather than with respect to the implications for the statement of financial position.

179 Current IFRS defines an entity's owners as the holders of its equity instruments. If the decision was taken to classify obligations to deliver equity claims as equity, a subsequent change to IFRS would be required to recognise this distinction.

Primary and secondary equity claims

180 EFRAG believes that primary equity claims (as described in the DP) are fundamentally different from secondary equity claims: secondary equity claims involve an enforceable right or obligation for the entity to receive or deliver something.

181 A primary equity claim, however, does not, by definition, contain any obligation on the entity to deliver anything.

182 Secondary equity claims involve an entity's contractual obligation to deliver, or contractual right to receive, equity instruments. These include options, warrants and forwards. These enforceable rights and obligations can be measured as if they were financial assets and liabilities. A secondary equity claim is a legal obligation to deliver (or receive) equity instruments, unlike a primary equity claim which is a claim on net assets without obligation. Secondary equity claims can be remeasured without requiring remeasurement or valuation of the entire entity.

183 One possible way for the Conceptual Framework to make clear the differences between primary and secondary equity claims would be to amend the definitions of assets and liabilities to include obligations to receive or deliver own equity (similar to some requirements in current IFRS). However, EFRAG notes that this results in an inconsistency, particularly with respect to treasury shares: the right to receive them would be classified as an asset, but upon settlement would be recognised as a debit within equity.

184 This difference between an obligation that may be satisfied by delivery of equity instruments and the underlying equity instruments themselves can be evidenced from the policies of credit ratings agencies in the 'equity credit' they apply to hybrid instruments that contain secondary equity claims, compared to the pure equity of primary equity claims.

185 There is also an important link with who an entity's owners are. As noted above, current IFRS describes owners as holders of instruments classed as equity. EFRAG does not believe that holders of secondary equity claims can accurately be described as the owners of an entity: they do not have a current unconditional claim on the residual net assets of an entity, but have a potential claim, that may or may not result in an eventual claim. Secondary equity claims could include claims that arise from an entity's trading, borrowing and investing activities and it would be inappropriate to describe these as owners of the entity. Examples of such claims could include:

(a) Holders of an instrument that obliges the entity to deliver CU100 of cash or CU110 of shares;

(b) Holders of an instrument that only converts to shares if the entity's regulator determines that the entity has breached capital adequacy regulations; and

(c) Derivatives used for speculation that include an option for the entity to deliver its own shares rather than cash on settlement.

186 EFRAG notes that the DP also explains (in paragraph 5.18) how these two types of claims are different from each other, but believes that the Conceptual Framework should explicitly acknowledge this and state that holders of secondary equity claims, in their capacity as holders of these claims, are not owners of an entity.

187 Therefore, EFRAG would support the Conceptual Framework stating that obligations to deliver (and rights to receive) equity instruments are equity claims, but only if the distinction between primary and secondary equity claims is explicitly acknowledged, only holders of primary equity claims are described as owners and subject to our reservations regarding remeasurement below.

Remeasurement of equity claims

Note to constituents

188 The total of equity is, by definition, assets minus liabilities. However, there could be different categories within equity. For example, local legislative requirements frequently require recognition of categories such as retained earnings, share capital and share premium. For example IFRS currently requires separate recognition within equity of non-controlling interests and revaluation reserves.

189 NCI within equity is currently remeasured to reflect changes in NCI's share of the residual net assets in a non-wholly owned subsidiary and does not represent anything other than changes in the carrying value of these asset and liabilities. In particular, it does not represent the 'value' of the NCI stake any more than the book value of equity represents the market value of ordinary shares.

190 Secondary equity claims include warrants and employee share options. Negative secondary equity claims, such as an entity's right (or obligation) to receive its own equity instruments also exist. How such claims are remeasured would be decided at a standards level, but the DP suggests that the IASB may decide that:

(a) *Primary equity claims could be remeasured based on the allocation of residual net assets (similar to NCI in current IFRS); and*

(b) *Secondary equity claims could be remeasured in the same manner as a financial asset or liability.*

191 From this, it does not appear that if an entity had two classes of primary equity claim which had a share on the residual net assets (for example two classes of ordinary shares, each of which had entitlement to a dividend in different currencies or different voting rights) any remeasurement of these would take place. Therefore the approach with respect to primary equity claims would appear to be consistent with the current requirements with respect to Non-controlling Interests.

192 However, the requirements with respect to secondary equity claims would be significantly different. This is consistent with the fact that holders of secondary equity claims are in a different contractual relationship to holders of primary equity claims, and that secondary equity claims can be measured as if they were financial assets or liabilities. For example:

(a) *An obligation to deliver shares for employee share options could be measured at current values of the inputs to the model used to value them (for the Black-Scholes model: share price, volatility, risk-free rate and dividend yield).*

(b) *An obligation to deliver shares worth €100 in one year's time could be measured at the present value of €100.*

193 The DP proposes that changes in each class of equity resulting from a remeasurement be reflected in the statement of changes in equity and called a 'wealth transfer'. Wealth transfers are described as being akin to contributions of equity by one class and equal distributions of equity to other classes.

194 The IASB believes that this would give equity holders a clearer and more systematic view of how other equity claims affect them, including the nature and extent of potential dilution.

EFRAG's response

EFRAG does not support the notion of 'wealth transfer' to describe changes in secondary equity claims.

EFRAG has an alternative proposal that ensure an entity's trading, borrowing and investing activities are presented within comprehensive income. This alternative proposal also provides a conceptual basis to addressing what some see as the counter-intuitive accounting in comprehensive income for puttable instruments, including NCI puts.

195 EFRAG does not support the use of a notion of 'wealth transfer' to describe changes in equity claims and believes that this proposal would significantly increase the complexity of financial reporting, reduce understandability and lead to information necessary to understand an entity's performance, including some of its trading, borrowing and investing activities, being reflected in the statement of changes in equity rather than in the statement(s) of profit or loss and other comprehensive income.

196 EFRAG notes there is a link to instruments where the entity is entitled to choose the method of settlement. Under the proposals in the DP, such an instrument would be an equity instrument unless the option to settle in equity instruments had no commercial substance. Experience with such requirements in current IFRS (for example in paragraph 25(a) of IAS 32) has shown that this is a very high hurdle.

197 Under the proposals in the DP, two transactions could be identical in how they are initiated, remeasured and settled, but because one of them contained an option (which may be extremely unlikely to be used) for the entity to settle in its own equity remeasurement of one claim would be portrayed in comprehensive income and the other within the statement of changes in equity.

198 The proposals in the DP would also not provide a conceptual solution to what some see as the counter-intuitive accounting in comprehensive income for puttable instruments, including puts on shares held by non-controlling interests ('NCI puts'). Current IFRS requires a liability to be recognised for a puttable instrument at the present value of the amount the entity may be obliged to pay. Paragraph 23 of IAS 32 applies that requirement even if the put option is contained within a separate contract. Changes in the carrying value of such a liability are recognised in comprehensive income.

199 For an instrument puttable at fair value, as the entity performs better the liability increases and an expense is recognised. Under the IASB's proposals, the entity's right (upon the put being exercised) to receive the share would presumably be reflected as a wealth transfer: resulting in volatility in both the statement(s) of profit or loss and other comprehensive income and the statement of changes in equity.

Primary equity claims

200 EFRAG agrees that the various primary equity claims on an entity should be portrayed based on claims on recognised net assets, as is the case with respect to NCI currently. This is a logical consequence of the notion of equity as a residual. However, as noted earlier if secondary equity claims are to be directly remeasured then it is no longer equity as a whole that is the residual: it is primary equity claims.

Secondary equity claims

201 The proposals in the DP with respect to secondary equity claims appear to be attempting to meet two objectives:

(a) Portraying the impact of dilution (or potential dilution) of secondary equity claims on holders of primary equity claims; and

(b) Portraying the performance of an entity with respect to contracts where the contract includes an option for the entity to deliver its own equity.

Portraying dilution

202 EFRAG is not convinced that the IASB's proposals would provide enough information for holders of equity instruments to understand how they may be diluted. Furthermore, EFRAG believes that what is important about dilution is potential dilution in the future, not the amount of dilution that had occurred at the reporting date.

203 In particular, EFRAG notes that two important sources of potential dilution would not be portrayed at all under the IASB's proposals:

(a) Dilutive instruments that are liabilities; and

(b) Instruments that dilute the claims of holders of equity instruments on the occurrence of an event that is determined to be within the control of the entity.

Dilutive instruments that are liabilities

204 Some instruments that dilute the returns to holders of equity instruments would be classified as financial liabilities and the potential dilution due to these would not be portrayed. Such instruments include:

(a) Convertible bonds;

(b) Instrument where the entity is required to transfer either cash or an equivalent value of equity instruments at the option of the holder; and

(c) Instruments that convert to equity only if a regulator/supervisor requires them to.

205 As these would meet the definition of financial liabilities under the proposals in the DP, it is not clear how, or if at all, the potential dilutive effects of these would be portrayed.

206 While it may be relatively simple for instruments such as convertible bonds to be split into equity and liability components[7], other such combined instruments are not so easily split at initial recognition. The proposals do not appear to effectively portray the dilutive effect of such instruments.

Instruments that dilute on the occurrence of events within the control of an entity

207 No liability is recognised for obligations that will only arise for situations within an entity's control, and presumably no secondary equity claim would be recognised for these obligations. The obligation to deliver equity instruments could crystallise on circumstances such as:

(a) An Initial Public Offering;

(b) A takeover; or

(c) The disposal of a portion of the entity.

208 Obligations that result in significant dilution of the claims of the holders of equity instruments can be involved, and the proposals in the DP do not appear to portray them.

How should dilution be portrayed?

209 EFRAG does not believe that dilution, and more importantly potential dilution, can be portrayed effectively in a single statement of changes in equity. Such a statement would necessarily reduce the dilutive effects of multiple scenarios to one dimension, which would not accurately or reliably portray economic substance.

210 It may be more appropriate to portray (potential) dilutive effects through disclosures. Through discussions with users of financial statements, EFRAG has identified a number of potential ways in which this could be done. These include:

[7] A convertible bond can be shown to be identical to a financial liability and a written call option.

(a) Scenario analysis, depicting the instruments in issue and their rights and/or payoffs in various material scenarios; and/or

(b) The provision by the entity of financial models showing the rights holders of various instruments have on net cash inflows, and how the number and types of these instruments may change.

Portraying the performance of an entity with respect to contracts that include an option for the entity to deliver its own equity instruments

211 Paragraphs 5.35 to 5.41 of the DP indicate that remeasurement of secondary equity claims would be required to understand the performance of an entity.

212 In particular, EFRAG notes that this could relate to:

(a) When an entity is obliged to deliver equity instruments worth a particular amount;

(b) When secondary equity claims are issued in relation to on-going services received by an entity (for example share options to employees);

(c) When secondary equity claims arise as a result of an entity's trading, borrowing and investing activities.

213 A secondary equity claim that could result in an entity being obliged to issue equity instruments worth a certain amount could come about as a result of a number of transactions, including:

(a) An arrangement to borrow money where the entity was contractually entitled to repay using equity instruments (for example, if an entity borrowed CU100 and was required to deliver either CU105 of cash or equity instruments worth CU110 in six months);

(b) A currency exposure (for example, if an entity entered into a forward contract to deliver a pre-determined amount of cash or equivalent value of equity instruments in exchange for a pre-determined amount of foreign currency); or

(c) A derivatives transaction (for example an interest rate or commodities derivative where the entity was entitled to settle net in equity instruments).

214 Under the strict obligation approach as proposed in the DP, an entity could enter into these transactions and settle them in cash, but as there is an almost purely theoretical option to settle in equity, the transaction would not be reflected in comprehensive income. The DP states that these would be akin to a contribution and distribution from equity holder. EFRAG disagrees – these transactions are not akin to contributions (such as a share issue) and distributions (such as the payment of a dividend) of equity, but are contractual rights and obligations more similar to those presented in comprehensive income.

215 The DP notes the ongoing tension caused by the different treatments of cash-settled and equity-settled share based payment obligations[8]. Due to changes in the value of share options after grant date, recipients of such instruments may receive the same increase in wealth, but the amount of expense recognised in comprehensive income of the entity might vary significantly (for example, if a share option was out-of-the-money, and an employee would no longer be incentivised by it, this would be reflected by a reduction in the liability for a cash settled option and reversal of the charge recognised in comprehensive income – which would not occur for the equity-settled instrument).

216 EFRAG believes it is inappropriate for transactions that are necessary to understand an entity's comprehensive income, including an entity's trading, borrowing and investing activities, to be recognised solely within the statement of changes in equity. If

[8] The value of a cash-settled share-based payment obligation is updated at each reporting date, with movements in this value taken through comprehensive income. The value of equity-settled obligations is generally determined solely at grant date, and then not subsequently updated.

the IASB believes that remeasurement of such obligations is necessary to ensure comparability and understandability of the transactions of the entity, the statement(s) of profit or loss and other comprehensive income is the appropriate primary statement(s) for the remeasurement.

217 During the revision of IAS 32 that resulted in the current requirements, the IASB rejected an argument that, because there was no change in assets or liabilities, there was no gain or loss on settlement of a contract to deliver equity instruments. Paragraph BC15 of IAS 32 states that 'the Board noted that any gain or loss arises before settlement of the transaction, not when it is settled.' EFRAG believes this logic still holds.

218 In particular, EFRAG believes that this is especially important in relation to transactions where the entity is entitled to choose the method of settlement. Under the proposals in the DP, two transactions could be identical in how they are initiated, remeasured and settled, but because one of them contained an almost purely theoretical option (such as an option to deliver shares worth 10% more than the cash) for the entity to settle in its own equity one transaction would be portrayed in comprehensive income and the other in the statement of changes in equity.

