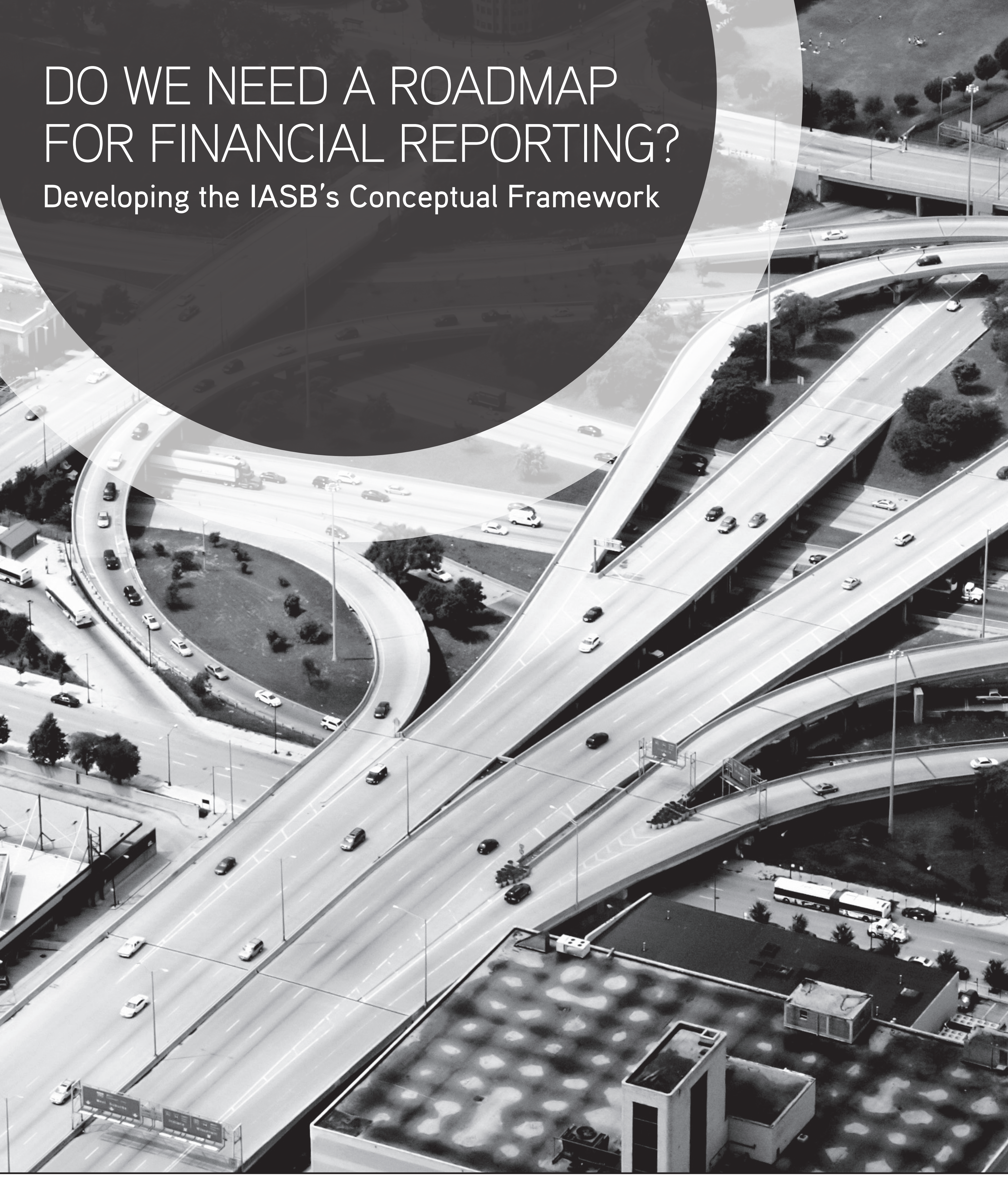
DO WE NEED A ROADMAP FOR FINANCIAL REPORTING?

Developing the IASB's Conceptual Framework



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FOREWORD

The International Federation of Accountants (IFAC) and The Institute of Chartered Accountants of Scotland (ICAS) have collaborated on this paper in order to highlight some of the key issues to be considered in developing the International Accounting Standards Board's (IASB's) Conceptual Framework.

The IASB initiative, in taking forward the difficult challenge of reviewing and updating its Conceptual Framework, is welcomed. ICAS and IFAC believe that it is important to engage all financial reporting stakeholders in the debate on the Conceptual Framework, as this will potentially become the roadmap for future financial reporting. There is a need for the accountancy profession to contribute to the debate and consider some of the difficult and unresolved issues in financial reporting that the Conceptual Framework is designed to address.

This paper is not intended to offer solutions. Its purpose is instead to provide some context and raise issues around the key themes in the IASB's *Discussion Paper: A Review of the Conceptual Framework for Financial Reporting*.

This paper has been prepared to complement the individual comment letters on the Discussion Paper which both ICAS and IFAC have submitted to the IASB, and is not intended to be a comprehensive review of all the issues in the Discussion Paper.

We hope that this paper helps raise awareness and interest in the IASB's project. We encourage the profession and other stakeholders to engage with and contribute to the IASB's project as it progresses. We also hope that this paper will be useful to the IASB as it reviews the responses to the Discussion Paper and begins work on an Exposure Draft.

The Working Group
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EXECUTIVE SUMMARY

The International Accounting Standards Board (IASB) has restarted its project to develop its *Conceptual Framework for Financial Reporting*. The Conceptual Framework is intended to set out the concepts that the Board uses in developing standards, but should it also provide those involved in the preparation of financial reports with the basis for working out answers to those issues that are not addressed in accounting standards? The Conceptual Framework may also be useful for interpreting what is in the standards. That would seem to suggest that the Conceptual Framework can be very useful in improving financial reporting and there is a strong case for developing it. There remain a number of intractable issues in financial reporting that have not been addressed by the IASB because concepts were needed to guide the development of specific accounting policy solutions in accounting standards. Some have looked to the development of the Conceptual Framework as the ideal moment for these issues to be addressed finally and comprehensively. However, is that a realistic hope? Can conceptual solutions be found to these issues or is it more pragmatic to settle for well-accepted conventions and norms?

The starting point might be to consider who financial reports are for and whether those reports are understandable. This may seem like an obvious question but often it gets pushed aside to deal with a specific financial reporting issue, such as how leases should be accounted for. And, if the Conceptual Framework is to be useful, what role should it serve? Should it be a set of principles that the IASB must follow or is it there to provide general guidance and direction? In either case, what happens with the existing body of literature? Do existing International Financial Reporting Standards (IFRSs) need to be revised to align with any new or revised concepts that the IASB considers to be the bedrock of sound financial reporting? What about global convergence of accounting standards – can that aim be achieved if major standard setters continue to develop their own conceptual frameworks or should there be a more concerted effort to develop a unified framework?

