STAFF PAPER

March 2014

IASB Meeting

Project	Conceptual Framework		
Paper topic	Feedback summary: Chapter 1 and Chapter 3 of the existing Conceptual Framework		
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Purpose of paper

1. This paper summarises the feedback received on the paragraphs discussing Chapter 1 *The objective of general purpose financial reporting* and Chapter 3 *Qualitative characteristics of useful financial information* from Section 9 of the Discussion Paper *A Review of the Conceptual Framework for Financial Reporting*.

2. This paper provides a high level summary of the comments received. When appropriate, we will provide a more detailed breakdown of the comments for future meetings.

Overview

3. About three quarters of respondents commented on whether the IASB should reconsider Chapters 1 and 3 of the existing Conceptual Framework. Although some of those respondents opposed changes to those Chapters, many of them argued that the IASB should do one or more of the following:

   (a) give stewardship more prominence;

   (b) reintroduce prudence;

   (c) reconsider the decision to replace the term ‘reliability’ with ‘faithful representation’; and

(d) include an explicit reference to substance over form, rather than leaving this implicit as part of faithful representation.

Structure of paper

4. This paper is structured as follows:

   (a) Background (paragraphs 5-7)

   (b) Summary of feedback (paragraphs 8-10)

   (c) Stewardship (paragraphs 11–21)

   (d) Prudence (paragraphs 22–34)

   (e) Reliability (paragraphs 35–44)

   (f) Primary user (paragraphs 45-49)

   (g) Other comments (paragraphs 50–54).

Background

5. When the IASB restarted work on the Conceptual Framework project in 2012, it did not fundamentally reconsider the chapters of the Conceptual Framework that it published in 2010 (Chapter 1 *The objective of general purpose financial reporting* and Chapter 3 *Qualitative characteristics of useful financial information* ('Chapters 1 and 3'). However, the IASB acknowledged that it would make changes if work on the rest of the Conceptual Framework highlights areas that need clarifying or amending.

6. Even before the publication of the Discussion Paper, the IASB was aware that some had expressed concerns about Chapters 1 and 3, and particularly the following aspects:

   (a) the treatment of stewardship;

   (b) the decision to replace the fundamental characteristic of reliability with that of faithful representation; and

   (c) the decision to remove to the concept of prudence.

7. Each issue listed in paragraph 6 was discussed in Section 9 of the Discussion Paper. Respondents to the Discussion Paper were asked whether they agreed with the IASB's proposed approach to Chapters 1 and 3 (ie, not to fundamentally reconsider these chapters).

Summary of feedback

8. About three quarters of respondents commented on this issue. Some agree with the proposal not to fundamentally reconsider Chapters 1 and 3 of the existing Conceptual Framework citing the following reasons:
   - (a) The concepts in Chapters 1 and 3 are sound.
   - (b) Chapters 1 and 3 were completed only three years ago and have been through extensive due process. Nothing has arisen since publication that would justify re-opening Chapters 1 and 3.
   - (c) Chapters 1 and 3 were developed jointly with the FASB. Any decision to change them would result in a non-converged result.
   - (d) Re-opening Chapters 1 and 3 would be a waste of time and resources, for both the IASB and constituents.

9. However, many of those who commented disagreed with the proposed approach to Chapters 1 and 3. In particular:
   - (a) Many disagreed with one or more aspect of Chapters 1 and 3. The most commonly cited aspects were the following:
     - (i) the treatment of stewardship in Chapter 1. This is discussed in paragraphs 11-21;
     - (ii) the decision to remove the concept of prudence. This is discussed in paragraphs 22-34;
     - (iii) the decision to replace the fundamental characteristic of reliability with that of faithful representation. This is discussed in paragraphs 35-44; and
     - (iv) the primary user of financial statements identified in Chapter 1. This is discussed in paragraphs 45-49.

(b) A few respondents stated that the IASB should re-expose Chapters 1 and 3 at the same time as the rest of the Conceptual Framework to allow respondents to assess the coherence of the whole document. They stated that when the IASB published Chapters 1 and 3, it committed itself to review these Chapters when it completed the rest of the Conceptual Framework.

