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Mr Hans Hoogervorst
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UNITED KINGDOM

Dear Hans

IASB Discussion Paper DP/2013/1
A Review of the Conceptual Framework for Financial Reporting:
Supplementary Paper to AASB's Submission

As mentioned in paragraph 31 of the Australian Accounting Standards Board's (AASB's) submission dated 11 February 2014 on the abovenamed IASB Discussion Paper (DP), to help IFRS Foundation staff classify the views in that submission, the AASB attaches a supplementary paper setting out its responses to the specific matters for comment in the DP. The attached supplementary paper also makes a number of suggestions that might be of assistance to IFRS Foundation staff in developing Board papers relating to the IASB Exposure Draft (ED) for a revised IASB Conceptual Framework.

These AASB responses to the specific matters for comment in the DP include, in addition to noting the preliminary views/proposals in the DP with which the AASB agrees:

- (a) summaries of, or cross-references to, the AASB's serious concerns, and other highly significant concerns, set out in the AASB's submission on the DP, attributed to the pertinent specific matters for comment;
- (b) the AASB's concerns with the DP that are not highlighted in the AASB's submission. Those additional concerns are less significant than the concerns expressed in the AASB's submission, and were omitted from the submission in the interests of retaining focus on the more important matters; and
- (c) suggestions for clarifying or otherwise improving the conceptual discussion in the DP.

The supplementary paper also includes, on pages 111 – 112, the AASB's comments on some issues raised (explicitly or implicitly) by the DP and that were not the subject of a specific matter for comment.

Some specific issues commented on

In relation to paragraphs (b) and (c) above, some AASB views that were not expressed or fully explored in the AASB's submission and are set out in the attached supplementary paper are that:

- (a) 'control' should be excluded from the definition of an asset, and 'past events' should be excluded from the definitions of an asset and a liability (see paragraphs S7 – S8; and S9 – S11 and S14 – S15, respectively, of the attached paper);
- (b) in relation to the definition of an 'economic resource' in the DP, all economic resources are rights. Adopting that view could simplify the conceptual guidance on economic resources (see paragraphs S16 – S19 of the attached paper);
- (c) the guidance in the DP dealing with executory contracts and other forward contracts lacks conceptual foundation, and a suggestion that the IASB discusses contractual rights and obligations in greater depth in the Exposure Draft developed from the DP (see paragraphs S61 – S64 of the attached paper);
- (d) most of the examples in paragraph 4.26 of the DP should be characterised as examples of when, because of uncertainty, it might be infeasible to *faithfully represent* a measure of an asset or a liability. (The DP characterises all of the examples in paragraph 4.26 as examples of when recognition of an asset or a liability might not provide *relevant* information.) The AASB also considers that the ability to faithfully represent a measure of an asset or a liability should (unlike relevance and cost-benefit) be assessed on an entity-specific basis (see paragraphs S68 – S83 of the attached paper and paragraphs A5 – A13 of the attachment thereto);
- (e) the IASB should clarify its preliminary view in paragraph 4.25(b) of the DP that an entity need not, or should not, recognise an asset or a liability if (among other things) no measure of that asset or liability would faithfully represent changes in that asset or liability (see paragraphs S84 – S89 of the attached paper);
- (f) in the DP's discussion of measurement, inventories seem to be arbitrarily classified as 'held for use' rather than 'held for sale'. In addition, the AASB considers that whether, in concept, an asset should be measured at (historical) cost or a current value should not depend on whether that asset is 'held for use' or 'held for sale'. This is explained in paragraphs S160 – S164 of the attached paper;
- (g) in the DP's discussion of measurement, it is confusing for 'other cash-flow-based measurements' to be put on an apparently equal ranking with cost, fair value and other current market prices. This concern is an example of the comment in the AASB's submission on the DP that the DP "inappropriately elevate[s] measurement methods to the status of measurement attributes", and is explained in paragraphs S171 – S176 of the attached paper;
- (h) in relation to the presentation of profit or loss and other comprehensive income (including recycling), the examples of 'mismatched remeasurements' discussed in

the DP do not provide convincing reasons for recognising particular items of income or expense in OCI and subsequently recycling them into profit or loss (the AASB's reasons for this view are explained in paragraphs S217 – S232 of the attached paper);

- (i) stewardship (or accountability) should not be given greater emphasis in the IASB Conceptual Framework's discussion of the objective of general purpose financial reporting. Nevertheless, the AASB's comments include a suggestion that the 'objective' should refer to "making *and evaluating* decisions about providing resources to the entity". Adding those words in italics might make more apparent the link between providing financial information for stewardship/accountability and for meeting the 'resource allocation decisions' objective (a detailed explanation of the AASB's reasons for this view is provided in paragraphs S236 – S253 of the attached paper);
- (j) it would be inappropriate to reintroduce 'reliability' to the IASB Conceptual Framework (a detailed explanation of the AASB's reasons for this view is provided in paragraphs S254 – S264 of the attached paper);
- (k) 'prudence' should not be reintroduced to the IASB Conceptual Framework (a detailed explanation of the AASB's reasons for this view is provided in paragraphs S265 – S270 of the attached paper); and
- (l) the 'business model' concept might be appropriate for financial reporting, but only in particular contexts (see paragraphs S281 – S307 of the attached paper).

We would be pleased to respond to any requests for elaboration of the AASB's comments.

If you have any queries regarding matters in the attached supplementary paper on IASB DP/2013/1, please contact me or Jim Paul (jpaul@aab.gov.au).

Yours sincerely



Kevin Stevenson
Chairman and CEO

AASB Supplementary Paper on IASB DP/2013/1

The AASB's response to the Specific Matters for Comment on the DP

The paragraphs in this paper are numbered with an 'S' to signify the nature of these comments as a supplement to the AASB's submission (dated 11 February 2014) on IASB DP/2013/1. Where these supplementary comments relate to comments made in the AASB's submission, they are cross-referenced. As mentioned in the covering letter to this supplement, some of the comments below are on matters not commented on in that AASB submission.

Section 1—Introduction

Question 1

Paragraphs 1.25–1.33 of the Discussion Paper set out the proposed purpose and status of the *Conceptual Framework*. The IASB's preliminary views are that:

- (a) the primary purpose of the revised *Conceptual Framework* is to assist the IASB by identifying concepts that it will use consistently when developing and revising International Financial Reporting Standards (IFRSs); and
- (b) in rare cases, in order to meet the overall objective of financial reporting, the IASB may decide to issue a new or revised Standard that conflicts with an aspect of the *Conceptual Framework*. If this happens the IASB would describe the departure from the Conceptual Framework, and the reasons for that departure, in the Basis for Conclusions on that Standard.

Do you agree with these preliminary views? Why or why not?

(a) Purpose and objective of the *Conceptual Framework*

S1 The AASB disagrees with the preliminary view that the IASB *Conceptual Framework* should have a primary purpose of assisting the IASB to develop and revise IFRSs. As explained in paragraphs B1 – B9 of Appendix B to the AASB's submission on IASB DP/2013/1, the AASB is concerned that adopting such a preliminary view might create a risk that the IASB:

- (a) in making decisions about the IASB Conceptual Framework, gives insufficient attention to helping other parties (such as preparers, auditors and users of financial reports) to understand and interpret IFRSs and to develop accounting policies when no IFRS specifically applies to a particular transaction or event; and
- (b) views the IASB Conceptual Framework essentially as a problem-solving resource for it, with the attendant risk that it might 'peek ahead' to standards-level answers that, in effect, focus more on accounting responses to transactions and other events than on economic phenomena.

S2 Therefore, as indicated in paragraph B9 of the AASB’s submission on the DP, the AASB recommends that the IASB gives due regard to the Conceptual Framework’s dual roles in:

- (a) assisting the IASB by identifying concepts that it will use consistently when developing and revising IFRSs; and
- (b) helping other parties to understand and interpret IFRSs and to develop accounting policies when no IFRS specifically applies to a particular transaction or other event.

(b) Conflicts between Standards and the *Conceptual Framework*

S3 The AASB agrees with the preliminary views in paragraph 1.32 of the DP that:

- (a) in order to meet the overall objective of financial reporting, it may be appropriate for the IASB to decide to issue a new or revised Standard that conflicts with an aspect of the *Conceptual Framework*; and
- (b) where such conflicts occur, the IASB should describe the departure from the Conceptual Framework, and the reasons for that departure, in the Basis for Conclusions on that Standard.

S4 The AASB’s single point of disagreement with the preliminary view referred to in Question 1(b) is with the statement that such conflicts may occur “in rare cases”. Whilst the AASB considers that, ideally, such conflicts should occur relatively infrequently, the use of “rare” seems unnecessarily and inappropriately optimistic. As mentioned in paragraph B3 of Appendix B to the AASB’s submission on the DP, the AASB is concerned that, if conflicts between IFRSs and the Conceptual Framework were to be pre-ordained to occur only rarely, this could lead to the IASB (and its constituents) “peeking ahead” to identify treatments that would be compatible with existing or anticipated IFRSs, rather than focusing on economic phenomena, when developing the revised IASB Conceptual Framework and subsequent updates thereof (and commenting on proposals in relation thereto).

Section 2—Elements of Financial Statements

Question 2

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

(a) Definition of an asset

S5 The AASB gives qualified support to the proposed definition of an asset. As indicated in paragraph 3(a) of its submission on the DP, the AASB strongly supports the proposal that the definition should be amended to focus on economic resources without referring to the inflows of economic benefits that the asset (economic resource) might generate. This amendment should help clarify the distinction between an entity's stocks of economic resources and future inflows of economic benefits expected from those stocks. The AASB agrees with the other reasons for this amendment set out in paragraphs 2.13(b) – 2.14 of the DP. In addition, the AASB agrees with inserting 'present' before 'economic resource' and making the definition of an asset explicitly parallel the definition of a liability in this respect (as mentioned in paragraph 2.16(b) of the DP).

S6 However, the AASB disagrees with including in the definition of an asset references to 'control' and 'past events'. Its reasons are set out, respectively, in paragraphs S7 – S8 and S9 – S11 below.

Control

S7 The AASB disagrees with including a reference to 'control' in the definition of an asset because control associates an economic resource (asset) with a particular entity. The AASB considers that the definitions of the elements should focus exclusively on economic phenomena, regardless of which entity might account for them. A factor that associates economic phenomena with a particular entity (such as control) is an accounting response, as distinct from the economic phenomena, and should therefore be treated as a recognition criterion. The AASB considers it is important that economic phenomena identified as the elements of financial statements are not limited to items expected to be recognised in financial statements. Otherwise, there would be a considerable risk that the development of new insights into the existence and nature of economic phenomena, and how they might be accounted for, could be impeded by focusing on accounting responses.

Therefore, the AASB would prefer control to be part of the recognition criteria for an asset.

- S8 The AASB emphasises that its disagreement with the inclusion of a reference to ‘control’ in the definition of an asset relates to the position of ‘control’ within the definition and recognition criteria, and is not a disagreement with the concept of ‘control’ per se. In other words, the AASB agrees that an asset recognised in an entity’s financial statements should be controlled by that entity.

Past events

- S9 The AASB disagrees with including a reference to ‘past events’ in the definition of an asset. The AASB considers that every asset of an entity that qualifies for recognition is the result of a past event¹. However, the AASB considers that *identification* of a past event affecting the entity should not be necessary for an asset to qualify for recognition. Paragraphs S10 – S11 below elaborate on this view briefly, in conjunction with discussing the proposal in the DP to include a reference to ‘past events’ in the definition of a liability.

- S10 The AASB observes that paragraph 2.16(c) of the DP says: “... It is not necessary to identify that [past] event in order to identify whether the entity has an asset or a liability.” The AASB similarly considers the critical aspect to be whether the element exists, rather than its source.

- S11 The AASB considers that past events are more pertinent to accounting recognition than the elements being described. Thus, the AASB would support:

- (a) describing a past event as an indicator that an asset or a liability would, subject to meeting the recognition criteria, qualify for recognition; while
- (b) noting that the existence of a past event does not guarantee that an asset or a liability continues to qualify for recognition.

(b) Definition of a liability

- S12 The AASB gives qualified support to the proposed definition of a liability for essentially the same reasons it gives qualified support to the proposed definition of an asset (see paragraph S5 above). Just as an asset is an economic resource giving rise to an inflow of economic benefits, a liability is a present obligation giving rise to an outflow of economic benefits. The AASB agrees with the reasons for the proposed amendment to the definition of a liability set out in paragraph 2.13(b) of the DP.

- S13 As indicated in paragraph S12 above, the AASB’s support for the proposed definition of a liability is qualified. This qualification relates to the AASB’s disagreement with the proposal to include a reference to ‘past events’ in the

¹ Note that this comment refers to assets that qualify for recognition, rather than items that meet the definition of an asset, because, as mentioned in paragraph S7 above, the AASB considers that factors that associate an item with an entity should ideally be treated as recognition considerations. A past event is an example of a factor that associates an item with an entity.

definition of a liability (see paragraph S14 below). The AASB also has concerns with some aspects of the additional guidance to support the proposed definition of a liability. These concerns are not mentioned here, because they are the subject of Questions 5 – 7 in the DP, on which the AASB’s comments (including cross-references to comments in particular paragraphs of the AASB’s submission on the IASB DP) are set out in paragraphs S47 – S64 below.

Past events

S14 The AASB disagrees with including in the definition of a liability a reference to ‘past events’. Consistent with the AASB’s comments in paragraph S9 above, the AASB considers that every liability of an entity that qualifies for recognition is the result of a past event. However, the AASB considers that *identification* of a past event affecting the entity should not be necessary for a liability to qualify for recognition. This view is elaborated on briefly, in relation to the definitions of both an asset and a liability, in paragraphs S10 – S11 above.

S15 The AASB also notes that, in its more detailed discussion of when a present obligation exists (in Section 3), the DP seems to emphasise, as a source of a liability, the past event of having received a benefit (e.g. see paragraphs 3.78(a) and 3.84 – 3.87 of the DP). However, the AASB thinks the past event of receiving a benefit is neither a pre-requisite for, nor of itself an indicator of, having a present obligation. For example, a number of IAS 37-type liabilities clearly do not result from the entity having received a benefit.

(c) Economic resource

S16 As indicated in paragraph 3(b) of its submission on the DP, the AASB strongly supports the general thrust² of the proposal that an ‘economic resource’ should be defined as “a right, or other source of value, that is capable of producing economic benefits” (paragraph 3.4 of the DP), which would confirm a shift away from traditional notions of accounting for physical objects and toward accounting for different rights (or other sources of value) composing economic resources (paragraph 3.7 of the DP). This shift should be particularly helpful over time in:

- (a) developing a deeper understanding of the economic substance, and accounting implications, of different rights (or other sources of value) composing economic resources; and
- (b) addressing derecognition of components of assets (e.g. components of a non-financial asset, such as rights to use an item of equipment and rights to the proceeds from any sale of that item of equipment).

S17 The AASB also generally supports the elaboration of the definition of an ‘economic resource’ in paragraphs 3.4 – 3.15 of the DP and of the meaning of ‘control of an economic resource’ in paragraphs 3.16 – 3.32 of the DP. However, the AASB suggests a clarification of that guidance, as set out in paragraphs S18 – S19 below.