The original Conceptual Framework was developed some time ago. There were several attempts to arrive at a set of principles but after many years of development that Conceptual Framework remains incomplete. There have been a number of developments in capital markets, economic relationships and corporate reporting since then, which significantly impact financial reporting. Business activities have continued to diversify and have become increasingly complex. Several financial shocks have caused some to re-think how entities communicate their story to their stakeholders, with integrated reporting being the latest, but not the only, innovation in this area. Do those developments suggest that more work needs to be done to reconsider whether developing the existing Conceptual Framework is the right approach or do we need a more fundamental re-think?

We do not pretend in this paper to have the answers to these difficult questions. We suggest that some of the concepts that are intended to be 'read into' the existing Conceptual Framework are worthy of debate to determine their role as the core building blocks of financial reporting. These include: the scope of financial reporting; the entity perspective; the concept of capital; the business model; the unit of account; stewardship and prudence. Further development of these concepts seems to be a precondition for resolving some of the more thorny issues to do with recognition, measurement, presentation and disclosure. Decisions about what assets and liabilities to recognise in the financial statements are central to providing relevant information to those who rely on them to make decisions. The IASB has proposed amendments to the definitions and removal of the recognition criteria. Do those changes result in the most meaningful way of identifying what should be in the statement of financial position?

Once it has been established what items should be included in the financial statements, how should these items be measured? How should a measurement basis be selected and what determines why one basis is more relevant than another? To what extent should values be market-based or entity-based and what rigour is needed around these accounting estimates to make them useful for users?

Coming back to the fundamental question of financial statements serving their intended purpose, the communication element of the Conceptual Framework raises a number of questions around presentation and disclosure. At the end of the financial reporting supply chain, what information gets communicated to stakeholders? So far, that area has lacked any real conceptual basis and presentation and disclosure have seemingly developed more by accident than by design – a consequence of decisions about recognition and measurement.

The IASB is at the early stages of its due process in developing the Conceptual Framework and there is not a better time for those with a stake in financial reporting to engage and assist the Board with its endeavour.

DO WE NEED A ROADMAP FOR FINANCIAL REPORTING?

Developing the IASB's Conceptual Framework

1. INTRODUCTION

Capital markets rely on a broad range of information to support decision-making. Financial statements form part of that information set and their relevance and timeliness have a significant impact on the reliance users place on them, compared with the increasingly diverse and rich array of information available. While financial statements were originally drawn up for capital providers, who remain their primary audience, it is clear that today they are used by a much broader range of stakeholders. The purpose of accounting standards is to bring rigour to what information is captured and how it is presented. This standardisation facilitates a degree of comparability of financial statements from year to year and between different entities. Standard-setting is not merely a technically driven process to arrive at the right answer. It often requires the standard setter to consider a broad range of views, perspectives and interests. Therefore, the standard setter should have a set of commonly agreed principles that guide its decisions about financial reporting. In theory at least, this assists in preventing the standard-setting process from being buffeted by storms of controversy when it comes to accounting for transactions where there is a lack of agreement about the underlying economics. Leases is a good case in point, where the debate continues to rage about whether the economics of a lease are essentially 'financing of an asset' or a 'service contract'.

The problem is that neither economics nor accounting are like the physical sciences where one can observe and describe with a high-degree of accuracy what happens when you combine, say, hydrogen and oxygen. Accounting is just not like that. Whilst we agree on the laws of double-entry bookkeeping, many issues are open to debate, and that is partly because of the lack of agreement about who financial reporting is for, what information it should convey, and how to best communicate that information. All of that continues to change over time, not just because of the evolution of capital markets but because economic, political and social considerations combine to shift the information equilibrium. However, the inherent complexity of the task should not dissuade standard setters from developing a conceptual framework to articulate the principles they employ in setting standards.

The purpose of this paper is to pose some questions that are worth exploring as the International Accounting Standards Board (IASB) begins to consider revisions to the existing Conceptual Framework. In July 2013 the IASB commenced its due process on the Conceptual Framework by issuing the *Discussion Paper: A Review of the Conceptual Framework for Financial Reporting.*[1] Some, including those in practice, may have marked this as something not deserving of much attention because of its high-level nature and the fact that it is unlikely to have any impact on requirements in accounting standards for some time to come. In this paper, we suggest this would be a mistake and that the Conceptual Framework deserves careful review and comment by all those who have a stake in financial reporting. It sets the direction of travel and it is at the heart of debates about what gets recognised (and what does not), how we measure financial performance, whether we account for items at their original transaction price or whether we attempt to approximate some current value, and what determines how financial information is presented and disclosed in the financial statements.

The Conceptual Framework sets the direction of travel.

2. WHAT ROLE SHOULD THE CONCEPTUAL FRAMEWORK PLAY?

Some users of financial statements highlight the impenetrability of financial statements which often run into hundreds of pages.[2] While the complexity of some business activities and transactions make it difficult to convey meaningful information in a very concise form, users have indicated the difficulty they have piecing together the impact of major transactions, such as business combinations, across a range of different notes to the financial statements. This suggests that the current financial reporting model needs improving. In this context, 'improvement' requires getting the design right from the start so that the revised Conceptual Framework is 'fit-for-purpose'.

In considering the design of the Conceptual Framework it is important to tackle the threshold issues of who financial reporting is for, and do those intended users understand the information contained in those reports? The existing Conceptual Framework presents a conundrum because it is aimed at 'general purpose' financial reporting, but standards are developed principally with the needs of capital providers in mind. Yet, even within the user category 'capital providers', a recent review of literature has highlighted that information needs and usage differ within this group.[3] There is also a related issue of whether the proposed revision is a means of 'catching up' and retrofitting the IASB's current thinking (reflected in the recent standards it has issued or about to issue) or whether it is more visionary and forward-looking with a view to what financial reporting should become.

The Framework's role in standard-setting

There seems to be widespread support for continuing to develop the Conceptual Framework and it was ranked as a high-priority project by many of the IASB's constituents.[4] However, opinion continues to be divided on what role it should play. Some, particularly those from more legalistic traditions of financial reporting, suggest that the Conceptual Framework is akin to a 'constitution' – it sets out the parameters within which the IASB must work. Significant weight is attached to following the recognition, measurement, presentation and disclosure principles set out in the Conceptual Framework, underpinned by the objective and qualitative characteristics of financial reporting. This would suggest a deductive model of standard-setting that begins from a set of agreed principles and develops standards by applying those principles to financial reporting issues. Like a constitution, the Conceptual Framework drives financial reporting outcomes pursued by the standard setter and so, while there is room for the IASB to exercise judgement in setting standards, it does so within these bounds. Therefore, the Conceptual Framework is a reasonably detailed map setting out the topography and features of the financial reporting landscape. Proponents of this view would argue that it is important that the Conceptual Framework sets out the core principles that underpin financial reporting. This implies that it is an enduring and reasonably fixed set of ideas that the IASB must follow.

