The Corporate Reporting Users' Forum

30th January 2014

Corporate Reporting Users' Forum response on Conceptual Framework

The Corporate Reporting Users' Forum welcomes the opportunity to comment on the Discussion Paper regarding the Conceptual Framework published in July 2013. Our response is set out below.

About the Corporate Reporting Users' Forum (CRUF)

The CRUF came together in 2005 as a discussion forum to help its participants in their approach to the debate on current and future corporate reporting requirements. In particular, participants are keen to have a fuller input into the deliberations of accounting standard setters such as the IASB. CRUF participants come from across the City of London and around the world, including individuals from both buy- and sell-side institutions, and from both equity and fixed income markets.

The CRUF is a discussion forum. Different individuals take leadership in discussions on different topics and in the initial drafting of representations. It does not seek to achieve consensus views, though at times some or all of its participants will agree to make joint representations to standard setters or to the media. It would not be correct to assume that those individuals who do not participate in a given initiative disagree with that initiative.

CRUF participants take part in discussions and joint representations as individuals, not as representatives of their employer organisations. The participants in the Forum that have specifically endorsed this response are listed at the end of this letter.

Value of a Conceptual Framework

We believe that a strong, internally consistent and clear conceptual framework is key to ensuring higher quality financial reporting standards going forward and we are happy to contribute to this debate.

We are responding to the consultation in the light of our own Guiding Principles document, which is attached to this response. These articulate briefly what we believe are the key roles of financial reporting standards from the user's perspective. We developed these Principles over 7 years ago as our first action after coming together as a group. Our aim was to reach consensus among a diverse group of users on our overarching desires from accounts and therefore our views on the appropriate nature of accounting standards. Several of the issues raised in the DP can be related back to these principles and, where relevant, we have sought to highlight the linkages. We have also attached our response to the 2008 consultation on Financial Instruments with the Characteristics of Equity as we still stand by our view regarding how to define equity and what equity providers need to see in order to understand the interactions between the different classes of equity participation.

In general we see the value of a Conceptual Framework as being a 'skeleton' that supports the development of Generally Accepted Accounting Practice; as opposed to a 'straight jacket' that limits the potential for future debate and change.

IASB DP Conceptual Framework

Q2

The definitions of an asset and a liability are discussed in paragraphs 2.6–2.16. 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?

It is not clear that a compelling case has been made for change although these definitions do look clear and appear to be operational. We would need to see more examples of fact patterns where accounting treatment is impacted by the change in order to opine more fully. We would note that the expectation of inflow or outflow of economic resources is a helpful part of the current definition. See our response to Question 3. Some mention also of risks and rewards might also be valuable in conveying the essence of these items.

Q3

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. 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?

We are not convinced that the notion of expectation should be dispensed with completely, and opinion among CRUF members is divided regarding the merits or otherwise of a probability threshold. If the IASB is simply proposing to avoid deciding this issue either way in the Conceptual Framework by omitting any reference to a probability threshold then we would be supportive, provided the point remained open for subsequent debate in the context of specific Standards.

Q4

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

These issues are of great importance to the users of financial statements and we do encourage the IASB to debate the topic expeditiously but accept that this may be better dealt with during a Financial

Statement Presentation Project. Indeed we prefer the term “Reporting Financial Performance” for the project which would be a better description to emphasise the need to report economic substance over legal or accounting form. Questions on OCI and equity addressed later in this letter are linked to this topic.

Q5

Constructive obligations are discussed in paragraphs 3.39–3.62. 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.

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

We agree that the definition of liabilities must extend to constructive obligations.

Q6

The meaning of ‘present’ in the definition of a liability is discussed in paragraphs 3.63–3.97. 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.

We consider View 3 to be closest to our view of what is necessary in order to reflect the economic substance of the entity’s position and to give a true and fair view. View 2 is rather too restrictive but would be acceptable if the focus instead was on the common sense question of whether it would be in the economic interest of the entity to seek to avoid discharging the obligation rather than the question of whether it might be legally possible to avoid doing so. We reviewed an example of a train operating company which had an obligation to pay a levy above a revenue threshold and debated whether the company had a liability prior to the threshold being reached. There was clear consensus amongst the CRUF participants that if the company believed that the threshold would be surpassed and that the company had no practical way to avoid payment then the levy should be accrued against the revenues below the threshold on a “matching principle” or under an “accruals concept” – whilst these terms are no longer in the conceptual framework, the concepts are still valid and reflect the substance of what analysts do when forecasting margins and operational performance. One point worth noting is that analysts typically treat “working capital” assets and liabilities differently to “non-operating” assets and liabilities when valuing an enterprise and so we would prefer the Conceptual Framework to allow for a range of potential approaches to be considered when developing/reforming individual Standards.