² The AASB’s qualification of that support, which relates to a matter of clarification rather than a fundamental difference, is outlined in paragraphs S18 – S19 below.

“Or other source of value”

- S18 In relation to the DP’s proposal that an ‘economic resource’ should be defined as “a right, or other source of value, that is capable of producing economic benefits” (paragraph 3.4 of the DP, emphasis added), the AASB considers that:
- (a) each of the “other sources of value” set out as an example of that phrase in paragraph 3.5(c) of the DP is accessed by a right, albeit not a right expressed in a contract or other source of explicit legal entitlement. That is, the entity has a right to obtain the economic benefits embodied in know-how, customer lists and customer relationships (to name a few of the examples in paragraph 3.5(c) of the DP). In this regard, the AASB considers it would be inappropriate to presume, explicitly or implicitly, that rights exist only when expressed in a contract or other source of explicit legal entitlement. Contracts or other sources of explicit legal entitlement simply make some rights explicit, to facilitate the ease and efficiency of the exercise (and, where necessary, enforcement) of those rights. Therefore, for example, the AASB considers that “enforceable intellectual property rights” (referred to as ‘enforceable rights’ in paragraph 3.5(a) of the DP) and “know-how” (referred to as ‘other sources of value’ in paragraph 3.5(c)(i) of the DP) both involve rights; their only difference (in the context of this issue) being that the former rights are explicitly enforceable. In this regard, the AASB considers that each of the rights implicit in the examples in paragraph 3.5(c) of the DP (e.g. rights relating to know-how, and customer lists) can be implicitly enforceable through relationships and/or possession of a source of value; and
 - (b) because each of the economic resources described in paragraph 3.5(a) – (c) of the DP is, in the AASB’s view, a right, the example of an economic resource in paragraph 3.5(d) of the DP is, by derivation, a right. That is, if an entity momentarily possesses a good or service that it consumes immediately, the entity momentarily possesses a right to consume that good or service. In that context, the good or service consumed is the underlying object, and not the economic resource.
- S19 For the reasons discussed in paragraph S18 above, the AASB considers that all economic resources are rights. The AASB recommends that the revised IASB Conceptual Framework adopts that notion, or at least explains why some economic resources are rights whilst other economic resources are not rights.

Question 3

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 of the Discussion Paper. 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?

(a) Removal of ‘expected’ from the definitions of an asset and a liability

S20 The AASB agrees with removing ‘expected’ from the definitions of an asset and a liability, and indicating that an economic resource is ‘capable’ of producing economic benefits (in paragraphs 2.10(a) and 2.11 of the DP), to help avoid misinterpretations that the probability of an inflow or outflow of economic benefits must meet a minimum threshold before a resource or an obligation meets the definition of an asset or a liability, respectively.

(b) & (c) Probability thresholds

S21 As indicated in paragraph B18 of Appendix B to the AASB’s submission on the DP, the AASB disagrees with the preliminary view in paragraph 2.35(c) of the DP that probability should be deleted from the recognition criteria.

S22 The AASB agrees with the general thrust of the key paragraphs of the IASB’s summary of preliminary views on recognition (i.e. paragraphs 4.24 – 4.25 of the DP). That is, the AASB agrees that:

- (a) an entity should recognise all of its assets and liabilities, except those for which recognition would not meet the fundamental qualitative characteristics of relevance and faithful representation and/or would not provide sufficiently useful information that the benefits of recognition would exceed the related costs; and
- (b) “If some assets or liabilities are not recognised, the resulting depiction of the entity’s resources and obligations would be incomplete and would thus provide a less faithful representation of the entity’s financial position” (paragraph 4.24 of the DP).

- S23 However, despite the AASB’s views set out in paragraph S22 above, the AASB considers that some form of probability-based criterion for recognition of assets and liabilities should be included in the revised IASB Conceptual Framework, essentially for ‘policy’ reasons. Those reasons are:
- (a) recognising all rights and obligations regardless of probability of outcome would appear to require entities to search ‘endlessly’ for potential rights and obligations, including those that are remote but still potentially material because of their amount (a similar point is acknowledged in paragraph 2.33 of the DP). Adopting some form of probability-based criterion for recognition would therefore arguably be a reasonable application of the principle, referred to in paragraph S22(a) above, that the benefits of recognition should exceed the related costs; and
 - (b) recognising in financial statements elements with only a remote chance of the outcome occurring would detract from the other recognised elements in financial statements.
- S24 The AASB considers that the ‘probable’ criterion as worded in paragraph 4.38(a) of the existing IASB Conceptual Framework should be retained (with brief guidance on how it should be applied) and that ‘probable’ should be defined as “more likely than not”.
- S25 The AASB considers that recognition criteria, including the ‘probable’ criterion, should apply, neutrally, to assets and liabilities. It also considers that the ‘probable’ criterion should apply to the issues raised in both Question 3(b) and Question 3(c) in the DP’s Invitation to Comment (i.e. it considers that a ‘probable’ threshold should apply to both the identification, and the recognition, of an asset or a liability). The AASB’s reason for considering that the criterion should apply when it is uncertain whether an asset or a liability exists (existence uncertainty, discussed in paragraphs 2.20 – 2.31 and 2.35 of the DP), and in testing whether to recognise an asset or a liability that probably exists but might not give rise to an inflow or outflow of economic benefits (outcome uncertainty, discussed in paragraphs 2.32 – 2.36 of the DP), is the practical difficulty in some circumstances of distinguishing:
- (a) uncertainty about whether an asset or a liability exists; and
 - (b) uncertainty about whether an asset or a liability that exists will result in an inflow or outflow of economic benefits.
- S26 Despite the practical difficulty, in some circumstances, of distinguishing existence uncertainty from outcome uncertainty in relation to assets and liabilities, the AASB considers that these types of uncertainty are conceptually different and that the discussion of them in paragraphs 2.20 – 2.36 of the DP:
- (a) is generally useful; and

- (b) subject to some concerns discussed in paragraphs B23 and B25 – B32 of the AASB’s submission on the DP, should be included in the revised IASB Conceptual Framework.

S27 These comments in paragraphs S21 – S26 above are elaborated on in paragraphs B18 – B34 of the AASB’s submission on the DP.

Question 4

Elements for the statement(s) of profit or loss and other comprehensive income (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 of the Discussion Paper.

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

General comments about the meaning of ‘elements of financial statements’

- S28 The AASB agrees with the statement in paragraph 2.3 of the DP that: “Elements are the building blocks from which financial statements are constructed.” However, the AASB disagrees with the preliminary views in paragraph 2.5 of the DP regarding the number of elements that exist. Those preliminary views reflect an implicit view that the building blocks of each financial statement should be identified as separate elements (for example, that cash inflows and cash outflows are the elements of the statement of cash flows). Applying that logic, for each additional financial statement prepared, new elements should be identified, regardless of whether the statement simply presents in a different format information contained in other financial statements. For example, under that logic, if (hypothetically) an entity prepared a statement of changes in financial position, showing all changes in the entity’s recognised assets and liabilities during the period, new elements would be identified for that statement, even though the statement is wholly composed of changes in assets and liabilities. The AASB thinks it would be inappropriate to adopt a view that new elements should be identified for each additional financial statement prepared.
- S29 The AASB considers that the elements should be identified by focusing on economic phenomena, rather than accounting responses (such as financial statement presentation formats, which can present the same economic phenomena—or subsets thereof—in different ways, as illustrated in paragraph S28 above). Consequently:
- (a) although, as mentioned in paragraph S28 above, the AASB agrees that elements are the building blocks from which financial statements are constructed, the AASB does not consider that different elements must be identified for each financial statement; and
 - (b) separately defined elements should be limited to economic phenomena that are substantially different from one another. Therefore, a change in an

element that is a stock should not necessarily³ be identified as a separate element simply because it is a flow. This would avoid duplication of descriptions of economic phenomena in definitions of different ‘elements’ that differ only because one is a stock and another is a flow of a component (or type) of that stock that does not fundamentally differ from flows of other components (or types) of that stock (e.g. cash flows do not fundamentally differ from other flows of assets). Similarly, repetition of elements, for example, through defining ‘separate’ elements that are subsets of other defined elements, should not occur in response to additional financial statements being prepared.

S30 These AASB views in paragraphs S28 and S29 above are reflected in the comments on specific issues in paragraphs S31 – S46 below.

Definitions of ‘income’ and ‘expenses’

S31 The AASB agrees with the preliminary view to retain, largely unchanged, the existing definitions of ‘income’ and ‘expenses’ (and continuing to treat them as elements), for the reasons set out in paragraphs 2.41 and 2.46 of the DP.

Items of profit or loss and other comprehensive income (OCI)

S32 The AASB agrees with the proposal in paragraph 2.50 of the DP not to define separate elements of income or expenses to describe what should be reported in profit or loss and what should be reported in OCI. This is because:

- (a) as indicated in paragraphs 23 – 25 of the AASB’s submission on the DP, the AASB strongly disagrees with the preliminary view in the DP that comprehensive income should necessarily be bifurcated into profit or loss and OCI. The AASB considers that, rather than adopting a binary classification of economic (‘comprehensive’) income, the IASB should develop principles for a multi-faceted disaggregation of economic income that facilitate classifying items of economic income (supported by disclosures) according to their different implications for predicting the amount, timing, uncertainty and velocity of future cash flows. Defining profit or loss and OCI as separate elements would be inconsistent with adopting a multi-faceted disaggregation of economic income; and
- (b) the AASB agrees with the reason for that proposal given in paragraphs 2.48 – 2.49 of the DP.

Whether to define cash flows as separate elements

S33 The AASB considers that income and expenses, and contributions and distributions of equity, each warrant being defined as separate elements because their separate definition is necessary to reflect that they are mutually exclusive changes in assets and liabilities. In contrast, cash inflows and cash outflows are all changes in one

³ See paragraph S34(a) below for an example of substantially different flows of stocks of the same elements that, because of their differences, warrant being defined as separate elements.

form of asset. Distinguishing cash inflows/outflows from other inflows/outflows of assets reflects that cash is one of the various classes of assets. The AASB considers that sub-classifications of elements do not give rise to additional (or different) elements. Therefore, the AASB considers that, at best, cash flows are sub-elements, and thus disagrees with the preliminary view in paragraph 2.5(d) of the DP.

Whether to define contributions and distributions of equity as separate elements

S34 The AASB agrees with the preliminary view in paragraph 2.5(c) of the DP that contributions and distributions of equity should be defined as separate elements, because:

- (a) changes in assets and liabilities resulting from transactions with owners acting in their capacity as owners are fundamentally different from income and expenses; and
- (b) doing so would be consistent with their implicit status as elements in the definitions of ‘income’ and ‘expenses’ in paragraph 4.25 of the IASB Conceptual Framework, which the DP proposes retaining largely unchanged.

See also paragraph S46 below, regarding the issue of whether ‘distributions of equity’ comprises two different elements.

Whether to define capital maintenance adjustments as separate elements

S35 In relation to the discussion of capital maintenance adjustments in paragraph 2.51 of the DP, the AASB considers that paragraph 4.36 of the IASB Conceptual Framework indicates incorrectly that revaluations or restatements of assets and liabilities that are excluded from the income statement under certain concepts of capital maintenance nonetheless meet the definitions of income and expenses.

S36 The AASB considers that the revised IASB Conceptual Framework should acknowledge that capital maintenance adjustments might, or might not, be in the nature of income and expenses, depending on the concept of wealth (or ‘capital’) and the concept of economic income (or ‘capital maintenance’) adopted. To illustrate this point:

- (a) under a measurement model that adopts current cash equivalents commanded as the concept of an entity’s wealth, and adopts the current general purchasing power of current cash equivalents commanded as the concept of an entity’s income (i.e. the wealth to be maintained before profit is identified), a capital maintenance adjustment is recognised as an item of income or expense (an expense when the general level of prices increases), together with changes in current cash equivalents commanded by assets and liabilities. Under that measurement model, the capital maintenance adjustment is calculated as the percentage change in the general level of prices multiplied by the opening balance of equity (i.e. it is not a remeasurement of assets and liabilities). When the general level of prices increases during the period, the capital maintenance adjustment represents the increase in current cash equivalents commanded needed just to keep

pace with the increase in the general level of prices (i.e. the loss of general purchasing power of the opening balance of the entity's current cash equivalents commanded by its recognised assets minus its recognised liabilities);

- (b) under a measurement model that adopts invested money capital as the concept of an entity's wealth, and adopts the current general purchasing power of invested money capital as the concept of an entity's income:
- (i) a capital maintenance adjustment is recognised directly in equity to restate the invested money capital embodied in non-monetary assets⁴. The capital maintenance adjustment is recognised directly in equity (i.e. excluded from economic income) because it is not regarded as representing a change in the entity's wealth; rather, it restates the historical cost-based measures of recognised non-monetary assets from current nominal currency units to the amounts that would have been incurred if, when those assets were initially recognised, the currency had the general purchasing power it has in the current period. For example, if the general level of prices increased (and the general purchasing power of the monetary unit thus decreased commensurately) since a non-monetary asset was acquired, a greater number of currency units would have needed to have been expended to acquire the asset if the currency had the same general purchasing power then that it has in the current period. The entity is assumed to neither gain nor lose (in general purchasing power terms) by holding non-monetary assets when the general level of prices changes (see the different assumption in (ii) below in relation to monetary assets held and monetary liabilities owed). Consistent with the transaction-based model for recognition of changes in assets and liabilities under historical cost accounting, under this measurement model, assets and liabilities are not remeasured for changes in their specific prices. Under this measurement model, the capital maintenance adjustment is calculated as the percentage change in the general level of prices multiplied by the opening balance of the non-monetary assets. Unlike with the measurement model referred to in (a) above, the capital maintenance adjustment is recognised as part of the restatement of the opening balance of each recognised non-monetary asset, and thus is intended to show in constant general purchasing power terms the invested money capital embodied in those assets. When the general level of prices rises, the capital maintenance adjustment increases the measured cost of non-monetary assets that must be recovered before recognised (transaction-based) income gives rise to profit; and

⁴ Under this measurement model and the measurement model referred to in (c) below, as described in the accounting literature (including standard setters' pronouncements) on accounting for changing prices or changing price levels, non-monetary liabilities are generally disregarded; i.e. they are effectively treated as monetary liabilities (see (ii) below). However, within each of those models, it would be conceptually ideal to treat non-monetary liabilities consistently with non-monetary assets in relation to the calculation and treatment of capital maintenance adjustments.

- (ii) a capital maintenance adjustment is recognised as an item of income or expense for the change in the general purchasing power of money affecting the entity's recognised monetary assets and liabilities. That capital maintenance adjustment is calculated in the same manner as that described in (i) above in relation to non-monetary assets; but is recognised as an item of income or expense because it is regarded as representing a change in the entity's wealth (i.e. the entity held or owed money when the general purchasing power of money changed); and
- (c) under a measurement model that adopts operating capability as both the concept of an entity's wealth and the concept of an entity's income, changes in the current market buying prices of non-monetary assets are recognised directly in equity as capital maintenance adjustments. Such revaluation increases or decreases are excluded from economic income for the period, because they reprice the same wealth (which paragraph 14 of the AASB's submission on the DP describes, in relation to any concept of wealth, as the capability to contribute to generating cash inflows to the entity). This is the measurement model advocated in the AASB's submission on the DP (see paragraphs 17 and B126 – B141 thereof).