The alternative view starts from a different premise. It views the Conceptual Framework as a statement which sets out the principles and logic the IASB typically invokes in setting standards. It is, by design, high-level and sets out only broad constructs for the IASB to follow. In addition, it provides for significant judgement to be exercised in the application of those principles when it comes to accounting for specific transactions and other events. For example, internally generated research and development may meet the definition of an asset and satisfy the related qualitative characteristics. Nonetheless, the IASB could decide that it should not be recognised until it is subject to an exchange transaction (such as when a business is sold to an entity outside the reporting entity). This approach is more iterative and less deductive and operates from an overriding consideration of what best satisfies the public interest given the issues identified through the IASB's due process. This would suggest that the Conceptual Framework is a high-level map that highlights key features of the landscape but does not provide a basis for navigating the terrain. One would need to look at individual standards for that level of detail. Those who espouse this view would see the Conceptual Framework as a means of articulating some of the common beliefs and understandings of the standard setter, so that it is more transparent than relying on the personal views of individual board members.

Who is financial reporting for?

It might appear reasonable to presume that this issue was resolved a long time ago, given that the current Conceptual Framework was derived from that developed by the US Financial Accounting Standards Board (FASB) in the 1970s and 1980s.[5] That presumes that the Conceptual Framework when it was originally developed was both complete and fit-for-purpose. The reality is that it took decades and several false starts to arrive at the components of the Conceptual Framework we have today. Whilst it has served as a useful standard-setting tool it is far from complete, which is perhaps testament to the sheer scale and complexity of the task – it is one thing to be able to describe the various measurement attributes that are likely to be relevant for, say, an equity instrument; but it is much tougher to then indicate under what circumstances a mark-to-model valuation for an untraded instrument is more relevant than its historical cost and why. Like many of the contentious issues in financial reporting, it comes down to 'it depends...' because of the vast array of economic relationships and the different balance of rights and obligations inherent in them. This would suggest that a single concept may lead to different interpretations when it is applied to specific transactions and other events. Accordingly, a single concept can potentially result in different accounting treatments in individual accounting standards. The level of detail of the Conceptual Framework also has a bearing on the latitude the standard setter has when applying it.

It also remains unclear what role the Conceptual Framework plays when there is already a comprehensive body of accounting standards. With new standards expected on revenue, financial instruments, insurance and leases, it is not clear what impact a revised Conceptual Framework will have on existing International Financial Reporting Standards (IFRSs). In its Discussion Paper, the IASB notes that it "will not necessarily change existing Standards for any of the areas discussed in this Conceptual Framework"[6] and any proposed changes would need to be evaluated as part of the due process on agenda setting. There is an issue about how to reconcile a body of accounting standards that is potentially at odds with the fundamental principles from which they are intended to be derived. There are a number of IFRSs that fall into that basket. In fact, it would be easier to count those that would not be affected. The IASB will need to consider how it reconciles the conflicts that arise between its existing standards and the revised Conceptual Framework.

The Framework's role in practice

Beyond its role in standard-setting, there is a question about what role the Conceptual Framework should play in practice. The FASB Conceptual Framework is restricted for use by the standard setter and is therefore not part of US Generally Accepted Accounting Practice (GAAP). However, under IFRS, the Conceptual Framework forms part of the GAAP hierarchy, set out in International Accounting Standard - *IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors,* to deal with issues not covered by individual IFRSs and it is used by the IFRS Interpretations Committee to interpret existing standards. That means that the Conceptual Framework potentially impacts practice, though perhaps less so than in the past as many transactions and other events are now addressed by specific standards. Arguably, given that the Conceptual Framework is hardwired into *IAS 8* it may demand, unlike the US equivalent, more detail and specificity so that it may be more easily used in practice to deal with real world accounting issues. If the Conceptual Framework is to be used in this manner then it needs to be written in a way which is understandable to the wider financial reporting community. Consideration also needs to be given to how key concepts and terminology can be translated for different jurisdictions.

The scope of the Framework

As noted above, the IASB's existing Conceptual Framework was derived from the one developed by the FASB (and standard setters in Australia, Canada and the United Kingdom also developed their own variants). However, the overall architecture of the Conceptual Framework remains unchanged from when it was first envisioned by the FASB in the 1970s. It begs the question of whether we have the right components of a conceptual framework to respond to today's needs. It seems that the first question of what sort of Conceptual Framework we need has not been asked (although the IASB's Discussion Paper does extend the boundaries of issues that should be addressed).

Integrated reporting has served as a reminder that the fundamental purpose of preparing financial reports, in accordance with IFRS, is to communicate useful information rather than merely complying with an increasingly complex set of requirements. Although the integrated report is intended to sit alongside the financial statements, it has brought some new thinking to corporate reporting.[7] The lessons of the financial crises and corporate scandals of the last few decades have reinforced the importance of telling a complete story of an entity's financial performance and financial position, giving a full account of how management have discharged their obligations and the attendant risks that an entity faces going forward. For instance, has the evolution of corporate reporting placed greater emphasis on the robustness and governance of financial reporting more generally? This draws into question whether the scope of the Conceptual Framework is wide enough and whether there are new areas that need to be developed. Is it adequate to simply review parts of the Conceptual Framework and, as the IASB has noted, to concentrate on "updating, improving and filling in gaps"[8], or do we need a more fundamental review?

How many frameworks are needed?

There is also a related question of how many conceptual frameworks we actually need, particularly given the ambition of the G20 leaders to have a single set of high quality globally-accepted standards. A precondition for a common global financial reporting language is to start from the same first principles. The IASB ambition, as noted in its existing Conceptual Framework, is that it will also be used "to assist national standard-setting bodies in developing national standards".[9] This implies that there should be a single conceptual framework but that is not currently the case. The FASB, the International Public Sector Accounting Standards Board and other standard setters have their own conceptual frameworks. While it is the prerogative of each standard setter to have their own conceptual framework, is it reasonable to expect there to be some concordance between them? Do differences actually signify alternative principles or is it just a matter of semantics where the intended meaning is the same but there is a preference for different language to express them? Perhaps it is somewhat naïve to contemplate a single conceptual framework but do we really need more than one? If so, why and how does that correspond with the globalisation of capital markets? The sovereign debt crisis has underscored that the same measure of transparency and accountability should equally apply to governments, though the emphasis of public sector financial reporting differs from that of listed companies.

Updating the Framework

Once it has been decided what role the Conceptual Framework should play, it then needs to be determined how often the Framework should be updated. Should the Conceptual Framework be seen as a stable platform to provide longer term stability for corporate reporting or should it be updated periodically to reflect changes in the business world and corporate reporting expectations?

KEY QUESTIONS:

- Who is financial reporting for? Is the concept of general purpose financial statements still relevant or should we focus only on the 'primary users'?
- Should the IASB be filling in the gaps of the existing Framework or taking a more visionary approach?
- Should the Conceptual Framework be a detailed or a high level map for financial reporting?
- How should the IASB address any conflicts that arise between its existing standards and the revised Conceptual Framework?
- How should the Conceptual Framework be used in practice?