219 EFRAG believes that having two transactions that are effectively identical being portrayed in different ways reduces comparability and is not appropriate. EFRAG therefore has an alternative proposal for remeasurement of secondary equity claims.

EFRAG's proposal

220 EFRAG believes that, if secondary equity claims are to be classified as equity, they should be remeasured, as if they were financial assets or liabilities, through comprehensive income.

221 EFRAG does note that this would require a change to the proposed definition of income and expense (by including changes in secondary equity claim), but EFRAG believes that it would ensure that the statement(s) of profit or loss and other comprehensive income would remain the primary statement(s) that portrays the performance of an entity, including its trading, borrowing and investing activities.

222 EFRAG also believes that such a change may provide a conceptual solution to what some see as the counter-intuitive accounting in the statement of profit or loss for puttable instruments, including puts on shares held by Non-controlling Interests ('NCI puts'). The proposals in the DP would not provide any such conceptual solution.

223 Recognising the remeasurement of such claims within comprehensive income would also be consistent with a notion of holders of primary equity claims as the owners of an entity.

<u>Consequences of such a change</u>

224 Current IFRS requires a liability to be recognised for a puttable instrument at the present value of the amount the entity may be obliged to pay. Paragraph 23 of IAS 32 applies that requirement even if the put option is contained within a separate contract. Changes in the carrying value of such a liability are recognised in the statement of profit or loss.

225 For an instrument puttable at fair value, as the entity performs better the liability increases and an expense is recognised. If the entity performs worse, the liability reduces and income is recognised.

226 If changes in secondary equity claims were recognised in comprehensive income, if an NCI put was exercisable at a proxy to fair value and this had resulted in an increased amount that the entity was obliged to pay:

(a) The increase in the liability would be recognised as an expense in comprehensive income; and

(b) The secondary equity claim representing the entity's right to receive NCI's shares (if so obliged) would also increase and be recognised as income in comprehensive income.

227 This would result in a net of zero income or expense recognised in the statement(s) of profit or loss and other comprehensive income, but would retain the recognition of a liability representing the amount the entity may be obliged to transfer.

Obligations that arise only on liquidation

Notes to constituents

228 The IASB proposes that obligations that arise only on liquidation of the reporting entity not be classified as liabilities, as this is inconsistent with the going-concern basis of preparation.

229 This conclusion would apply even if the reporting entity has a pre-determined limited life (or if another party can compel liquidation). However, the IASB notes that this conclusion may not be appropriate in consolidated financial statements for obligations that would become payable on liquidation of a consolidated subsidiary before liquidation of the parent.

EFRAG's response

EFRAG generally supports the proposal that obligations that arise only on liquidation of the reporting entity not be classified as liabilities, given that financial statements are prepared on a going concern basis.

230 EFRAG supports the IASB's proposal with respect to obligations that will arise only on liquidation of the reporting entity – as this is consistent with a going concern basis to financial reporting – but believes it is important to appropriately distinguish instruments that are, in substance, liabilities.

231 With regards to obligations that will only arise on liquidation of a consolidated subsidiary, EFRAG believes there is an important link to the notion of control, as expressed in IFRS 10 *Consolidated Financial Statements*. For an entity to consolidate a subsidiary it must control it. If it controls a subsidiary, the liquidation of such a subsidiary would be at the discretion of the reporting entity; in such a circumstance EFRAG believes it would be appropriate that obligations that arose on liquidation of the subsidiary not be classified as liabilities.

232 However, if the entity has contractually committed itself to liquidation of such a consolidated entity (for example by inclusion in the contractual arrangements of a special purpose vehicle) and as a result is obliged to transfer an economic resource, EFRAG believes it would be appropriate for such a contractual obligation to be classified as a liability.

If an entity has no equity instruments

Notes to constituents

233 The IASB proposes that, if an entity has issued no equity instruments, it may be appropriate to treat the most subordinated class of instrument it has issued as if it were an equity instrument. This means that this class of instrument would not be remeasured and that, even if such an instrument met the conceptual definition of a liability, it would not be classified as such.

234 Such an approach might be similar to that contained within the requirements of paragraphs 16A to 16F of IAS 32.

EFRAG's response

EFRAG appreciates the difficulties presented by situations where an entity has issued no instruments that are purely equity, but is not convinced that the approach proposed is the best one.

235 EFRAG finds the IASB's proposal somewhat confusing in that it appears to contradict the key decisions taken with respect to the definition of equity. The IASB appears to be proposing that all financial statements be prepared with a definition of equity consistent with an entity concept, unless this would result in no equity, in which case a proprietary perspective is appropriate.

236 While EFRAG supports this explicit recognition that the proposed definition of equity does not always result in appropriately classifying the basic ownership instruments in some corporate structures common across Europe, EFRAG believes that this merely reflects the problems inherent in the definition and is not persuaded that an approach of reclassifying the most residual instrument is appropriate.

237 The requirements of paragraphs 16A to 16F of IAS 32 have led to significant implementation issues and confusion, as evidenced by requests to the IFRS Interpretations Committee. In particular, as noted above, there may be practical difficulties in identifying the most residual instrument.

238 EFRAG believes that a more appropriate approach is to allow entities to present additional information which has the status of IFRS as set out in paragraphs 167 to 168 above. This would allow entities to present information that defines equity from a proprietary perspective, while preserving the comparability and relevance of an entity perspective. Such an approach provides important information to the holders of basic ownership instruments.

Other matters

239 Previous debates on the equity/liability distinction and questions to the IFRS Interpretations Committee have resulted in a number of additional issues that EFRAG believes should also be addressed at the conceptual level. These are:

(a) The role of economic compulsion (which EFRAG has discussed above in paragraphs 86 and 87);

(b) The boundaries of the entity in determining whether an obligation exists; and

(c) The nature of instruments that oblige an entity to transfer (or distribute) an amount determined by reference to profit, revenue or cash flows.

Boundaries of an entity

Notes to constituents

240 It is important to identify the boundaries of the entity in determining whether or not there is an obligation. This is because an obligation to deliver an economic resource on the occurrence of an event within the control of the entity is not a liability.

EFRAG's response

241 EFRAG does not believe the DP adequately addresses the issue of the boundaries of the entity, particularly with respect to the relationship with holders of ownership instruments.

242 There is no clear conceptual basis provided for determining whether an entity's Annual General Meeting (or any meeting of the holders of a class of instruments) is part of the entity or not. The importance of this is if (for example) the attendees could require declaration of a dividend in excess of that proposed by directors. If this were to be determined to not be part of the entity, it would be an obligation outside the control of

the entity and a liability should be recognised for the amount the entity could be compelled to distribute.

243 EFRAG does not believe this would provide useful financial reporting and believes the issue should be addressed at a conceptual level.

Instruments that oblige an entity to transfer (or distribute) an amount determined by reference to profit, revenue or cash flows

Notes to constituents

244 Some financial instruments may require an entity to transfer (or distribute) cash or another economic resource, and are therefore liabilities, but the amount that is transferred is calculated by reference to the results of the entity, or part of the entity. Examples of such instruments include:

(a) *Shares that require an entity to distribute 10% of profit each year; or*

(b) *Profit or revenue share agreements, which are common in the exploitation of natural resources and the pharmaceutical industry.*

245 As these oblige an entity to transfer an economic resource and are beyond the control of the entity, they are financial liabilities, as noted in paragraph 24 of IAS 32. However, this can result in what some believe is counter-intuitive accounting due to the measurement of the liability based on expected future cash flows. As the prospects of the entity improve, the expected cash flows, and therefore the liability, increase. This would result in the recognition of an expense in comprehensive income for an expectation of better future performance.

EFRAG's response

246 EFRAG believes that the current financial reporting requirements, derived from paragraph 24 of IAS 32, do not always result in useful information. This is particularly the case with respect to instruments that oblige the entity to distribute a portion of net income each year. EFRAG believes that it would be more appropriate for any liability in these instruments to be recognised at the same time as the revenue or net income they require distribution of as this would result in a more relevant economic depiction of the of the entity. EFRAG also notes that this is linked to Section 5 of the DP, and an approach of recognising a liability concurrent with the revenue or net income would be consistent with Approach 2 ('A present obligation must have arisen from past events and be practically unconditional') described there.

SECTION 6 MEASUREMENT

Question 11

How the objective of financial reporting and the qualitative characteristics of useful financial information affect measurement is discussed in paragraphs 6.6–6.35 of the DP. The IASB's preliminary views are that:

(a) the objective of measurement is to contribute to the faithful representation of relevant information about:

- (i) the resources of the entity, claims against the entity and changes in resources and claims; and
- (ii) how efficiently and effectively the entity's management and governing board have discharged their responsibilities to use the entity's resources.

(b) a single measurement basis for all assets and liabilities may not provide the most relevant information for users of financial statements;

(c) when selecting the measurement to use for a particular item, the IASB should consider what information that measurement will produce in both the statement of financial position and the statement(s) of profit or loss and OCI;

(d) the relevance of a particular measurement will depend on how investors, creditors and other lenders are likely to assess how an asset or a liability of that type will contribute to future cash flows. Consequently, the selection of a measurement:

- (i) for a particular asset should depend on how that asset contributes to future cash flows; and
- (ii) for a particular liability should depend on how the entity will settle or fulfil that liability.

(e) the number of different measurements used should be the smallest number necessary to provide relevant information. Unnecessary measurement changes should be avoided and necessary measurement changes should be explained; and

(f) the benefits of a particular measurement to users of financial statements need to be sufficient to justify the cost.

Do you agree with these preliminary views? Why or why not? If you disagree, what alternative approach to deciding how to measure an asset or a liability would you support?

Notes to constituents

247 *The current Conceptual Framework does not include specific guidance on measurement. This is one of the most important omissions in the Framework that the IASB intends to address in its current project on the Conceptual Framework.*

248 *The objective of financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity. Financial information that is useful in making those decisions includes information about the resources of the entity, claims against the entity, and how efficiently and effectively the entity's management and governing board have discharged their responsibilities to use the entity's resources.*

249 *In addition, if financial information is to be useful, it must be relevant and must faithfully represent what it purports to represent. Those two characteristics – relevance and faithful representation – are the fundamental qualitative characteristics of useful financial information.*

250 *Applying the objective of financial reporting to measurement, the IASB's preliminary view is that the objective of measurement is to contribute to the faithful representation*

of relevant information about the resources of the entity, claims against the entity and changes in resources and claims, and about how efficiently and effectively the entity's management and governing board have discharged their responsibilities to use the entity's resources.

251 Measuring all assets and liabilities on the same basis would result in all amounts in the financial statements having the same meaning, which would make totals and subtotals more understandable than those in financial statements prepared under existing requirements. However, there are numerous problems with this approach (please see paragraphs 6.11–6.14 of the DP). Because of these problems, the IASB's preliminary view is that the Conceptual Framework should not recommend measuring all assets and liabilities on the same basis.

252 Measurement affects both the statement of financial position and the statement(s) of profit or loss and other comprehensive income (OCI). Both those statements need to provide relevant information for users of financial statements. Selecting measurements by considering either the statement of financial position alone or the statement(s) of profit or loss and OCI alone will not usually produce the most relevant information for users of financial statements. Therefore, the IASB's preliminary view is that when selecting the measurement to use for a particular item, the IASB should consider what information that measurement will produce in both the statement of financial position and the statement(s) of profit or loss and OCI.

253 Because the way that an asset or a liability will contribute to future cash flows affects the way that users of financial statements assess the prospects for future net cash inflows for the entity, the IASB is proposing in the DP that measurement should depend on how a particular asset contributes to future cash flows and how the entity will settle or otherwise fulfil a particular liability.

254 The enhancing qualitative characteristic of understandability (see paragraphs QC30–QC32 of the existing Conceptual Framework) also has an important implication for setting measurement requirements. Users of financial statements need to be able to understand the measurements used. The more measurements that are used, and the more changes there are in the types of measurement used for particular items, the harder it is to understand how those measurements interact to depict the entity's financial position and financial performance. Consequently, the IASB's preliminary view is that it should limit the number of different measures used to the smallest number necessary to provide relevant information. In order to enhance understandability, the subsequent measurement should be the same as, or at least consistent with, the initial measurement.

255 The cost constraint described in paragraph QC35 of the existing Conceptual Framework should also influence the IASB's decisions about measurement requirements. Cost depends greatly on the availability of information. Many measurements are estimates, and the information needed for inputs to those estimates may not be freely available. Costs will be incurred in gathering, processing and verifying the information. In general, the costs associated with a particular measurement increase as the subjectivity associated with the measurement increases. At the same time, even if a measurement is potentially the most relevant, the benefit to users of financial statements declines as it becomes more subjective (and thus more costly to produce). Unfortunately, a measurement with no subjectivity may not be relevant. The IASB believes that it will need to balance the costs of providing the most relevant available information with the benefit to users of financial statements (which, if the estimate is very subjective, may not be great). The IASB also believes that it should consider different measurement when the relevance of a particular measurement is too low or its cost is too high.

EFRAG's response

EFRAG broadly agrees with IASB's preliminary views expressed under Question 11. EFRAG however believes that the business model should also play an important role in selecting the appropriate measurement basis, and therefore helps implementing the proposed principles in a reliable manner. EFRAG also believes that limiting the number of measurement bases could conflict with the objectives of financial reporting.

Measurement objective, relevance and faithful representation

256 EFRAG agrees that the objective of financial reporting and the fundamental qualitative characteristics of useful financial information should provide the basis for the objective of measurement and the supportive guidance.

257 EFRAG supports the IASB's preliminary view that the objective of measurement is to contribute to the faithful representation of relevant information about the resources of the entity, claims against the entity and changes in resources and claims, and about how efficiently and effectively the entity's management and governing board have discharged their responsibilities to use the entity's resources. Nevertheless, EFRAG wonders in what way this objective in substance differs from the general objective of financial reporting, the objective of recognition or the objective of presentation.

