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**International Accounting Standards Board**

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## **Comments on Discussion Paper on Conceptual Framework for Financial Reporting (DP/2013/1)**

The School of Business, Economics and Law, at the University of Gothenburg, Sweden, has the following comments on the Discussion Paper on a Conceptual Framework for Financial Reporting (DP/2013/1). Answers are provided to the questions where we have substantive input. In summary, we see it as positive that the Discussion paper forms a good basis for an improved Conceptual Framework. For example, the suggestions will make the Conceptual Framework more logically coherent. There are, however, some issues with the text and points that need clarification, as discussed below.

### ***Section 1***

*Question 1:* We agree that the primary purpose of the Conceptual Framework is to guide the IASB in its standard-setting activities. This is because principles-based standards require consistent principles. Consistency in principles also diminishes preparer incentives to make non-neutral choices on which standard that is applicable to a certain transaction or condition. There are, however, situations where principles will collide, so that they cannot be entirely consistent. The suggestion that the IASB will clearly identify and motivate any departure from principles is positive. It is also important that such departures only occur rarely.

### ***Section 2***

*Question 2:* We do not have any comment on the particular definitions of assets and liabilities, except that it is, at this stage, difficult to see the effects the changes in definitions will have on existing and future standards.

On a more general note, we question whether it is beneficial to focus on assets and liabilities rather than revenues and expenses. In the definition, assets and liabilities are primary, while revenues and expenses are deduced from the former items. This comment applies both to the existing conceptual framework, and to the discussion paper. Financial statement users are often focused on the value-generating process (also referred to by the IASB itself in several parts of both the existing and in the

discussion paper (e.g. in paragraphs 8.3 – 8.4)). Would it be more relevant to define revenue and expense in terms of cash flows allocated in time, in order to better reflect this process? Such a definition could be inspired by Dechow & Dichev (2002).

Possible motives for the focus on assets and liabilities could include:

1. It is coherent with the underlying logic of double-entry bookkeeping, that the income statement is an outgrowth of equity. This could, however, also be seen as a more technical argument, with low conceptual merit.
2. Users of financial statements are interested in how efficiently a firm uses a collection of assets (and operating liabilities) in carrying out its business model (as pointed out in Section 3). However, the focus is still on how this use of assets (and liabilities) can generate a value creation margin, so the validity of that argument can be questioned.

*Question 3:* In the discussion on the role of uncertainty and probability there seems to be a mix of both conceptual deduction and pragmatic safeguards (cf. also Section 3 below). Deductively, the IASB proposes that uncertainty and probability should not be considered in the definition and/or recognition of assets and liabilities. But, there are still inductive safeguards, e.g. in paragraph 2.35 where the point is made that a very low probability is likely to result in non-recognition.

We note that all assets and liabilities included in the balance sheet, with the exception of cash, require and expected future event in order to meet the definitions of asset or liability. Since these events are in the future, they always involve uncertainty. In the Discussion Paper it is unclear how this uncertainty should be reflected in financial statements. Does it enter in the measurement process (cf. section 6)? We cannot see the conceptual overview of the role of uncertainty, involving both definitions and measurements issues, as well as the interrelation between the two, in the Discussion Paper.

### **Section 3**

*Question 7:* A basic issue is whether the definitions of assets and liabilities should be based on deductive or inductive reasoning. Implied in the discussion is a desire to be deductive, meaning definitions should emanate from theory and principles. On the other hand, there is an inductive element, in that effects of the definitions in specific situations are considered. The former method leads to more logically coherent definitions, while the latter may lead to more useful and relevant definitions from a practice perspective. A problem with the latter method is that new situations may not be well covered by the definitions.

If the pragmatic view of development of a conceptual framework is taken, the discussion risks being dominated by concrete issues currently discussed (e.g. revenue recognition, nonfinancial liabilities, derecognition of financial assets, etc.) This could be a problem, since judging by the previous conceptual framework, the life span can be 30 years (and even longer than that for the FASB). There are indications in the Discussion Paper that the IASB is especially focused on recent issues and discussions.

The definitions of economic resource and control are in a way circular. An *economic* resource is by definition something that is scarce, and using it will generate economic benefits in the future. Scarcity in itself implies control, so does control really need to be defined separately? Further, the focus on rights rather than physical resources also implies the existence of control.