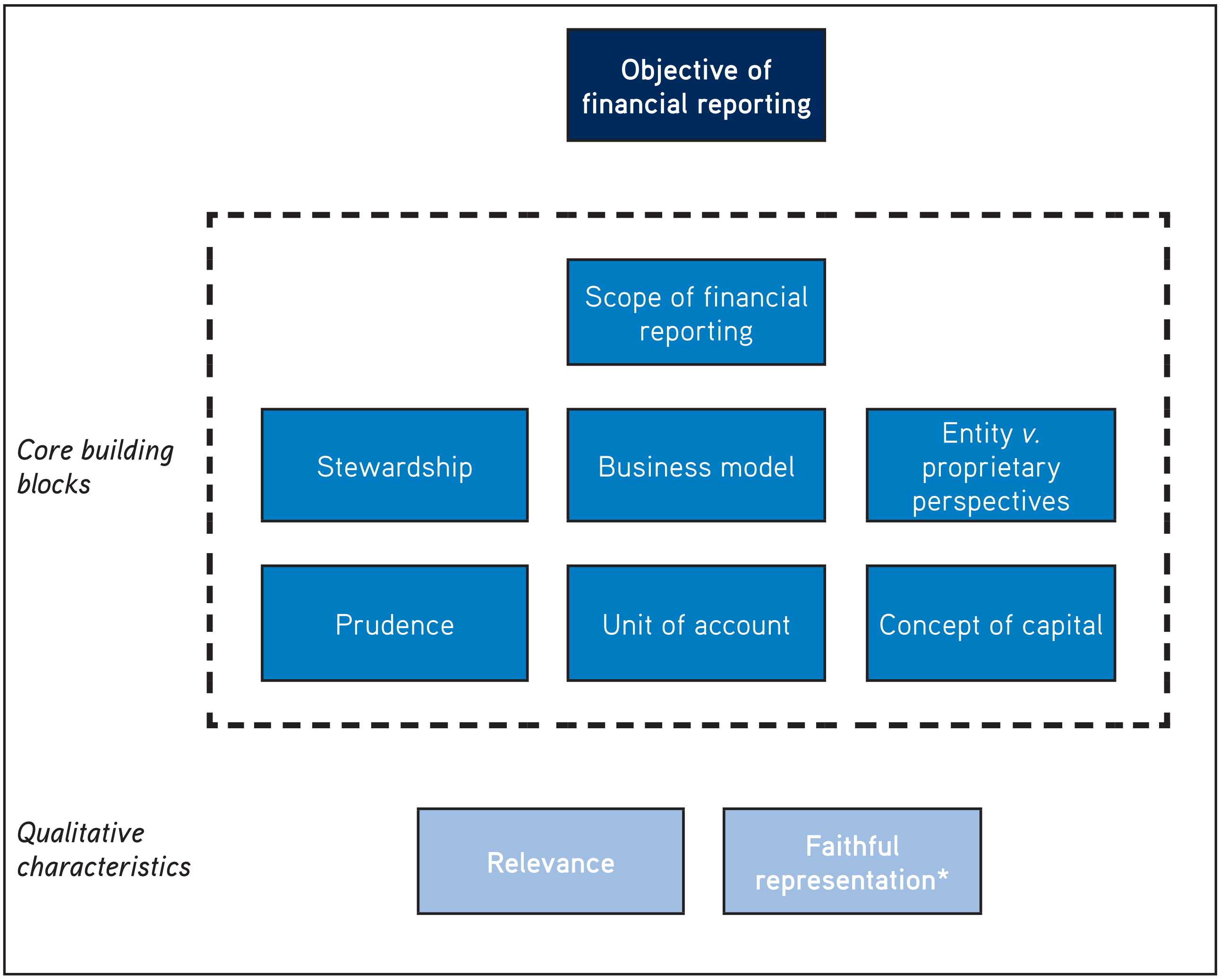
3. WHAT SHOULD BE INCLUDED IN THE CONCEPTUAL FRAMEWORK?

This is a good question to which there is no obvious answer. Is it sufficient to be circumscribed by the scope of the existing Conceptual Framework? Even if the answer to that question is 'yes' it should be arrived at only after careful consideration rather than by default. As the IASB identifies in its Discussion Paper, some commentators have indicated that there are issues that they believe should be tackled in the Conceptual Framework such as stewardship, the role of the business model in financial reporting, determining the unit of account and the concept of capital maintenance. These are issues that go beyond financial statements and have implications for corporate reporting more generally. In a number of jurisdictions, there have been significant developments in how these notions have been applied to the 'front-end' or 'narrative part' of the corporate report. That suggests that the Conceptual Framework cannot be developed in isolation, and it may be helpful for the IASB to consider the implication of these developments because it is not helpful for users of corporate reports to have inconsistent notions in the same report. At the very least, there needs to be some articulation between the notions employed in the narrative sections and the financial statements.

Other considerations include the scope of financial reporting, the concept of capital and the entity and proprietary perspectives. These could be viewed as contextualising the objective of financial reporting by helping to provide a basis for making judgements about recognition, measurement, presentation and disclosure – they are related and interlocking considerations that provide a bridge between the objective on the one hand and the qualitative characteristics on the other.

Each of these is discussed in the following section and illustrated in the diagram below. We would suggest that they represent some core building blocks that are currently absent from the Conceptual Framework and need to be given careful consideration by the IASB. It might be helpful for the standard setter to explain what gives financial information utility and why; otherwise too many assumptions are employed about a hypothetical user and their anticipated information needs.

The potential core building blocks and characteristics of the Conceptual Framework



* As noted on page 11 of this paper, there is a view that the term 'reliability' encompasses more than 'faithful representation'

The core building blocks

Scope of financial reporting

It could be argued that one of the most basic questions that the Conceptual Framework should address is determining the boundaries and purpose of financial reporting. Over time, the boundary between the financial statements and other information has become considerably blurred. This has led to the duplication of information in financial statements with that contained in other parts of the corporate reporting package. Resolving issues about what disclosures should be included in the notes to the financial statements requires, amongst other things, to determine what belongs in the financial statements. Unfortunately, the scope of financial reporting is not mentioned in the IASB's Discussion Paper and it is not clear why it has been dropped from the project, as it was included in their previous Conceptual Framework project.[10] Being clear about the scope of financial reporting is also useful in managing users' expectations about what financial and other information they can expect to find within the financial statements and notes (and any other components included within the scope of financial reporting) and what is located elsewhere.

Stewardship

The Conceptual Framework no longer refers specifically to stewardship and the concept is subsumed within the discussion about how users assess an entity's prospects for future net cash inflows. The argument is based on the view that investors and creditors are only interested in information that is likely to be relevant in assessing an entity's future cash flows. Critics of this view have highlighted that this relies on a very narrow construct of users and their needs. This has been borne out in the accounting literature.[11] Developments in integrated reporting and other information that entities provide to the market highlights that users are not only interested in how much cash a business will generate in the future but also how well management has performed in protecting or increasing the shareholders' wealth invested in the company and the sustainability (in the widest sense) of its business model.