Qs 8-9

We have not debated recognition and derecognition as a group and therefore do not have detailed comments to convey. The approach that the IASB has proposed appears to be reasonable and reflects the need to look at fact patterns when developing or revising particular standards.

Q10

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. 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)).

(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?

We would prefer the definition of equity to focus on instruments that participate in the unrestricted rewards from the business rather than looking to identify instruments that are entitled to a residual (which implies a focus on liquidation which is at odds with the “going concern” concept). That is not to say we completely disagree with that notion, or that the equity is not the ultimate bearer of risk. We believe that accounts should always be prepared on the basis that the entity is a going concern and that the entity will meet all obligations in full when they fall due. What is therefore much more important to an equity owner is an understanding of all the dilutive instruments which can only be valued with reference to the fair value of the whole enterprise. We would observe that changes in value of these dilutive instruments after issue/grant is not something which we believe should be recognised in the financial statements, but disclosures must be improved so that the precise risks and rewards for each equity instrument are clear to all users. This further implies that this is the dividing line for what is or is not included in the statement of comprehensive income when reconciling shareholders equity as this will be before remeasurement of potentially dilutive instruments. Indeed we believe that remeasuring dilutive instruments creates unnecessary noise in the income statement – we are not interested in the fair value of a convertible today because what we want to know is the impact of the potential dilution. This is the main thrust of the letter we wrote in 2008, which is attached.

Our definition of equity and disclosure need would better be described as: "Any stakeholder should be treated as Equity where, on disposal of the reporting entity to a third party, they would see a variation in proceeds without upward limit, proportionate to marginal changes in consideration received. Where there are multiple instruments that have these characteristics they should each be treated entirely as "Equity", provided that the equity characteristic is not provided by an embedded derivative, in which case the derivative should be disaggregated. Disclosure should be adequate to distinguish material variations in rights and returns including but not limited to: votes, liquidation preference, dividends and proportionate share in gains and losses."

It is clear from the above that improved disclosure of the changes of value between different classes of equity would provide very useful information to users, including the existing holders of issued share capital. We must emphasise that we do not consider that fair value changes of different equity instruments (the significance of which could vary greatly according to the circumstances) should be reflected on the face of the financial statements.

Obligations to issue equity instruments should not in normal circumstances be treated as liabilities. However, if the terms on which such instruments would be issued are not fixed as regards amount and price or where there would be an actual outflow of resources from the entity to facilitate a settlement of the claim, such as buying shares from the market at a later date or of paying cash to extinguish the claim, recognition of a liability is likely to be the more appropriate reflection of its nature.

We are not attracted by the idea of treating the most subordinated class of instrument as the equity of the entity. What is particularly important is that the information needs of the prime class of equity are properly met. Having said that, if this definition were used we would need very good disclosure to understand potential dilution across a range of enterprise values as other instruments participated in upside. We would also need to see all fair value moves associated with these instruments clearly broken out in the accounts so we could remove them for the purposes of measuring performance.

Q's 11-15

We are generally in agreement with the IASB views regarding the nature of assets and liabilities and how this impacts the way that they should be reported and measured.

Q's 16-18

We are comfortable that the IASB's views regarding the extent to which disclosure requirements and materiality should be reflected in the Conceptual Framework are reasonable. We look forward to engaging with them on these topics in the future.

Q19

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.

Do you agree? 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 amending Standards?

We agree that a total or sub-total profit or loss is necessary, both because it is appropriate for the entity and its management to account to their share owners for their performance in the use of the resources of the company and of its capital providers, and because annual profit is a key component for analysts in making judgments as to the value of the entity and its future cash-flows. As mentioned in Q6, we consider that compilation of profit or loss through matching of income and expense is likely to provide a result that best meets the requirements and expectations of users.

Q20

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

Do you agree? 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?

We question whether the Conceptual Framework is the right place to determine the answers to such detailed questions - many CRUF members argue that this debate should form part of the Financial Statement Presentation Project.