S37 Further to paragraph S36 above, the AASB recommends identifying capital maintenance adjustments that are not income or expenses (i.e. capital maintenance adjustments that represent a restatement or repricing⁵ of the same wealth, or capital)—which are identified in the circumstances described in paragraphs S36(b)(i) and S36(c) above—as a separate element of financial statements. This is because:

- (a) such capital maintenance adjustments are fundamentally different from income and expenses (i.e. they are not part of the entity's economic income); and
- (b) identifying them as elements and specifically excluding them from the definitions of 'income' and 'expenses' is important for avoiding misconceptions that, because the measures of assets and liabilities are adjusted, such capital maintenance adjustments are inflows/outflows or enhancements/depletions of assets.

S38 The reason in paragraph S37(b) above is consistent with the reason, in paragraph S34(b) above, why the AASB agrees that contributions and distributions of equity should be defined as separate elements of financial statements.

⁵ 'Restatement' and 'repricing' are distinguished here in the sense that 'restatement' is used in the academic accounting literature, under the 'current purchasing power of historical cost' measurement model, to signify that assets and liabilities are restated in terms of the current purchasing power of their historical cost, without being remeasured for changes in the specific prices of those assets and liabilities; whereas 'repricing' is used in the academic accounting literature to signify remeasurement of assets and liabilities for changes in their specific prices (although such remeasurements are only viewed in the academic accounting literature as repricing the same capital under an operating capability concept of wealth, or capital).

Whether to define transfers between classes of equity as separate elements

- S39 The AASB considers that transfers between classes of equity should not be defined as separate elements of financial statements. This is because (for the reasons explained in paragraph S40 – S45 below) the AASB regards such transfers as, in concept, matters of presentation and disclosure rather than element identification.
- S40 The AASB is unaware of any transfers between different classes of equity that represent events that are equally significant as, or more significant than, a change in the rights of other parties in relation to their claims on the entity's assets. The AASB notes that such changes in rights, by definition, do not constitute a change in the element represented by that claim on the entity's assets⁶. Therefore, the AASB considers that such changes in the rights of other parties in relation to their claims on the entity's assets would often warrant separate presentation or disclosure but would not warrant identification as a separate element. For example:
- (a) if options giving holders the right, upon exercise, to receive primary equity instruments of the entity, and the options are classified as a separate (secondary) class of equity, the change in the rights attaching to the option holder's equity claim when the options are exercised (which might be accounted for as a transfer between that secondary class of equity and the primary class of equity) would not change the amount of the entity's assets, liabilities or equity. In contrast, all other flows that qualify as elements of financial statements would result in such a change. Therefore, the AASB considers that the change in the rights attaching to the option holder's equity claim would warrant separate presentation or disclosure but should not be treated as an element. (The strike price paid by the holder of the option upon exercising their right to receive primary equity instruments would increase the entity's equity and qualify as a contribution of equity. However, that would be a separate economic event from any 'transfer' between classes of equity and therefore should be excluded from consideration of this issue.);
 - (b) if equity were reclassified between 'restricted' and 'unrestricted' classes, it might be argued that those classes are economically different (and consequently that reclassifications of equity between those classes are economic phenomena that qualify as an element). Examples of such reclassifications are where:
 - (i) a stipulation relating to a donation of assets to the entity, other than a liability, has expired; and
 - (ii) in some jurisdictions, a balance of equity is designated as 'restricted' to signify a restriction on distributions to some classes of equity claimants (i.e. the designation might affect the relative interests of

⁶ In contrast with, for example, a forgiveness of debt.

different classes of equity claimants to future equity distributions by the entity to them)⁷.

Although such reclassifications of equity reflect economic phenomena, the AASB considers that differences between ‘restricted’ and ‘unrestricted’ classes of equity are similar to differences between secured and unsecured liabilities, which are treated as matters of presentation (or disclosure) rather than different elements. In addition, the AASB’s tentative thinking about the notion of ‘restricted equity’ is that, in many cases, such as that in subparagraph (i) within this paragraph, ‘restricted equity’ should more appropriately be regarded as restricted assets (e.g. restrictions on donations often attach to the donated assets that correspond to an amount of equity); and

- (c) some transfers between reserves do not signify an economic phenomenon. For example, amounts might be transferred from retained earnings to a general reserve or from a general reserve to an asset replacement reserve. Although such transfers might signify a change in management’s intentions (see the next sentence), they generally do not reflect changes in the rights of other parties, or other changes in the entity’s financial position, and therefore generally do not signify an economic phenomenon. Some transfers between reserves, such as transfers to asset replacement reserves, signify a new intention of management (or even a self-imposed ‘restriction’) to make future expenditures. However, future expenditures are financed by assets, not equity—therefore, a transfer to an asset replacement reserve does not signify an economic phenomenon.

Dilution gains and losses of equity claimants

S41 Transfers between classes of equity should, in concept, exclude dilution gains and losses of equity claimants that might result from some equity claimants acting, or being placed, differently from others. An example of such dilution gains and losses provided in the DP is “wealth transfers between different classes of equity claims” (referred to in paragraph 5.12(b)(ii) of the DP). According to paragraph 5.13 of the DP, such ‘wealth transfers’ should be identified by updating measurements of different classes of equity and recognised in the statement of changes in equity. This treatment is illustrated in Example C2 in paragraphs C8 – C17 of Appendix C to the DP, which illustrates that, for a written put option with settlement net in shares, changes in the fair value of the option could be recognised as a transfer between a class of equity termed ‘obligation to issue shares’ and retained earnings. As mentioned in paragraphs S116 – S118 below, the AASB disagrees with recognising such ‘wealth transfers’ between different classes of equity within the statement of changes in equity because (among other reasons) such recognition:

⁷ Although such a restriction might be created at the entity’s discretion, in some cases the entity might not have unfettered discretion to remove that restriction (in contrast to the self-imposed ‘restriction’ described in paragraph S40(c) below).

- (a) conflicts with the general principle that an entity's financial statements depict economic phenomena affecting the entity, and not economic phenomena affecting other parties only; and
- (b) seems unlikely to meet its stated aims. For example, accounting for transactions with a particular class of owner cannot cater for the indirect effects of those transactions on the value of other classes of equity claims.

S42 The AASB observes that “wealth transfers between different classes of equity claims”, as referred to in paragraph 5.12(b)(ii) of the DP, do not differ in concept from any other dilution gains and losses of equity claimants, which can occur *within* classes of equity claims as well as *between* such classes. Examples of where dilution gains and losses within the same class of equity claims might arise are where:

- (a) some equity claimants, but not others, participate in a rights issue; and
- (b) a share placement is made with an institutional investor at a ‘below-market price’, but nevertheless is intended to raise additional capital in the most cost-efficient manner by avoiding the costs of issuing a prospectus that would be incurred if a public offering were made.

S43 For the reasons discussed in paragraphs S41 – S42 above, the AASB considers that no type of dilution gains and losses of equity claimants should be recognised within the statement of changes in equity. The AASB mentions dilution gains and losses of equity claimants within classes of equity claims (such as those illustrated in paragraph S42 above) to highlight the potential widespread application of a concept to (inappropriately) recognise dilution gains and losses.

S44 Nevertheless, disclosing by note information about dilution gains and losses (such as those illustrated in paragraph S42(b) above) might provide useful information to users for making resource allocation decisions.

So-called transfers between classes of equity

S45 The AASB also considers that some so-called transfers between classes of equity should not, in concept, be accounted for as transfers. For example:

- (a) if an entity's owners forgo distributions of retained earnings and reinvest those dividends in the entity's capital, what might be regarded by some as a transfer between ‘retained earnings’ and ‘contributed capital’ is, in substance, a distribution of equity (distribution to owners) and a contribution of equity (contribution by owners), each of which the AASB considers should be identified as a separate element (see paragraph S34 above). Therefore, the AASB considers that, in concept, such events should not be accounted for as transfers between classes of equity; and
- (b) capital maintenance adjustments recognised directly in equity (i.e. excluded from economic income) should not, in concept, be transferred to ‘retained earnings’. Retained earnings should only be increased by economic income.

If a distribution to owners is intended to be ‘paid out’ of accumulated capital maintenance adjustments recognised directly in equity, as might be permitted in jurisdictions in which payments of dividends are subject to a solvency test (rather than a profits test), it would nonetheless be inappropriate, in concept, to transfer an amount from accumulated capital maintenance adjustments to retained earnings in anticipation of making such a distribution. This is because:

- (i) it would not be representationally faithful to show in retained earnings amounts that were never recognised in earnings; and
- (ii) such a distribution is fundamentally different from a distribution made out of retained earnings, i.e. it is a return *of* capital rather than a return *on* capital. The AASB considers that information about whether distributions of equity are returns of capital or returns on capital (or a combination of both) is relevant to users of financial statements for predicting the entity’s future cash flows. This is because the distinction between the two types of return is important for assessing the sustainability of the entity’s business model.

Whether ‘distributions of equity’ comprises two different elements

S46 For the reason given in paragraph S45(b)(ii) above, the AASB considers that distributions of equity that are, respectively, returns of capital and returns on capital are fundamentally different from each other and consequently should, in concept, be defined as different elements. The AASB suggests that the IASB considers whether to define those categories of distributions of equity as different elements.

Section 3—Additional guidance to support the asset and liability definitions

Question 5

Constructive obligations are discussed in paragraphs 3.39–3.62 of the Discussion Paper. 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 of the Discussion Paper.

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

Question 6

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

Present obligations

S47 The AASB’s answers to Questions 5 and 6 are provided jointly in paragraphs S48 – S54 below.

S48 As indicated in paragraph B35 of Appendix B to its submission on the DP, in contrast to the preliminary views in the DP, the AASB considers that:

- (a) the Conceptual Framework should limit the definition of a liability to obligations that are enforceable, and therefore the definition of a liability should not encompass unenforceable constructive obligations (see paragraph 3.62 of the DP); and

- (b) of the three ‘Views’ of a present obligation (i.e. a liability) discussed in paragraphs 3.75 – 3.97 of the DP, neither ‘View 2’ nor ‘View 3’ is appropriate (see paragraphs 3.96 – 3.97 of the DP). (As noted in paragraph S53 below, the AASB has reservations regarding ‘View 1’, which paragraph 3.96 of the DP indicates is not supported by the IASB.)

S49 The AASB considers present obligations must presently be enforceable against the entity⁸. If a promise or stipulation is not enforceable against the entity, the entity cannot be obliged to transfer an economic resource. The AASB thinks enforceable obligations include not only contractual terms that can be enforced in a court of law, but also equitable obligations that can be pursued through the law of equity.

S50 In relation to paragraph S49 above, the AASB emphasises that an obligation being presently enforceable is a broader notion than the obligation being either ‘legally vested’ or ‘due and payable’. For example, as indicated in paragraph B41 of Appendix B to the AASB’s submission on the DP:

- (a) regarding contractual promises to pay employee bonuses subject to vesting conditions, in some jurisdictions, employees might have a legal right of recourse against an employer that terminated their employment contract as the vesting date for an employee bonus approaches⁹. If so, the employees would hold a valuable legally enforceable contractual option to continue rendering services and qualify for the bonus (or compensation in lieu thereof)¹⁰—‘legally enforceable’ and ‘legally vested’ should not be regarded as synonymous; and
- (b) regarding levies on the volumes of particular items (e.g. revenues, activities or outputs) above a specified threshold, a present¹¹ obligation might exist without the entity having reached the pertinent threshold. For example, if an operator of a landfill site is subject to an enforceable levy for methane emissions above a certain amount, and that entity’s best estimate is that (without remedial action) it will unavoidably pass that threshold in a future period as a lagged effect of burying substances in the current period, the entity would incur a present (and growing) obligation as the substances are buried. Any future action by the entity in paying or avoiding the levy (in the latter instance, by taking remedial action) would require a future transfer of economic resources. Therefore, the entity would have a present obligation (e.g. avoiding the levy would not avoid a future transfer of economic resources).

⁸ Because the AASB considers that present obligations must *presently* be enforceable against the entity (although not necessarily mature, i.e. due and payable), the AASB disagrees with the comment in paragraph 3.59 of the DP that “Any requirement for an obligation to be enforceable by legal or equivalent means ... would not rule out obligations that would become enforceable only on the occurrence of an uncertain future event”.

⁹ This might also be the case with unvested long service leave, which raises essentially the same issues as employee bonuses but accrues rateably as employee services are rendered.

¹⁰ The employer would have a real option to terminate their employment and pay any compensation amount enforced against it. However, that option would not nullify the existence of a present obligation of the employer.

¹¹ i.e. enforceable

For these reasons, the AASB considers that whether a present obligation exists in respect of a levy (or other impost) involving a threshold would not, of itself, depend on whether the entity has reached the threshold.

S51 For the reasons in paragraphs S48 – S50 above, the AASB considers that, consistent with paragraph S48(a) above, ‘constructive obligations’ should be included in the concept of a liability only when they are enforceable. In expressing this view, the AASB notes that¹², in some jurisdictions, some but not all ‘constructive obligations’ as defined in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* might be enforceable¹³. In this regard:

- (a) an example of an obligation that some describe as ‘constructive’ although it might be enforceable in some jurisdictions is an unvested entitlement to an employee bonus (see paragraph S50(a) above for an explanation); and
- (b) an example of an obligation that some describe as ‘constructive’ but is unenforceable is an obligation to clean up contamination in order to honour a widely published policy of the entity, when neither legislation nor other mechanisms in the relevant country enable other parties to enforce the clean up. (Furthermore, because the AASB considers that unenforceable ‘constructive obligations’ should be excluded from the concept of a liability, it disagrees with the preliminary view that the guidance set out in paragraph 3.50 of the DP should be added to the conceptual guidance on a nature of a present obligation.)

S52 The AASB disagrees with both ‘View 2’ and ‘View 3’ because they are too broad, i.e. they potentially include unenforceable obligations in the notion of a liability. The AASB is concerned that unenforceable obligations are inherently indistinguishable from economic compulsion.

S53 Although ‘View 1’ comes closest to the AASB’s view that a liability must be enforceable, in some respects (as elaborated on in paragraphs B40 – B41 of Appendix B to the AASB’s submission on the DP) it seems to differ from the AASB’s view. For the reasons in paragraph S52 and this paragraph, the AASB does not support specifically adopting any of the three ‘Views’ discussed in paragraphs 3.75 – 3.97 of the DP.

S54 These comments in paragraphs S47 – S53 above are elaborated on in paragraphs B35 – B42 of Appendix B to the AASB’s submission on the DP.

Question 7

Do you have comments on any of the other guidance proposed in this section to support the asset and liability definitions?

¹² As is also noted in paragraph 3.57 of the DP.