Business model

Understanding how an entity creates value through its business model has been implicit in financial reporting since entities started producing financial statements. In the nineteenth century the relatively simple business model of a manufacturer was well understood and is reflected in the basic structure of the financial statements we have today. However, business activities have significantly diversified and many businesses today have more intangible assets (by value) than tangible ones. Many operate across borders, with complex organisational structures to maximise returns for their shareholders. Some argue that this has resulted in financial reporting, as currently designed, struggling to keep pace with the change in economic activity.

The business model concept has already been employed in various IFRSs. For example, *IFRS 9 Financial Instruments* and the recent amendment to *IFRS 10 Consolidated Financial Statements for Investment Entities* both explicitly rely on an entity's business model to determine the appropriate accounting. Other standards, such as *IAS 12 Income Taxes*, consider an entity's business model to an extent in considering how the entity intends to recover or settle the carrying amount of its assets and liabilities. Some have suggested that the business model should play a more pervasive role in the preparation of financial statements, influencing recognition, measurement, presentation and disclosure. In contrast, others have suggested that the business model is an unhelpful concept and is likely to undermine the comparability of financial statements. Whichever view prevails, it is an issue that warrants further discussion and consideration in the Conceptual Framework – even if it is just to clarify the role of the business model in existing IFRSs.

Unit of account

The accounting process involves aggregating amounts relating to transactions and other events to produce financial statements. What can be difficult to determine is the unit or level of aggregation at which various judgements should be made. For example, at what level should an impairment test for an asset be applied or to what extent should components of complex assets be accounted for separately? Issues about 'unbundling' rights and obligations highlight some of the inherent difficulties in deciding what level of aggregation, or unit of account, is likely to be most relevant to users of the financial statements. Although the detail of this issue may be more appropriately dealt with at standards level, it would be helpful for the Conceptual Framework to establish the broad principles to be applied. In particular, it would be helpful to explain how the unit of account links to materiality.

Underlying assumptions: Entity perspective and concept of capital

Accounting standards are based on assumptions that have typically been regarded as rather academic in nature and therefore not helpful to include in the Conceptual Framework. However, they can have a profound impact on judgements made in preparing financial statements. For instance, if transactions are viewed from the perspective of the owner (or proprietor) this can result in different accounting than if they are considered from the perspective of the entity distinct from its owners. Under an entity perspective, the distinction between creditors and owners is less relevant because they all have claims on the entity's resources (Assets = Liabilities + Equity), whereas under a proprietary view (Equity = Assets – Liabilities), owners have a residual interest in an entity after liabilities. This affects how compound financial instruments are accounted for and the distinction between debt and equity. The IASB's Discussion Paper proposes that a narrow equity approach may be consistent with the proprietary perspective and a strict obligation approach aligning with an entity perspective, without linking them clearly to the needs of users of the financial statements.[12] It remains an open question whether financial statements can include items that are recognised and measured based on the different perspectives of those that have claims on an entity's resources. Perhaps the more fundamental consideration is deciding on who the primary users of financial statements are, as this will drive what the financial statements are intended to depict.

Similarly, the concept of capital is a fundamental building block. The concept of capital is relevant when selecting a measurement attribute because profit only arises after either financial or physical capital has been maintained (marking the distinction between a return *on* capital and a return *of* capital). As noted in the Discussion Paper, this is particularly relevant for entities operating in hyperinflationary economies.[13] However, current periods of relatively low inflation in many developed economies do not justify limiting the concept to only those experiencing hyperinflation. It has more general application in clarifying what is being measured; even modest inflation can lead to substantial erosion of value in a relatively short period. The question remains whether the Conceptual Framework should explain the merits of each concept of capital and explain under which circumstances one is likely to be more relevant to the user than the other.

Prudence

The IASB has indicated in its Discussion Paper that it does not intend to reconsider fundamentally chapter three of the Conceptual Framework, which deals with the qualitative characteristics.[14] In the last revision of the Conceptual Framework, 'reliability' was refashioned into 'faithful representation', but some consider that it constituted more than a name change.[15] Some have been critical of this change for several reasons:

- Reliability is a necessary precondition that must be met for information to be relevant: information needs to pass a reliability threshold before it can be considered relevant;
- The characteristic of 'faithful representation' could allow the recognition of information that may be intrinsically unrealistic;
- Users want to understand the degree of uncertainty in the numbers presented and the potential range in outcomes;[16]
- The notion that users can rely on the financial statements is a key concept; and
- The concept of reliability is better understood and underscores the robustness required better than 'faithful representation' particularly when considering mark-to-model valuations.

The IASB argues in the Discussion Paper that the main difference between 'reliability' and 'faithful representation' is that the latter does not encompass prudence (because this could lead to bias in the preparation of financial statements) and does not specifically refer to substance over form (because it is implicit in faithful representation).[17] Some have suggested that the absence of these components hollows out the definition and de-emphasises the importance of users being able to have confidence in the numbers presented in the financial statements.

Part of that confidence in the numbers comes from the exercise of prudence by those preparing them. Some commentators have expressed concerns about the concept of prudence being removed from the qualitative characteristics, and do not necessarily agree with the IASB that it is inherent in the notion of faithful representation and has been effectively replaced by the notion of neutrality. In the past, the Conceptual Framework distinguished between 'good' and 'bad' prudence:

> *Prudence is the inclusion of a degree of caution in the exercise of the judgements needed in making the estimates required under conditions of uncertainty, such that assets and income are not overstated and liabilities and expenses are not understated. However, the exercise of prudence does not allow, for example, the creation of hidden reserves or excessive provisions, the deliberate understatement of assets or income, or the deliberate overstatement of liabilities and or expenses, because the financial statements would not be neutral and therefore, not have the quality of reliability.*[18]

Some suggest that this notion of prudence encompasses more than being neutral: a depiction without bias in the selection or presentation of financial information. It could be argued that neutrality is a rather passive notion – not deliberately fudging the numbers but then again not exercising a degree of caution, of professional challenge to the inputs and assumptions that underlie accounting estimates. It is fair to say that the IASB itself has used prudence recently in its standard-setting: the expected loss model for the impairment of financial assets and the constraint on revenue recognition both reflect the need to exercise caution in accounting estimates. Those charged with governance and oversight of financial reporting should surely need to go beyond ensuring the numbers are neutral – are they robust enough to be relied upon? Given that, by definition, users of general purpose financial statements have no other capacity to demand financial information, if they cannot rely on the numbers how are their interests being served?

Preparing financial statements typically involves the making of numerous judgements, often about assumptions and other factors that need to be taken into account in complying with accounting standards, or in areas where accounting standards themselves are silent. The Conceptual Framework only deals with the output of these judgements, ie. that the resulting numbers should satisfy the qualitative characteristics. The Framework does not provide guidance on how these judgements should be exercised. For example, what degree of caution should be exercised in developing an estimate?