258 In addition, EFRAG believes that relevance of information can be judged from different perspectives. As noted in EFRAG's comment letter on the research paper *Toward a Measurement Framework for Financial Reporting by Profit-Oriented Entities,* issued by the Canadian Institute of Chartered Accountants in 2012, empirical evidence seems to indicate that the information that is most relevant for estimating future cash flows may not be most relevant for assessing stewardship. A Conceptual Framework would therefore have to provide a basis for balancing these different objectives.

259 Measurement affects both the statement of financial position and the statement(s) of profit or loss and OCI and thus both need to provide relevant information for users. Selecting measurements by considering either the statement of financial position alone or the statement(s) of profit or loss and OCI alone will not usually produce the most relevant information for the users of financial statements.

260 Therefore, EFRAG supports the view that when selecting the measurement to use for a particular item, the IASB should consider what information that measurement will produce in both the statement of financial position and the statement(s) of profit or loss and OCI. In addition, EFRAG believes that the business model should also play an important role in selecting the appropriate measurement basis (see also paragraphs 264 and 265 below).

261 The DP suggests that there is no single measurement basis that always provides the most useful information. In other words, the DP is proposing that some assets (and liabilities) could be measured using a historical basis while others could be based on a current basis. Similarly, different types of income (and expenses) could be based on historical measures while others would be based on current measures. EFRAG supports the view that a single measurement basis for all assets and liabilities will not provide the most relevant information for users of financial statements. EFRAG believes that on balance a mixed measurement model provides the most useful information.

262 Nevertheless, EFRAG believes that having different measurement basis for the statement of financial position and the statement(s) of profit or loss and OCI has a direct link to the meaning of the 'bridging item' concept and the use of OCI as discussed in the Section 8 *Presentation in the statement of comprehensive income–profit or loss and other comprehensive income* of the DP. Consistency among measurement and presentation would be of significant importance. In addition, EFRAG believes that using two different measurement bases is only warranted if both measures provide sufficiently useful information about different facets of the entity's

financial position and financial performance. In this case, only disclosing a different measurement basis in the notes would not be sufficient. As the use of two measurement bases would result in additional costs and might make the financial statements less understandable, the IASB would need to justify that the benefits of the additional information on the face of primary financial statements would outweigh those disadvantages.

263 In order to create a common understanding as to what the IASB aims to accomplish, EFRAG recommends that the measurement section should state clearly the linkage with the presentation section. This linkage is particularly important when the cash flows from one item are contractually linked to the cash flows from another item. In the cases when assets and liabilities are related in some way, using different measurements for those assets and liabilities can create a measurement inconsistency (sometimes referred to as an 'accounting mismatch'). Measurement inconsistencies can result in financial statements that do not faithfully represent the reporting entity's financial position and performance.

Choosing a measurement basis

264 EFRAG supports the view that the selection of a measurement for a particular asset should depend on how that asset contributes to future cash flows and for a particular liability should depend on how the entity will settle or otherwise fulfil that liability. The DP notes (paragraphs 6.75–6.96) that the way an asset will ultimately contribute to cash flows will often not be certain. For most assets there are choices, and choices may change.

265 EFRAG believes that considering the business model (i.e. how the asset contributes to future cash flows and for a particular liability how the entity will settle or otherwise fulfil that liability) for measurement purposes would help users to better understand the financial performance of an asset (or a group of assets) in comparison with the expected outcome. For more information and analysis on the role of the business model for measurement, please refer to Bulletin *The Role of the Business Model in Financial Reporting,* which was issued in June 2013 by EFRAG, the French Autorité des Normes Comptables (ANC), the Accounting Standards Committee of Germany (ASCG), the Italian Organismo Italiano di Contabilità (OIC) and the UK Financial Reporting Council (FRC); and paragraphs 412-423 below.

Relevance of a particular measurement basis

266 EFRAG supports the IASB's preliminary view that the relevance of a particular measurement will depend on how investors, creditors and other lenders are likely to assess how an asset or a liability of that type will contribute to future cash flows.

Understandability and other enhancing characteristics

267 Understandability has an important implication for setting measurement requirements. Users need to be able to understand the measurements used. Changes in the types of measurement used for particular items will make it more difficult for users to understand how measurement bases interact to depict the entity's financial position and financial performance. EFRAG agrees that unnecessary changes in the types of measurement used for a particular item should be avoided and require clear explanations of the reasons for necessary changes, and the effects of those changes.

268 In EFRAG's opinion, the IASB's preliminary view that the number of different measurements used should be the smallest number necessary seems to suggest that the IASB would like to predetermine the number of measurement bases to be used. EFRAG believes that limiting the number of measurement bases could conflict with the objective of financial reporting − to contribute to the faithful representation of relevant information about the resources of the entity, claims against the entity, performance of the entity; and stewardship. In addition, EFRAG does not expect that excluding this limitation from the *Conceptual Framework* would cause a proliferation of measurement bases.

269 The three enhancing characteristics of useful financial information other than understandability – timeliness, verifiability, and comparability – need to be considered when establishing measurement requirements. EFRAG agrees that comparability implies using measurements that are the same between periods and between entities. However, it is important that the measurement is the same for items which contribute to future cash flows in a similar way. EFRAG believes that measurement considering the business model would enhance comparability. Having the same accounting requirements for assets, which are used differently and contribute to future cash flows in a different way, would effectively diminish the comparability of financial statements; thereby, the events or transactions may not be faithfully represented. As noted above, for more information and analysis on the role of the business model for measurement, please refer to the Bulletin *The Role of the Business Model in Financial Reporting*.

Cost constraint

270 EFRAG supports the IASB's preliminary view that the benefits of a particular measurement basis to users of financial statements need to be sufficient to justify the cost for the preparers. Consistent with the EFRAG's comment letter on the research paper *Toward a Measurement Framework for Financial Reporting by Profit-Oriented Entities,* issued by the Canadian Institute of Chartered Accountants in 2012 (e.g. paragraph 55) EFRAG believes that cost constraints should be considered in selecting the appropriate measurement basis. That would also be consistent with the general cost constraint of useful financial reporting (QC35 of the existing Conceptual Framework) that reporting financial information imposes costs, and it is important that those costs are justified by the benefits of reporting that information.

Faithful representation

271 Consistent with the EFRAG's comment letter on the research paper *Toward a Measurement Framework for Financial Reporting by Profit-Oriented Entities,* issued by the Canadian Institute of Chartered Accountants in 2012 (please see paragraph 56) EFRAG believes that measurement for financial reporting purposes should be capable of reasonable substantiation and that also disclosures should be considered when assessing whether an economic phenomenon is faithfully represented. That is, we think that in some cases it may be necessary to provide disclosures in relation to verifiable figures in order to achieve a faithful representation. However, EFRAG does not think that disclosures can compensate for large margins of accuracy in measurement, i.e. for the measurement's lack of accuracy.

Question 12

The IASB's preliminary views set out in Question 11 have implications for the subsequent measurement of assets, as discussed in paragraphs 6.73 – 6.96 of the DP. The IASB's preliminary views are that:

(a) if assets contribute indirectly to future cash flows through use or are used in combination with other assets to generate cash flows, cost-based measurements normally provide information that is more relevant and understandable than current market prices.

(b) if assets contribute directly to future cash flows by being sold, a current exit price is likely to be relevant.

(c) if financial assets have insignificant variability in contractual cash flows, and are held for collection, a cost-based measurement is likely to provide relevant information.

(d) if an entity charges for the use of assets, the relevance of a particular measure of those assets will depend on the significance of the individual asset to the entity.

Do you agree with these preliminary views and the proposed guidance in these paragraphs? Why or why not? If you disagree, please describe what alternative approach you would support.

Notes to constituents

272 As stated in paragraph 6.16 of the DP, the relevance of a particular measurement will depend on how investors, creditors and other lenders are likely to assess how an asset of that type will contribute to the entity's future cash flows. Consequently, the IASB's preliminary view is that the measurement used for a particular asset should depend on how it contributes to future cash flows.

273 The way an asset will ultimately contribute to cash flows will often not be certain. For most assets there are choices, and choices may change. The IASB has to decide how to deal with that uncertainty. Some alternatives are:

(a) *measure based on how the value of the asset is likely to be realised as indicated by current activities (business model), plans, strategies, declared intent or past practices. That measure is most likely to indicate the actual cash flows, but it allows for measuring similar or identical assets differently, which some view as a disadvantage. This approach is closest to what IFRS currently requires.*

(b) *measure based on the most profitable means of contributing. This subsequently shows the cost or benefit of management's decision to depart from the optimal contribution method but could lead users of financial statements to expect cash flows that will not occur. Similar or identical assets would be measured the same way.*

274 Another possible way of dealing with uncertainty about how an asset will contribute to future cash flows would be to provide more than one measure of the asset. This could be done by:

(a) *using one measure in the primary financial statements and disclosing another measure in the notes to the financial statements; or*

(b) *using one measure in the statement of financial position and using a different measure to determine the amounts recognised in profit or loss (presenting the difference between the two measures in OCI). This approach is discussed further in Section 8 of the DP.*

275 The IASB will decide how to deal with uncertainty about how an asset will contribute to future cash flows when developing or revising particular Standards but, however the IASB deals with the uncertainty, it will need to consider how an asset will contribute to future cash flows. The paragraphs 6.78–6.98 discuss the different ways in which an asset can contribute to future cash flows.

276 The DP identifies four general ways in which an asset contributes to future cash flows, which are (paragraph 6.74 of the DP):

(a) *using it in business operations to generate revenues or income (see paragraphs 6.78–6.82 of the DP);*

(b) *selling it (see paragraphs 6.83–6.85 of the DP);*

(c) *holding it for collection according to terms (see paragraphs 6.86–6.90 of the DP); and*

(d) *charging others for rights to use it (see paragraphs 6.91–6.96 of the DP).*

EFRAG's response

EFRAG broadly agrees with IASB's preliminary views expressed under Question 12.

277 EFRAG believes that classifying assets into four categories (as set out in the DP) is reasonable because the ways in which cash flows are generated differ significantly depending on the categories. However, EFRAG believes that the Conceptual

Framework should not be conclusive about what situations fall under the respective categories. Such generalisation is difficult and the IASB should assess each situation in light of the measurement objective and the supportive guiding principles.

Using Assets

278 EFRAG generally agrees with the view that cost-based measures would provide relevant information for assets that are used in (a) purchasing, producing, marketing, or delivering assets or services the entity sells and (b) administration, treasury or any other function necessary to keep the entity operating. EFRAG also supports the IASB's arguments that a current measure and the resulting unrealised gains and losses due to asset price changes may not be relevant for assets the entity is using unless they indicate impairments or reversals of impairments.

279 However, EFRAG disagrees with arguments that a current measure would provide better information for assessing how efficiently and effectively an entity's management and governing board have used the entity's resources. That would effectively mean representation of opportunity costs that management and governing board were missing and reflect 'what if' scenarios, which are (in the framework of the entity's business model) seldom possible and thus relevant.

280 EFRAG believes that changes in an asset's capacity to generate cash flows (i.e. adding value through the value chain) through time can be effectively reflected through cost-based 'adjustments' such as depreciation/amortisation expense, impairment losses and reversals of impairment losses.

Selling Assets

281 There are various situations in which assets are being sold. Therefore, each selling situation would need to be separately analysed in order to find an appropriate measurement basis. If an entity holds an asset with the purpose of selling it in the near future and generating a profit from fluctuations in a market price, the fair value (i.e. current exit price) measurement would be relevant so as to predict future cash inflows for the entity, despite the fact that this measurement would result in unrealised gains (or losses) being reported in comprehensive income. These assets are usually fungible and since it is quite likely any held at the end of a reporting period will be sold in the next reporting period, this measurement represents the very likely future cash flows.

282 Current exit prices are readily available when deep, liquid markets exist and in this case the measure is also verifiable and can be provided in a timely manner. When a current market price is not readily available, it may be necessary to estimate this. EFRAG believes that as current financial accounting standards require use of estimates in many other situations (e.g. impairment, contingent liabilities and retirement benefit liabilities), it would therefore also be possible to use estimates for current exit prices. Sometimes such estimates might be very uncertain. Consequently, if this uncertainty is properly explained (e.g. in the notes), the information would still be useful. However, EFRAG does not think that disclosures can compensate for large margins of accuracy in measurement (i.e. for the measurement's lack of accuracy).

283 However, an entity that manages a portfolio of financial assets within the 'liability driven hold and sell' business model, where financial assets are managed to match stable liabilities, may be seen as holding financial assets for the long-term investment horizon. Despite the fact that the fair value (i.e. current exit price) measurement could be seen as a relevant measurement basis for the statement of financial position, due to the long-term investment horizon unrealised gains (or losses) being reported in profit or loss would not be an appropriate primary measure of performance. The nature of assets might be seen as very different in those two cases.

284 In addition, for inventories, the DP argues that a current market price is less relevant as the sale usually requires the seller to undertake significant activities to identify purchasers (the DP states that this is not the case for most financial instruments or commodities). Furthermore, it is argued that the assessment of prospects for future

cash flows from sales of inventories is usually based on expectations about future margins that are derived from cost-based information about past sales, cost of sales, and other recurring components of profit and loss. The use of current market prices could obscure this information.