¹³ Whilst paragraph 3.57 of the DP refers to whether such ‘constructive obligations’ may be legally enforceable, rather than enforceable *per se*, the point still holds.

Reporting the substance of contractual rights and contractual obligations

- S55 The AASB agrees with the policy in the existing IASB Conceptual Framework (noted in paragraph 3.100 of the DP) that financial statements should report the substance of an entity's contractual rights and contractual obligations. The AASB also agrees with the IASB's proposal, set out in paragraphs 3.101 – 3.102 of the DP, that the revised IASB Conceptual Framework should provide additional guidance on assessing the substance of contractual rights and contractual obligations, and that this additional guidance should reflect the principles underlying the requirements in the extant Standards dealing with the substance of contractual terms illustrated in paragraph 3.101 of the DP.
- S56 However, the AASB considers that the proposed guidance in paragraph 3.102 of the DP is inadequate. This is because the proposed guidance merely gives some pointers about different contractual rights and contractual obligations, without analysing their nature and financial reporting implications. The AASB recommends that the revised IASB Conceptual Framework sets out principles for identifying the substance of contractual rights and contractual obligations by describing the nature of different contractual rights and contractual obligations, how to account for those rights and obligations and how to address the issues touched on in paragraph 3.102 of the DP. For example, in relation to paragraph 3.102(b) of the DP, if a 'linkage' approach were to be applied to different contracts (which is a 'unit of account' issue), the revised IASB Conceptual Framework should set out the principles for when and how that approach should be applied. The AASB considers that leaving entities to identify and report the 'substance' of contractual rights and contractual obligations themselves, without the revised IASB Conceptual Framework providing explicit underlying principles for such identification, is likely to result in subjective, and potentially divergent, assessments by different entities.
- S57 Indeed, adopting the AASB's recommendation in paragraph S56 above would remove the need for entities themselves to determine how to identify the 'substance' of contractual rights and contractual obligations. Thus, it would avoid the risk that 'reporting (economic) substance' receives the status of a vague quasi-principle that could over-ride explicit principles for the definition and recognition of assets and liabilities set out in the revised IASB Conceptual Framework. An example of where 'reporting (economic) substance' might implicitly receive the status of an over-arching conceptual principle, with conceptually inappropriate outcomes, is in relation to the role of economic compulsion. This is discussed in paragraphs S58 – S60 below.

Apparently different treatments of economic compulsion

- S58 Although the preliminary view on constructive obligations in paragraph 3.62 of the DP is that conceptual guidance should be added to help distinguish constructive obligations (treated as liabilities in paragraph 3.62) from economic compulsion¹⁴, the DP, in the context of assessing the substance of contractual obligations, says

¹⁴ Paragraph 3.50(a) of the DP elaborates on this point, saying that, for an entity to have a constructive obligation, "(I)t is not sufficient that an entity will be economically compelled to act in its own best interests or in the best interests of its shareholders."

“The IASB thinks that ... it might be appropriate to take economic compulsion or significant economic incentives into account when determining whether a contractual claim against the entity is a liability or part of equity” (paragraph 3.108). The AASB considers the discussion of economic compulsion in relation to the existence of constructive obligations, and assessing the substance of contractual obligations, respectively, seems potentially inconsistent and consequentially confusing. Arguably, the DP could be read as indicating that, in some contexts (such as assessing the substance of contractual obligations), applying vague notions of ‘economic substance’ could over-ride explicit conceptual principles (such as the above-mentioned principle in paragraph 3.62 of the DP).

- S59 The AASB acknowledges that paragraph 3.108 of the DP goes on to say, in effect, that any guidance on the role of economic compulsion when determining whether a contractual claim against the entity is a liability or part of equity should be developed only at a standards level, and that the conceptual guidance on reporting the substance of contractual rights and contractual obligations should be limited to widely applicable principles, such as those set out in paragraph 3.102 of the DP. However, in relation to interpreting the references in paragraph 3.102 of the DP to assessing ‘commercial substance’, it is reasonable to expect that entities would have regard to the IASB’s thinking on economic compulsion as quoted from paragraph 3.108 of the DP in paragraph S58 above, even if that were not the IASB’s intention.
- S60 If the IASB proceeds with its preliminary view that either ‘View 2’ or ‘View 3’ of a present obligation should be adopted, the AASB considers that, for the reasons discussed in paragraph S58 above, and because economic compulsion is a pervasive issue in identifying whether liabilities (as defined in the DP) of an entity exist¹⁵, it is important that the revised IASB Conceptual Framework sets out more clearly the IASB’s position regarding the conceptual role of economic compulsion. The AASB also considers that it is important that the role of economic compulsion in relation to both the existence of constructive obligations, and assessing the substance of contractual obligations, should be consistent. Nevertheless, the AASB considers that economic compulsion should have no role in either context.

Executory contracts and other forward contracts

- S61 The AASB agrees with the IASB’s intention, set out in paragraph 3.110 of the DP, to explain the nature of the rights and obligations that arise under executory contracts and other forward contracts and (if conceptually appropriate) the reason(s) why those rights and obligations might not be recognised as an asset or a liability.
- S62 However, the AASB considers that the proposed clarifications in paragraph 3.110 of the DP and the related discussion in paragraphs 3.111 – 3.112 of the DP do not provide a conceptual analysis of the issues, even in summary form. The paragraphs seem to essentially be composed of assertions (e.g. paragraph 3.110(a) of the DP) and descriptions of current practice, which do not belong in a Conceptual

¹⁵ Consequently, for the IASB, economic compulsion is also a pervasive issue in identifying whether counterparties possess corresponding assets.

Framework. For example, in relation to paragraph 3.110(a) of the DP, the AASB thinks an explanation should be provided of:

- (a) the criteria that led to the in-principle conclusion that a net asset or a net liability arises in the circumstances described;
- (b) how those criteria relate to those that would apply to other enforceable contracts; and
- (c) if those criteria differ for ‘executory’ and ‘non-executory’ contracts, the reason(s) for those differences.

S63 Depending on the responses on these issues, the conceptual treatment of enforceable contractual rights and obligations might not necessarily differ for ‘executory’ and ‘non-executory’ contracts. Accordingly, the AASB considers that the notion of an ‘executory contract’ could become redundant upon the development of comprehensive concepts for enforceable rights and obligations (whether contractual or non-contractual)¹⁶. As noted in paragraph S16 above, the AASB regards the proposal to define an ‘economic resource’ as “a right, or other source of value, that is capable of producing economic benefits” (paragraph 3.4 of the DP) as logically leading toward developing a deeper understanding of the economic substance, and accounting implications, of different rights (or other sources of value) composing economic resources, and related obligations.

S64 In addressing the AASB’s concern set out in paragraph S62 above, the AASB suggests that the IASB discusses:

- (a) key sources of accounting literature covering the topic, such as the FASB Research Report *Recognition in Financial Statements: Underlying Concepts and Practical Conventions*, by L. Todd Johnson and Reed K. Storey (July 1982); and
- (b) the analysis of contractual rights and obligations developed by the IASB and FASB in the early stages of their joint project on *Revenue from Contracts with Customers*.

¹⁶ See also the AASB’s recommendation in paragraph S56 above that the revised IASB Conceptual Framework should set out principles for identifying the substance of contractual rights and contractual obligations by describing the nature of different contractual rights and contractual obligations and how to account for those rights and obligations.

Section 4—Recognition and derecognition

Question 8

Paragraphs 4.1–4.27 of the Discussion Paper discuss recognition criteria. In the IASB’s preliminary view, an entity should recognise all its assets and liabilities, unless the IASB decides when developing or revising a particular Standard that an entity need not, or should not, recognise an asset or a liability because:

- (a) recognising the asset (or the liability) would provide users of financial statements with information that is not relevant, or is not sufficiently relevant to justify the cost; or
- (b) no measure of the asset (or the liability) would result in a faithful representation of both the asset (or the liability) and the changes in the asset (or the liability), even if all necessary descriptions and explanations are disclosed.

Do you agree? Why or why not? If you do not agree, what changes do you suggest, and why?

Main comments

S65 As is indicated in paragraphs S21 – S25 above, the AASB:

- (a) broadly agrees, in principle, with the preliminary views described in Question 8; but
- (b) for ‘policy’ reasons, disagrees with the preliminary view in paragraph 2.35(c) of the DP that probability should be deleted from the recognition criteria.

S66 In respect of paragraph S65(b) above, the AASB considers that the ‘probable’ criterion as worded in paragraph 4.38(a) of the existing IASB Conceptual Framework should be retained and that ‘probable’ should be defined as “more likely than not”.

S67 The AASB agrees with the preliminary view referred to in Question 8(b) above to, in effect, replace the ‘reliable measurement’ recognition criterion in paragraph 4.38(b) of the existing IASB Conceptual Framework with a ‘faithful representation’ recognition criterion. This is because such a change would be consistent with the IASB having replaced ‘reliability’ with ‘faithful representation’ as a qualitative characteristic. However, the AASB is concerned about a lack of clarity of the preliminary view in paragraph 4.25(b) of the DP that, in concept, an asset or a liability should not be recognised if no measure of the asset or liability would faithfully represent changes in that asset or liability (after all necessary descriptions and explanations are disclosed). (See paragraphs S85 – S89 below for an elaboration of this concern. Paragraphs A1 – A3 of the attachment to this paper set out other comments on the ‘faithful representation’ recognition criterion.)

S68 For the reasons outlined in paragraphs S72 – S73 below, the AASB considers that the IASB (rather than entities) should determine, at a standards level:

- (a) the general relevance of information provided by recognising particular classes/types of elements [for example, internally generated goodwill, as mentioned in paragraph 4.26(e) of the DP¹⁷]; and
- (b) whether recognition of a particular class/type of element by entities in general would be likely to provide information sufficiently relevant to justify the cost.

S69 In addition, the AASB considers that, although the relevance criterion should be applied by the IASB alone (at a standards level), this principle should be stated in the revised IASB Conceptual Framework, to enable readers of the revised IASB Conceptual Framework to obtain a broad view of the recognition criteria. The AASB also considers that, for the reasons outlined in paragraphs S78 – S82 below, the revised IASB Conceptual Framework should specify a ‘faithful representation’ recognition criterion to be applied on an entity-specific basis. These views, which are discussed in further detail in paragraphs A5 – A8 and A10 – A12 of the attachment to this paper, are mentioned here as context for the AASB’s general concerns about where the recognition criteria are set out, as outlined in paragraphs S70 – S71 below.

S70 As indicated in paragraph B6 of Appendix B to the AASB’s submission on the DP, the AASB is concerned that a potential problem for preparers and auditors would arise from adopting the preliminary views that, in effect:

- (a) no recognition criteria should be contained in the revised IASB Conceptual Framework; but
- (b) the IASB might incorporate recognition criteria in particular IFRSs.

S71 The potential problem referred to in paragraph S70 above is that, for transactions and other events that are outside the scope of those particular IFRSs (and do not arise in respect of an issue that is similar or related to issues within those IFRSs), entities would be unable to apply any of those recognition criteria (i.e. they would be required to recognise all of the material assets and liabilities that arise from the transaction or other event). Consequently, in the context of the AASB’s views in paragraphs S68 – S69 above, entities would be unable to apply the ‘faithful representation’ recognition criterion, even though, for the reasons explained in paragraphs S78 – S82 below, the ‘faithful representation’ recognition criterion should be applied on an entity-specific basis.

¹⁷ In noting this example of the IASB’s proposed use of a class-of-asset-specific (rather than entity-specific) assessment of relevance in the draft revised IASB Conceptual Framework, the AASB is not making a general comment regarding the appropriateness of recognising internally generated goodwill. The AASB’s comments on the DP’s discussion of that issue are set out in paragraphs S90 – S93 below.

Specific comments

Relevance and cost-benefit

- S72 The AASB considers that the relevance criterion should be applied by the IASB alone (at a standards level) because:
- (a) as implied in the preliminary view in the first sentence of paragraph 4.24 of the DP, it should generally be presumed that recognition of any element of financial statements would provide relevant information to users of financial statements (the DP focuses on relevance in relation to assets and liabilities; hereinafter, for consistency with the DP, references are made only to those elements); and
 - (b) the relevance of an item of financial information is a general quality of financial information that pertains to classes/types of assets and liabilities held/owed, potentially, by any entity. That is, relevant information is intrinsically capable of making a difference in resource allocation decisions made by users of financial reports, even if, for a particular entity, the information might be immaterial (and thus not capable of making a difference in resource allocation decisions of users of its financial report). Therefore:
 - (i) relevance does not vary according to entity-specific circumstances¹⁸; and, accordingly,
 - (ii) the IASB is the most appropriate party to determine whether recognising a particular class/type of asset or liability would provide relevant information. Making such determinations should not create an undue burden for the IASB. The AASB expects that the IASB would seldom conclude that recognising a particular class/type of asset or liability would not provide relevant information. The AASB notes that the example given in the DP of a class/type of asset the recognition of which would, in the IASB's opinion, be unnecessary to meet the objective of general purpose financial reporting is internally generated goodwill (in paragraphs 4.9(c) and 4.26(e) of the DP)¹⁹.
- S73 The AASB also considers that, as implied by paragraph 4.25 of the DP, the IASB alone should determine (at a standards level) whether recognition of a particular class/type of asset or liability in general²⁰ would be likely to provide information that is sufficiently relevant to justify the cost. For similar reasons to those set out in

¹⁸ Note that, as discussed in paragraph S74 below, materiality is an entity-specific aspect of relevance.

¹⁹ The AASB notes this example to explain its expectation that the IASB would seldom conclude that recognising a particular class/type of asset or liability would not provide relevant information, and is not making a general comment about whether recognition of internally generated goodwill is necessary to meet the objective of general purpose financial reporting. The AASB's comments on the DP's discussion of whether internally generated goodwill should be recognised as an asset are set out in paragraphs S90 – S93 below.

²⁰ i.e. rather than for a particular reporting entity.

paragraph S72 above (in relation to the IASB alone determining whether recognising a particular class/type of asset or liability in general would provide relevant information), the cost constraint is related to relevance²¹—not materiality—and therefore does not depend on entity-specific circumstances. As indicated in paragraph QC39 of the IASB Conceptual Framework, the IASB “seeks to consider costs and benefits in relation to financial reporting generally and not just in relation to individual reporting entities”. As mentioned in paragraph S280 below, if assessments of costs and benefits were to be made by individual reporting entities, the assessments would be likely to be specific to the entity and not to have regard to the benefits of financial reporting generally (including the benefits of comparability between entities).