It could be argued that the concept of prudence is in the wrong place and that it should be one of the building blocks referred to above, as it is closer to the concept of stewardship than faithful representation. The qualitative characteristics refer to the quality of the information, whereas prudence refers to the manner by which financial statements are prepared – it could therefore be considered more a behaviour rather than a quality. Prudence can have very different meanings for different people, from a degree of caution to a deliberate understatement of assets and overstatement of liabilities. If prudence is used in the Conceptual Framework this issue needs to be addressed.

The removal of substance over form, on the basis that it is implicit in the concept of faithful representation, also deserves closer examination. Often accounting for complex transactions requires judgements to be made about how the various transactions within an overall arrangement interact, so there is a need to take a broader look and think about 'what is really going on here'. In the Discussion Paper the IASB states "accounting for something in accordance with its legal form rather than its economic substance could not result in a faithful representation" – compelling as that logic sounds, the commentary on derecognition in an earlier chapter of the Discussion Paper highlights that it is perhaps not so straightforward.[19] In the example of a bond repurchase agreement the IASB concludes: "the risks-and-rewards approach portrays more clearly than the control approach the fact that the transaction had virtually no effect on the amount, timing and uncertainty of Entity C's cash flows…".[20] This suggests that what appear to be obvious notions are not always so clear cut when applied to specific transactions.

KEY POINTS:

- In the Conceptual Framework consideration should be given to:
  - addressing the boundaries and purpose of financial reporting;
  - recognising the stewardship role of financial reporting;
  - clarifying the role of the business model;
  - including an overall framework of broad principles on the unit of account;
  - linking the entity *versus* the proprietary perspectives with the needs of users; and
  - establishing and explaining the concept of capital maintenance and how it would apply to financial statements.
- Prudence and reliability are regarded by many as key elements of the standard-setting process and of financial reporting.
- The term 'prudence' can be interpreted in very different ways. Its inclusion in the Conceptual Framework needs to be considered by the IASB, based on a very specific definition.
- The concept of 'substance over form' is vital in ensuring information is reliable. The IASB should consider reinstating or emphasising this matter in the Conceptual Framework.

Definitions and recognition of the elements

At the heart of the Conceptual Framework are the definitions of, and recognition criteria for, assets and liabilities. In its Discussion Paper, the IASB proposes to amend the existing definitions to confirm what they are intended to mean. The definition of an asset essentially retains its three key components: 'a resource' that is 'controlled by the entity' as a result of 'past events'.

However, the new definition is potentially confusing by defining 'a resource' as a right that is capable of producing economic benefits. In economics, a resource usually gives rise to rights – they are not the same thing so it seems odd to conflate the two in the new definition. For example, an acreage is a resource which can give rise to a number of rights such as rights of use, rights of exchange, rights to develop etc. Where that land is leased, the lessor converts part of his rights of use for a right to receive lease payments (a receivable from the lessee). It is, therefore, possible to unbundle rights but it is not possible to unbundle the resource itself – what remains unresolved in the Discussion Paper is a unit of account issue: to what extent can the 'asset' be unbundled? The other notable change to the definition is that there no longer needs to be an expectation that future economic benefits will flow from the asset, only that it is capable of generating inflows of economic benefits and there is no minimum probability threshold. An example, given in the Discussion Paper, is a lottery ticket – the asset is the right to participate in the lottery not the cash prize. The point being that the lottery ticket is capable of generating future economic benefits in the form of a prize, not that there is an expectation that the holder will win. The probability of winning may be so low that the asset is measured at zero (particularly if it has no value in exchange prior to the prize draw). The proposed changes leave the door open on whether items such as intangibles satisfy the definition of an asset. The implications of the new definition are that more items are likely to qualify as assets, but their recognition (at amounts other than zero) will be contingent on their measurement. Accordingly, the proposals appear to shift the debate from the definition and existence of an asset to an issue of measurement, which does not really get us closer to resolving the problem of what assets and liabilities should ultimately be reported in the statement of financial position.

Corresponding changes are proposed to the definition of a liability. Again 'expected' outflows changes to 'capable', such that a liability exists even if, at the reporting date, there is no expectation that there will be any cash flows. Any expectation of outflows is reflected in the measurement of the liability. In the Discussion Paper, the IASB distinguishes between element uncertainty – doubt as to whether an asset or liability exists, and outcome uncertainty – where the definition is met but the outcome is uncertain. As an example of the latter, a claim against an entity may result in an outcome to pay damages from zero to $100 million.

However, these changes and explanations do not fully address certain important issues, such as whether deferred tax gives rise to a liability, because the IASB has not addressed what role future events play in creating a 'present obligation'. The IASB notes a range of options based on whether the existence of the present obligation is strictly unconditional, practically unconditional or conditional on future events, but does not deal with the question of linking past events to an entity's practical inability to avoid settlement of an obligation.

Flowing from the changes to the definitions, the IASB is proposing to drop the current recognition criteria. Instead, the IASB will decide at a standards level when an asset or liability is not recognised because: (a) it would fail to provide relevant information; or (b) no measure would provide a faithful representation. The treatment of identifiable intangibles in *IFRS 3 Business Combinations* is an example of where the IASB removed the reliability criterion. This has led to less diversity in practice in what intangibles are recognised, thereby improving comparability.[21] However, others would point to the proposed amendment to *IAS 37 Provisions, Contingent Liabilities and Contingent Assets* where many expressed concern that removal of the recognition criteria would lead to the recognition of significantly more liabilities, further complicated by measuring them at their expected value with (unlike a business combination) no third party exchange transaction at a market price.[22] The concerns about removing the recognition criteria highlight that it has always been difficult to separate the definitions, recognition criteria and measurement because of the interaction between them. What matters is what ends up being reported in the financial statements and its relevance to users.

While it is helpful for the IASB to propose sharpening the definitions of assets and liabilities, it is important that a better understanding is developed about their application, particularly to new forms of economic activity which enhance (or put at risk) the value of an entity. The Conceptual Framework continues to struggle with items such as intangibles and complex financial instruments, which clearly have an economic impact but the definitions and recognition (and derecognition) criteria do not adequately capture them in the statement of financial position. What is perhaps even more challenging, is how to measure items that do qualify for recognition.

KEY POINTS:

- **There is a significant change in the definition of assets and liabilities.**
- **The proposals recognise the capacity to generate inflows not the probability of generating inflows.**
- **The IASB's proposed changes to the definitions of assets and liabilities appear to shift the debate from the existence of assets and liabilities to measurement. The changes may have significant implications for financial reporting.**

Measurement

Since the early twentieth century accounting thinkers have been grappling with, and proposing alternative ways of, measuring the items in the financial statements. This includes measurement at initial recognition and subsequent measurement. Debates have raged about the relevance of historical cost and current values. Within current values there are a range of measurement bases to use, from market-related exit prices to entry prices, and various combinations of the two, and entity-specific values such as value-in-use. Deprival value employs a range of current values and selects measurement attributes based on a decision framework of rational choices of how assets and liabilities are recovered and settled. Over the last decade the IASB has considered fair value to be the most relevant measurement basis for many transactions. However, some commentators consider that some assets and liabilities which are not traded do not have an observable fair value, and the development of imputed market prices using models might be considered just as irrelevant as historical cost amounts and even less objective. In recent years the IASB has given further consideration to the balance between fair value measurement in many cases and has considered the relevance of other measurement attributes under certain conditions.