285 EFRAG believes that what is more important is that inventories are actually not a homogenous group of non-monetary assets. EFRAG notes that IAS 2 generally requires inventories to be measured at the lower of cost and net realisable value. However, IAS 2 includes an exception to this general requirement that allows commodity broker-traders to measure their inventories at fair value less cost of sale with changes in fair value less cost to sell recognised in profit or loss. The standard justifies the different treatment for broker-trader inventories because those inventories are principally acquired with the purpose of selling in the near future and generating a profit from fluctuation in prices and trade margins (IAS 2, paragraph 5). This is similar to financial instruments which are actively traded, which would therefore justify a similar accounting treatment. The benefit in terms of relevant representation of the performance and expected future cash flows is also the same. In EFRAG's opinion fungibility of an asset could thus also play a role in measurement. EFRAG also believes this a good example where the business model was in the past implicitly used in an IFRS.

286 EFRAG believes that it is difficult to generalise the discussion about the appropriate measurement basis and each situation should be assessed in light of the measurement objective for the statement of financial position as well as the statement(s) of profit or loss and OCI and the supportive guiding principles. In order to create a common understanding as to what the IASB aims to accomplish, measurement should explicitly recognise the linkage with presentation, the use of OCI and the concepts underlying the use of OCI. Consistency among measurement and presentation would be of significant importance, when having different measurement basis for the statement of financial position and the statement(s) of profit or loss and OCI.

Holding assets for collection according to terms

287 EFRAG generally agrees with the statement that cost-based measurement provides relevant information for assets held for collection according to terms. In addition, we believe that floating rate financial assets should, despite possible significant variation in cash flows, be eligible for cost-based measurement due to the fact that this variation does not cause a change in the fair value of such instruments. EFRAG also agrees that current market prices are likely to be the most relevant measure for assets with significant variability in either cash flows or net value flows, such as derivative instruments.

Charging for rights to use assets

288 EFRAG will provide views on this item after consultation with European constituents on the recent IASB re-exposure on Leases.

Question 13

The implications of the IASB's preliminary views for the subsequent measurement of liabilities are discussed in paragraphs 6.97–6.109 of the DP. The IASB's preliminary views are that:

(a) cash-flow-based measurements are likely to be the only viable measurement for liabilities without stated terms.

(b) a cost-based measurement will normally provide the most relevant information about:

  (i) liabilities that will be settled according to their terms; and

  (ii) contractual obligations for services (performance obligations).

(c) current market prices are likely to provide the most relevant information about liabilities that will be transferred.

Do you agree with these preliminary views and the proposed guidance in these paragraphs? Why or why not? If you disagree, please describe what alternative approach you would support.

Notes to constituents

289 In the same way as for assets, the nature of a liability and the way it will be settled are important in identifying the appropriate measurement for that liability. Liabilities fall into two groups – those with stated terms and those without stated terms.

290 Liabilities without stated terms can arise from torts or violations of laws or regulations. Liabilities of this type require negotiation or judicial action to determine a settlement amount. The IASB's DP states that it is impossible to measure liabilities without stated terms at cost as the liability does not have a cost and current market prices are likely to be difficult to determine. Consequently, a cash-flow-based measurement may be the only possibility for liabilities without stated terms. Cash-flow-based measurements are discussed in paragraphs 6.110–6.130 of the DP.

291 Some types of contractual liabilities have stated terms but highly uncertain settlement amounts that have not yet been determined (for example, insurance contracts and post-employment benefits). For liabilities of this type, a cost-based measurement is unlikely to provide relevant information and current market prices may be difficult to determine. Consequently, a cash-flow-based measurement may also provide the most relevant information for liabilities of this type.

292 Liabilities with stated terms are those that come from contracts, statutes or regulations that state either a settlement amount or the method for determining the settlement amount. There are three ways in which an entity might settle a liability with stated terms:

  (a) *by paying cash or delivering other assets according to the stated terms;*

  (b) *by being released by the creditor on transferring the obligation to another party; or*

  (c) *by performing services or paying others to perform services.*

293 It is likely that most liabilities have contractual terms that specify payments, and almost all of those are settled according to their terms. Few liabilities can be transferred to other entities in a ready market. If a liability cannot be transferred, then measuring that liability at a current market price reflects, in comprehensive income, changes in market prices that cannot, in many cases, be realised and may reverse over the life of the liability. Consequently, these liabilities are viewed as analogous to assets held for collection, and a cost-based measurement will normally provide the most relevant information about liabilities that will be settled according to their terms.

294 A few liabilities can be transferred to a third party without negotiating for the consent of the creditor. The most relevant measure of a liability that will be settled by transfer would be a current market price, or a current market price plus transaction costs, because that is an estimate of the cash that will be paid in inducing another party to assume the liability.

295 Liabilities arising from contractual obligations for services ('performance obligations') have specified outcomes instead of stated terms. A cost-based measurement starting with the proceeds received (in some cases, with interest accretion) provides information about recurring components of profit or loss and that information can be used to derive expectations about future margins. Hence, a cost-based measurement is likely to be appropriate for such obligations. However, the current market price of the services may also be relevant information, especially if the entity will pay others to perform the services.

EFRAG's response

EFRAG broadly agrees with IASB's preliminary views expressed under Question 13.

Liabilities without stated terms

296 The IASB's DP states that it is impossible to measure liabilities without stated terms at cost as the liability does not have a cost. It is therefore argued that a cash-flow based measure other than estimates of current prices may be the only possible options for such liabilities.

297 EFRAG believes that applying a cash-flow based measure could be used to estimate a current value or cost, therefore, it would also be possible to measure liabilities without stated terms, such as liabilities arising from torts or violations of laws or regulations, at a current value or cost.

298 The DP includes a list of issues that should be considered when deciding, on a standards level, how to construct a cash-flow based measure (see paragraphs 6.112–6.130 of the DP). However, EFRAG notes that the DP does not provide any preliminary views on how a cash-flow based measure for liabilities without stated terms should be constructed (for example, how to deal with uncertainties about the amount of cash flows, i.e. the most likely amount or the expected probability-weighed value; whether the view of market participant or reporting entity's perspective should be reflected etc.), therefore it is not possible to assess the consequences of that proposal.

Liabilities with stated terms but highly uncertain amounts

299 The DP also concludes that a cash-flow based measurement (other than one that functions to estimate current prices) provides the most relevant information for liabilities with stated terms but highly uncertain amounts. The argument provided is that for liabilities of this type, a cost-based measure is unlikely to provide relevant information and current market prices may be difficult to determine.

300 EFRAG believes that circumstances in which current market prices are difficult to determine first call into question whether the measurement objective should be to represent current market prices. For example, EFRAG recommended early on in the *Insurance Contracts* project that an entity-specific settlement value measurement objective was more relevant than a current market price objective, as current market price estimates would be highly hypothetical and transferring insurance liabilities was not a characteristic of the business model of an insurer. The absence of observable market prices should call into question whether a market exists and therefore whether a transfer scenario is probable. If, after further analysis, a current market price measurement objective is confirmed as a fair representation of an entity's business model or of the underlying economics of a specific transaction, cash flow based estimates should be used.

Liabilities with stated terms that are settled by cash or by delivering other assets according to the terms

301 EFRAG believes that the use of a cost-based measure could be appropriate for a liability that is expected to be settled by an entity through the payment of cash or delivering other assets according to its terms.

302 EFRAG believes that if the obligation is expected to be fulfilled by the payment of cash or delivering other assets according to the term, a cost-based measure would be the appropriate measurement basis for both the statement of comprehensive income and the statement of financial position, because it would reflect future cash outflows from an entity.

303 For example, if a financial liability cannot be transferred then measuring that liability at a current market price reflects, in comprehensive income, changes in market prices that cannot be realised. Consequently, these liabilities are viewed as analogous to assets held for collection. Therefore, EFRAG agrees with IASB's preliminary view on this issue.

304 However, derivatives that are liabilities should be measured at a current market price or another measure that varies according to the cash flows required by the contract. EFRAG believes such a measure is a much better indicator of ultimate cash flows than a cost-based measurement, therefore EFRAG also agrees with IASB's preliminary view on this issue.

Liabilities with stated terms that are settled by being transferred to a third party without negotiating for consent of the creditor

305 EFRAG agrees with the argument in the DP that the most relevant measure of a liability that will be settled by being transferred would be a current market price, or a current market price plus transaction costs, because that is an estimate of the cash that will be paid to induce another party to assume the liability.

Liabilities with stated terms that are settled by performing a service or paying others to perform services

306 EFRAG believes that an appropriate measurement basis for a liability that is expected to be settled by the performance of services or, payments to others for performing services, would differ depending on whether (i) an entity performs the services or (ii) an entity pays others to perform services.

307 If an entity performs the services, a cost-based measure starting with the proceeds received (in some cases with interest accretion) is likely to be appropriate for such obligations, especially if the services are a recurring revenue-generating activity, because it provides information about recurring components of profit or loss and that information can be used to derive expectations about future margins.

308 However, the current market price of the services may be more relevant information if the entity will pay others to perform the services.

Question 14

Paragraph 6.19 of the DP states the IASB's preliminary view that for some financial assets and financial liabilities (for example, derivatives), basing measurement on the way in which the asset contributes to future cash flows, or the way in which the liability is settled or fulfilled, may not provide information that is useful when assessing prospects for future cash flows. For example, cost-based information about financial assets that are held for collection or financial liabilities that are settled according to their terms may not provide information that is useful when assessing prospects for future cash flows:

(a) if the ultimate cash flows are not closely linked to the original cost;

(b) if, because of significant variability in contractual cash flows, cost-based measurement techniques may not work because they would be unable to simply allocate interest payments over the life of such financial assets or financial liabilities; or

(c) if changes in market factors have a disproportionate effect on the value of the asset or the liability (i.e. the asset or the liability is highly leveraged).

Do you agree with this preliminary view? Why or why not?

EFRAG's response

EFRAG agrees with IASB's preliminary view expressed under Question 14

309 Derivative instruments have contractual terms, but are subject to significant variability in either cash flows or net value flows. As it was already stated in paragraphs 287 and 304 above, EFRAG agrees that current market prices are likely to be the most relevant measure for assessing prospects for future cash flows of derivative instruments.

310 On the other hand, EFRAG notes that there is no substantial difference between a simple interest swap and a loan and deposit with netting and therefore there should be no justification for any measurement differences.

Question 15

Do you have any further comments on the discussion of measurement in this section?

EFRAG's response

EFRAG does not have any further comments regarding measurement.

SECTION 7 PRESENTATION AND DISCLOSURE

Question 16

This section sets out the IASB's preliminary views about the scope and content of presentation and disclosure guidance that should be included in the Conceptual Framework. In developing its preliminary views, the IASB has been influenced by two main factors:

(a) the primary purpose of the Conceptual Framework, which is to assist the IASB in developing and revising Standards (see Section 1); and

(b) other work that the IASB intends to undertake in the area of disclosure (see paragraphs 7.6–7.8 of the DP), including:

- (i) a research project involving IAS 1, IAS 7 and IAS 8, as well as a review of feedback received on the Financial Statement Presentation project;
- (ii) amendments to IAS 1; and
- (iii) additional guidance or education material on materiality.

Within this context, do you agree with the IASB's preliminary views about the scope and content of guidance that should be included in the Conceptual Framework on:

(a) presentation in the primary financial statements, including:

- (i) what the primary financial statements are;
- (ii) the objective of primary financial statements;
- (iii) classification and aggregation;
- (iv) offsetting; and
- (v) the relationship between primary financial statements.

(b) disclosure in the notes to the financial statements, including:

- (i) the objective of the notes to the financial statements; and
- (ii) the scope of the notes to the financial statements, including the types of information and disclosures that are relevant to meet the objective of the notes to the financial statements, forward-looking information and comparative information.

Why or why not? If you think additional guidance is needed, please specify what additional guidance on presentation and disclosure should be included in the Conceptual Framework.

Notes to constituents

311 *The DP proposes that the objective of primary financial statements be to provide summarised information about recognised assets, liabilities, equity, income, expenses, changes in equity and cash flows that have been classified and aggregated in a manner that is useful to users in making decisions about providing resources to the entity.*

312 *The DP states that in order to provide information that is useful to users in making economic decisions about providing resources to the entity, classification and aggregation into line items and sub-totals (where relevant) should be based on similar properties such as: the function of the item, the nature of the item or how the item is measured.*

313 *Offsetting will generally not provide the most useful information for assessing an entity's financial position and financial performance. However, the IASB may choose to*

require offsetting when such a presentation provides a more faithful representation of a particular position, transaction or other event. It may also choose to permit offsetting when it considers this necessary on cost-benefit grounds.

314 The DP proposes that no primary financial statement should have primacy over the other primary statements and primary statements should be looked at together. The way items are presented in primary financial statements helps users take an overall view of an entity's financial position and performance. This could be achieved by ensuring that the relationships between the statements and among items presented in them are clear.

315 In relation to note disclosures, the DP notes that many respondents to the Agenda Consultation 2011 told the IASB that they thought a framework for disclosures was needed and suggested such a framework should:

(a) *provide a structured way to review the need for disclosure, simplify the disclosure process and reduce the costs to preparers;*

(b) *consider the costs and benefits of disclosure;*

(c) *include a discussion of materiality in order to ensure that only material and/or relevant amounts are disclosed; and*

(d) *contain clear communication objectives so that disclosure is understandable and relevant.*

316 The IASB has considered ways to address the concerns raised and thinks that one aspect of the response is the development of material for the Conceptual Framework that the IASB would consider in setting disclosure requirements.

