CFA Society United Kingdom

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IASB
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Response to exposure draft ED/2015/3:
Conceptual Framework for Financial Reporting

The Financial Reporting and Analysis Committee (FRAC) of the CFA Society of the UK (CFA UK) welcomes the opportunity to respond to the IASB's exposure draft on proposed amendments to its Conceptual Framework for Financial Reporting. CFA UK represents about 11,000 investment professionals working across the financial sector including asset managers, buy-side analysts, sell-side analysts and credit rating analysts, among others. For advocacy purposes in the field of financial reporting, these members are represented by the FRAC.

While we appreciate the opportunity to provide feedback on the Conceptual Framework that underpins IFRS we note that the exposure draft is 92 pages long and the supporting basis for conclusions runs to 134 pages. A shorter consultation document would be easier for investors to digest and would probably generate a greater degree of engagement from the investor community.

Overall, we are satisfied with the exposure draft and support the key concepts behind the Conceptual Framework. We look forward to providing input to the IASB on future projects such as financial statement presentation, which we believe could be of great benefit to investors.

Below we respond to your specific questions on the exposure draft in more detail.

Question 1— Proposed changes to Chapters 1 and 2
Do you support the proposals:
(a) to give more prominence, within the objective of financial reporting, to the importance of providing information needed to assess management's stewardship of the entity's resources;
(b) to reintroduce an explicit reference to the notion of prudence (described as caution when making judgements under conditions of uncertainty) and to state that prudence is important in achieving neutrality;
(c) to state explicitly that a faithful representation represents the substance of an economic phenomenon instead of merely representing its legal form;
(d) to clarify that measurement uncertainty is one factor that can make financial information less relevant, and that there is a trade-off between the level of measurement uncertainty and other factors that make information relevant; and
(e) to continue to identify relevance and faithful representation as the two fundamental qualitative characteristics of useful financial information?
Why or why not?

Response:

a) We strongly support the concept of stewardship and look to financial information to enable investors more effectively to hold management to account. However, we recognise that the word does not translate easily into other languages.

b) We are supporters of neutrality, meaning free from bias, in the application of accounting policies. Since some interpret "prudence" as having a conservative bias, we have some reservations about its reintroduction. However, in the spirit of compromise with constituents who feel strongly about this, we support the reintroduction of prudence in the way the ED defines it, namely, the exercise of caution when making judgements under conditions of uncertainty. But it must remain clear that applying prudence in financial reporting does not mean applying any type of bias.

   We note that the Basis for Conclusions distinguishes between the selection of accounting policies (and the setting of standards) and the application of those accounting policies. While rightly ruling out "asymmetric" prudence as a characteristic of useful information, the BC (2.11-2.15) then has to explain why it seems to exist in some standards. We agree that the characteristics of relevance and faithful representation (supported by "cautious" prudence) tackle uncertainty without compromising neutrality, but are concerned about potential confusion over the role of "asymmetric" prudence.

c) We believe it is helpful to state that faithful representation is intended to capture the underlying economic reality or substance of a company's financial position and performance rather than its legal form.

d) While a high level of measurement uncertainty can make financial information less relevant, we would like to be sure this trade-off does not lead to the exclusion of information that helps users of accounts to assess future cash flows.
   If assets/liabilities do not meet the recognition criteria due to their uncertainty, but are important to users of accounts, they should be disclosed in the notes, perhaps

with a range of potential values and probabilities. Disclosure of a range of values is more useful to investors than false precision or omission.

e) While we are happy that relevance and faithful representation remain the two fundamental qualitative characteristics of useful financial information, for recognition purposes, it is difficult to envisage no role for probability in tackling uncertainty. Moreover, the description of faithful representation in the exposure draft does not make it clear whether users can depend on the information. Table 2.1 on page 26 of the Basis for Conclusions demonstrates that faithful representation has virtually the same meaning as reliability. It would be helpful to include this, or something similar, in the main text of the Framework.