The IASB's Discussion Paper includes one of the most comprehensive considerations of measurement it has issued to date. The IASB is proposing a 'mixed' measurement model where how an item is used to generate cash flows within a business (assets) or is intended to be settled (liabilities) determines the measurement attribute to apply.[23] It effectively brings together the range of measurement attributes described in various standards within a single coherent model. The IASB has indicated that the selection of a measurement attribute should consider the impact on both the statement of financial position and statement of profit or loss and other comprehensive income (OCI). This is helpful given that some have been concerned that the existing Conceptual Framework has a balance sheet bias.

Some have suggested that the description of the various approaches in the IASB's Discussion Paper does not advance the debate very far. They would suggest that until fundamental issues such as the objective of measurement and the relevance of entity or market perspectives are addressed, what is being advocated is not much different from the status quo. Whether an item is measured from the perspective of the entity (based on management's assessment) or from that of a hypothetical market participant, raises both conceptual and practical concerns:

- Is the theory sound and if it is, can it be applied in the real world?
- Is it a useful distinction to draw, and if so, should financial statements include amounts based on hypothetical assessments of the market?

Consider the following example: an entity has a specialised manufacturing facility in a reasonably remote area with no real prospect of an alternative use - what measurement attribute is likely to be most relevant for users of the financial statements? Depreciated cost less any impairment based on the entity's cash flow projections; exit price, which is likely to be a nominal value unless a buyer acquired the whole business; current replacement cost which would represent the cost of replacing the operating capacity, or some other measure? Potentially all these measures are relevant depending on how the information is to be used. If the answer to the question of the appropriate measurement attribute is that the asset should be measured at an exit price, why is it superior in satisfying the qualitative characteristics compared to the other options available?

The other consideration, which is noted above, is reliability, which appears to have been given less priority, compared to the prominence given to relevance. A model can be developed to simulate a market price and the outcome would result in a faithful representation because it purports to be an estimate of the asset's fair value. However, can it be relied upon for decision-making purposes? Where there is no market it is not clear what logic there is to simulate a hypothetical market, given it will yield an amount that has no analogue in the real world - as was perhaps demonstrated in the lead up to the financial crisis. Clearly, there are no easy answers to these questions but surely if the Conceptual Framework is to have any currency as a set of principles to guide financial reporting it would seem appropriate to tackle these issues head on.

KEY POINTS:

- The IASB should reconsider:
  - The objective of measurement and what factors should be taken into account in determining the most appropriate measurement base; and
  - What role reliability should play in determining measurement bases.

Presentation and disclosure

The IASB is seeking to address presentation and disclosure in its current project on the Conceptual Framework. Like measurement, this requires some fundamental thinking about the purpose of financial reporting and what an entity is trying to communicate. There are some difficult notions to work with: under the current accounting model comprehensive income is defined as the changes in assets and liabilities, other than transactions with owners in their capacity as owners, but users typically want to understand what represents 'profit' for the period. For decades, standard setters have tried to draw a line in the income statement to isolate a profit or loss. It has resulted in a burgeoning section of the income statement labelled 'other comprehensive income' (OCI), which serves as a home for those items that do not make it into the calculation of the profit or loss. The situation is further complicated by recycling of some OCI amounts into profit or loss, often when items are realised or settled.

Some have argued that rather than continuing to create *ad hoc* rules about where to draw the dividing line in the income statement, the IASB should stand back and establish a concept of financial performance. Once performance has been defined, presentation in the income statement will flow logically from that. It is a nice idea. Perhaps if the building blocks referred to above were in place it would be possible to achieve, by reference to an entity's business model, a meaningful construct of financial performance. However, this presupposes that financial performance can be conveyed in a single sub-total and with a single purpose in mind. For example, investment analysts typically make various adjustments to items in the statement of profit or loss and other comprehensive income to suit their models in predicting future returns and companies themselves disclose a range of non-GAAP measures. That is perhaps why the IASB has proposed a set of presentation rules in its Discussion Paper to bring some order to what is included in profit or loss and OCI and the extent of recycling. Although it is not really a concept it does at least bring us closer to an agreed convention, and it may be possible for the IASB to derive a definition of profit or loss which underpins amounts that are to be included in that subtotal.

Disclosure, unfortunately, appears to have become the residual consideration in the current standard-setting process. After battles over how to address recognition and measurement issues, the IASB typically acquiesces to whatever good ideas respondents to their due process have for helpful disclosures (as do many other standard setters). Like presentation, this is new territory for the Conceptual Framework and an area where financial reporting lags behind developments in other parts of the annual report concerning management commentary, environmental and social responsibility reporting and governance. A number of other bodies, such as the FASB[24], the European Financial Reporting Advisory Group (EFRAG)[25], ICAS and NZICA[26], have already developed some useful thinking in this area which the IASB appears to have taken on board in undertaking its current disclosure initiative.[27] The FASB has already commenced the development of its disclosure framework. There would be considerable merit in both the IASB and FASB working together so that they potentially arrive at a consistent approach to disclosure.

KEY POINTS:

- The IASB should consider if it is possible to develop a concept of financial performance and profit.
- Disclosure appears to have become the residual consideration in the standard-setting process. It would be helpful if disclosure was based on clear principles.

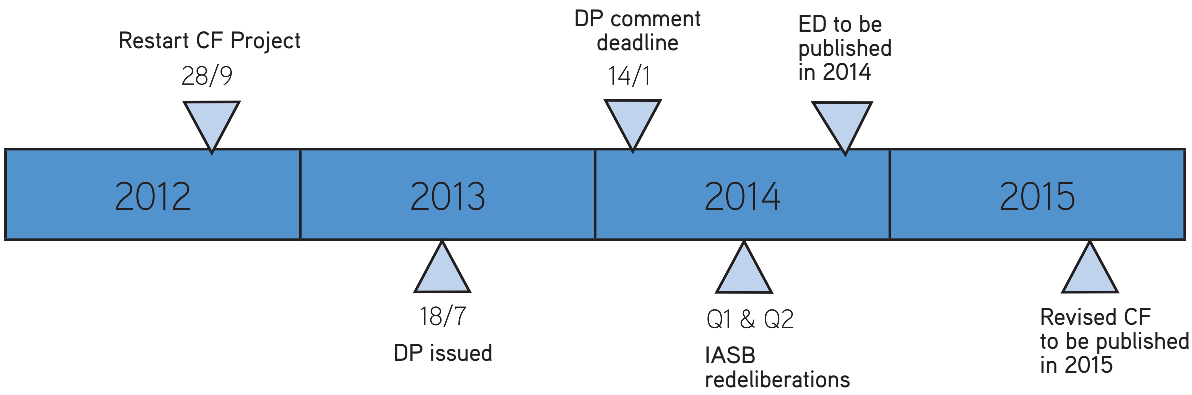
4. IS IT A MAP OR A COMPASS WE NEED?

