RESPONSE OF THE UK SHAREHOLDERS' ASSOCIATION LTD (UKSA)
to
the IASB's Conceptual Framework Exposure Draft of May 2015

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?

1(A) Stewardship

UKSA is pleased to see greater prominence given to the importance of stewardship- the idea of looking after someone else's money.

However the objective as defined in para 1.2 makes no reference to stewardship. It refers to "providing resources": that is, it implicitly assumes that the objective is only of use to those investors who are traders and not to those whose interest is in remaining as investors but who wish to have the clearest possible understanding of what has been done with their money. The idea of stewardship is added in Para 1.3 but only as a subsidiary purpose of accounts.

UKSA believes that the concept of stewardship and the associated potential challenge to management are important for good governance. Good corporate governance benefits the economy as a whole.

1(b) Prudence:

UKSA has long argued that the notion of prudence needed to be reintroduced and reinforced. It strongly supports the idea of neutrality but has been concerned that the absence of prudence had led to overstatement of profits and has prevented auditors from being able to challenge the natural and desirable optimism of management.

The European Accounting Association commented in 2009 "… it is not simply a question of prudence- conservatism only being required for stewardship accounting. There is a decision-making as well as a stewardship demand for prudent accounting measures." (Abacus; vol45 Nov 4: 2009)

The Exposure Draft (ED) defines prudence as "caution when making judgements under conditions of uncertainty". What it does not do is accept that uncertainty is ALWAYS present and that such caution is always required in making judgements. Thus UKSA would want to see the definition of prudence amended by deletion of the words "under conditions of uncertainty".

UKSA supports the point made in para 2.18 that the exercise of prudence must not result in the understatement of assets or the overstatement of liabilities, though these are lesser evils than the reverse.

The Basis for Conclusions (BC) argues that there are two forms of prudence:- that of being equally cautious in valuing both assets and liabilities and that by which some liabilities are recognised more easily than equivalent assets, called asymmetry. The BC states

"- Such an approach is reflected in many existing Standards, for example IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* requires different recognition thresholds for contingent liabilities and contingent assets. " (BC 2.14)

The IASB find the ideas of prudence and reliability difficult to reconcile.

"However, the IASB also thinks that not all asymmetry is inconsistent with neutrality."(BC 2.11) is hardly a positive expression of a concept.

Further, they do not discuss the requirement that stocks (inventory) be valued at the lower of cost and net realisable value, whilst the "fair" value of such stock may be in excess of cost. Thus such assets are valued "asymmetrically". UKSA, whilst recognising the difficulties here believes that it is not sufficient for a statement of fundamental concepts not to have an adequate and clear concept of how and when what they call "cautious prudence" and "asymmetric prudence" should be applied.

The ED should make additional reference to the prudence problem and not just leave it to the BC.

1(c) Substance over form.

UKSA supports the view that substance must take preference over form where the two differ. This approach has been accepted for many years but it should not be forgotten that it does introduce an element of subjectivity in deciding what the true form of a transaction is.

1 (d) Measurement uncertainty

The ED suggests that there is a "trade-off between the level of measurement uncertainty and other factors which make the information relevant". It is not clear what concept, if any , is being brought in here. It appears that a guess (high level of measurement uncertainty) may be " relevant" or it may not. This does little to help achieve the objects of this ED which are to:

help the IASB develop standards based on consistent concepts

assist preparers, and

assist others to understand standards.(ED summary page 6)

1(e) Relevance and faithful representation

UKSA believes that the most fundamental aspect of financial reporting is that it is reliable whilst acknowledging the judgements which are involved. It very much supports the comment made in BC 2.23 that "the idea that financial statements should be credible (that is, that they provide reliable information that users can depend on) is a key concept that should be acknowledged in the *Conceptual Framework".*

The BC goes on to argues that the term reliability has, been used in too restrictive a manner and that for that reason it prefers the term "faithful representation". The CF which applied before the term "reliability" was dropped in 2010, stated that "reliability" also included substance over form, completeness, prudence and neutrality. UKSA sees each of these as necessary characteristics of accounting numbers but believes that "reliable information that users can depend on" is absolutely essential and should be reaffirmed. In the view of UKSA reliability involves having confidence that the numbers have been both properly stated and suitably challenged where necessary.