Relevance and immateriality

- S74 The AASB considers that the revised IASB Conceptual Framework should clarify the role of materiality in relation to recognition, particularly to clarify the relationship between relevance and materiality in this context. For example, the AASB considers that the revised IASB Conceptual Framework should clarify that:
- (a) as noted in paragraph S72(b) above, the relevance of an item of financial information is a general quality that pertains to classes/types of assets and liabilities held/owed, potentially, by any entity. That is, relevant information is intrinsically capable of making a difference in resource allocation decisions made by users of financial reports, even if, for a particular entity, the information might be immaterial (and thus not capable of making a difference in resource allocation decisions by users of its financial report). As mentioned in paragraph QC11 of the IASB Conceptual Framework, information is material if its omission or misstatement could influence resource allocation decisions of users of financial reports of a specific entity, i.e. “materiality is an *entity-specific aspect of relevance* based on the nature or magnitude, or both, of the items to which the information relates ...” (emphasis added); and, therefore,
 - (b) the IASB alone should determine, at a standards level:
 - (i) the general relevance of information provided by recognising a particular class/type of asset or liability; and
 - (ii) whether recognition of that particular class/type of asset or liability by entities in general would be likely to provide information sufficiently relevant to justify the cost; and
 - (c) the materiality of assets and liabilities being considered for recognition should be assessed on an entity-specific basis.

²¹ The close nexus between the cost constraint and relevance is reflected in the preliminary view in paragraph 4.25(a) of the DP that the IASB would assess whether “recognising the asset (or the liability) would provide users of financial statements with information that is not relevant, or not sufficiently relevant to justify the cost”.

- S75 The AASB considers that the revised IASB Conceptual Framework should not describe the role of materiality in relation to recognition as a ‘recognition criterion’. This is because the AASB regards the most important principle to note about materiality is that an item meeting the definition of an asset or a liability *need not* be recognised by a particular entity when recognition of that item by the entity would provide immaterial information. In general, it should not be necessary for information about an individual asset or liability to be material for that item to qualify for recognition (see paragraph S77 below for explanation). However, there should be an overall constraint on the extent to which immaterial information (including immaterial recognised classes of assets and liabilities) is included in financial reports.
- S76 Although the inclusion of any immaterial information in financial reports would generally be undesirable, the AASB’s recommended constraint, referred to in paragraph S75 above, is that financial reports should not include so much immaterial information (i.e. clutter) that users of financial reports would be impeded from identifying the information that is important for making resource allocation decisions (e.g. by impairing the understandability of the financial information reported)²². Creating clutter with these adverse consequences should generally be more of an issue for the notes to the primary²³ financial statements²⁴. However, recognising immaterial classes of assets and liabilities can also create clutter with these adverse consequences. Therefore, the AASB considers that the revised IASB Conceptual Framework should state that recognition of immaterial classes of assets and liabilities should not occur to the extent that users of financial reports would be impeded from identifying the information that is important for making resource allocation decisions. Such a statement would in effect give conceptual acknowledgement to the principle proposed in IASB ED/2014/1 *Disclosure Initiative: Proposed Amendments to IAS 1* (March 2014) that paragraph 30A of IAS 1 *Presentation of Financial Statements* should include: “An entity shall not ... disaggregate information in a manner that obscures useful information, such as by ... overwhelming useful information with immaterial information.”
- S77 The AASB does not recommend precluding recognition of any item meeting the definition of an asset or a liability even when that provides immaterial information. To do so would seem likely to require an unrealistically precise identification of what is ‘material’ in practice. The AASB considers that, in practice, some information would clearly be material, some information would clearly be immaterial, and there would be a ‘grey area’ of information on the cusp of being material (about which judgement would be required to assess whether it is material). It would seem reasonable (and unlikely to be a significant source of ‘disclosure overload’) for an entity to decide to disclose information that has a significant

²² In paragraph S271 below, this paper sets out a suggestion of the AASB to clarify the description of ‘material’ information in the IASB Conceptual Framework to convey more clearly that the omission or misstatement of such information could *adversely* influence decision making by users of an entity’s financial report.

²³ The primary financial statements are described in paragraph 7.14 of the DP.

²⁴ For example, recognising assets or liabilities that individually are immaterial within classes of assets or liabilities that are material should not create clutter, because recognition of those immaterial assets or liabilities would not create additional line items on the face of the financial statements.

chance of being material when there is doubt about whether that information is material. However, if the revised IASB Conceptual Framework were, in concept, to preclude recognition of any asset or liability when recognition provides immaterial information, a precise determination of materiality would in concept be required. Accordingly, precluding recognition of assets and liabilities when their recognition would provide immaterial information would, in concept, require a more precise identification of materiality than presently occurs, which would be difficult and potentially cost more to perform than the resulting benefits.

Draft guidance on whether recognition of an item meeting the definition of an asset or a liability “might not provide relevant information” (paragraph 4.26 of the DP)

- S78 The AASB observes that most of the examples, in paragraph 4.26 of the DP, of purported indicators that recognition of an asset or a liability might not provide relevant information would seem to relate to entity-specific circumstances, rather than relevance and cost assessments that would logically be made by the IASB on a class-of-assets basis or class-of-liabilities basis. The only example given in that paragraph of a class of assets that might be concluded by the IASB to be insufficiently relevant to warrant recognition is internally generated goodwill (referred to in paragraph 4.26(e) of the DP)²⁵.
- S79 For the reasons in paragraphs A5 – A13 of the attachment to this paper, the AASB considers that most of the examples, in paragraph 4.26 of the DP, of purported indicators that recognition of an asset or a liability might not provide relevant information should instead be characterised as examples of assessing whether, because of uncertainty, it is infeasible to faithfully represent a measure of an asset or a liability. For example, paragraph 4.26 of the DP says:
- (a) if the range of possible outcomes is extremely wide and the likelihood of each outcome is exceptionally difficult to estimate (e.g. for some major litigation cases) recognition of a single point estimate might not provide any further relevant information than disclosing the range of (possible) outcomes and the factors affecting their likelihoods [paragraph 4.26(a)]; and
 - (b) if an asset or a liability exists but there is only a low probability that an inflow or outflow of economic benefits will result: in some such cases, the IASB might conclude that measures of the resource or obligation may be exceptionally sensitive to small changes in the estimate of the probability and there may be little evidence to support such estimates [paragraph 4.26(b)].
- S80 The AASB considers that in neither of these examples is the general relevance of the information in question.
- S81 The AASB considers that the examples in paragraphs 4.26(a) – 4.26(d), inclusive, of the DP relate, in substance, to matters of faithful representation (which the AASB considers should be assessed on an entity-specific basis) rather than relevance. In

²⁵ Paragraph 4.26 of the DP does not include examples of classes of liabilities that might be concluded by the IASB to be insufficiently relevant to warrant recognition.

addition, the first sentence of paragraph 4.26(b) says that, if an asset or a liability exists but there is only a low probability that an inflow or outflow of economic benefits will result, in some such cases the IASB might conclude that users of financial statements would be unlikely to include information about that inflow or outflow directly in their analyses. This additional point is commented on in paragraph A9 of the attachment to this paper.

- S82 The number of examples in paragraph 4.26 of the DP that the AASB considers to relate, in substance, to matters of faithful representation underlines the need (in the AASB's view) for the revised IASB Conceptual Framework to specify the 'faithful representation' recognition criterion, for application on an entity-specific basis (i.e. not for determination by the IASB in standards-level projects) [see paragraphs S69 – S71 above]. In addition, the AASB recommends amending paragraph QC16 of the IASB Conceptual Framework to indicate that, if the level of uncertainty in an estimate is particularly large, the estimate might not faithfully represent the measurement basis applied to the asset or liability being measured (see explanation in paragraphs S272 – S277 below).
- S83 The AASB's comments in paragraphs S78 – S81 above regarding the examples in paragraph 4.26 of the DP focus on which qualitative characteristic relates to those examples; those AASB comments do not address whether the elements of financial statements discussed in those examples should, in concept, be recognised. That latter aspect is discussed in the AASB's specific comments on the draft guidance in paragraph 4.26 of the DP, set out in paragraphs A5 – A13 of the attachment to this paper.

'Faithful representation' recognition criterion

- S84 As indicated in paragraph S67 above, the AASB agrees with the preliminary view to, in effect, replace the 'reliable measurement' recognition criterion in paragraph 4.38(b) of the existing IASB Conceptual Framework with a 'faithful representation' recognition criterion. The AASB also agrees with the preliminary view, in paragraph 4.25(b) of the DP, that an asset or liability should only be assessed as failing the 'faithful representation' recognition criterion if disclosing "all necessary descriptions and explanations" would not achieve faithful representation (i.e. all best endeavours should be made to meet the criterion). However, whilst the AASB broadly supports the 'faithful representation' recognition criterion in paragraph 4.25(b) of the DP, it has the concerns with how application of that criterion is described in the DP, as discussed in paragraphs S85 – S89 below and paragraphs A1 – A3 of the attachment to this paper.

Faithfully representing changes in an asset or a liability

- S85 It is unclear to the AASB how the IASB would intend applying the preliminary view in paragraph 4.25 of the DP that "the IASB might decide ... that an entity need not, or should not, recognise an asset or a liability ... (b) if no measure of the asset (or the liability) would result in a faithful representation of the asset (or the liability) and of changes in the asset (or the liability), even if all necessary descriptions and

explanations are disclosed” (emphasis added). This lack of clarity is explained in paragraphs S86 – S88 below.

S86 Paragraph 4.19 of the DP states that:

“When the IASB considers whether it is possible to provide a faithful representation of a resource or obligation, the IASB needs to consider not just its description and measurement on the face of the statement of financial position, but also ... (b) the depiction of the resulting income and expense ...”.

S87 Apparently the only example in the DP of applying that principle is given in paragraph 4.19(b) thereof, which refers to the adverse consequence of omitting to recognise an acquired asset and recognising an expense instead. However, it is not apparent why, in that example, assessing faithful representation of the acquired resource also requires consideration of ‘the depiction of the resulting income and expense’. Therefore, that example in paragraph 4.19(b) of the DP does not provide much insight into the principle quoted in paragraph S86 above.

S88 The principle quoted in paragraph S86 above implies that the IASB also contemplates a situation in which an asset or a liability should *not* be recognised because of the IASB’s concern about how recognition of that asset or liability would impact on the recognition of income or expenses. The AASB is not aware of such a situation. If the IASB proceeds with that principle, it should provide an example of its application.

S89 For the reasons discussed in paragraphs S86 – S88 above, the AASB considers that, if the preliminary view in paragraph 4.25 of the DP quoted in paragraph S85 above were to be included in the Exposure Draft of the revised IASB Conceptual Framework, the IASB should clarify the meaning of its reference to “faithful representation ... of changes in the asset (or the liability)”.

Recognition of internally generated goodwill

S90 In relation to the preliminary view in paragraphs 4.9(c) and 4.26(e) of the DP that recognition of internally generated goodwill would not provide information necessary to meet the objective of financial reporting, the AASB considers that paragraph 4.9(c) of the DP provides an insufficient reason for reaching this preliminary view in relation to internally generated goodwill but not also in relation to purchased goodwill. This is explained in paragraphs S91 – S92 below.

S91 Paragraph 4.9(c) of the DP says:

“... the IASB has concluded that recognising internally generated goodwill is unnecessary to meet the objective of financial statements. Financial statements are not designed to show the value of a reporting entity [footnote omitted]. Measuring internally generated goodwill would require an estimate of the value of the reporting entity. Consequently, recognising internally generated goodwill does not provide relevant information. In contrast, at the time of a business combination, recognising the goodwill

acquired depicts more completely the economic resources acquired to be used by management, and the economic resources transferred (or equity instruments delivered) to the vendors.”

- S92 Since an entity’s internally generated goodwill and purchased goodwill are conceptually indistinct (i.e. the manner in which they are acquired is conceptually irrelevant), the arguments in paragraph 4.9(c) of the DP (quoted above) distinguishing the two seem conceptually unfounded. Specifically:
- (a) the argument in paragraph 4.9(c) of the DP that recognising internally generated goodwill would not provide relevant information because measuring that goodwill would require an estimate of the value of the reporting entity is not a convincing reason why recognising purchased goodwill would provide more relevant information. The fact that purchased goodwill arises only in respect of an acquiree changes only the scope of that asset (i.e. it is a subset of the goodwill of the group reporting entity), not the nature of that asset. Furthermore, although under IFRS 3 *Business Combinations* goodwill is determined by reference to the consideration transferred in making the acquisition²⁶, the value of that consideration is a proxy for the acquisition-date fair value of the acquiree²⁷, which is a more conceptually appropriate measure for deriving the value of goodwill; and
 - (b) the argument in paragraph 4.9(c) of the DP that, “at the time of a business combination, recognising the goodwill acquired depicts more completely the economic resources acquired to be used by management” implies information about purchased assets is more relevant than information about assets the entity acquired without purchasing them (for example, assets donated to the entity or biological assets obtained through natural reproduction). This argument is implied by the argument quoted above from paragraph 4.9(c) of the DP, because both purchased goodwill and internally generated goodwill are acquired by the entity; the only difference between those types of goodwill is that the first of them is acquired for consideration in an identifiable transaction (or identifiable transactions) whilst the second is not. The AASB would disagree with saying, in effect, that a particular class of asset is relevant only if the items in that class have been purchased by the entity.
- S93 For the reasons discussed in paragraphs S90 – S92 above, the AASB considers that, if the IASB confirms its preliminary view that recognition of internally generated goodwill would not provide information necessary to meet the objective of financial reporting, it should reconcile that preliminary view with its view that recognising acquired goodwill would provide information necessary to meet the objective of financial reporting.

²⁶ Such consideration is referred to in the last sentence of paragraph 4.9(c) of the DP.

²⁷ That is, under IFRS 3, goodwill is not determined by reference to the acquisition-date fair value of either the acquiree as a whole or the acquirer’s interest in the acquiree, and instead is determined by reference to the consideration transferred in making the acquisition, which is generally measured at its acquisition-date fair value (paragraph 32 of IFRS 3 and paragraph BC330 of the IASB’s Basis for Conclusions on IFRS 3 refer).

Enhancing qualitative characteristics

S94 The AASB agrees with the preliminary view in paragraph 4.23 of the DP that the revised IASB Conceptual Framework should not include recognition criteria relating to the enhancing qualitative characteristics of comparability, verifiability, timeliness and understandability. This is because the AASB broadly agrees with the comments in paragraphs 4.22 – 4.23 of the DP.

Other comments on paragraphs 4.25 – 4.26 of the DP

S95 The AASB's other comments on paragraphs 4.25 – 4.26 of the DP are set out in paragraph A4 of the attachment to this paper.

Brief summary of the AASB's views on the recognition criteria and materiality

S96 As indicated in paragraphs S68 – S71 above, the AASB considers that:

- (a) the relevance and cost/benefit recognition criteria should be applied by the IASB alone (on a class-of-assets or class-of-liabilities basis), at a standards level, but should also be included in the revised IASB Conceptual Framework; and
- (b) the other recognition criteria should be included in the revised IASB Conceptual Framework for application by entities. These criteria would, presumably, also be set out in IFRSs.

S97 The recognition criteria that the AASB considers should be included in the revised IASB Conceptual Framework in respect of items (or classes/types of items) that meet the definition of an asset or a liability are set out below, indicating by whom they should be applied.

Classes/types of assets and liabilities

S98 As indicated in paragraphs S68 – S69 and S72 – S73 above, the AASB considers that the revised IASB Conceptual Framework should state that items of a class/type of asset or liability should (subject to the application of the recognition criteria in paragraph S99 below on an item-by-item basis) be recognised when their recognition would provide users of financial statements with information that is sufficiently relevant to justify the cost. This test should be presumed to be met for a particular class/type of asset or liability, unless the IASB has determined at a standards level that it is not met for that class/type.