317 The DP proposes that the objective of the notes to the financial statements is to supplement the primary financial statements by providing additional useful information about:

(a) *the assets, liabilities, equity, income, expenses, changes in equity and cash flows of the entity; and*

(b) *how efficiently and effectively* the entity's *management and governing board have discharged their responsibilities to use the entity's resources.*

318 To meet that objective the Conceptual Framework should identify the following as disclosures that the IASB would normally consider requiring in a general standard on disclosure (such as IAS 1) or in particular Standards:

(a) *information about the reporting entity as a whole, to the extent necessary to understand:*

(i) *the assets, liabilities, equity, income, expenses, changes in equity and cash flows of the entity; and*

(ii) *how effectively the entity's management and governing board have discharged their responsibilities to use the entity's assets.*

(b) *the amounts recognised in the entity's primary financial statements, including changes in those amounts;*

(c) *the nature and extent of the entity's unrecognised assets and liabilities;*

(d) *the nature and extent of risks arising from the entity's assets and liabilities (whether recognised or unrecognised); and*

(e) *the methods, assumptions and judgements and changes in those methods, assumptions and judgements, that affect amounts presented or otherwise disclosed.*

319 The DP notes that the IASB can consider different forms of disclosure (e.g. disaggregations, descriptions, roll-forwards, sensitivity analysis) depending on the nature of the item in question.

320 The objective of disclosures is not to provide information that enables a user to recalculate the amounts recognised in the primary financial statements. Instead disclosures need to provide sufficient information to enable a user to identify the key drivers of an entity's financial position and performance and to understand the key risks that the entity faces, and the key facts that cause uncertainties about measurements used in the financial statements.

321 The DP notes that information about management's interpretation of the entity's performance, belongs outside financial statements, for example in management commentary.

322 The DP also states that forward-looking information should only be required if it provides relevant information about existing resources and claims or resources and claims that existed during the reporting period.

EFRAG's response

EFRAG agrees with the proposals, but think that more guidance in needed for some areas.

323 EFRAG agrees with the proposals, but think that more guidance is needed for some areas in order to address the issues raised by constituents during the *Agenda Consultation 2011*.

324 In particular we think more guidance is needed on how to 'provide a structured way to review the need for disclosure', which was one of the issues respondents to the Agenda Consultation identified as an area that should be developed. The DP indicates some subjects of information: the reporting entity, amounts in the primary statements, unrecognised amounts, nature and extent of risks, methods and assumptions, but it does not explain how the IASB should select among different types of disclosure. The DP simply states that 'the IASB can consider different forms of disclosure (e.g. disaggregation, descriptions, roll-forwards, sensitivity analysis) depending on the nature of the item in question.' EFRAG considers this too generic a statement that does not introduce sufficient discipline in the IASB's process of deciding on disclosure requirements at a standards level.

325 EFRAG thinks that the Conceptual Framework should provide more guidance in order to provide a structured way to review the need (and develop the appropriate requirements) and to enable preparers to understand the rationale behind disclosure requirements and hence guide them in the application of these requirements. EFRAG considers that the discussion paper *Towards a Disclosure Framework for the Notes* issued by EFRAG, the French Autorité des Normes Comptables (ANC) and the UK Financial Reporting Council (FRC) and the related feedback statement, presenting the comments of constituents, could be useful in that regard.

326 *Towards a Disclosure Framework for the Notes* suggests that notes should fulfil the following categories of users' needs:

(a) what the components of a line item are;

(b) for disaggregated amounts, information on:

(i) what the item is;

(ii) how the item fits into the entity's operation and financial structure;

(iii) how the item has been accounted for.

327 Accordingly, as a starting point, standard setters should require information on relevant terms and conditions for understanding an item when one of these indicators exists – but not in other cases (and entities should provide the information if it is material).

328 The DP provides a list of disclosures the IASB would normally consider requiring. This list includes information about: the reporting entity; the amounts recognised in its primary financial statements; and the nature and extent of its unrecognised assets and liabilities. However, the list also requires information about: the nature and extent of risks arising from an entity's assets and liabilities; and the methods, assumptions and judgements and changes in those methods. EFRAG considers that the first three requirements relate to the elements on which an entity should provide information about, and the latter two requirements relate to the type of information an entity should provide. EFRAG considers that a distinction should be made between these two types of requirements.

329 EFRAG notes that a consequence of the proposals of the DP on forward-looking information is that non-adjusting after the reporting period events should not be disclosed in the notes. EFRAG considers that if note disclosure overload should be limited by providing principles for what information the notes should contain, it would be very difficult to set the principles so that all current requirements that are considered useful by some would be within those principles. EFRAG therefore accepts this consequence and notes that information about non-adjusting after the reporting period events can be provided elsewhere in a financial report or the IASB can treat this information as an exception to the principles on presentation and disclosure.

330 On a more detailed level, EFRAG notes that the DP suggests requiring disclosures about risks with indication of the nature and extent of risks arising from the entity's assets, liabilities, equity, income, expenses and cash flows. Risk may be interpreted in different ways and EFRAG is concerned that it could encompass almost any type of information. In addition, it is not specified what the information should be about which make the list of possible disclosures close to endless.

331 In the view of EFRAG, the categories of information that are useful for assessing risk in relation to the financial position and financial performance of an entity are:

(a) measurement (and recognition) uncertainty;

(b) impact of a potential change in operating objectives (for example when measurement reflects the entity's business model);

(c) exposure to market conditions or other external factors; and

(d) information on an entity's risk appetite.

332 EFRAG therefore considers that information about risks should be limited to these categories, which are further explained in *Towards a Disclosure Framework for the Notes*.

Question 17

Paragraph 7.45 of the DP describes the IASB's preliminary view that the concept of materiality is clearly described in the existing Conceptual Framework. Consequently, the IASB does not propose to amend, or add to, the guidance in the Conceptual Framework on materiality. However, the IASB is considering developing additional guidance or education material on materiality outside of the Conceptual Framework project.

Do you agree with this approach? Why or why not?

Notes to constituents

333 The IASB is considering providing additional material on the application of materiality, by amending Standards or by providing educational material. In particular, this additional material on materiality would seek to emphasise the following:

(a) *if information to meet a disclosure requirement in a standard is not considered material, the entity may omit it from its financial statements;*

(b) *disclosures additional to those specifically required by a Standard may be required for material items in order to meet the disclosure objective of that Standard or to meet the objective of financial reporting;*

(c) *disclosure of immaterial information can impair the understandability of material information that is also disclosed; and*

(d) *just because a line item presented in a primary financial statement is determined to be material, it does not automatically follow that all IFRS disclosures pertaining to that line item are material to the entity's financial statements. An entity would assess the materiality of each disclosure requirement individually.*

EFRAG's response

EFRAG thinks that more general guidance on materiality could be included in the Conceptual Framework.

334 The IASB has chosen to direct the Conceptual Framework towards its own standard setting. The IASB's choice not to consider materiality further in the Conceptual Framework is consistent with this choice, as the assessment of materiality is mostly relevant for preparers, auditors and regulators and less relevant when preparing standards.

335 However, as mentioned above, EFRAG considers that the Conceptual Framework should also be useful for preparers. It could therefore be useful to include the general guidelines mentioned in paragraph 7.46 of the DP [which are reproduced in paragraph 333 above] in the Conceptual Framework. More specific guidance should, however, be provided somewhere else in order to avoid the Conceptual Framework becoming an accounting textbook. In addition, including guidance in Standards results in the appropriate authority of the requirements.

336 EFRAG agrees with the DP that additional material on the application of materiality could be provided by amending Standards or by providing educational material. The most useful may be a combination. In the discussion paper *Towards a Disclosure Framework for the Notes*, EFRAG, the ANC and the FRC have developed some indicators for materiality for types of information. EFRAG considers that these indicators, could be a useful basis for developing some concrete guidance on the issue.

Question 18

The form of disclosure requirements, including the IASB's preliminary view that it should consider the communication principles in paragraph 7.50 of the DP [which is summarised in paragraph 339 below] when it develops or amends disclosure guidance in IFRSs, is discussed in paragraphs 7.48–7.52 of the DP [which are summarised in paragraphs 344 to 339 below].

Do you agree that communication principles should be part of the Conceptual Framework? Why or why not?

If you agree they should be included, do you agree with the communication principles proposed? Why or why not?

Notes to constituents

337 The DP proposes that each Standard that proposes disclosure and presentation requirements should have a clear objective. This objective would guide entities when identifying the best disclosures and presentation to meet the objective.

338 The DP notes that disclosure guidance in Standards should seek to promote disclosure (including presentation) in the financial statements as a form of communication guided by Standards, as opposed to a mechanism whose sole purpose is compliance with specific requirements of Standards. Consequently, the IASB should develop guidance that promotes effective communication of that information.

339 As a result, the DP proposes that the IASB should consider the following communication principles when it sets disclosure requirements:

(a) *Disclosure guidance should seek to promote the disclosure of useful information that is entity-specific.*

(b) *Disclosure guidance should result in disclosures that are clear, balanced and understandable. Guidance should therefore give entities the flexibility to write disclosures as simply and directly as possible.*

(c) *Disclosure guidance should enable an entity to organise disclosures in a manner that highlights to a user of financial statements what is important.*

(d) *Disclosures should be linked. Standards should therefore permit the use of cross-referencing where possible and appropriate.*

(e) *Disclosure guidance should not result in the duplication of the same information in different parts of the financial statements.*

(f) *Disclosure guidance should seek to optimise comparability without compromising the usefulness of the information disclosed. This assessment will determine whether the IASB permits or requires disclosures and whether Standards stipulate the form of disclosure, for example, in tables rather than descriptions.*

EFRAG's response

EFRAG agrees that communication principles should be part of the Conceptual Framework and generally agrees with the principles suggested.

340 EFRAG agrees with the DP that communication principles should be part of the Conceptual Framework. Financial statements are aimed at communicating financial information to users. While the content of the notes is of utmost importance to achieve relevance and faithful representation, poor communication hinders the quality of information, especially within lengthy reports.

341 As the notes form part of telling 'the story' of an entity's financial performance and position it is difficult to establish anything other than high-level generic principles that can be used when presenting information in the notes. In *Towards a Disclosure Framework for the Notes*, EFRAG, the ANC and the FRC developed principles which are broadly similar to those suggested in the DP. EFRAG generally agrees with the high-level generic principles suggested in the DP.

SECTION 8 PRESENTATION IN THE STATEMENT OF COMPREHENSIVE INCOME–PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME (OCI)

Question 19

The IASB's preliminary view that the Conceptual Framework should require a total or subtotal for profit or loss is discussed in paragraphs 8.19–8.22 of the DP [which is summarised below in paragraphs 343–345].

Do you agree with this preliminary view? Why or why not? If you do not agree do you think that the IASB should still be able to require a total or subtotal profit or loss when developing or revising particular Standards?

Notes to constituents

342 *The DP includes the following discussion on the presentation in the statement(s) of profit or loss and other comprehensive income:*

(a) *The purpose of the statement(s) of profit and loss and other comprehensive income – OCI*[9] *(paragraphs 8.5–8.7 of the DP);*

(b) *Current IFRS guidance about presentation in the statement(s) of profit or loss and other comprehensive income, including a discussion about financial performance (paragraphs 8.8–8.18 of the DP);*

(c) *Whether the Conceptual Framework should require a profit or loss total or sub-total and require (or permit) recycling (paragraphs 8.19–8.26 of the DP)? and*

(d) *Alternative approaches to profit or loss and recycling (paragraphs 8.27–8.97, including Table 8.5, of the DP).*

343 *The existing Conceptual Framework does not specifically discuss presentation of financial performance in the statement(s) of profit or loss and OCI. Respondents to the Agenda Consultation 2011 identified the reporting of financial performance, including the use of OCI and recycling, as a priority topic that the IASB should address. European constituents expressed similar views at the EFRAG's outreach events on Financial Statement Presentation held in late 2010.*

344 *The DP states that all items recognised in the statement(s) of profit or loss and OCI provide some information about financial performance and thus does not equate financial performance with either 'total comprehensive income' or 'profit or loss' or with any other total, subtotal or other commonly used performance measure. Instead, the DP explores how all recognised items of income and expense can be presented, using totals and subtotals, in a way that is useful for users of financial statements in their decisions about providing resources to the entity.*

345 *The IASB has previously acknowledged that many investors, creditors, preparers and others view profit or loss as a useful performance measure and that 'profit or loss' as a subtotal or a phrase is deeply ingrained in the economy, business and investors' minds. Users from all sectors incorporate profit or loss in their analyses, either as a starting point for further analysis or as the main indicator of an entity's performance. It is therefore the IASB's preliminary view that the Conceptual Framework should require profit or loss as a total or subtotal.*

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[9] In the DP the statement(s) of profit or loss and OCI refers to either: (a) one statement, namely a combined statement of profit or loss and OCI; or (b) two statements, being the statement of profit or loss and the statement of comprehensive income.

EFRAG's response

EFRAG agrees that the Conceptual Framework should require profit or loss to be presented.

346 EFRAG agrees with the view that users from all sectors incorporate profit or loss in their analyses, either as a starting point for analysis or as the main indicator of an entity's performance. EFRAG also considers that profit or loss is the primary measure of an entity's performance. Therefore, EFRAG believes that profit or loss is an essential number that supports users' needs and agrees that Conceptual Framework should require profit or loss to be presented.

347 EFRAG does not agree with the arguments by some that splitting items between profit or loss and other comprehensive income will prevent users from seeing and evaluating all items of income and expense. EFRAG believes that providing a profit or loss will provide greater transparency and help a user better assess the entity's performance and prospects for future net cash inflows.

348 EFRAG believes that if profit or loss excludes some items of income and expense resulting from changes of current measures of assets and liabilities (remeasurements), the profit or loss total has more predictive value than total comprehensive income. Nevertheless, EFRAG would strongly oppose shifting to OCI cost-based 'adjustments' such as impairment losses and reversals of impairment losses.

Question 20

The IASB's preliminary view that the Conceptual Framework should permit or require at least some items of income and expense previously recognised in in OCI to be recognised subsequently in profit or loss; i.e. recycled, is discussed in paragraphs 8.23–8.26 of the DP [which are summarised below in paragraphs 349–350].