(c) A few commented that the financial crisis had changed the standard-setting environment. Consequently, in their opinion, Chapters 1 and 3 reflected concepts that were no longer appropriate.

(d) A few expressed the opinion that some aspects of Chapters 1 and 3 were the result of compromises with the FASB. Now that the project is no longer a joint project with the FASB, the IASB should revisit those aspects.

10. Whether a respondent agreed or disagreed with the proposal not to reconsider Chapters 1 and 3 does not appear to be linked to their geographical region or respondent type. The treatment of prudence, stewardship and reliability appears to be of particular importance to European respondents but it was also raised by respondents in other territories.

Stewardship

Background

11. In describing the objective of general purpose financial reporting, Chapter 1 does not use the word ‘stewardship’. However, Chapter 1 states that users of financial statements need information about how effectively and efficiently the entity’s management and governing body have discharged their responsibilities:

> To assess an entity’s prospects for future net cash inflows, existing and potential investors, lenders and other creditors need information about the resources of the entity, claims against the entity, and how efficiently and effectively the entity’s management and governing board have discharged their responsibilities to use the entity’s resources. Examples of such responsibilities include protecting the entity’s resources

> from unfavourable effects of economic factors such as price and technological changes and ensuring that the entity complies with applicable laws, regulations and contractual provisions. Information about management's discharge of its responsibilities is also useful for decisions by existing investors, lenders and other creditors who have the right to vote on or otherwise influence management's actions.[1]

12. Paragraph BC1.27 of Chapter 1 states that information that can be used to assess future cash flow prospects and inputs to assess stewardship are both important for making decisions about providing resources to an entity. In addition, inputs to assess stewardship are important for resource providers who have the ability to vote on, or otherwise influence, management's actions.

13. The Basis for Conclusions goes on to explain that the IASB decided to describe what is meant by the term 'stewardship' rather than using the term itself, because there would be difficulties translating the term 'stewardship' into other languages.

Summary of feedback

14. Some respondents expressed the view that it is unnecessary to change how Chapter 1 of the existing Conceptual Framework deals with stewardship. These respondents noted that, while Chapter 1 does not use the term 'stewardship', the wording of Chapter 1 and its Basis for Conclusions clearly indicate that inputs to assess stewardship are important to meet the objective of financial reporting.

15. Other respondents believe that the IASB could deal with the issue of stewardship by making explicit reference to stewardship in Chapter 1 (ie use the word stewardship). However, additional changes would be unnecessary.

16. A few respondents expressed the view that introducing stewardship as a competing primary objective of financial reporting could lead to ambiguity in standard-setting.

17. One user group stated that stewardship should not be given greater prominence in the Conceptual Framework because some would seek to use it as a justification to introduce management bias into recognition and measurement.

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[1] See paragraph OB4 of the existing Conceptual Framework.

18. However, many of those who commented on stewardship stated that the IASB should change how Chapter 1 deals with stewardship. In particular, respondents expressed the following views:

(a) It is unclear in Chapter 1 that information needed to assess stewardship by management is necessary to meet the objective of financial reporting.

(b) Some inputs needed to assess stewardship by management (for example, information about related party transactions, compensation of key management personnel) are not needed to make resource allocation decisions. That is inconsistent with Chapter 1, which states that the primary objective of financial reporting is to provide decision-useful information and that inputs used in assessing stewardship by management are part of what is needed to meet that overall objective.

(c) Chapter 1 appears to imply that inputs used in assessing stewardship by management are also part of the information needed to assess prospects for future cash flows. However:

(i) Providing inputs to help users assess stewardship by management is just as important as providing information needed to assess prospects for future cash flows.

(ii) Information needed to assess the prospects for future cash flows is predictive in nature while inputs needed to assess stewardship by management are confirmatory in nature. This distinction could be important when deciding the measurement basis for an item (eg cost or fair value).

(d) One of the purposes of financial reporting is to hold management to account. Providing inputs to an assessment of stewardship helps to align management's behaviour with the objectives of investors thereby reducing moral hazard. This role should be clearly stated in the Conceptual Framework.