With regard to recycling, there are a range of views within CRUF. Some argue that once an item has passed through the statement of comprehensive income then there is no need to recycle as it has been recognised appropriately. Others argue that at least some recycling of items previously recognised in OCI into profit or loss in a later period is practically necessary and not just for items such as elements of cash-flow hedging. Broadly speaking, they believe that a profit or loss figure which is compiled on something close to a cost-based approach is appropriate and that recycling is the necessary process that reconciles this with a sometimes more current value based presentation of the entity's statement of financial position (balance sheet). Some CRUF members believe that recycling should be required for all, or almost all, items initially recognised in OCI.

Given the practical importance of the profit or loss total in providing a figure for ongoing earnings to which a 'multiple' may be applied as part of the valuation process, and a strong desire among CRUF members to ensure that arbitrary 'smoothing' or 'manipulation' of earnings is made difficult, clear disclosure and a consistent approach is essential.

Q21

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

Which of these approaches do you support, and why?

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

We question whether this debate is one that needs to be resolved in the Conceptual Framework, but in answer to the question, we prefer the broad approach on the assumption that it would allow ‘transitory’ items of income and expense to be eligible for reporting in OCI. However, we do not agree that this should mean recycling of such items should never occur. If those items prove to be permanent in whole or part it may be appropriate for them eventually to appear in profit or loss.

We would be concerned by an approach to OCI that encouraged managements to systematically underestimate costs in the P&L in the knowledge that the difference could be ‘hidden’ in OCI.

Q22

Chapters 1 and 3 of the existing Conceptual Framework

Paragraphs 9.2–9.22 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.

The IASB should reconsider in particular its earlier conclusions on stewardship and prudence. By doing so it may help the Board both to meet better the requirements and legitimate expectations of users of accounts, and also to push back against potential and unwarranted interference in the objectives and processes of the standard setting community.

With respect to stewardship, we recognise that there may be difficulties in achieving congruity of meaning across different languages but we do not believe that this is a good reason to avoid attempting to reflect the importance of stewardship in accounting. Providing an account to the ownership body of the reporting entity for the past use of the resources of the company is a fundamental objective, as is the provision of information to the members of the ownership body to enable them to discharge their governance responsibilities. These objectives sit beside those of decision usefulness for users of accounts generally, including to inform investment decisions in the financial markets.

We believe that the Conceptual Framework should make specific reference to prudence. We believe that doing so would support the IASB’s objective in financial reporting of promoting neutrality and improving decision-usefulness for financial market participants.

We consider that exercise of prudence when making judgements is the right approach in the face of uncertainty. Exercising judgement in a prudent manner is likely to better align the interests of shareholders, managers, auditors, and other stakeholders, both to help promote consistency in reporting across the preparer community and to act as a bulwark against the natural desire of managements to take an optimistic view of the future.

This approach is not incompatible with neutrality, indeed quite the reverse. We suggest that there is a necessary exercise of tension between prudence and neutrality that will help promote a true and fair view. By contrast, the deliberate understating of income in order to build up hidden reserves and smooth profits is clearly not ‘neutral’ but neither is it what we would regard as ‘prudent’ (or compatible with a stewardship objective in accounting) and we do not believe such an approach promotes a true and fair view.

To bear in mind the objective of prudence would also be of benefit in helping reach appropriate conclusions on many of the conceptual matters addressed elsewhere in the discussion paper and beyond. For example, it would help in responding appropriately to the question of 'reliability'.

The two concepts could usefully be considered together when developing new Standards or proposing amendments to existing ones and it might be helpful if the Basis for Conclusions for a new Standard explained why the IASB thinks what they have proposed is "prudent" when reporting "stewardship". As an example, the proposed expected loss model appears to us to be more prudent in its approach and more likely to encourage good stewardship of a bank's resources. Similarly the recent changes to pensions accounting to restrain managements' ability to book expected returns on pension assets as profits encourages a more prudent approach with helpful implications from a stewardship perspective.

Q23

Business model

The business model concept is discussed in paragraphs 9.23–9.34. This Discussion Paper 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?

The business model concept has proved fruitful in navigating challenges in development of financial reporting standards over recent time periods and should therefore be retained. It focuses instead on how the entity is holding out itself, to its shareholders and other capital providers, to be conducting its business activities. It is much more appropriate than use of 'management intent' in helping to select appropriate accounting treatments.

Defining the business model with precision is difficult, but like 'beauty', many CRUF members understand what is meant by the term. In essence it is the raison d'etre of the entity, encapsulating the purpose for which the company is currently configured and the means by which the company intends to generate returns on equity in excess of the cost of equity on a sustainable long-term basis. As such it will underpin everything the company does, and will strongly influence the way in which the company's operations and systems are configured.

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