UKSA would therefore strongly support the reintroduction of the term "reliability".

The BC (BC 2.24)goes on to discuss just measurement in its case against the use of "reliability". UKSA sees the term reliability as much broader and more key than just measurement.

Relevance:

Clearly information must be relevant. It would help to here explicitly state here that the relevance is to the objective(s).

General:

Within several jurisdictions, including the EU, there is a requirement that financial statements are to show a "true and fair" view. The ED fails to recognise this and should do so.

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?

2 (a) Reporting entity

Yes

2(b) Extent of reporting entity

UKSA agrees that consolidated accounts should include all the entities "controlled" by the reporting entity. Control is defined as:-

The ability to direct the use of the economic resource and obtain the economic benefits that flow from it (ED 4.18)

However para 3.14 is unclear. It seems to say that the parent can produce its own accounts, defined either as unconsolidated accounts or group accounts - consolidated. The present language is not clear and UKSA would like it clarified.

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?

3 (a) Asset

The definition is convoluted and the terms are not used consistently.

For example why is the definition of an asset restricted to a "present" economic resource. An asset will normally exist whether or not it is presently controlled by the entity.

If an asset is an "economic resource" is there a good reason not to use the word asset throughout the ED rather than "economic resource"? Occasionally the word "resource" is used on its own without the word "economic" which the IASB in the BC regards as a significant distinction.(E.G, the last sentence of para 1.3of the ED).Are the two intended to be the same or not?

3(b) Liability

There is no need for the word "present". An entity can only recognise a liability at any given date.

3(c) Equity

Interestingly "assets" is used here not "economic resource". Is there any valid distinction?

3(d) Income

Income is said to be "increases in assets or decreases in liabilities". This treats the whole concept of accounting from a purely balance sheet perspective which brings in the whole question of whether changes in " fair values" constitute income. The definition needs to recognise this point.

As equity has just been defined as assets less liabilities "income" as defined must increase equity. Thus the reference to increases in equity is superfluous.

The definition goes on to refer to equity "claims". This term is not defined but appears to include both "equity claims" and other "claims", presumably liabilities. The word requires proper definition particularly as it is extensively used.

3(e) Liabilities

The comments on the asset definition also apply here.

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?

The definition appears reasonable. However what is not defined is a provision against an asset as against a provision for a liability.

It would be helpful to refer here to the concept of matching which states that both the income of a period and the expenses associated with that income are accounted for in the same period. This support the idea of a liability arising from past events.

Whilst UKSA appreciates that IASB are aiming at concepts with universal application it is clear that in certain jurisdictions- notably the EU- provisions have, by law, to be made for losses thought "likely" to occur. Such "likely" losses will clearly have arisen from past events in that the asset has been acquired.

The ED requires a reference to this.

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.

UKSA notes that the IASB believes there is a difficulty in defining certain hybrid instruments as either equity or liabilities and envisages addressing this in the future. (BC 4.101).UKSA believes that the distinction is fundamental. It is concerned that this point has not been fully addressed in the ED and needs to be.

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?

The approach to the recognition of elements in the ED requires recognition if

(a) Relevant information is given

(b) There is faithful representation. UKSA believes that an element should be recognised if it can be stated reliably and would wish this aspect to be recognised.

(c) It is cost effective. No guidance is given as to how this could possibly be measured.

The ED goes on to say do not recognise that an asset or liability exists if;-

You are not certain it does exist, which seems self-evident.

you are not sure it will produce income (or expenditure),

UKSA would seek here a reference to prudence in attempting to forecast whether cash flows would result. Interestingly the IASB specifically comment that the ED does not rule out so called "asymmetric" prudence in such forecasts. That is to say that one can be more cautious when measuring liabilities than when measuring assets and if you can only guess as to as to a valuation of the element.

But mark to model is allowed generally by the ED, which appears inconsistent

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?

UKSA finds it difficult to understand how a reliable representation of an entity's assets and liabilities after a transaction can do other than reflect that change (ED 5.26). If that is possible it would appear that the concept of substance over form should be applied and it would be helpful to refer to that concept.

UKSA is surprised that it is asked to agree with a discussion. Other than the point mentioned above it agrees with the conclusion.