Assets and liabilities assessed on an item-by-item basis

S99 The AASB considers that the revised IASB Conceptual Framework should state that recognition criteria for entities to apply to their assets and liabilities are:

- (a) the 'probable' criterion as worded in paragraph 4.38(a) of the existing IASB Conceptual Framework (see paragraph S66 above); and

- (b) a criterion that the asset or liability possesses a measure that can be faithfully represented (see paragraphs S69 and S78 – S84 above).

Materiality

S100 As indicated in paragraphs S75 – S77 above, the AASB considers that the revised IASB Conceptual Framework should state that:

- (a) an item meeting the definition of an asset or a liability *need not* be recognised by a particular entity when recognition of that item by the entity would provide immaterial information (this principle would not be a recognition criterion); and
- (b) recognition of immaterial classes of assets and liabilities should not occur to the extent that users of financial reports would be impeded from identifying the information that is important for making resource allocation decisions (this principle would be, in effect, a recognition constraint applied by entities at an aggregate level).

Question 9

In the IASB's preliminary view, as set out in paragraphs 4.28–4.51 of the Discussion Paper, an entity should derecognise an asset or a liability when it no longer meets the recognition criteria. (This is the control approach described in paragraph 4.36(a) of the Discussion Paper). However, if the entity retains a component of an asset or a liability, the IASB should determine when developing or revising particular Standards how the entity would best portray the changes that resulted from the transaction. Possible approaches include:

- (a) enhanced disclosure;
- (b) presenting any rights or obligations retained on a line item different from the line item that was used for the original rights or obligations, to highlight the greater concentration of risk; or
- (c) continuing to recognise the original asset or liability and treating the proceeds received or paid for the transfer as a loan received or granted.

Do you agree? Why or why not? If you do not agree, what changes do you suggest, and why?

S101 As indicated in paragraph B46 of Appendix B to its submission on the DP, the AASB agrees with the preliminary view, reprised in Question 9 of the DP, that “an entity should derecognise an asset or a liability when it no longer meets the recognition criteria” (i.e. it should apply the ‘control approach’ to derecognition). The ‘control approach’ has the advantage of being neutral between initial recognition and subsequent recognition (e.g. in assessing whether an element meets the criteria for recognition, it would be irrelevant whether the element had previously been recognised).

S102 However, as discussed in paragraphs B47 – B52 of Appendix B to its submission on the DP, the AASB disagrees with the preliminary view that the IASB Conceptual

Framework should provide only limited-scope conceptual guidance on derecognition. Specifically, the AASB disagrees with the preliminary view (expressed in Question 9 of the DP) that: “if the entity retains a component of an asset or a liability, the IASB should determine when developing or revising particular Standards how the entity would best portray the changes that resulted from the transaction”. The AASB considers that:

- (a) the revised IASB Conceptual Framework should contain derecognition concepts that would cover, without exception, transactions or other events that potentially give rise to derecognition of an asset or a liability (or a component of an asset or a liability). Otherwise, ad hoc and/or inconsistent decisions might be made in different Standards-level projects; and
- (b) conceptually, the ‘control approach’ to derecognition should be applied in all cases.

S103 The AASB notes that, if the entity retains a component of an asset or a liability, one of the possible treatments referred to in paragraph 4.50(c) of the DP is continuing to recognise the original asset or liability, and treating the proceeds received or paid for the transfer as a loan received or granted. As indicated in paragraphs B51 – B52 of Appendix B to its submission on the DP, the AASB considers that the revised IASB Conceptual Framework should not identify this treatment as being potentially acceptable in concept, because it would not be representationally faithful to recognise in full an asset or a liability that has partially been transferred to another entity.

S104 As indicated in paragraph B53 of Appendix B to its submission on the DP, the AASB recommends stating in the revised IASB Conceptual Framework that, in accounting for a transaction involving the derecognition of some components of an asset or a liability:

- (a) the partial derecognition approach should be applied in respect of any components of an asset or a liability that are retained by the entity; and
- (b) the full derecognition approach should be applied to any other components, with initial recognition of the new or substantially different rights or obligations arising from the transaction.

S105 Consequently, it should be unnecessary for the revised IASB Conceptual Framework to raise the possibility that if the entity retains a component of an asset or a liability, possible alternative standards-level approaches²⁸ include:

- (a) enhanced disclosure; and

²⁸ In addition to the approach mentioned in paragraph S103 above.

- (b) presenting any rights or obligations retained on a line item different from the line item that was used for the original rights or obligations, to highlight the greater concentration of risk.

The AASB considers that these approaches would be inappropriate.

S106 These comments in paragraphs S101 – S105 above are elaborated on in paragraphs B43 – B58 of Appendix B to the AASB’s submission on the DP.

Section 5—Definition of equity and distinction between liabilities and equity instruments

Question 10

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 of the Discussion Paper. 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) of the Discussion Paper).
- (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?

(a) Definition of ‘equity’

S107 The AASB agrees with the preliminary view in paragraph 5.2 of the DP to retain the definition of ‘equity’ in the existing IASB Conceptual Framework, and therefore with defining ‘equity’ as a residual interest.

S108 In reaching that conclusion, the AASB noted the following points:

- (a) the distinction between liabilities and equity is fundamental to the treatment of interest as an expense rather than a distribution to owners. If all distributions to claimants were treated consistently (with returns on the investments of different categories of claimants treated as a matter of disclosure), the importance of the liability/equity distinction would largely disappear;
- (b) many financial instruments have attributes of both liabilities and equity. Treating all claims as types of the same element of financial statements (i.e. not distinguishing between ‘liabilities’ and ‘equity’) would faithfully represent the economic substance of those instruments from an entity perspective and could reduce the complexity of accounting for those instruments;
- (c) despite the arguments in (a) and (b) above for treating all claims on an entity’s assets as types of the same element of financial statements, that issue would seem too fundamental to address at this stage. Therefore, the AASB’s comments on Question 10 are premised on the basis that the identification of liabilities and equity as different elements would continue; and
- (d) on the presumption noted in (c) immediately above, treating equity as a residual can be conceptually justified on the basis that:
 - (i) it would faithfully reflect that the interests of equity holders are subordinate to the interests of creditors; and
 - (ii) if ‘stand-alone’ definitions of a liability and equity were developed instead, overlaps (or gaps) between those definitions could arise.

S109 The AASB considers that the DP’s focus on ‘equity instruments’, rather than ‘equity’ more generally, is unnecessarily narrow. For example, although a partnership has no equity instruments, the distinction between its liability and equity claims is equally affected by the discussion in Section 5 of the DP, particularly in paragraphs 5.55 – 5.59 therein.

(b) Distinction between liabilities and equity instruments

S110 The AASB agrees with the preliminary view in Question 10(b) of the DP that the revised IASB Conceptual Framework should state that the definition of a liability should be used to distinguish liabilities from equity instruments. In particular, as indicated in paragraph B71(a) of Appendix B to its submission on the DP, the AASB agrees with the preliminary view in paragraph 5.37 of the DP that the ‘strict obligation’ approach is preferable to the ‘narrow equity’ approach to distinguishing liabilities from equity (i.e. consistent with paragraph 5.34 of the DP, only obligations to deliver economic resources would be classified as liabilities, and all equity claims would be classified as equity).

- S111 The AASB prefers the ‘strict obligation’ approach to the ‘narrow equity’ approach because:
- (a) consistent with the proposed definition of a liability in paragraph 2.11 of the DP, with which the AASB broadly agrees (see paragraphs S12 – S15 above), the primary consideration in identifying whether a claim on an entity’s assets is a liability should be whether that entity has an obligation to transfer its own economic resource(s); and
 - (b) adopting the ‘narrow equity approach’ as described in paragraph 5.30 of the DP would involve adopting a ‘parent perspective’ to financial reporting, which:
 - (i) differs from the ‘entity perspective’ generally adopted in the IASB Conceptual Framework and IFRSs; and
 - (ii) would give rise to inappropriate outcomes. For example, adopting a ‘parent perspective’ to financial reporting would, in relation to the boundaries of a reporting entity, logically imply that only a parent’s share of ‘intra-group transactions’ (with ‘group’ based on the presently-used concept of control for defining the boundary of a group reporting entity) should be eliminated on consolidation. This is because the boundary of a group reporting entity would logically, but inappropriately, be redefined as the share of assets and liabilities attributable to the parent.
- S112 In relation to paragraph S111(b) above, even if the potential (and preferable) variant of the ‘narrow equity’ approach identified in footnote 44 to paragraph 5.30(b) of the DP were adopted, the AASB would disagree with adopting the ‘narrow equity’ approach, for the reason set out in paragraph S111(a) above.
- (i) **Obligations to issue equity instruments**
- S113 Consistent with its view that, in concept, the ‘strict obligation’ approach to distinguishing liabilities from equity should be adopted (see paragraphs S110 – S112 above), the AASB agrees with the preliminary view in paragraphs 5.34 and 5.37 of the DP that obligations to issue equity instruments should not in concept be identified as liabilities. The AASB observes that the proposed definition of a ‘liability’ in paragraph 2.11 of the DP, with which the AASB broadly agrees (see paragraph S111(a) above), includes an essential characteristic that the entity is obliged to transfer an economic resource.
- (ii) **Obligations arising only on liquidation of the reporting entity**
- S114 The AASB agrees with the preliminary view in paragraph 3.89(a) of the DP that requirements to make payments (or other transfers of assets) that would arise only on liquidation of the entity are not present obligations. The AASB considers that this preliminary view is appropriate, even if the entity has a predetermined life or another party holds an option to compel liquidation of the entity (see, for example, the comments in paragraph S127 below regarding financial instruments puttable for

a proportionate share of the entity's net assets). The AASB agrees with the preliminary view where financial statements are prepared on the going concern assumption, because identifying present obligations in respect of requirements that would arise only on liquidation of the entity would be incompatible with that assumption.

(c) Remeasuring secondary equity claims

S115 The AASB's response to parts (i) and (ii) of Question 10(c) in the DP is set out integrally in paragraphs S116 – S118 below.

S116 As indicated in paragraph B59 of Appendix B to its submission on the DP, the AASB disagrees with the preliminary view that, at the end of each period, an entity should update the measurement of each class of equity claim and consequently show transfers between the amounts of recognised net assets attributed to each class of equity, within the statement of changes in equity (paragraphs 5.12 – 5.13 of the DP). The AASB's concern is focused on the apparent implication that secondary equity claims would be measured 'directly', for example, in the same manner as an entity would measure a comparable financial liability. The AASB does not have concerns regarding the DP's discussion of how primary equity claims would be measured, because there is no indication in the DP that these claims would be measured differently from their conceptually appropriate treatment under the existing Conceptual Framework, that is, using an allocation of the underlying net assets.

S117 The AASB disagrees with 'directly' remeasuring changes in some classes of equity because such an approach:

- (a) conflicts with the general principle that an entity's financial statements depict economic phenomena affecting the entity, and not economic phenomena affecting other parties only. No changes in the entity's assets or liabilities, or future cash flows, occur as a result of changes in the value of its equity instruments to equity holders;
- (b) seems unlikely to meet its stated aims; and
- (c) seems unnecessary.

S118 These comments in paragraphs S116 – S117 above are elaborated on in paragraphs B59 – B69 of the AASB's submission on the DP. Regarding paragraph S117(b) above, an additional reason, to those included in the AASB's submission on the DP, why 'directly' remeasuring changes in some classes of equity seems unlikely to achieve its aims, is because accounting for transactions with a particular class of owner cannot cater for the indirect effects of those transactions on the value of other classes of equity claims. For example, the issue of ordinary shares during a period of credit rationing might enable an entity to finance a new investment opportunity and thus increase the value of all classes of equity interests in the entity. The issue of shares would, under existing practice, be presented in the statement of changes in equity solely as an increase in issued share capital, even though the value of other equity interests (e.g. written call options on

the entity's shares) might also be enhanced. This existing treatment in practice (i.e. not accounting for indirect effects of transactions or other events on the value of all classes of equity interests in the entity) is conceptually appropriate because, as mentioned in paragraph S117(a) above, the financial statements should only depict economic phenomena affecting the entity.

(d) Treating the most subordinated class of instruments as if it were an equity claim

S119 As indicated in paragraphs B70 and B72 of Appendix B to its submission on the DP, the AASB disagrees with the preliminary view in paragraph 5.57 of the DP that: “the revised *Conceptual Framework* should indicate that an entity should treat some obligations that oblige the issuer to deliver economic resources as if they were equity instruments ... Arguably, this treatment might be appropriate if the obligations are the most subordinated (lowest ranking) class of instruments issued by an entity (such as some co-operatives or mutuals) that would otherwise report no equity” if that preliminary view is intended to indicate that, in concept, some liabilities should be treated as equity. This view of the AASB is elaborated on in paragraphs S120 – S128 below.

Financial instruments puttable for a proportionate share of the entity's net assets

S120 The AASB notes that the preliminary view in paragraph 5.57 of the DP mentioned in paragraph S119 above is presented in the context of the DP's discussion of puttable financial instruments that:

- (a) give the holders a pro rata residual interest in the entity's net assets, after deducting all its liabilities; and
- (b) oblige the entity to deliver cash or other assets to the holders on liquidation, or on early redemption at an amount broadly equivalent to that pro rata share.

S121 As indicated in paragraph B72 of its submission on the DP, the AASB considers that there might be valid conceptual reasons to identify such puttable instruments as equity instruments (see paragraphs S125 – S127 below, which set out a possible conceptually robust approach to liability/equity classification of such puttable instruments identified in the AASB's submission). However, these reasons include neither of the reasons implicit in the arguments noted in paragraph 5.57 of the DP that:

- (a) at least the most subordinated (lowest ranking) class of instruments issued by an entity must be classified as equity; and
- (b) it would be inappropriate for an entity to report no equity.

S122 As indicated in paragraph B73 of its submission on the DP, the AASB is concerned that a logical extension of the argument that such puttable instruments should be classified as equity instruments (even if they are liabilities) if they are the most subordinated class of instruments issued by the entity would be that any entity

should treat its most subordinated class of issued instruments as equity. Such an extension of the application of that argument would create tension with the preliminary view that the ‘narrow equity’ approach to distinguishing liabilities from equity should not be adopted in the IASB Conceptual Framework.

- S123 In addition, as indicated in paragraph A1(a) of Appendix A to its submission on the DP, the AASB is concerned that the preliminary view in paragraph 5.57 of the DP (quoted in paragraph S119 above) does not address the fundamental issue of whether, in concept, it would be representationally faithful for some entities to report no equity.
- S124 Furthermore, as indicated in paragraph A8(d) of Appendix A to its submission on the DP, the AASB notes that, although paragraph 5.57 of the DP says “the revised *Conceptual Framework* should indicate that an entity should treat some obligations that oblige the issuer to deliver economic resources as if they were equity instruments”, Question 10(d) says “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.” It is unclear to the AASB whether the latter statement is merely a reminder that changes in requirements occur through standards-level projects, or whether the IASB intends to address this issue only at a standards level. If the latter were the case, the AASB would be concerned that such a pervasive issue would be addressed only at a standards level without conceptual underpinnings to guide that standards-level decision, when resolving it would seem likely to require an overarching principle. The AASB thinks the Conceptual Framework is the place to establish an appropriate overarching principle for this issue.