Do you agree with this preliminary view? Why or why not? If you agree, do you think that all items of income and expense presented in OCI should be recycled into profit or loss? Why or why not?

If you do not agree, how would you address cash flow hedge accounting?

Notes to constituents

349 *In discussing whether the Conceptual Framework should include a concept for profit or loss, the arguments for and against recycling also need to be considered. This is because, if there is no recycling, then profit or loss is not that different in nature from other totals or subtotals. Therefore, the IASB's preliminary view is that some items of income or expense should or could be recycled to profit or loss.*

350 *The DP also identifies an approach for deciding what should be recognised in OCI which would result in items of income and expense recognised in the statement(s) of profit or loss and OCI only once and never recycled ('Approach 1'). Arguments against recycling are described in paragraph 8.25 of the DP. The IASB sees a total or subtotal for profit or loss that involves no recycling as, conceptually, no different from other totals or subtotals in the primary financial statements.*

EFRAG's response

EFRAG thinks that all items presented in OCI should qualify for recycling to profit or loss unless recycling would not provide relevant information in profit or loss.

351 EFRAG's general view is that the Conceptual Framework should require at least some items of income and expense previously recognised in OCI to be recognised

subsequently in profit or loss (i.e. recycled). Accordingly, EFRAG is not persuaded by the arguments against recycling (Approach 1) presented in the DP. As noted in paragraph 346 above, EFRAG thinks that the Conceptual Framework should require profit or loss to be presented in the financial statements and in the view of EFRAG this would mean that recycling would be needed. Otherwise it would not be possible to provide the correct depiction of an entity's performance, which is primarily reflected in profit or loss.

352 EFRAG therefore also believes that discussions on recycling are closely related to those on what the objectives or purposes of profit or loss and OCI are. If the objective of profit or loss would be clearly identified then it would be much easier to determine for which items of OCI recycling would provide relevant information.

353 If there were to be no recycling, the Conceptual Framework would not need to specify whether an entity should present profit or loss, or any other total or subtotal, and the decision whether to require or permit profit or loss, or any other total or subtotal, would be one that the IASB could take when it developed or revised particular Standards.

354 EFRAG thinks that when an item of income and expense is presented in OCI, it should automatically qualify for the recycling, unless recycling would not result in relevant information in profit or loss, the primary measure of an entity's performance. EFRAG believes that recycling of remeasurements that are expected to reverse fully or significantly change over the holding period of the asset or liability would generally not result in relevant information in the profit or loss.

355 EFRAG finds a lot of appeal in the simple principle that items initially presented outside of profit or loss need to be recycled into it when the reason for initial exclusion no longer applies. However, we recognise that it is not that simple to make such a high level principle operational.

Question 21

In this Discussion Paper, two approaches are explored that describe which items could be included in the OCI: a narrow approach (Approach 2A described in paragraphs 8.40−8.78 of the DP) and a broad approach (Approach 2B described in paragraphs 8.79-8.94 of the DP).

Which of these approaches do you support, and why?

If you support a different approach, please describe that approach why do you believe it is preferable to the approaches described in this Discussion Paper.

Notes to constituents

356 *The DP contains two approaches that explore the IASB's preliminary view about profit or loss and recycling, namely Approach 2A and Approach 2B. Both approaches are based on three principles (i.e. Principle 1, Principle 2 and Principle 3). Both approaches use exactly the same Principle 1 and Principle 2, but these principles would be applied more broadly under Approach 2B. The third principle is different. The first two principles, which determine which items of income and expense would be eligible to be recognised in profit or loss or OCI, are:*

(a) Principle 1: items of income and expense presented in profit or loss provide the primary source of information about the return an entity has made on its economic resources in a period.

(b) Principle 2: all items of income and expense should be recognised in profit or loss unless recognising an item in OCI enhances the relevance of profit or loss in that period.

357 *Approach 2A has as Principle 3: 'an item that has previously been presented in OCI should always be reclassified (recycled) to profit or loss–this occurs when the reclassification results in relevant information.'*

358 *Approach 2B has as Principle 3: 'an item that has previously been recognised in OCI should be reclassified (recycled) to profit or loss when, and only when, the reclassification results in relevant information.' This would mean items may be recognised in OCI without necessarily resulting in recycling.*

359 *Approach 2A and Approach 2B treat profit or loss items as the default category and describe the types of items that could be recognised in OCI (rather than what could be recognised in profit or loss), namely:*

(a) *Approach 2A: a 'narrow' approach to describing which items could be recognised in OCI (see paragraphs 8.40–8.78 of the DP), where consequently all the items that had been recognised in OCI would be recycled to profit or loss. However, if recycling would not result in relevant information in any subsequent period, the item of income or expense would not be eligible for recognition in OCI. This approach actually proposes that only two groups of items would be eligible for recognition in OCI: 'bridging items' (paragraphs 8.55–8.61 of the DP) and 'mismatched remeasurements' (paragraphs 8.62–8.68 of the DP). Limiting OCI to these two groups of items could mean that some items currently in OCI would conceptually not qualify for recognition in OCI; and*

(b) *Approach 2B: a 'broader' approach to describing which items could be recognised in OCI (see paragraphs 8.79–8.94 of the DP, including Table 8.3), which would allow the IASB greater discretion when developing or revising particular Standards to determine whether an item of income or expense should be recognised in OCI and whether the item should subsequently be recycled. Under approach 2B an item may be recognised in OCI even if it would not subsequently qualify for recycling, therefore it would permit more items to be recognised in OCI than under the Approach 2A. Approach 2B proposes that, in addition to using the concepts of 'mismatched remeasurements' and 'bridging items' from the Approach 2A, the IASB should consider recognising items of income and expense in OCI if they are 'transitory remeasurements' (see paragraphs 8.88–8.92 of the DP). Such transitory remeasurements would be recycled only if the recycling provided sufficiently relevant information to justify the cost and complexity that recycling adds to financial reporting. Consequently, the IASB would determine in the Standard dealing with each particular type of transitory remeasurement whether and when it should be recycled.*

EFRAG's response

EFRAG supports Approach 2B and believes an entity's business model should play a role in defining primary performance and thus which items of income and expense should go to profit or loss and which into OCI. Therefore, the Conceptual Framework should not artificially limit the IASB's possibilities for defining the primary performance, reflected in profit or loss.

Principles in Approach 2A and Approach 2B

360 EFRAG agrees with principle 1 on the basis that presenting items separately in profit or loss and OCI clearly identifies different components of the return an entity has made on its resources during a period and hence provides useful information for assessing the prospects for future cash flows arising from them. EFRAG agrees with the use of the term 'primary' in principle 1, as it reflects the prominence of profit or loss while at the same time acknowledges that items presented outside profit or loss may still provide relevant information for the user to assess the performance of the entity.

361 In EFRAG's opinion OCI items are unjustifiably treated by many as pieces of information of really minor relevance. OCI contains relevant information for the assessment of the entity's overall performance.

362 EFRAG agrees with principle 2. It also agrees with the reasoning in the DP that presenting in OCI items of income or expense resulting from cost-based measurements, including amortised cost (depreciation and amortisation; accrual of interest, accretion of a discount, or amortisation of a premium; or impairment of assets or increases to the carrying amount of liabilities that have become onerous) would not enhance the relevance of profit or loss and that the OCI should be limited to items of income and expense resulting from changes in current measures of assets and liabilities (remeasurements).

363 EFRAG disagrees with the application of Principle 3 from Approach 2A that limits the recognition of item of income or expense in OCI if recycling would not result in relevant information in profit or loss.

364 Since Principle 3 from Approach 2B states that an item that has previously been recognised in OCI should be reclassified (recycled) to profit or loss *when, and only when*, the reclassification results in relevant information, EFRAG supports the Principle 3 from Approach 2B. That principle is actually aligned with EFRAG's preliminary view expressed under Question 20 that all items presented in OCI should qualify for recycling to profit or loss unless recycling would not provide relevant information in profit or loss.

Applying the principles in Approach 2B

365 Based on the three principles described above, Approach 2B proposes that three groups of items would be eligible for recognition in OCI. These are labelled as 'bridging items' (at the moment only changes in the discount rate of the financial assets measured at fair value through OCI from *IFRS 9 2012 ED* and changes in the discount rate of insurance contracts from *Insurance Contracts 2013 ED*), 'mismatched remeasurements' (for example net investment in foreign operations from IAS 21 *The Effects of Changes in Foreign Exchange Rates*) and 'transitory remeasurements', which are discussed below.

Bridging items

366 The 'bridging items' concept should, in EFRAG's opinion, be used only when this presentation (reporting two measurements) best reflects the entity's financial position and performance in the specified circumstances, based on the entity's business model (please see paragraphs 402 to 423 below).

367 EFRAG agrees that using two different measurement bases is only warranted if both measures provide sufficiently useful information about different facets of the entity's financial position and financial performance. Those measures need to be determined consistently with the measurement concepts as described in Section 6 *Measurement* of the DP. As the use of two measurement bases would result in additional costs and might make the financial statements less understandable, the IASB would need to justify whether the benefits of the additional information would outweigh those disadvantages.

368 In line with EFRAG's view expressed above, bridging amounts in OCI (i.e. the difference between the two measurement bases) should be recycled to profit or loss *unless* recycling would not result in relevant information in the statement of profit or loss. For example, if a debt instrument is measured at fair value in the statement of financial position, but recognised in profit or loss using amortised cost, then amounts previously reported in OCI would generally be recycled.

Mismatched remeasurements

369 Mismatched remeasurements arise when one of the items (or part of an item) within a linked set of items is regularly remeasured, while the linked item is not remeasured or

is not recognised until later. For example, when all derivatives are measured at fair value and the derivative is used to hedge a forecast transaction, changes in the fair value of the derivative arise in a reporting period or periods before the income or expense resulting from the forecast transaction. To the extent that the hedge is effective and qualifies for hedge accounting, in accordance with Standards, an entity reports in OCI the gains or losses on the derivative, and subsequently recycles those gains or losses into profit or loss when the forecast transaction affects profit or loss. That enables users of financial statements to see the results of the hedging relationship.

370 EFRAG supports the concept of mismatched remeasurements' to define additional group of items (other than 'bridging items') which are eligible for presentation in OCI. When an item of income and expense is delinked from a set of items to which it relates, the item provides little relevant information about the return the entity has made on its economic resources in the period. In this case amounts in OCI related to mismatched remeasurements would be recycled into profit or loss only when they can be presented with the transactions with which they are linked.

Transitory remeasurements

371 In addition to only two groups of items eligible for recognition in OCI under Approach 2A (bridging items and mismatched measurements), Approach 2B introduces an additional category of OCI items, namely the transitory remeasurements. This category is based on the view that remeasurements of some long-term assets or liabilities are best reflected outside profit or loss. Presentation of a remeasurement (or components of a remeasurement) in OCI in these circumstances may provide more transparent information about how the asset is likely to contribute to future cash flows or how the liability is likely to be settled.

372 EFRAG supports the concept of transitory remeasurements' under which additional items of income and expense would qualify for presentation in OCI. The inclusion of the transitory remeasurements concept will help avoid OCI recognition and recycling requirements being applied mechanically.

EFRAG's position on Approach 2A, Approach 2B and recycling

373 To summarise, EFRAG supports Approach 2B as suggested in the DP, based on the bridging items, mismatched remeasurements and transitory remeasurements concepts. EFRAG believes the business model should play a role in defining primary performance and thus which items of income and expense should go to profit or loss and which into OCI. Therefore, the Conceptual Framework should not artificially limit IASB's possibilities for defining primary performance, reflected in profit or loss, which may be the outcome if Approach 2A were adopted.

374 As already expressed under question 20, EFRAG thinks that all items presented in OCI should qualify for recycling to profit or loss unless recycling would not provide relevant information in profit or loss. Therefore some bridging items (i.e. the difference between the two measures) that should, according to the DP, always be recycled to profit or loss, could be exempted from recycling. EFRAG believes that IASB should in this case set out why it does not think recycling would provide relevant information in profit or loss when developing each Standard (most likely in Basis for Conclusions).

375 In the case of mismatched measurements, EFRAG supports the concept itself as well as the related recycling principle: the amounts in OCI related to mismatched remeasurements would be recycled into profit or loss only when they can be presented with the transactions with which they are linked. For EFRAG's comprehensive view on recycling please refer to paragraphs 351-355.

SECTION 9 OTHER ISSUES

Chapters 1 and 3 of the existing Conceptual Framework

Question 22

Paragraphs 9.2–9.22 of the DP [which are summarised in paragraphs 376 to 378 below] address the chapters of the existing Conceptual Framework that were published in 2010 and how those chapters treat the concepts of stewardship, reliability and prudence. The IASB will make changes to those chapters if work on the rest of the Conceptual Framework highlights areas that need clarifying or amending. However, the IASB does not intend to fundamentally reconsider the content of those chapters.

Do you agree with this approach? Please explain your reasons.

If you believe that the IASB should consider changes to those chapters (including how those chapters treat the concepts of stewardship, reliability and prudence), please explain those changes and the reasons for them, and please explain as precisely as possible how they would affect the rest of the Conceptual Framework.

Notes to constituents

376 The IASB has decided not to revisit Chapter 1 and Chapter 3 of the Conceptual Framework that it published in 2010. It considers that these chapters have been through due process and provide a sound foundation for the rest of the Conceptual Framework. In addition, it thinks that a fundamental reconsideration of these chapters would delay the finalisation of the revised Conceptual Framework without resulting in significant changes.

377 The IASB will, however, make changes to these first chapters if work on the rest of the Conceptual Framework highlights areas that need clarifying or amending.

378 In its DP, the IASB is providing the reasons for how the current Conceptual Framework addresses: stewardship, reliability and prudence.