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?

IASB state that the objective of measurement is:-

To contribute to the faithful representation of relevant information about:
(a) the resources of the entity, claims against the entity and changes in resources and claims; and
(b) how efficiently and effectively the entity's management and governing body have discharged their responsibilities to use the entity's resources.

(BC 6.38)

The IASB take the view that multiple measurement bases can be applied within one set of accounts. They classify them principally into historical (or amortised) cost and current values.

UKSA is concerned that the use of multiple bases within one set of accounts makes such accounts less easy to understand. It is appreciated that there is considerable support for current values (usually "fair"). So UKSA would like to see accounts stated at historical cost with a separate statement- perhaps by way of note- showing current values. UKSA believes that such accounts on an historical cost basis would also avoid many of the current worries about the reliability of current values. Matters such as pension and deferred tax accounting would need to be addressed if this aim is to be achieved.

Whilst drawing somewhat different conclusions Professor G Whittington has commented "in a realistic market … a more appropriate approach to the measurement problem might be to define a clear measurement objective and to select the measurement method that best meets that objective…". (Abacus: vol 44 No2 2008)

IASB seek "relevant "information. BC 6.38 argues that one set of information can be "relevant" both for reporting on assets, liabilities and income or expenditure <u>as well as</u> for stewardship. UKSA believes that accounting would be improved by recognising the differing needs of users and accepting that accounts drawn up different bases will be more useful to different classes of users.

8(a) Resources and claims

IASB ask if the ED has correctly identified the different measurement bases to be identified in the ED. As in practice these seem to boil down to two-historical and fair- it is unclear why other bases need to be referred to. UKSA believes the ED would be clarified if it was restricted to considering these two bases only.

8(b) Descriptions of measurement bases

UKSA believes that historical cost is properly described.

Fair value is suitably described but without any comment that in times of volatile markets recording such market values- obviously at a particular date- may well not provide relevant information as values change, often rapidly and frequently.

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?

UKSA is concerned that multiple measurement bases are confusing and do not help with one of the underlying aims which is comparability.

The discussion of when to use what basis is not helpful and does not seem to lay out any particular concepts.

Specifically there is a reference (In BC 6.57) to leaving the application of prudence to individual standards. UKSA disagrees with this. The idea of prudence is so fundamental that it should be fully incorporated in a conceptual framework.

In the ED (6.55/6.57) it is suggested that an "unobservable price can be faithfully represented" so long as the estimates made are fully explained. UKSA does not see this as contributing to reliability which it regards as essential.

In 6.58 it is very surprising that that IASB merely suggest that a "similar" basis may be appropriate for measuring related asset and liabilities. There should be a specific statement that related assets and liabilities are to be measured on the same basis.

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?

No.
The ED does not state the reasons why it thinks the use of differing bases of measurement for the balance sheet and the revenue statement can be a good thing. If such differing bases are thought to be helpful an underlying concept needs to be expressed.
Further the suggested approach involves use of the statement of "OCI". There is no apparent expression of any underlying concept for the use of this statement which is a major omission. It appears to be a resting place for balances in the accounts which IASB do not know what to do with.

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?

General

UKSA agrees with the wording of this chapter subject to the two following points:-

Cash flows:
A statement of cash flows has for many years been a part of the financial statements not an objective of financial statements. IASB do not make clear why such information which it agrees is "important to users" (BC7.b) is not central. The logic of the argument is contorted. Under 3.4 of the ED information is intended to be supplied about, inter alia, assets for the purpose of assessing future cash flows. Cash is an asset. Historical cash flows are an important part of that assessment.
Is there any good reason not to fully include a statement of cash flows?

Classification.
Para 7.11 of the ED refers to splitting the income and expense. The paragraph is very obscure as to when and why that should be appropriate.

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.

OCI

BC 7.25 refers to the intention to retain the term" other comprehensive income" as a way of recognising income and expenses which the IASB believe should not go through the P&L account, or at least not immediately.

This comment raises questions which the ED does not seem to address.

1 The very term is unhelpful: Other - other than what?
Comprehensive- does this imply that there may be income which is NOT comprehensive?
Income - the OCI is used for expenses as well as income so this word appears misleading.