Addressing whether a required distribution of assets would be a capital reduction

- S125 In relation to the types of puttable instruments described in paragraph S120 above, paragraph B75 of Appendix B to the AASB’s submission on the DP encourages the IASB to consider the logic of the following possible approach²⁹:
- (a) if the value of the assets to be delivered upon early redemption is proportionate to the entity’s net assets, the distribution of assets would be a capital reduction (the option holder would realise its share of the business), that is, it would be a distribution to an owner. If the instrument does not convey to the holder rights to also demand a non-proportionate transfer of the entity’s net assets, the instrument would be wholly equity in nature (it would be a proportionate interest in the entity’s net assets that therefore exposes the holder to the risks and rewards of ownership of the entity’s ordinary share capital); and
 - (b) if the holder of the option also has rights to demand a transfer of assets that is not proportionate to the entity’s net assets, those additional rights would

²⁹ This approach deals with the case in which there exists one class of equity. The approach could be refined to address cases in which there are two or more classes of equity, each with different equity rights.

represent liabilities, and the instrument should be bifurcated into liability and equity components.³⁰

S126 As indicated in paragraph B77 of Appendix B to its submission on the DP, the AASB considers that the logic set out in paragraph S125 above would be consistent with the ‘strict obligation’ approach preferred by the IASB (with which the AASB concurs). Paragraph 5.34(b) of the DP says, under the ‘strict obligation’ approach, all equity claims would be classified as equity—“in other words ... all claims that give the holder the right to receive a portion of any distributions of equity made to holders of that class of claim”. An important difference between the ‘strict obligation’ approach and ‘narrow equity’ approach discussed in the DP is those approaches’ different treatments of whether liabilities should include obligations that would be settled without transferring assets of the entity. The logic in paragraph S125 above would not involve treating as liabilities obligations that would be settled without transferring assets of the entity, and thus would be consistent with this important aspect of the ‘strict obligation’ approach.

S127 In addition to the comments in paragraph S126 above (which repeat paragraph B77 of the AASB’s submission), the AASB acknowledges that the possible approach described in paragraph S125 above might be considered to identify equity more broadly than under some interpretations of the ‘strict obligation’ approach. This is because an instrument issued by the entity might be classified as an equity instrument despite the entity having an obligation to stand ready to deliver assets to the holder upon exercise of the put option. However, the AASB also notes the view, in relation to the puttable instruments described in paragraph S120 above, that “deliver[ing] ... assets to the holders [of the instruments] ... on early redemption at an amount broadly equivalent to [their pro rata residual interest]”³¹ would, for some entities issuing such puttable instruments (e.g. some partnerships and co-operatives), constitute³² the winding up and reconstitution of the entity. Under that view, for at least some entities, “deliver[ing] ... assets to the holders [of the instruments] ... on early redemption at an amount broadly equivalent to [their pro rata residual interest]” would not differ, in substance, from “deliver[ing] ... assets to the holders [of the instruments] on liquidation ... at an amount broadly equivalent to [their pro rata residual interest]”³³ and, accordingly:

- (a) because of the preliminary view in paragraph 3.89(a) of the DP that requirements to make payments (or other transfers of assets) that would arise only on liquidation of the entity are not present obligations, the puttable instruments should be classified as equity; and

³⁰ Note that paragraph B74 of Appendix B to the AASB’s submission on the DP says: “The AASB disagrees with the suggestion in paragraph 5.58(b) of the DP that [the IASB] would address at a standards level only the issue of whether to bifurcate the puttable instruments into an embedded put option (for which a liability would be recognised) and a host equity instrument. The AASB considers this issue should first be addressed (at least broadly) in developing the revised IASB Conceptual Framework, because the issue is conceptually significant and its resolution would provide insights into the robustness of the proposed conceptual definitions of a liability and of equity.” [footnote omitted]

³¹ Paragraph 5.55(b) of the DP refers.

³² In substance, whether legally or otherwise.

³³ Paragraph 5.55(b) of the DP refers.

- (b) applying the possible approach described in paragraph S125 above would achieve the objective stated in paragraph 5.57 of the DP that: “the revised *Conceptual Framework* should indicate that an entity should treat some obligations that oblige the issuer to deliver economic resources as if they were equity instruments”, but would not (as paragraph 5.57 of the DP suggests) be an exception to the general preliminary views that:
 - (i) the ‘strict obligation’ approach should be applied to distinguish liabilities from equity; and
 - (ii) requirements to make payments (or other transfers of assets) that would arise only on liquidation of the entity are not present obligations.

S128 These comments in paragraphs S119 – S127 above are elaborated on in paragraphs B70 – B79 of the AASB’s submission on the DP.

Section 6—Measurement

Question 11

How the objective of financial reporting and the qualitative characteristics of useful financial information affect measurement is discussed in paragraphs 6.6–6.35 of the Discussion Paper. The IASB’s preliminary views are that:

- (a) the objective of measurement is to contribute to the faithful representation of relevant information about:
 - (i) the resources of the entity, claims against the entity and changes in resources and claims; and
 - (ii) how efficiently and effectively the entity’s management and governing board have discharged their responsibilities to use the entity’s resources.
- (b) a single measurement basis for all assets and liabilities may not provide the most relevant information for users of financial statements;
- (c) when selecting the measurement to use for a particular item, the IASB should consider what information that measurement will produce in both the statement of financial position and the statement(s) of profit or loss and OCI;
- (d) the relevance of a particular measurement will depend on how investors, creditors and other lenders are likely to assess how an asset or a liability of that type will contribute to future cash flows. Consequently, the selection of a measurement:
 - (i) for a particular asset should depend on how that asset contributes to future cash flows; and
 - (ii) for a particular liability should depend on how the entity will settle or fulfil that liability.
- (e) the number of different measurements used should be the smallest number necessary to provide relevant information. Unnecessary measurement changes should be avoided and necessary measurement changes should be explained; and
- (f) the benefits of a particular measurement to users of financial statements need to be sufficient to justify the cost.

Do you agree with these preliminary views? Why or why not? If you disagree, what alternative approach to deciding how to measure an asset or a liability would you support?

(a) The objective of measurement

S129 As indicated in paragraph 12 of its submission on the DP, the AASB agrees with the preliminary view relating to the measurement objective in paragraph 6.35(a) of the DP [repeated in Question 11(a)]. The AASB also considers that, consistently with paragraph OB3 of the IASB Conceptual Framework, the measurement objective should be strengthened by stating that a key objective of measurement concepts should be to identify measurement bases or attributes that provide the most useful information for predicting the entity’s future cash flows.

S130 As indicated in paragraphs 13 – 14 of its submission on the DP, the AASB considers that:

- (a) in addition to specifying the measurement objectives referred to in paragraph S129 above, the Conceptual Framework should include measurement concepts that (if applied at a standards level) would result in measurements possessing the following qualities:
 - (i) the amounts can meaningfully be added, subtracted and compared; and
 - (ii) their economic significance, individually and collectively, is capable of being understood; and
- (b) to achieve the goals in (a) above and help achieve the measurement objectives referred to in paragraph S129 above, an ideal concept of ‘wealth’ needs to be identified. The wealth embodied in an entity’s assets is their capability to contribute (directly or indirectly) to generating cash inflows to the entity; the reduction in wealth embodied in an entity’s liabilities is the reduction they cause in the entity’s capability to generate cash inflows.

S131 As indicated in paragraphs 17 – 18 of its submission on the DP, the AASB considers that:

- (a) operating capability is the concept of wealth most useful for achieving the objective of financial reporting, including the provision of information useful for predicting the entity’s future cash flows (see paragraph S134 below for an elaboration); and
- (b) historical cost-based measurements would not achieve the objective (mentioned in paragraph S129 above) that measurements should provide the most useful information for predicting the entity’s future cash flows, except when those measurements do not differ materially from current market entry prices.

S132 These comments in paragraphs S129 – S131 above are elaborated on in paragraphs 12 – 19 of the AASB’s submission on the DP.

(b) Single measurement basis for all assets and liabilities

S133 As indicated in paragraph 11 of its submission on the DP, the AASB strongly disagrees with the preliminary view in paragraph 6.35(b) of the DP that a single measurement basis for all assets and liabilities may not provide the most relevant information for users of financial statements.

S134 As indicated in paragraphs A18 – A20 of Appendix A to its submission on the DP, the AASB observes that the mixed-measurement requirements in IFRSs presently lack coherence, and considers there is a pressing need for a single conceptual measurement model (based on an explicitly identified ideal concept of wealth) to

provide a foundation for developing consistent measurement requirements. As noted in paragraph S131(a) above, the AASB's preferred measurement model adopts an operating capability concept of wealth. As indicated in paragraph 15(b) of the AASB's submission on the DP, an entity's 'operating capability' represents its ability, at any given time, to carry out its activities at the scale determined by its then-existing resources, both monetary and non-monetary. Using an operating capability concept of wealth, the entity's recognised economic resources and present obligations, and recognised changes in those resources and obligations resulting from the entity's operations, are measured in terms of the specific prices currently relating to them, i.e. their current cost. Specifically:

- (a) recognised assets are generally measured at the amounts the entity would currently need to pay to acquire them³⁴; and
- (b) recognised liabilities are generally measured at the current cost of the assets the entity expects to consume in extinguishing those liabilities (e.g. by providing promised goods and services to customers)³⁵. In the case of outstanding loans, these amounts would be the present value of loans discounted at a current borrowing rate.

S135 As indicated in paragraph 11 of the AASB's submission on the DP, the DP does not explore the possibility that a single measurement basis (or model) could allow for practical standards-level compromises while providing consistent conceptual direction in improving measurement. Appendix C to the AASB's submission on the DP illustrates how the AASB's preferred measurement model (see paragraph S134 above) might be modified for application in IFRSs without radical changes to those Standards at this stage.

S136 These comments in paragraphs S133 – S135 above are elaborated on in paragraphs 11, 15 and A18 – A26 of the AASB's submission on the DP.

³⁴ More particularly, recognised assets would be measured at the lower of their current cost and recoverable amount. For assets used in sustainable cash-generating operations, current cost would be lower than recoverable amount. Therefore, current cost would generally be the measurement basis used under an operating capability concept of wealth.

³⁵ More particularly, recognised liabilities would be measured according to their least costly mode of extinguishment, which would be determined as the lowest of: (1) the present value of the resources required to fulfil the obligation; (2) the amount that the entity would have to pay to cancel the obligation; and (3) the amount that the entity would have to pay to transfer the obligation to a third party. For financial liabilities such as loans payable, those three amounts should seldom differ significantly. For those non-financial liabilities in respect of which those three amounts differ significantly, the lowest amount would generally be the fulfilment value referred to in (1) above. The fulfilment value of a non-financial liability (such as a performance obligation or a provision) would incorporate the risk-adjusted estimated cash flows for the entity to fulfil the obligation, reflecting the entity's likely mode of fulfilling the obligation (i.e. using contractors, internal resources or a combination of both). In that sense, the current cost of a liability would be the current cost of the assets the entity expects to consume in extinguishing the liability, or (e.g. in relation to financial liabilities) an amount that does not differ significantly from the current cost of those assets.

(c) Considering what information a measurement would produce in both the statement of financial position and the statement(s) of profit or loss and OCI

S137 The AASB is unsure of the underlying purpose of Question 11(c). The AASB notes that, on the face of it, Question 11(c) rephrases the measurement objective referred to in Question 11(a). Therefore, the AASB questions whether a different question is really being asked in Question 11(c). The AASB's comments in paragraphs S138 – S140 below address the literal wording of Question 11(c) and not any different question. The AASB's comments in paragraphs S141 – S144 below address the question the AASB thinks is possibly, although not literally, being asked in Question 11(c).

S138 In relation to the preliminary view in paragraph 6.35(c) of the DP that, when selecting the measurement [basis] to use for a particular item, the IASB should consider what information that measurement will produce in both the statement of financial position and the statement(s) of profit or loss and OCI, the AASB considers that an ideal concept of wealth would, if applied at a standards level:

- (a) result in the provision of useful information for assessing the entity's assets, liabilities, equity, income and expenses—as reported in the statement of financial position and the statement(s) of profit or loss and OCI³⁶ (this view is consistent with the AASB's agreement with the measurement objective in the preliminary view in paragraph 6.35(a) of the DP, noted in paragraph S129 above); and
- (b) identify the measurement basis (bases) that provides the most useful information for predicting the entity's future cash flows. Information useful for this purpose is provided in both the statement of financial position and the statement(s) of profit or loss and OCI.

S139 One of the key benefits of identifying an ideal concept of wealth—which the AASB advocates in paragraph 14 of its submission on the DP—is that the measurement of recognised assets and liabilities (and thus equity) and of changes in recognised assets and liabilities (including income and expenses) would be coherent. This would avoid the concern expressed in paragraph 6.15 of the DP, which Question 11(c) seems to address, that “Selecting measurements by considering either the statement of financial position alone or the statement(s) of profit or loss and OCI alone will not usually produce the most relevant information for users of financial statements.”

S140 The AASB does not rank either the statement of financial position or the statement(s) of profit or loss and OCI as more important than the other. Consistent with this, the AASB considers that adopting operating capability as an ideal concept of wealth and thus generally measuring assets at their current cost (as noted in paragraph S134 above) would yield the benefits of an ideal concept of wealth mentioned in paragraphs S138(a) and S138(b) above in relation to information in

³⁶ In making this comment, the AASB is not expressing a view on whether profit or loss and OCI should be reported separately, or, in particular, reported separately in the manner discussed in Section 8 of the DP. The AASB's comments on those aspects are provided separately in paragraphs S212 – S233 below.

both the statement of financial position and the statement(s) of profit or loss and OCI. In that regard, paragraph B128 of Appendix B to the AASB's submission on the DP illustrates the ways in which measuring assets at their current cost would provide useful information to investors and creditors.

S141 Rather than the literal meaning of Question 11(c), to which paragraphs S138 – S140 above respond, the question the AASB thinks is possibly being asked by Question 11(c) is whether either or both of the following propositions is agreed with:

- (a) in some circumstances, a particular measurement basis that provides useful information about an asset or a liability (e.g. a current market price) should not be identified as conceptually appropriate because it does not provide useful information in the statement(s) of profit or loss or OCI (e.g. because changes in that current market price would result in excessive volatility in income or expense, whether recognised in profit or loss or in OCI); or
- (b) in some circumstances, an entity should “[use] one measure in the statement of financial position and [use] a different measure to determine the amounts recognised in profit or loss (presenting the difference between the two measures in OCI)” [paragraph 6.76(b) of the DP]. The difference between the two measures would be a ‘bridging item’ recognised in OCI under paragraphs 8.55 – 8.60 of the DP.