(e) Inputs to assess stewardship by management are particularly important to long-term investors. If providing such inputs is not identified as an objective of financial reporting, there is a risk that Standards will focus more on the needs of short-term rather than long-term investors.

19. To address these concerns, some respondents suggested that the IASB should give greater prominence to stewardship as part of what is needed to meet the decision-usefulness objective of financial reporting. In particular, Chapter 1 should state that providing inputs to assess stewardship by management is as important as providing information to assess the prospects for future cash flows.

20. Other respondents stated that stewardship should be included as an additional objective of financial reporting, separate from decision-usefulness.

> In our view, the provision of information that provides accountability is a primary objective of financial reporting. It should be reflected in the Conceptual Framework as a separate objective, equal in prominence to that of providing information that is useful for making decisions about the provision or resources to the entity. *UK Financial Reporting Council*

21. Few respondents agreed with the IASB's statement that the term 'stewardship' is difficult to translate or is not well understood. Moreover, some respondents stated that a problem with translating 'stewardship' was not a good reason for excluding the term from the Conceptual Framework. Some respondents suggested that if the term 'stewardship' is unclear the IASB should consider using 'accountability' instead.

Prudence

Background

22. Both Chapter 3 of the existing Conceptual Framework and the pre-2010 Conceptual Framework state that financial statements should be neutral, that is, free from bias. However, the pre-2010 *Conceptual Framework* went on to describe the concept of prudence. Chapter 3 does not refer to prudence.

23. Paragraph 37 of the pre-2010 *Conceptual Framework* describes prudence as follows:

> The preparers of financial statements do, however, have to contend with the uncertainties that inevitably surround many events and circumstances, such as the collectability of doubtful receivables, the probable useful life of plant and equipment

and the number of warranty claims that may occur. Such uncertainties are recognised by the disclosure of their nature and extent and by the exercise of prudence in the preparation of financial statements. 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 or income are not overstated and liabilities or 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 or expenses, because the financial statements would not be neutral and therefore, not have the quality of reliability.

24. In developing Chapter 3 of the Conceptual Framework, the IASB removed any reference to the concept of prudence.

Summary of feedback

25. Many of those who commented on our suggested approach to Chapters 1 and 3 discussed prudence. Some stated that the concept of prudence should not be reinstated in the Conceptual Framework. Reasons cited include the following:

(a) There is no common understanding of what the term means. Different parties interpret it differently. Consequently, including the word in the Conceptual Framework could lead to inconsistent application.

(b) The exercise of prudence will lead to bias in the financial statements and is inconsistent with neutrality.

(c) The exercise of prudence in one period could lead to the overstatement of performance in subsequent periods.

(d) Users of financial statements are aware of the potential for management bias towards optimism and adjust for it. The exercise of prudence leads to greater subjectivity in the financial statements that can make it difficult to assess an entity’s financial performance.

(e) Prudence should be applied by investors and regulators when analysing entities. It should not be applied by the IASB in setting standards.

26. One user group argued that support for prudence is, for many, a means of reducing or rejecting fair value measurements and stated it would be more useful to have an open debate on fair value rather than have to have the debate indirectly through a debate on prudence.

27. However, many commenting on this issue (including many user groups) stated that the concept of prudence should be reinstated. Reasons cited include the following:

(a) The concept of prudence is used in both existing and proposed Standards. It is therefore important to explain it in the Conceptual Framework so that it can be applied consistently.

(b) Prudence is needed to counteract management’s natural bias towards optimism.

(c) Investors are more concerned about downside risk than upside potential. Prudence helps address this concern.

(d) Recent academic research has suggested that ‘conditional conservatism’ (defined as the more timely recognition of losses than gains) has a role to play in financial reporting.

(e) The exercise of prudence helps to align the interests of shareholders and managers and can reduce moral hazard.

(f) The financial crisis has demonstrated the need for prudence when making estimates.

(g) The EU directives refer to the need for prudence and so including reference to prudence in the Conceptual Framework may avoid endorsement problems for new Standards.