Question 2— Description and boundary of a reporting entity
Do you agree with:
(a) the proposed description of a reporting entity in paragraphs 3.11–3.12; and
(b) the discussion of the boundary of a reporting entity in paragraphs 3.13–3.25?
Why or why not?

Response:
Yes, we agree with the description of a reporting entity and the discussion of its boundary.

Question 3— Definitions of elements
Do you agree with the proposed definitions of elements (excluding issues relating to the distinction between liabilities and equity):
(a) an asset, and the related definition of an economic resource;
(b) a liability;
(c) equity;
(d) income; and
(e) expenses?
Why or why not? If you disagree with the proposed definitions, what alternative definitions do you suggest and why?

Response:
We believe that having the elements of income and expense driven by movements in balance sheet elements reinforces the perception that the IASB is focused on the balance sheet. We believe it is important to note that different 'types' of income are of differing levels of usefulness for users. For example, non-operating items (such as gains/losses on sales of financial assets) are a very different sort of income/expense to revenue.

In the Basis for Conclusions (Chapter 4, page 33, par BC4.3 d and e), it is clearer that income and expenses cover both in/out flows and enhancements/depletions of assets/liabilities. We suggest that these dual definitions are made clear, even if there is not a complete separation of operating income/expense and gains/losses in asset and liability values.

Additionally, we note that the definitions of equity and liability still leave potential loopholes for hybrid instruments to be misclassified by companies, thereby presenting a misleading impression of their financial position. We therefore welcome the wider project being conducted by the IASB on the equity/liability distinction. We believe it is important that this project is not constrained by the current definitions, but note that any changes may have significant other implications.

Question 4— Present obligation
Do you agree with the proposed description of a present obligation and the proposed guidance to support that description? Why or why not?

Response:
We have no objections to the definition used but see some scope for confusion or selective interpretation by preparers.

***Question 5*— Other guidance on the elements**
Do you have any comments on the proposed guidance?
Do you believe that additional guidance is needed? If so, please specify what that guidance should include.

Response:
We note the revised chapter on elements no longer defines revenue nor does it discuss operating/ordinary activities. The draft also does not define the elements of the cash flow statement. We believe the Framework would be more robust if it included such definitions.

***Question 6*— Recognition criteria**
Do you agree with the proposed approach to recognition? Why or why not? If you do not agree, what changes do you suggest and why?

Response:
We broadly agree with the reasons for recognising or not recognising an asset. Our general view is that financial statements are not designed to show the value of a reporting entity but rather to help investors make an assessment of the potential for generating cash flows, from which they will derive their own valuation.

***Question 7*— Derecognition**
Do you agree with the proposed discussion of derecognition? Why or why not? If you do not agree, what changes do you suggest and why?

Response:
Yes.

***Question 8*— Measurement bases**
Has the IASB:
(a) correctly identified the measurement bases that should be described in the Conceptual Framework? If not, which measurement bases would you include and why?
(b) properly described the information provided by each of the measurement bases, and their advantages and disadvantages? If not, how would you describe the information provided by each measurement basis, and its advantages and disadvantages?

Response:
We agree with the measurement bases identified, namely amortised historical cost and current value (fair/market value or value in use to the entity). We like the emphasis on current value, with fair value as in market prices, as a sub-set. We would reiterate that the primary purpose of financial statements for most investors is to forecast future cash flows and make their own assessment of valuation.

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***Question 9*— Factors to consider when selecting a measurement basis**

Has the IASB correctly identified the factors to consider when selecting a measurement basis? If not, what factors would you consider and why?

Response:

The more permissive approach to the choice of measurement bases under the current value heading demotes fair value/market value and, in giving more choice of measurement tool, allows entity-specific factors (business model) to play a bigger role. This has pros and cons, with the greater potential relevance of the information reported under the business model approach to be weighed against both a loss of comparability between companies and a greater risk of management bias influencing the numbers.

***Question 10*— More than one relevant measurement basis**

Do you agree with the approach discussed in paragraphs 6.74–6.77 and BC6.68? Why or why not?

Response:

We have been concerned in the past about different treatments in the P&L and on the balance sheet of some financial assets, with the OCI trying to square the circle in between. If two perspectives (historical cost and fair value) are useful, then we support having the alternative in the notes.