With the suggested definitions it becomes very hard to see how internally generated intangible resources, e.g. goodwill, would not constitute assets, except as a specific IAS 38 exception to Conceptual Framework principles. For most intangible resources the firm has “the ability to direct the use of the asset so as to obtain benefits” (paragraph 3.22). Combined with the removal of recognition criteria (section 4), this would mean internally generated intangible assets are included in the statement of financial position. Is it the intent of the IASB to propose that, even though it is currently deemed to be information that is not relevant to include? This leads into a more general discussion of the purpose of the asset definition. Is it to have consistency across standards that will lead to more relevant financial statements? Will these definitions achieve that?

What we are really looking for is a definition that specifies the collection of assets (and liabilities) that matter for the value creation of the firm, thus providing information about this value creation. And, since users are focused on periodic value creation (profit and loss statement), and not the statement of financial position per se, we would like a definition that make resources meet the asset (and liability) definition during the time period that starts with the event leading to the creation of an economic resource for the firm and ending with the event leading to its consumption for value creation. How should that be done? Would it be easier and more relevant to focus be on revenue and expense, and their timing in relation to the timing of cash flows?

Time is an important variable. Assets and liabilities are essentially a temporary allocation of transactions to the statement of financial position, with the objective of receiving a more relevant profit and loss statement. With this in mind, is it still relevant with an asset and liability focus in the definitions?

#### ***Section 4***

*Question 8:* The removal of recognition criteria make the asset and liability definitions more important, as the definitions will imply the recognition criteria. The removal is fine, if these definitions are clear enough. Note that 4.25 and 4.26 represent general inductive safeguards related to recognition based on deductive principles (cf. discussion on Section 3 above).

In removing recognition criteria, the IASB proposes that the concept of probability of future events is no longer relevant to consider. It should be noted that *all* assets and liabilities included in the balance sheet (with the exception of cash) are contingent on future events, where probability of occurrence  $< 1$ . This is implied in the definition of assets and liabilities, through the definition of economic resource. It is unclear how this probability will be reflected in the proposed conceptual framework, and how it will affect existing standards.

*Question 9:* Provided that the definitions of assets and liabilities are clear, and based on divisible rights, derecognition should not be a problem. We also note that the discussion about derecognition in the discussion paper is carried at a level of detail more appropriate for a standard than for a conceptual framework.

#### ***Section 5***

*Question 10:* This discussion is useful, as it helps provide structure and conceptual clarity to an area many people find complex. A problematic issue relates to the inclusion of the fair value of outstanding options as part of equity. If equity is seen as a cushion for bad times (implicitly in most industries, and

explicitly in banking and insurance), the information content deteriorates with the inclusion of options. If a firm gets into financial distress, its stock price will decline, and the option will have no value. It only has value in good or normal economic times, thus providing no cushion effect.

### ***Section 6***

*Question 11:* It is positive that the IASB makes explicit what has previously been implicit in standards, i.e. that the measurement basis is related to how the asset or liability will generate future cash flows. This clearly has the potential for increasing relevance of financial statements. There are, however, two unresolved issues:

1. Based on the ideas put forward in the Discussion Paper, would it be possible to write standards that capture the intended use of assets, and the diversity of this across firms? While some assets, e.g. derivatives, can always be assumed to have a use related to fair value (as hedging or speculative instruments), it is not necessarily true for assets such as investment property. Then, is fair value really relevant for investment property in firms that intend to hold the assets for very long time periods? And, if fair value is not relevant for all firms, how could standards be written to distinguish between measurement models? The issue of intended use would especially apply to assets held with the intent of charging for the right to use the assets. This is also related to the discussion of business model, cf. section 9.
2. Even in cases where fair value would be highly relevant, issues related to faithful representation, and the associated issue of cost, may make fair value difficult to use in practice. A possible example is contingent consideration in business combinations. If so, the IASB has to write standards that define how to weigh faithful representation and relevance against each other, i.e. an optimization issue will arise. It is not clear how such an optimization will occur based on the ideas presented in the Discussion Paper.

The objective to minimize the number of measurement bases contradicts the objectives of providing relevant and faithfully represented information in specific cases. This is another difficult optimization issue in standardsetting.

Another issue is the potential overlap between measurement and asset and liability definitions. In some cases there is a choice of seeing the reporting issues as relating to either definition or measurement, e.g. for impairment of long-term assets.

### ***Section 7***

*Question 16:* We agree with the division of financial statements into ‘primary financial statements’ and notes. This view has unofficially been held by many for some time, and it is beneficial that it obtains a more solid conceptual foundation from the IASB.

This leads into the question of what such a conceptual foundation should be. Relating to Chapter 3 of the existing conceptual framework, we assume that the qualitative characteristics apply equally to both primary financial statements and to the notes. There are, however, indications that investors see notes as having a lower level of faithful representation than items recognized in primary financial statements. This is shown analytically by Barth et al (2003), and empirically, relating to amendments to IAS 19, by Runesson (2014).