28. A number of different interpretations of the word prudence were suggested by respondents including:

(a) caution under conditions of uncertainty. Many of those suggesting that prudence should be reinstated agreed with this interpretation of prudence and suggested that the pre-2010 definition of prudence should be used;

(b) different recognition thresholds for assets and liabilities. (Agenda Paper 10C *Conceptual Framework–Feedback summary: elements of financial statements* discusses respondents' comments on whether prudence might have a role to play in the recognition criteria);

(c) the need for greater evidence regarding the existence of assets and income rather than liabilities and expenses;

(d) the more timely recognition of liabilities and expenses than of assets and income;

(e) a conservative bias in recognition and measurement;

(f) unrealised gains should not be recognised;

(g) likely losses should be recognised as early as possible; and

(h) prudence is a state of mind rather than a characteristic of financial information.

29. A few respondents suggested that, because of the different interpretations that attach to the word 'prudence' it might be preferable to refer to 'caution' instead.

30. A few respondents use the words 'prudence' and 'conservatism' interchangeably and do not necessarily equate 'conservatism' with bias. However, others warn against using the word 'conservatism' and equate it with bias.

31. Many respondents stated that, if prudence is reintroduced into the Conceptual Framework, the IASB needs to clearly define what is meant by the term. Of those who view prudence as the exercise of caution under conditions of uncertainty, many state that the IASB should clarify that the use of prudence does not mean:

(a) systematic overstatement of losses and liabilities and understatement of assets and income;

(b) smoothing of reported profits;

(c) a prohibition on the use of fair value measurements; or

(d) prudence as exercised by regulators.

32. Many supporters of reintroducing prudence expressed the view that the exercise of prudence is not necessarily incompatible with the concept of neutrality:

> We think that prudence and neutrality can co-exist as characteristics of financial reporting; however prudence needs to be defined robustly to prevent disagreement about how it should be applied in practice. In particular, it should not be an invitation to intentional bias. *Deloitte*

33. However, as noted in paragraph 25(b) some respondents believe that prudence is inconsistent with neutrality and for that reason would object to its reintroduction.

34. In addition, some supporters of reintroducing prudence question whether neutrality in financial reporting is achievable or appropriate.

Reliability

Background

35. Before Chapter 3 was published in 2010, the Conceptual Framework stated that one of the qualitative characteristics of useful financial information was reliability. In 2010, Chapter 3 replaced reliability with the qualitative characteristic of faithful representation—information is useful if it faithfully represents what it purports to represent.

36. The concepts of reliability (in the previous version) and faithful representation (in the existing version) have much in common. Both concepts require neutrality, completeness and freedom from error. Faithful representation is described in the pre-2010 *Conceptual Framework* as an aspect of reliability (that is, information is reliable if it can be depended upon to represent faithfully what it purports to represent). The main difference between the two concepts is that Chapter 3 does not refer to prudence, and does not refer explicitly to substance over form.

Summary of feedback

37. Some respondents expressed the view that the IASB should not reconsider its decision to replace reliability with faithful representation. Reasons cited included:

    (a) The term faithful representation captures better than 'reliability' the features that make financial information useful. The term reliability is equated by many with verifiability and certainty to the exclusion of other features of a faithful representation.

(b) Because of the similarity between reliability and faithful representation, it is unclear what effect changing back to the term reliability would have on financial statements.

(c) Reliability is incorrectly equated by some with financial statements that show only financial performance that is sustainable over time.

38. However, many respondents expressed the view that reliability should be reinstated in the Conceptual Framework. Reasons cited included:

(a) The previous Conceptual Framework acknowledged a trade-off between the qualitative characteristics of relevance and reliability. The most relevant information may not be capable of being portrayed reliably, and the most reliable information might not be relevant. Some respondents believe that this trade-off is missing in the existing Conceptual Framework.

(b) The existing Conceptual Framework implies that anything can be faithfully represented if sufficient disclosures are given. Consequently, the qualitative characteristic of faithful representation does not act as an effective filter to identify the types of information that should be included in financial statements.

(c) 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.

(d) The term reliability is clearer and better understood than the term faithful representation.