EFRAG's response

EFRAG thinks that the first chapters of the Conceptual Framework should be revised. EFRAG believes that it should appear from the first chapters that the objective of assessing stewardship is as important as assessing the prospects for future cash flows. Reliability should be reintroduced as a concept and prudence should be built into IFRS.

379 EFRAG believes that a fundamental discussion is needed on the Chapters 1 and 3 of the Conceptual Framework on stewardship, reliability and prudence. EFRAG's views on these issues are further explained in the following paragraphs.

Stewardship

380 Paragraph OB4 of the existing Conceptual Framework states:

> To assess an entity's prospects for future net cash inflows, existing and potential investors, lenders and other creditors need information about the resources of the entity, claims against the entity, and how efficiently and effectively the entity's management and governing board have discharged their responsibilities to use the entity's resources. Examples of such responsibilities include protecting the entity's resources from unfavourable effects of economic factors such as price and technological changes and ensuring that the entity complies with applicable laws, regulations and contractual provisions. Information about management's discharge of its responsibilities is also useful for decisions by existing investors, lenders and other creditors who have the right to vote on or otherwise influence management's actions.

381 Accordingly, the existing Conceptual Framework acknowledges that financial reporting should provide information that would be useful for assessing stewardship (or 'accountability' which some consider to be a better term).

382 However, it appears also from OB4 that the current Conceptual Framework seems to:

(a) State that providing information to help existing and potential investors assess the prospects for future net cash inflows to an entity is the primary objective of financial reporting. Providing information that is useful for assessing stewardship is just something that could be useful for assessing future cash flows.

(b) Assume that information about stewardship is useful for estimating future cash flows. In other words, information that is useful for assessing stewardship is also useful for estimating future cash flows.

383 As it is explained in the Bulletin *Accountability and the objective of financial reporting* issued by EFRAG, ANC, ASCG, OIC and FRC, EFRAG disagrees with both of these assertions[10].

384 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, however, notes that academic literature shows that information most useful for estimating future cash flows is not always the most useful for assessing stewardship[11]. The Conceptual Framework should acknowledge this. In cases where the two objectives would conflict, a decision would therefore have to be taken on which objective is considered most important in the current case. This decision should be considered on a standards level and be subject to public consultation.

385 EFRAG notes that the Conceptual Framework only deals with financial reporting. In order to avoid doubt, EFRAG would, however, specify that it does not think that financial information is the only means by which stewardship should be assessed.

Reliability

386 EFRAG acknowledges that the DP suggests that an entity should not recognise an asset or liability if no measure of the asset (or liability) would result in a faithful representation of a resource or obligation of the entity, or of a change in its resources or obligations, even if all necessary descriptions and explanations are disclosed.

387 EFRAG agrees with this suggestion. Academic literature suggests that reliability is at least equally important as relevance, and that disclosure of the process and inputs into an estimate cannot always compensate for measurement uncertainty.

388 Although EFRAG agrees with the suggestion to consider faithful representation when recognising assets and liabilities, it thinks that this should also lead to some changes in how faithful representation is explained in Chapter 3 of the current Conceptual Framework. In the view of EFRAG the most appropriate would simply be to replace the term with 'reliability'. 'Reliability' should be defined in the same way it was in Conceptual Framework before 2010. That is, 'reliability' would, as a starting point, mean that information:

(a) should be free from material error and bias.

(b) can be depended upon by users to represent faithfully that which it either purport to represent or could reasonably be expected to represent. This also means that transactions and other events are accounted for and presented in accordance with their substance and economic reality and not merely their legal form.

(c) is prepared under the exercise of prudence (see below).

[10] Not all the partners issuing the Bulletin share the preliminary view of EFRAG on these issues. The different views are explained in the Bulletin.

[11] EFRAG and ICAS will issue a literature review on studies on capital providers' use of financial statements.

(d) is complete.

389 EFRAG acknowledges that besides including the reference to prudence (which is further considered below) and specifying that transactions and other events should be presented in accordance with their substance, the elements of 'reliability' are similar to those used to describe 'faithful representation' in the current Conceptual Framework. However, EFRAG thinks that when the term was changed in 2010 from 'reliability' to 'faithful representation', there was also a change in the context in which reliability should be considered. EFRAG is of the opinion that before the change in 2010, there was a trade-off between relevance and reliability which should be reintroduced. That is, information could be relevant without being reliable and vice versa. After the changes all reference to this trade-off have been removed. EFRAG believes that this trade-off should be reintroduced. EFRAG thinks that reintroducing the trade-off would also be consistent with the proposal in the DP that an entity should not recognise an asset or liability if no measure of the asset (or liability) would result in a faithful representation. If the IASB thought that assets and liabilities should not be recognised when they could not be measured reliably because this would not result in relevant information, the IASB could just have referred to relevance as the recognition criterion. By referring to faithful representation in addition to relevance, it seems as if some assets and liabilities could be relevant to recognise – but recognition would not result in reliable information.

390 In order to reflect its decision on the recognition criterion, the IASB should also amend the wording of paragraphs QC15 and QC16. These paragraphs note that 'if the level of uncertainty in an estimate is sufficiently large, that estimate will not be particularly useful''. However, they also state that 'a representation of [an] estimate can be faithful if the amount is described clearly and accurately as being an estimate, the nature and limitations of the estimating process are explained, and no errors have been made in selecting and applying an appropriate process for developing the estimate' and that 'if there is no alternative representation that is more faithful, that estimate may provide the best available information'. Without any clarification, EFRAG does not believe the latter would reflect EFRAG's view and the IASB's suggestion in the DP as noted in paragraph 386 above.

391 In addition to replacing 'faithful representation' with 'reliability' as defined in the pre-2010 Conceptual Framework, EFRAG considers that verifiability should form part of reliability instead of just being considered an enhancing qualitative characteristic. In the description of verifiability, the meaning seems weak as it requires only a consensus between different knowledgeable and independent observers, rather than a reasonable level of certainty over the measurement of the financial effects of the item.

392 EFRAG's view on reliability is further explained in the Bulletin *Reliability of financial information* issued by EFRAG, ANC, ASCG, OIC and FRC.

Prudence

393 On prudence, EFRAG agrees with the DP that, although widely accepted as a concept, there are differing views as to what prudence means in practice. In EFRAG's view prudence represents a degree of caution which generally recognises downside risks and not upside potential inherent in uncertain future events.

394 As such a prudence filter within the Conceptual Framework should operate in setting standards for recognition or measurement – it does not relate to disclosure as the uncertainties/risks can be described at least qualitatively if not quantitatively. For example, when the inflows related to an asset are contingent on an uncertain future event, the filter could prevent this (contingent) asset from being recognised at all on the statement of financial position. However, information about the potential asset could and should be provided in the notes to the financial statements.

395 Prudence is clearly reflected both in Standards in force today and those being developed. So, for example, the new Standard on revenue recognition requires a customer contract to exist in order to recognise revenue and hence the uplift in

inventory above cost; similarly even with a customer contract recognition of variable consideration is limited to the amount which is reasonably assured (rather than, for example, the expected amount). In contrast a potential reduction in inventory below cost is recognised as soon as it is expected. Whilst for financial instruments the measurement criteria are generally more even handed, even then, for example, the treatment of day one profits uses the concept of prudence. EFRAG therefore believes that it is essential to include a clearly articulated concept of prudence in the Conceptual Framework in order to ensure that it is applied consistently across the Standards (both current and future).

396 EFRAG's view on prudence is further explained in the Bulletin *Prudence* issued by EFRAG, ANC, ASCG, OIC and FRC.

The use of the business model concept in financial reporting

Question 23

The business model concept is discussed in paragraphs 9.23–9.34. This DP does not define the business model concept. However, the IASB's preliminary view is that financial statements can be made more relevant if the IASB considers, when developing or revising particular Standards, how an entity conducts its business activities.

Do you think that the IASB should use the business model concept when it develops or revises particular Standards? Why or why not?

If you agree, in which areas do you think that the business model concept would be helpful?

Should the IASB define 'business model'? Why or why not? If you think that 'business model' should be defined, how would you define it?

Notes to constituents

397 The DP provides the IASB's preliminary view that financial statements can be made more relevant if the IASB considers how an entity <u>conducts its business activities</u> when the IASB develops new or revised Standards.

398 The way in which an entity <u>conducts its business activities</u> is considered in the following other sections of the DP.

(a) *Section 6 – Measurement: The measurement section proposes that the IASB should consider how an asset contributes to future cash flows and a liability will be settled or fulfilled when deciding on an appropriate measurement method.*

(b) *Section 7 – Presentation and disclosure: In determining the level of aggregation or disaggregation in the primary financial statements, the IASB or an entity will need to consider how the item is used in the entity's business.*

(c) *Section 8 – Presentation in the statement(s) of profit and loss and other comprehensive income: In deciding whether to present different measurements in the profit or loss and the statement of financial position (i.e. a bridging item), the IASB should consider (amongst other things) how the entity intends to use that item in its business.*

399 The DP provides a description how the business model concept has been used in existing Standards:

(a) *The IASB first used the term 'business model' in IFRS 9 Financial Instruments, issued in November 2009, where classification and measurement of financial assets depend on an entity's business model for managing those assets. IFRS 9 does not define an entity's business model but notes a number of factors in determining a business model.*

(b) *The IASB has recently required investment entities not to consolidate their subsidiaries (IFRS 10 Consolidated Financial Statements) because investment entities have a unique business model that makes reporting subsidiaries at fair value more appropriate than consolidation.*

(c) *Other Standards do not explicitly refer to a business model, but the way in which an entity uses its assets has previously been used by the IASB, particularly in classifying and measuring different types of non-financial assets (IAS 2 Inventories, IAS 40 Investment Property, IAS 16 Property, Plant and Equipment, IFRS 5 Non-current Assets Held for Sale and Discontinued Operations).*

(d) *An entity's business model also affects how it reports operating segments in accordance with IFRS 8 Operating Segments.*

400 So far the IASB has not defined the term 'business model' and the DP does not define the business model concept. The DP discusses how others have described the business model concept:

(a) *The International Integrated Reporting Council suggests that the business model is defined as: 'the chosen system of inputs, business activities, outputs and outcomes that aims to create value over the short, medium and long term'.*

(b) *Some think that a business model would reflect the configuration of the business; activities of the business; how the business adds value including the generation of its cash flows, and customers of the products or services.*

(c) *Some think that the business model refers to management's use or disposition of assets and holding or transferring/settling obligations, holding the view that there is no difference between management's intent and a business model approach.*

401 The DP discusses some of the advantages and disadvantages of using a business model concept in financial reporting:

(a) *Some believe that applying the business model concept when developing Standards provides relevant information because it provides insights into how the entity's business activities are managed and consequently, it helps users assess the resources of the entity, claims against the entity, and how the entity's management and governing board have discharged their responsibilities to use the entity's resources.*

(b) *Others think that the business model should not be used in standard-setting because they think it reduces comparability; it could encourage less neutral reporting because it could encourage preparers to present the most favourable outcome and because the business model concept is difficult to define and apply on a consistent basis.*

EFRAG's response

EFRAG believes that the business model notion should be referred to in IASB's financial reporting requirements on a systematic basis and thus be part of the IASB's *Conceptual Framework*.

402 The role of the business model for financial statements has been subject to extensive research conducted through EFRAG's proactive project undertaken jointly with the French ANC and the UK FRC. The final results of this project will be presented in a Research Paper, issued towards the end of 2013.

403 In addition to the Research Paper, EFRAG and the standard-setters from France, Germany, Italy and the United Kingdom issued a Bulletin in June 2013 as part of a series of papers to promote discussion on topics related to the IFRS Conceptual Framework debate.

404 Both the Research Paper and the Bulletin discuss the following issues:

(a) The use of the business model in IFRS;

(b) An assumed meaning of the term;

(c) The conceptual discussion on the business model;

(d) A discussion on the distinction between business model and management intent; and

(e) Implications of the business model for IFRS.

405 A summary of this discussion is provided below.

An assumed meaning of the term

406 Both the Research Paper and the Bulletin use an assumed meaning of the term. The assumed meaning focuses on the value creation process of an entity, i.e. how the entity generates cash flows. In case of non-financial institutions, it represents the end-to-end value creation process or processes of an entity within the business and geographical markets it operates.

The conceptual discussion on the business model

407 To assess whether the business model could, or even should, play a role in financial reporting, the Research paper and the Bulletin discuss the notion to assess whether such a role is essential for, or enhances the response to, the key qualitative characteristics in the IASB Conceptual Framework.

408 Based on this assessment the tentative view expressed in the Bulletin is that the business model should play a role in financial reporting, including the financial statements. Not doing so results in less relevant information, does not lead to a faithful representation of economic reality, harms comparability, and makes the financial statements less understandable. For this reason, the role of the business model should be explicitly incorporated in the IASB literature.

A discussion on the distinction between business model and management intent

409 The Research Paper and the Bulletin provide a discussion on the similarities and differences between the business model and management intent, an issue which has been debated extensively in the academic literature.

410 An important similarity between the business model and management intent is that they are both entity-specific, i.e., the financial statements reflecting the business model and management intent both present what actually happened and how the entity performed. In other words, the financial statements provide information that is useful for an assessment of management's accountability, or stewardship. The resulting information therefore meets the relevance criterion. Both business model and management intent are also verifiable, if they are documented on the necessary level of detail. Some take these similarities one step further and argue that the business model is the same as management intent, or that the two notions are connected, at least for purposes of financial reporting.

411 The tentative view expressed in the Bulletin is that there is a distinction between business model and management intent. Both notions provide relevant information, but business models tend to focus on the larger picture, are generally more stable, and usually require much less documentation to make them verifiable.