Regarding the term ‘relevance’, the distinction between primary financial statements and notes is more complex. Primary financial statements have a one-dimensional bottom line (net income, equity, cash flows), while notes are multidimensional. The IASB proposes to react to this distinction by introducing a ‘communication principle’ for the notes, cf. Question 18 below.

To summarize, the point of this discussion is that it is not self-evident that Chapter 3 of the conceptual framework applies equally, or should apply equally, to primary financial statements and notes. Thus, in conjunction with the proposed distinction, the IASB should consider interaction effects with Chapter 3.

An additional way to think about the distinction between primary financial statements and notes is that notes could capture that which is relevant information, but does not fit the definitions of financial statement elements. This is, e.g., suggested as a possibility by Schipper (2007). With this view, both Chapter 3 of the existing conceptual framework, and the discussion in Sections 2 – 4 in the Discussion Paper need to consider effects on disclosure.

*Question 17:* Materiality is an important concept, e.g. in relation to making disclosures more relevant to users. One way of making disclosures more relevant is to make them more entity-specific (cf. Question 18 below), which requires an application of materiality by preparers. We agree with the IASB that the current definition of materiality is appropriate, but that further guidance for preparers is needed. It is not entirely clear, however, that the Conceptual Framework is the right place for such guidance.

*Question 18:* A communication principle for disclosures is relevant, but the problem is how to translate such a principle into enforceable and auditable guidance and standards. Paragraph 7.50(a) suggests a need for more principles-based disclosure requirements. The difficulty in practice with such an approach is shown empirically by Runesson & Marton (2013), relating to disclosures required under IAS 1, paragraphs 122 and 125. One way to make principles-based disclosures function better in practice is to develop guidance on materiality (cf. Question 17 above). If that approach is taken, the guidance has to relate specifically to disclosures, not only to primary financial statements (cf. Barker et al, 2013).

## **Section 8**

*Question 19:* If there are items recognized in the statement of financial position (i.e. reflected in equity), that should not be reflected in profit or loss, the alternative is to include the items directly in equity or in OCI (concurrent with the statement of profit and loss). There are two separate questions relating to this. First, what type of items should be treated in such a way? Second, how should they be presented?

Regarding the first issue, examples of items to be included are those where there are different recognition criteria in the statement of financial position and the statement of profit and loss. However, if all items that meet the definition of financial statement elements are included (as suggested in Section 2 of the Discussion Paper), could there really be situations where such a mismatch would arise? That would only occur in exceptional cases, which would require a good motivation. A possible motivation would be for long-term items, where current changes in value are not expected to affect cash flows because over time they tend to reverse (e.g. pensions and currency translations). But, the measurement criteria proposed in Section 6 state that expected cash flow effects

should be considered in the choice of measurement model. So, the item should not be measured at current value in the statement of financial position, and no mismatch would arise. Our point is that the suggested changes to the conceptual framework would remove most (all?) situations where there is a need for OCI.

On the second issue, research shows that there is a difference for users if items are presented concurrent with profit and loss (as OCI) or if they are taken directly to equity (cf. Hirst & Hopkins, 1998 and Thinggaard et al, 2006). Therefore, we agree with the IASB proposal financial statements should include a presentation of OCI, provided that any such items appear.

### ***Section 9***

*Question 22:* Even though not a direct answer to question 22, we would still like to comment on the discussion on faithful representation and reliability. We interpret this discussion as reinforcement that the IASB wants IFRS to be principles-based standards. This is positive, as recent research shows the benefits of principles-based over rules-based standards, at least in the case of credit losses in banking (Marton & Runesson, 2014).

*Question 23:* The concept of business model is already implied in many standards. A clear example is real estate, which could be accounted for in accordance with IAS 2, IAS 16 or IAS 40 depending on how the real estate relate to the reporting entity's business model. Further, the interpretation of transactions and conditions in applying accounting standards in accordance with IAS 8, paragraph 7, requires an understanding of the entity's economic situation, i.e. of the business model. It would be beneficial and facilitate for preparers if the business model concept and its relation to financial reporting was conceptualized in a stringent manner in the conceptual framework. More specifically, the concept could be especially useful for the discussion on measurement (Section 6) and for entity-specific disclosures (Section 7).

*Question 26:* In the discussion paper, the point is made that capital maintenance is primarily useful in economies with high inflation. Given the low number of high-inflation economies, and their limited global economic importance, it is doubtful if this should be included in a general conceptual framework. In the vast majority of cases this part of the conceptual framework has low usefulness.

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