(e) Omitting reference to reliability from the Conceptual Framework allows items that cannot be measured reliably to be recognised. Agenda Paper 10C *Conceptual Framework–Feedback summary: elements of financial statements* includes comments made by respondents on reliability and the recognition criteria.

(f) The term 'freedom from material error', which is a component of a faithful representation, does not adequately capture what was meant previously by the term 'reliability'.

39. Many of the respondents who believe changes should be made to Chapter 3 suggested that reliability should replace faithful representation as a fundamental qualitative characteristic. However, some suggested that reliability should be included in the Conceptual Framework as an enhancing qualitative characteristic. Others suggested that it should be treated as a feature of a faithful representation.

40. Some respondents suggested that the IASB could address some of the concerns over the term 'faithful representation' by giving more prominence to the enhancing qualitative characteristic of verifiability. Some suggested that verifiability should be elevated by treating it as part of a faithful representation. Others suggested that verifiability should be treated as a fundamental qualitative characteristic.

41. A few respondents stated that the concepts of prudence and reliability were closely linked; that is, if financial statements were required to be prudent they would be more reliable.

Substance over form

42. The pre-2010 Conceptual Framework included reference to the concept of substance over form. The existing Conceptual Framework does not include an explicit reference to substance over form. Instead, the Basis for Conclusions on Chapter 3 states that accounting for something in accordance with its legal form, rather than its economic substance, would not result in a faithful representation.

43. Many of the respondents who suggested making changes to Chapter 3 expressed the view that Chapter 3 should make explicit reference to substance over form to make it clear that it should still be considered when applying Standards

> We believe that faithful representation captures the aim of reflecting the underlying economic reality. We would support the idea of making this more explicit. This could be done by including in Chapter 3 a sentence from the basis for conclusions for the 2010 Framework which says:

> "Representing a legal form that differs from the economic substance of the underlying economic phenomenon would not result in a faithful representation." *CFA Society UK*

44. Agenda Paper 10D *Conceptual Framework–Feedback summary: additional guidance to support the asset and liability definitions* discusses respondents' comments on the use of substance over form in assessing contractual obligations.

Primary user

Background

45. Chapter 1 of the existing Conceptual Framework identifies the primary users of financial reports as existing and potential investors, lenders and other creditors.

Summary of feedback

46. Although the Discussion Paper did not discuss the primary user of financial statements, a few respondents commented on this issue.

47. Some expressed the view that the primary user group is defined too narrowly. A few respondents suggested that the primary user group should be expanded to include, for example, employees, customers, suppliers, regulators and others. One respondent suggested that the user group should be expanded to include the users of not-for-profit financial statements.

48. However, others (including some users) expressed the view that the primary user group is defined too broadly. They believe that the primary users of financial reporting should be identified as the owners of the entity (perhaps defined as the entity's ordinary shareholders). Those with this view believe that ordinary shareholders have different (and perhaps more comprehensive) information needs because they are exposed to different types of risk than other capital providers. This view appears to be linked to the idea that stewardship should play a more prominent role in the objective of financial reporting.

49. One respondent suggested that the IASB should, both in the Conceptual Framework and when developing Standards, discuss more explicitly the conflicting needs of

different user groups. In addition, it was stated that the perspective adopted (entity or proprietary) would help to specify the intended user group.

Other comments

50. Some respondents (mostly from the UK) asked the IASB to clarify whether it is possible to override the requirements of the Standards if that is necessary in order to present a true and fair view. In addition, a few respondents suggested that a requirement to provide a true and fair view should be part of the objective of financial reporting.
51. A few respondents expressed the view that the concepts of stewardship, reliability and prudence are all linked; that is that financial statements that are reliable and prudent are necessary to assess the stewardship of management.
52. A few respondents suggested that the Conceptual Framework should include guidance on how to assess the costs and benefits of new Standards.
53. A few respondents suggested that the decision usefulness objective of financial reporting has not been properly justified and suggested that the IASB should reconsider whether providing decision useful information should be the objective of financial reporting.
54. It was suggested by a few respondents that simplicity should be included as an objective of financial reporting or understandability should be elevated to a fundamental characteristic. However, others disagreed with this stating that business is complex and this can make accounting complex.