It would be a mistake to underestimate the difficulty of developing the Conceptual Framework for financial reporting. The development of the Conceptual Framework for financial reporting has a long and troubled history. However, it is a noble endeavour and the IASB would be remiss if they were not able to set out the principles they use to guide their decision-making in setting standards. Some have suggested that the proposals set out in the IASB Discussion Paper are not ambitious enough – the Conceptual Framework should be far more aspirational. Others have been somewhat cynical and have expressed doubts as to whether the Conceptual Framework actually adds very much to the standard-setting process.

What is clear is that the issues, identified in the IASB's Discussion Paper and others set out in this paper, will not go away. So regardless of what mechanism is used to address them, the viability of financial reporting depends on some solutions being found. Perhaps a comprehensive Conceptual Framework is unachievable and whilst some concepts can be developed and advanced, in other areas we may have to settle on accepted conventions and norms. It is important for all those who have a stake in financial reporting to take an interest and engage in the debate about what sort of Conceptual Framework is needed and how to address the various issues within it.

Whether you have a compass or a map, you have to be able to locate accurately where you are and know where you want to get to. Sometimes the terrain dictates that you cannot get there quickly.

Timeline for the IASB's Conceptual Framework project



Notes:

CF = Conceptual Framework

DP = Discussion Paper

ED = Exposure Draft

Dates sourced from the IFRS Foundation (IASB) website - www.ifrs.org.uk

ENDNOTES

1 IASB (2013), *Discussion Paper: A Review of the Conceptual Framework for Financial Reporting*, available at www.ifrs.org/Current-Projects/IASB-Projects/Conceptual-Framework [accessed 9 January 2014].

2 ACCA (2013), *Understanding Investors: Directions for Corporate Reporting*, p15, available at www.accaglobal.com/content/dam/acca/global/PDF-technical/financial-reporting/pol-afb-ui02.pdf [accessed 13 January 2014].

3 Cascino, S., Clatworthy, M., Osma, B.G., Gasen, J., Iman, S. and Jeanjean, T., (2013), *The use of information by capital providers*, published by ICAS and EFRAG, p11, available at www.icas.org.uk/clatworthy [accessed 9 January 2014].

4 Most respondents to the IASB's *2011 Agenda Consultation* identified the Conceptual Framework as a priority project for the IASB – see www.ifrs.org/Current-Projects/IASB-Projects/Conceptual-Framework [accessed 9 January 2014].

5 See Storey, R.K. and Storey, S., (1998), *The Framework of Financial Accounting Concepts and Standards*, published by the FASB.

6 IASB (2013), *Discussion Paper: A Review of the Conceptual Framework for Financial Reporting*, para 1.22, p18.

7 Integrated reporting <IR> is a process founded on integrated thinking that results in a periodic integrated report by an organization about value creation over time and related communications regarding aspects of value creation (IIRC website). For further information see IIRC (2013),*The International <IR> Framework,* available at www.theiirc.org [accessed 9 January 2014].

8 IASB (2013), *Discussion Paper: A Review of the Conceptual Framework for Financial Reporting*, para 1.8, p16.

9 IASB (2010), *The Conceptual Framework for Financial Reporting*, and IASB (2013), *Discussion Paper: A Review of the Conceptual Framework for Financial Reporting*, para 1.25, p19.

10 For more information see www.iasplus.com/en/projects/completed/framework/framework-joint [accessed 13 January 2014].

11 For a discussion on the information needs of capital providers and the stewardship and decision-making objectives of financial reporting see Cascino, S., Clatworthy, M., Osma, B.G., Gasen, J., Iman, S. and Jeanjean, T., (2013), *The use of information by capital providers*, published by ICAS and EFRAG. This review demonstrates that the stewardship objective of accounting is not a subset of the decision-making or valuation objective (estimating future cash flows) of accounting, pp19-21. Available at www.icas.org.uk/clatworthy [accessed 9 January 2014].

12 IASB (2013), *Discussion Paper: A Review of the Conceptual Framework for Financial Reporting*, para 5.31, p95.

13 IASB (2013), *Discussion Paper: A Review of the Conceptual Framework for Financial Reporting*, para 6.41, p114.

14 IASB (2013), *Discussion Paper: A Review of the Conceptual Framework for Financial Reporting*, paras 9.2-9.4, p181.

15 See *2013 IFRS (Red Book)*, chapter 3 and IASB (2013), *Discussion Paper: A Review of the Conceptual Framework for Financial Reporting*, para 4.14, p70.

16 For a discussion of how entities can communicate a degree of uncertainty inherent in the measurement of assets and liabilities (Confidence Accounting) see www.accaglobal.com/gb/en/research-insights/risk-reward/confidence-accounting.html [accessed 9 January 2014].

17 IASB (2013), *Discussion Paper: A Review of the Conceptual Framework for Financial Reporting*, para 9.14, p184.

18 IASB (2013), *Discussion Paper: A Review of the Conceptual Framework for Financial Reporting*, para 9.16, p184.

19 IASB (2013), *Discussion Paper: A Review of the Conceptual Framework for Financial Reporting*, para 9.14, p184 and section 4.

20 IASB (2013), *Discussion Paper: A Review of the Conceptual Framework for Financial Reporting*, para 4.40, example 4.2, p78.

21 See *Basis for Conclusions to IFRS 3*, BC174.

22 See *Exposure Draft 2010/1 Measurement of Liabilities in IAS 37 - Proposed amendments to IAS 37*, available at www.ifrs.org/Current-Projects/IASB-Projects/Liabilities/EDJan10/Documents/EDIAS37Liabilities0110.pdf and discussed in detail at www.iasplus.com/en/meeting-notes/iasb/2010/agenda_1011/agenda1541 [accessed 20 January 2013].

23 IASB (2013), *Discussion Paper: A Review of the Conceptual Framework for Financial Reporting*, section 6.

24 For further information on the FASB Disclosure Framework project see www.fasb.org/jsp/FASB/FASBContent_C/ProjectUpdatePage&cid=1176156344894 [accessed 13 January 2014].

25 For further information on the EFRAG Disclosure Framework project see the EFRAG website and *Towards a Disclosure Framework for the Notes; Discussion Paper*, published by EFRAG, the French Autorité des Normes Comptables and the UK Financial Reporting Council available at www.efrag.org/front/p169-1-272/proactive---a-disclosure-framework-for-the-notes-to-the-financial-statements.aspx [accessed 13 January 2014].

26 See report prepared for the IASB by ICAS and NZICA (2011), *Losing the excess baggage – reducing disclosures in financial statements to what's important*, available at www.icas.org.uk/excessbaggage/ [accessed 13 January 2014].

27 For further details on the IASB Disclosure Initiative project see www.ifrs.org/Current-Projects/IASB-Projects/Disclosure-Initiative/Pages/Disclosure-Initiative.aspx [accessed 9 January 2014].

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