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

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

Response:

We welcome the additional research planned by the IASB on the subject of performance reporting. We wrote to the IASB in 2009 regarding a CFA UK member survey we conducted that showed a large majority of members (80% or above in each case) in favour of enhanced transparency on cash flows. The CFA has long campaigned for improvements to the cash flow statement. In response to the IASB's 2011 Agenda Consultation we reiterated that the main area that CFA UK members have identified as being in need of improvement is financial statement presentation. Otherwise we have no specific comments on this section.

***Question 12*— Description of the statement of profit or loss**

Do you support the proposed description of the statement of profit or loss? Why or why not?

If you think that the Conceptual Framework should provide a definition of profit or loss, please explain why it is necessary and provide your suggestion for that definition.

Response:

If the P&L is the primary performance indicator, its main components should be defined, as should the terms 'profit', 'return' and 'performance'. The proliferation of non-GAAP earnings measures is partly due to the lack of a definition of operating performance. Where operating, or transaction-based, gains and losses are muddled up with, or treated as equivalent to, remeasurements, it makes it more difficult to forecast future cash flows. Better guidance is needed on the sub-totals that make up total comprehensive income.

***Question 13*— Reporting items of income or expenses in other comprehensive income**

Do you agree with the proposals on the use of other comprehensive income? Do you think that they provide useful guidance to the IASB for future decisions about the use of other comprehensive income? Why or why not?

If you disagree, what alternative do you suggest and why?

Response:

We believe that the use of OCI should be strictly limited. As it is generally ignored by most investors it would be better to abandon OCI entirely and simply allow companies to present an income statement with current value adjustments clearly broken out from operating figures in order that investors can make their own assessment of underlying earnings (eg through the use of additional columns in the income statement).

***Question 14*— Recycling**

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

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

Response:

The P&L is still the primary performance statement for investors, therefore recycling of OCI items through the P&L is an important matter. As an underlying principle, all OCI items that are eventually realised through an external transaction should be recycled through the P&L.

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

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

Response:

We have no comments on the analysis.

***Question 16*— Business activities**

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

Response:

Entity specific information is of great interest to users: no two sets of accounts are the same. Management commentary provides much entity-specific detail, including non-GAAP numbers, which users may find helpful. However, we would be wary of the IASB routinely adopting a business model approach in setting standards. It risks compromising the comparability of information across companies.

***Question 17*— Long-term investment**

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

Response:

We agree that the Framework should not refer explicitly to the business activity of long-term investment as providing different accounting options for business activities. Allowing management to deem some activities to be more long term than others opens the door to potential manipulation.

We agree that the draft Conceptual Framework contains sufficient discussion of primary users and their information needs, and of the objectives of general purpose financial reporting, to address appropriately the needs of long-term investors.

***Question 18*— Other comments**
Do you have comments on any other aspect of the Exposure Draft? Please indicate the specific paragraphs or group of paragraphs to which your comments relate (if applicable).
As previously noted, the IASB is not requesting comments on all parts of Chapters 1 and 2, on how to distinguish liabilities from equity claims (see Chapter 4) or on Chapter 8.

Response:
In general we are happy with the draft changes to the Conceptual Framework and look forward to providing input to the IASB on future projects such as financial statement presentation, which we believe could be of great benefit to investors.

We would welcome further discussions on the issues raised in this response.

Yours sincerely,

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About CFA UK and CFA Institute

The CFA Society of the UK (CFA UK) represents the interests of more than 10,000 leading members of the UK investment profession. The society, which was founded in 1955, is one of the largest member societies of CFA Institute and is committed to leading the development of the investment profession through the promotion of the highest ethical standards and through the provision of continuing education, advocacy, information and career support on behalf of its members. Most CFA UK members have earned the Chartered Financial Analyst® (CFA®) designation, or are candidates registered in CFA Institute's CFA Program. Both members and candidates attest to adhere to CFA Institute's Code of Ethics and Standards of Professional Conduct.

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