Implications of the business model for Conceptual Framework

412 EFRAG believes that financial reporting should portray the business model in order to faithfully represent the economic reality of the reporting entity, since it focuses on the actual, past and current transactions and events. Therefore, once the business model is identified and observed, the accounting treatment related to a business model should be derived from the business model.

413 EFRAG, the ANC, the DRSC, the OIC and the FRC do not believe that the current status quo, i.e. the business model being referred to in financial reporting requirements only on an ad hoc basis, explicitly or implicitly, at standards level should be maintained. As a consequence, they support the development of a proper rationale as part of the Conceptual Framework, with appropriate guidance for standard setting purposes.

414 Such guidance would help identify whether and when the business model notion should be explicitly incorporated on individual standards level. The Conceptual Framework should also require that the business model be based on observable and verifiable evidence.

415 If the business model approach is applied, its meaning would need to be described in the *Conceptual Framework* and in individual accounting standards that explicitly incorporate the term. In our opinion a very general definition/identification of the business model notion would suffice for the *Conceptual Framework*, but if the business model notion would be explicitly incorporated in individual standards then the notion would need to be defined/identified in more detail to be operational.

416 Furthermore, accounting standards should reflect faithfully an entity's business model or models. If that is not the case, EFRAG believes that financial reporting requirements have not been developed appropriately.

417 Additionally, the *Conceptual Framework* should highlight and illustrate how the business model can play a role in (i) recognition, (ii) measurement, (iii) presentation and (iv) disclosures. Some suggestions are presented hereafter.

Playing a role in recognition

418 If the business model plays a role in recognition, an item could be an asset for some entities and not recognised by others. An example can be found in IAS 39, paragraph 5, which states that the standards should be applied to "contracts to buy or sell a non-financial items that can be settled net in cash ... with the exception of contracts that were entered into and continue 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." This means that a contract to receive an amount of coal is a non-recognised executory contract for an energy producer, but a recognised financial instrument for a commodities trader.

Playing a role in measurement

419 Measurement (and the related accounting policy choice) is an obvious place where the business model should play a role, because current IFRS require, or permit, different measurement requirements depending on how an asset or a liability, or a group of assets or liabilities, contribute to the entity's cash flow generation. Please see paragraph 285 above in Section 6 *Measurement* which addresses the measurement of inventory.

420 Furthermore, EFRAG also believe that the business model provides an essential basis for understanding how assets and liabilities are used within a certain entity and thus how the assets contribute to future cash flows and how liabilities will be settled or fulfilled. The DP notes (paragraphs 6.75–6.96) that the way an asset will ultimately contribute to cash flows will often not be certain and that for most assets there are choices that may change. The business model thus actually limits management discretion (management intent) in selecting the appropriate measurement basis.

Playing a role in presentation

421 Measuring, but also presenting assets, liabilities, income and expenses in such a way that investors can understand how they contribute to the entity's cash flow generation can in itself be a way of representing the entity's business model. Segregating assets and liabilities which play a different economic role in the entity, for example helping provide optimum daily cash management versus creating liquidity for acquisitions and

capital expenditures, would provide users with both a better basis for looking at financial results and forming expectations of future financial results.

422 To a certain extent, this was the approach presented in the IASB-FASB joint project *Financial Statements Presentation*, which proposed that not only separation be made into operating, investing and financing activities, based on the nature of the assets and liabilities but also on the economic role they played in the activities of the entity. These underlying principles were widely welcomed (although constituents active in the financial services industry commented that such distinction was not always easy to make), and such a presentation was supportive of more meaningful sub-totals and performance indicators, such as operating profit.

Playing a role in disclosures

423 Business models could also play a role in the determination of priorities in information provided. In order to help users to clearly identify the most important elements of information, it could be assumed that the most important and relevant information should be given priority in the primary financial statements. The business model notion would help in identifying this most important information. Complementary (secondary) information would be presented somewhere else, for example in the notes to the financial statements. In particular, if there are two ways of measuring the same item or transaction, the one that is more closely related to the representation of the effects of the application of the business model in terms of cash flow generation should be placed in the primary financial statements and the complementary one in the note disclosures.

424 For more analysis on the above issues, please refer to the Bulletin *The Role of the Business Model in Financial Reporting*, which EFRAG and the standard-setters from France, Germany, Italy and the United Kingdom issued in July 2013. The Bulletin is open for comments until 30 September 2013. We encourage constituents to provide responses to the Bulletin as an early input on this particular topic.

Questions to constituents:

425 Do you support EFRAG's tentative position on the implications of the business model for Conceptual Framework, expressed in paragraphs 412-423? If not, please explain your reasoning.

426 The questions below reproduce the questions from the Bulletin *The Role of the Business Model in Financial Reporting*, issued in July 2013 by EFRAG and the standard-setters from France, Germany, Italy and the United Kingdom. Constituents should provide their input either as a response to the Bulletin or as a response to this draft comment letter.

(a) Do you think the assumed meaning as used in the Bulletin makes sense from a financial reporting perspective?

(b) Do you support the tentative view that management intent and business model are distinct?

(c) Do you support the tentative view that the business model should play a role in financial reporting?

(d) Do you agree with the proposed implications for the IFRS literature identified in the Bulletin?

(e) Do you have any other comments?

Unit of account

Question 24

The unit of account is discussed in paragraphs 9.35–9.41 [which are summarised in paragraphs 427 to 431 below]. The IASB's preliminary view is that the unit of account will normally be decided when the IASB develops or revises particular Standards and that, in selecting a unit of account, the IASB should consider the qualitative characteristics of useful financial information.

Do you agree? Why or why not?

Notes to constituents

427 The IASB is proposing that, in principle, a physical asset consists of different rights (the right to use the asset, the right to sell the asset and the right to pledge the asset). Although, in principle, each of these rights is capable of being a separate asset, combining them into a single unit of account and recognising a single asset (e.g. a machine) will in many cases provide the most relevant and understandable information to users of the financial statements.

428 The unit of account is also relevant in other circumstances. For example:

(a) *When measuring assets and liabilities (for example, a different measure may be obtained for equity instruments when measuring each share individually or measuring the total value of the equity investment).*

(b) *When determining whether an asset is impaired based on the asset in isolation or the cash generating unit to which the asset belongs.*

(c) *When measuring assets and liabilities based on the most likely outcome, that outcome may differ depending on whether it is determined for each asset or liability individually, or for a group of assets or liabilities.*

429 The IASB is proposing that determining the unit of account should be done when it develops new or revised Standards. When determining the unit of account on a standards level, the IASB should consider the qualitative characteristics of useful financial information.

430 The selected unit of account must:

(a) *provide relevant information. Information about individual rights or obligations may not be relevant if those rights or obligations cannot be, or are unlikely to be, the subject of separate transactions or if they would expire in different patterns.*

(b) *faithfully represent what it purports to represent. Grouping unrelated assets or liabilities together, in order to measure them, may not faithfully represent an entity's financial position or performance.*

431 *In addition, the costs associated with the selected unit of account must not exceed the benefits. In general, the costs associated with recognising and measuring items will be greater for a smaller unit of account.*

EFRAG's response

EFRAG generally agrees with the proposal but thinks that the IASB should commit itself more explicitly to consider the unit of account in relation to each Standard.

432 EFRAG agrees that the Conceptual Framework should include a section on how to determine the unit of account. The unit of account affects several measurement and recognition issues.

433 EFRAG thinks that when the unit of account is determined on a standards level, the assessment should focus on the figures (the aggregate of events and transactions) ultimately reported in the financial statements taking the entity's business model into account. For example, if an entity has sold one product in the accounting period and has provided a product warranty, the most likely outcome of this obligation may be zero (when the entity has experience that its products are free from errors). However, if the entity has sold thousands of similar products, the most useful information about the likely outcome of the warranty obligation may be to consider the bundle of warranties as the unit of account when reporting the most likely outcome. Similarly, if the entity's business model is to buy and sell equity instruments in bundles rather than individually, it may be more relevant to consider these bundles as the unit of account rather than measuring each equity instrument individually and then add these together (see also the comments to the business model above).

434 For some industries the unit of account may not be a physical item or a contractual right. For example, the unit of account for financial institutions may be the different risk components. In other cases EFRAG believes that the unit of account could consist of both assets and liabilities (e.g. in relation to insurance) if this results in the most relevant information.

435 Although EFRAG agrees with the DP that the unit of account should be considered in relation to each Standard, we think that the Conceptual Framework should commit the IASB more explicitly to consider the unit of account when developing new or revised guidance. In other words, if a new or revised Standard in the future does not consider the unit of account, the IASB should provide convincing arguments for not addressing this issue in the Basis for Conclusions to the new or revised guidance.

Going Concern

Question 25

Going concern is discussed in paragraphs 9.42–9.44 of the DP [which are summarised in paragraphs 436 to 437 below]. The IASB has identified three situations in which the going concern assumption is relevant (when measuring assets and liabilities, when identifying liabilities and when disclosing information about the entity).

Are there any other situations where the going concern assumption might be relevant?

Notes to constituents

436 The existing Conceptual Framework states that the financial statements are normally prepared on the assumption that an entity is a going concern and will continue in operation for the foreseeable future. Hence it is assumed that the entity has neither the intention nor the need to liquidate or curtail materially the scale of its operations; if such an intention or need exists, the financial statements may need to be prepared on a different basis and, if so, the basis used should be disclosed.

437 The DP identifies the following situations where the going concern assumption is relevant:

(a) *When distinguishing between debt and equity as payments that would arise only on liquidations do not meet the definition of a present obligation;*

(b) *When measuring assets and liabilities, as an entity's ability to continue as a going concern may affect how it will use an asset and settle a liability; and*

(c) *When preparing disclosures.*

EFRAG's response

EFRAG agrees with the situations identified. However, we think that the link between the going concern assumption and concepts such as 'practically unconditional' and 'no realistic alternative' should be explained.

438 EFRAG agrees with the situations identified in the DP where the going concern assumption is relevant. EFRAG notes that there are currently mixed views about whether the going concern assumption should play a role in assessing whether a liability exists. The issue has arisen when the liability depends on the entity's future actions. For example, in situations where the entity will have to pay a levy if it stays in business. In the section on additional guidance to support the asset and liability definitions, the DP, however, notes that the going concern assumption should not play a role for the assessment in those circumstances. The IASB notes that even though financial reporting generally presumes that an entity is in going concern, that fact does not mean that the entity is obliged to remain in business. EFRAG considers this guidance helpful, and thinks that it should be included in the Conceptual Framework.

439 However, EFRAG thinks that more guidance on going concern is needed. For example, if the IASB chooses an approach where liabilities are recognised for obligations that are practically unconditional. In these cases, guidance is needed on how practicality and the going concern assumption interact. Similarly, EFRAG thinks that the going concern assumption indirectly will affect when a constructive obligation should be recognised as 'no realistic alternative' also assumes that the entity will remain a going concern. Both 'practically unconditional' and 'no realistic alternative' are, however, more than just the going concern assumption.

Capital maintenance

Question 26

Capital maintenance is discussed in paragraphs 9.45–9.54 of the DP [which is summarised in paragraph 440 below]. The IASB plans to include the existing descriptions and the discussion of capital maintenance concepts in the revised Conceptual Framework largely unchanged until such time as a new or revised Standard on accounting for high inflation indicates a need for change.

Do you agree? Why or why not? Please explain your reasons.

Notes to constituents

440 The existing Conceptual Framework describes financial capital maintenance and physical capital maintenance but does not prescribe a particular model of capital maintenance. It states that the management of an entity should exercise judgement and select the concept of capital maintenance that provides the most useful information to the users of financial statements.

EFRAG's response

EFRAG agrees that the IASB should defer its work on capital maintenance until it considers how to account for inflation.

441 EFRAG is not aware that the current guidance on capital maintenance, or the lack of further guidance on the issue, has resulted in any major issues. EFRAG therefore support the proposal of not dealing with the issue at this moment.

ADDITIONAL ISSUES

442 In addition to the issues considered in the DP, EFRAG would like to provide some additional comments related to the reporting entity and the reporting period.

Reporting entity

443 The IASB has decided not to discuss the reporting entity issue in relation to this DP. Instead the IASB will consider the comments received in response to its 2010 exposure draft on the reporting entity when preparing an exposure draft on the review of the Conceptual Framework for financial reporting. EFRAG considers this unfortunate. EFRAG thinks that several issues could have benefitted from additional discussion before moving to the next phase of the review of the Conceptual Framework. In particular EFRAG believes that the perspective from which financial statements are presented is critical and should be discussed in the Conceptual Framework. EFRAG notes that this issue was not included in the 2010 exposure draft on the reporting entity. However, clarifying the perspective is important in assessing how to resolve accounting policy issues and is central to considering how to satisfy the objective of financial reporting. EFRAG therefore thinks that it is necessary to carry out an in-depth analysis of the implications of adopting either perspective and to ensure they are properly debated. It would have been beneficial to initiate this work when developing the DP.

444 In addition, EFRAG thinks that the IASB should examine more comprehensively whether the application of a joint control approach for determining the boundaries of the group reporting entity provides decision-useful information.

Reporting period

445 EFRAG considers that some guidance on what the reporting period represents should be provided. EFRAG, for example, questions the logic of current requirements where:

(a) Impairment of goodwill recognised in one interim period cannot be reversed although it would not have been recognised if only an annual report had been prepared.

(b) A levy relating to an entire year that only meets the criteria for recognition in the last quarter of a financial year would only be reflected in the result of this last quarter. Accordingly, some could argue that the quarterly reports of the first periods of the financial year have provided a too optimistic reflection of the entity's performance.

446 EFRAG acknowledges that these issues may primarily relate to interim reporting, and could thus be considered in relation to this specific Standard. However, EFRAG wants to raise the issue in case the IASB considers it more appropriate to deal with the issue in relation to the Conceptual Framework.