It is certainly "not particularly descriptive or well understood" by our investors .It is difficult to think of a term which could be more confusing.

2 The basic principle of an arrangement which takes some items into account outside the P&L is not discussed. No fundamental concept is offered.

3 The BC(para 7.32)comments
"the use of OCI and of recycling are not well understood by the user community and OCI is not looked at by many users"

UKSA agrees.

4 Para 7.34 notes that some "remeasurements" are included in OCI and some are not but it appears that IASB are unable to indicate what concepts these involve.

5 In para 7.43 IASB effectively retain to themselves in individual standards the power whether or not to require the use of OCI. How does that support one of the main aims of the ED which is said to be to offer guidance to those drawing up accounts?

UKSA would ask the IASB to consider a requirement to show an historical cost profit as well as a current value one. If this idea is adopted many of the problems which the ED has <u>not</u> addressed would be avoided.

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?

We have commented above about our unhappiness with both the principle of OCI and the fact that the ED does not attempt to lay down a concept of how such a statement should be used.
It appears to us that the problem arises because IASB are attempting to reconcile two conflicting views. They seem to be saying that " current values" provide useful information on some occasions and for certain purposes but not for others.
This leaves the problem of so called "recycling" i.e. bringing an entry made in the OCI in an earlier period into P&L in a later period. We assume that the idea is that if a profit (or loss) has been recognised by the use of current values and entered in OCI then, when a transaction occurs that realises that profit or loss, the amount previously recognised in OCI is brought into P&L. It is argued that such treatment provides "relevant" information.

However there is no concept expressed as to when a profit is regarded as being made- little by little by use of "current" values or when realised.

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?

This is largely dealt with in the comments on questions 12 and 13 above. As there is no clear logic in that described role for OCI the question of recycling cannot be usefully addressed.

Chapter 8; concepts of capital and capital maintenance

Whilst IASB are not asking questions about this chapter UKSA would comment that the whole idea of what constitutes profit is- apparently intentionally- left undecided. It appears that profit can be calculated "in either nominal monetary units or units of constant purchasing power."(ED Para 8.3.b).

UKSA finds this very unhelpful.
Firstly is one to assume that "nominal monetary units" are the same as historical cost? Or if not what are they?
Secondly do "units of constant purchasing power "equate with " current values" as used elsewhere in the ED?
Thirdly this leaves open the question of whether profits include revaluations as well as realised profits.

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?

UKSA is pleased that IASB recognise the inconsistencies between the ED and certain existing standards.
It is a matter of concern, however, that e.g. para BCE 4 reduces the value of a statement of fundamental concepts in that it allows the IASB itself to come up with ways of dealing with inconsistencies at some time in the future. Again such uncertainty undermines one of the stated principal objectives of such a statement which is to provide guidance both to itself and to others.

Question 16—Business activities

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

UKSA agrees that there is no need for further consideration of business activities on the ED

Question 17—Long-term investment

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

No
Long term is not defined. If it is intended to include investors who are interested in more than high speed, daily, weekly or even monthly dealing in shares UKSA members would generally regard themselves as "long term" but certainly not as a class of investor outside the norm. There seems no good reason to attempt any further distinction for the long term.

BDIN 39 lists various reasons for a differing approach which, it suggests "long term" investors might seek but in Par 40 IASB dismiss those arguments. However UKSA would support them:-
39(a): We believe that IASB does focus too much on short-term investors.
39(b); The IASB does give too much weight to the needs of potential investors and not enough to the needs of existing investors.
39(c) The IASB does make excessive use of current values
39 (d) Excessive use of current values can

(i) contribute to imprudent dividend distributions
(ii) lead to inflated management remuneration and
(iii) lead to short-termist behaviour.

Indeed accounting information should not be the sole determinant of bonuses and dividends but it certainly appears to be a very significant one.

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.

UKSA does not think it satisfactory that a statement of the IASB's Conceptual Framework should avoid discussion of key concepts such as those referred to here. UKSA has commented on several of these in its replies above including notably chapter 8 which it believes is very important.
UKSA believes that fundamental concepts such as these- including the debate on OCI -are essential for such a statement to both achieve its own aims and to be fully coherent.

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