S142 An example of where the issue in paragraph S141(a) above potentially arises is the DP's discussion of the subsequent measurement of assets held for use. Regarding assets held for use, paragraph 6.79 of the DP emphasises the relevance (in the IASB's view) of (historical) cost-based measurements in respect of the amounts of income and expenses reported, without explicitly commenting on whether (historical) cost-based measurements are relevant for measuring such assets in the statement of financial position. Paragraph 6.79 of the DP could be construed as indicating that, regardless of how relevant current market prices might be for measuring such assets in the statement of financial position, the greater relevance (in the IASB's view) of historical cost than current market prices to the measurement of income and expenses means historical cost should be adopted as the measurement basis for such assets in both the statement of financial position and the statement(s) of profit or loss and OCI.

S143 An example of where the issue in paragraph S141(b) above potentially arises is, as described in paragraph 8.57 of the DP, where specified debt instruments are measured at fair value in the statement of financial position, but measured at amortised cost to determine the amounts recognised in profit or loss (with the difference being treated as a ‘bridging item’ recognised in OCI).

S144 The AASB would disagree with the proposition implicit in either of the possible questions in paragraphs S141(a) and S141(b) above. In relation to those paragraphs, the AASB considers that the same measurement basis should be used for an asset or a liability recognised in the statement of financial position and changes in that asset or liability recognised in the statement(s) of profit or loss and OCI. Any

implications of remeasurements of assets or liabilities for assessing the entity's financial performance should be dealt with as matters of presentation and disclosure, within a presentation approach to income and expenses that (as advocated in paragraph A48 of the AASB's submission on the ED) is based on a multi-faceted disaggregation of those elements. Thus, the implications of a measurement basis for reporting aspects of financial performance should not, in concept, preclude adopting a relevant measurement basis for the statement of financial position. In addition, as indicated in paragraph A63 of Appendix A to its submission on the DP, the AASB strongly disagrees with adopting the concept of 'bridging items'.

S145 The AASB also considers it is not apparent how the lead-in of paragraph 6.35 of the DP relates to the preliminary view in paragraph 6.35(c). That is, it is not apparent to the AASB how consideration of the objective of financial reporting and the qualitative characteristics led to that preliminary view. The AASB considers there should be a clear articulation of the progression from the objective of financial reporting and the qualitative characteristics to the preliminary view in paragraph 6.35(c) of the DP.

(d) How investors, creditors and other lenders are likely to assess how an asset or liability of that type will contribute to future cash flows

S146 As mentioned in paragraph S129 above, the AASB considers that a key objective of measurement concepts should be to identify the measurement basis (bases) that provides the most useful information for predicting the entity's future cash flows. In that context, the AASB agrees, but only in a very limited sense (see paragraphs S148 – S149 below) with the preliminary view in paragraphs 6.16 and 6.35(d) of the DP, as reproduced in Question 11(d), that:

“the relevance of a particular measurement will depend on how investors, creditors and other lenders are likely to assess how an asset or a liability of that type will contribute to future cash flows. Consequently, the selection of a measurement:

- (a) for a particular asset should depend on how that asset contributes to future cash flows; and
- (b) for a particular liability should depend on how the entity will settle or fulfil that liability.”

S147 Under the AASB's preferred concept of wealth (operating capability), assets and liabilities are generally measured at current cost (see paragraph S134 above). In relation to the preliminary view quoted in paragraph S146 above:

- (a) whilst the current costs of assets do not explicitly measure the cash inflows those assets would generate, those measures are considered by the AASB to be the most useful to users for making predictions of the entity's future cash flows (for an elaboration, see paragraphs 17, B119 and B128 of the AASB's submission on the DP); and

- (b) the current costs of liabilities explicitly reflect the cash outflows (or other consumptions of resources) expected to be incurred in extinguishing³⁷ those liabilities using the least costly mode of extinguishment. Those cash outflows (or other resource consumptions), in turn, reflect *how* the entity expects to extinguish the liability, subject to the constraints mentioned in the footnote to paragraph S134(b) above.

S148 However, the AASB notes that, in illustrating the preliminary view quoted in paragraph S146 above, paragraphs 6.16(a) and 6.16(b) of the DP indicate that “how an asset or a liability ... will contribute to the entity’s future cash flows” includes whether assets contribute *directly* or *indirectly* to the entity’s future cash flows. As indicated in paragraphs 19 and B90 of its submission on the DP, the AASB strongly disagrees with the statements in paragraphs 6.16, 6.78 – 6.80 and 6.83 of the DP that the selection of a measurement for a particular asset should differ according to whether that asset is expected to contribute *directly* or *indirectly* to the generation of future cash flows. This view of the AASB is articulated in more detail in the AASB’s comments on parts (a), (b) and (d) of Question 12 on the DP (see paragraphs S156 – S165 below), because views on the pertinence of whether an asset is expected to contribute *directly* or *indirectly* to the entity’s future cash flows to the identification of a relevant measure of that asset are explicitly sought in those parts of Question 12.

S149 In addition, the AASB notes that the reason for the preliminary view in paragraph 6.35(d) of the DP that “the selection of a measurement for a particular liability should depend on how the entity will settle or fulfil that liability” is given (in paragraph 6.16(c) of the DP) that “current market prices may not provide the best indication of the ultimate cash outflows arising from the liability”³⁸. That reason seems to focus on whether to use current market prices or historical (amortised) cost to measure liabilities. In contrast, although (as indicated in paragraph S147(b) above), the AASB’s preferred measurement basis for liabilities (i.e. current cost) reflects how the entity expects to extinguish (settle or fulfil) its liabilities using the least costly mode of extinguishment, reflecting that aspect is pertinent to which current market prices (entry or exit) to use to measure liabilities, and not whether to use current market prices or historical (amortised) cost to measure liabilities. As is indicated in paragraphs 18 and A34 of its submission on the DP, the AASB considers that historical cost (or amortised historical cost) is not in concept a relevant measurement basis for assets or liabilities.

(e) The number of different measurements used

S150 The AASB disagrees with the preliminary view in paragraph 6.35(e) of the DP because it considers that identifying an ideal concept of wealth (see paragraph S130(b) above) should render redundant the question of how many measurement bases might be appropriate. Identifying an ideal concept of wealth would limit the number of measurement bases to very few. Some concepts of

³⁷ This Paper uses ‘extinguish’ to encompass the terms ‘settle or fulfil’ used in paragraph 6.35(d) of the DP.

³⁸ Paragraph 6.16(c) of the DP gives an example of current market prices for a non-derivative liability with fixed cash flows varying even though the expected cash flows do not.

wealth (for example, operating capability) can involve more than one measurement basis. Provided the concept of wealth is coherent, it should not matter how many measurement bases its adoption would entail.

- S151 Paragraph 6.23 of the DP says the reason for the preliminary view in paragraph 6.35(e) of the DP that: “the number of different measurements used should be the smallest number necessary to provide relevant information” is that: “The more measurements that are used ... the harder it is to understand how those measurements interact to depict the entity’s financial position and financial performance.” The AASB has the following concerns with this reason for the preliminary view (and, therefore, with the preliminary view itself):
- (a) it implies understandability is a constraint on the reporting of information that meets the fundamental qualitative characteristics of relevance and faithful representation, although Chapter 3 of the IASB Conceptual Framework makes no such statement (i.e. Chapter 3 of the IASB Conceptual Framework describes understandability as an *enhancing* characteristic);
 - (b) it implies information is not understandable, or is less understandable, if it is difficult to understand. This implies the enhancing qualitative characteristic of understandability is ‘easy to understand’, which is a higher threshold than that used in Chapter 3 of the IASB Conceptual Framework. In contrast, the Basis for Conclusions on that Chapter says:
 - “understandability ... enables users to comprehend the information and therefore make it useful for making decisions.” (paragraph BC3.40); and
 - “Classifying understandability as an enhancing qualitative characteristic is intended to indicate that information that is difficult to understand should be presented and explained as clearly as possible.” (paragraph BC3.42);
 - (c) measurements interact best to depict the entity’s financial position and financial performance if they reflect an ideal concept of wealth and an ideal concept of economic income (see the comments in paragraphs A29 – A30 in Appendix A to the AASB’s submission on the DP). However, the DP does not propose identifying an ideal concept of wealth and an ideal concept of economic income; and
 - (d) paragraph 4.25 of the DP sets out a preliminary view that, as an exception to the preliminary view in paragraph 4.24 that an entity should recognise all its assets and liabilities, “the *Conceptual Framework* should state that the IASB might decide in developing or revising particular Standards that an entity need not, or should not, recognise an asset or a liability ... (b) if no measure of the asset (or the liability) would result in a faithful representation of the asset (or the liability) and of changes in the asset (or the liability), *even if all necessary descriptions and explanations are disclosed*” (emphasis added). The AASB thinks that, for consistency with the implication in paragraph 4.25 of the DP that all necessary descriptions and explanations

should be disclosed in order to enable an item to meet the fundamental qualitative characteristic of faithful representation, all necessary descriptions and explanations should be provided before concluding that assets or liabilities measured on a particular basis should not be recognised or disclosed.

S152 Having regard to the concerns in paragraph S150 above, the AASB also considers it is not apparent how the lead-in of paragraph 6.35 of the DP relates to the preliminary view in paragraph 6.35(e). That is, it is not apparent to the AASB how consideration of the objective of financial reporting and the qualitative characteristics led to that preliminary view. The AASB considers there should be a clear articulation of the progression from the objective of financial reporting and the qualitative characteristics to the preliminary view in paragraph 6.35(e) of the DP.

(f) The benefits and costs of a particular measurement

S153 Whilst the AASB agrees with the DP discussing (in paragraphs 6.30 – 6.34) how the cost constraint might be applied when choosing measurement concepts, the AASB disagrees with reiterating the cost constraint as a preliminary view in paragraph 6.35(f) of the DP, given that the cost constraint applies to all financial information by virtue of Chapter 3 of the IASB Conceptual Framework. To be consistent, it would seem logical to state that a particular measurement needs to meet each of the qualitative characteristics of financial information, and to name each of those characteristics—however, the AASB would consider this unnecessary. In addition, explicitly referring to the cost constraint (but not each of the qualitative characteristics) in the preliminary views on measurement might be construed as indicating the IASB considers the cost constraint to be a more important consideration than the qualitative characteristics. The AASB would not support such a message.

S154 The AASB also considers it is not apparent how the lead-in of paragraph 6.35 of the DP relates to the preliminary view in paragraph 6.35(f). That is, it is not apparent to the AASB how consideration of the objective of financial reporting and the qualitative characteristics led to that preliminary view. The AASB considers there should be a clear articulation of the progression from the objective of financial reporting and the qualitative characteristics to the preliminary view in paragraph 6.35(f) of the DP.

Question 12

The IASB's preliminary views set out in Question 11 have implications for the subsequent measurement of assets, as discussed in paragraphs 6.73–6.96 of the Discussion Paper. The IASB's preliminary views are that:

- (a) if assets contribute indirectly to future cash flows through use or are used in combination with other assets to generate cash flows, cost-based measurements normally provide information that is more relevant and understandable than current market prices.
- (b) if assets contribute directly to future cash flows by being sold, a current exit price is likely to be relevant.
- (c) if financial assets have insignificant variability in contractual cash flows, and are held for collection, a cost-based measurement is likely to provide relevant information.
- (d) if an entity charges for the use of assets, the relevance of a particular measure of those assets will depend on the significance of the individual asset to the entity.

Do you agree with these preliminary views and the proposed guidance in these paragraphs? Why or why not? If you disagree, please describe what alternative approach you would support.

S155 The AASB strongly disagrees with these preliminary views in Question 12. The AASB's specific response to parts (a) – (d) of the question is set out integrally in paragraphs S156 – S168 below, with grouping of comments in common to some parts of the question.

(a), (b) & (d) How assets contribute to future cash flows

S156 The AASB's comments in paragraphs S157 – S165 below relate collectively to parts (a), (b) and (d) of Question 12 on the DP.

S157 As indicated in paragraphs 19, A33 and B90 of its submission on the DP, the AASB strongly disagrees with the manner in which paragraphs 6.16, 6.78 – 6.80 and 6.83 of the DP elaborate on the preliminary view in paragraph 6.35(d)(i) of the DP that “the selection of a measurement for a particular asset should depend on how that asset contributes to future cash flows”. Those paragraphs with which the AASB strongly disagrees state that the selection of a measurement for a particular asset should differ according to whether that asset is expected to contribute *directly* or *indirectly* to the generation of future cash flows. In particular, the AASB strongly disagrees with the preliminary views in those paragraphs that:

- (a) if assets contribute directly to future cash flows by being sold, a current exit price is likely to be relevant; but
- (b) if assets contribute indirectly to future cash flows through use or are used in combination with other assets to generate cash flows, (historical) cost-based

measurements³⁹ normally provide information that is more relevant and understandable than current market prices.

S158 As indicated in paragraphs 18 and A34 of its submission on the DP, the AASB considers that, in concept, current values of assets and liabilities would always be more useful than historical cost measurements for meeting the ‘resource allocation decision’ objective of financial reporting. (Paragraph A36 of the AASB’s submission notes examples of findings in academic studies that current values provide more relevant information than historical costs for predicting an entity’s future cash flows.) Therefore, the AASB fundamentally disagrees with preliminary views in paragraphs 6.16(b) and 6.79 – 6.80 of the DP that it would provide more relevant information to measure on an historical cost basis assets held to generate cash flows in a particular manner.

S159 These comments in paragraphs S157 – S158 above are elaborated on in paragraphs 19 and B90 – B125 of the AASB’s submission on the DP.

Characterisation of inventories as ‘held for use’

S160 In addition to the comments in the AASB’s submission on the DP referred to in paragraph S159 above, an example of why the AASB considers the preliminary views in paragraphs 6.16, 6.78 – 6.80 and 6.83 of the DP to be conceptually flawed is that inventories seem to be arbitrarily classified as ‘held for use’ rather than ‘held for sale’. This concern is elaborated on in paragraphs S161 – S164 below.

S161 Paragraph 6.80 of the DP says that, although inventories will be sold, they are similar to assets that are used, in that they cannot generate cash flows independently of the other assets of the entity. Paragraph 6.80 asserts (historical) cost-based measurement is more relevant for inventories than for assets that will be sold. Under that argument, inventories would be measured consistently with assets held for use, which paragraph 6.79 of the DP argues should be measured at (historical) cost. One of the arguments in paragraph 6.80 of the DP for (historical) cost-based measurement of inventories is that, unlike with the sale of most commodities or financial instruments, the sale of inventories usually requires the seller to undertake significant activities to locate purchasers [paragraph 6.80(a)]. The AASB rejects that argument because:

- (a) differences in the extent of selling activities required for different types of inventory are often a matter of degree, depending on such matters as whether inventory is specialised or generic, the significance of existing customer relationships, and the extent of market competition;
- (b) regardless of the amount of selling effort required, the cash inflows from sales of inventories seem to be direct; the need to incur cash outflows in generating those cash inflows does not seem to affect the direct nature of those cash inflows;

³⁹ As explained in paragraphs B93 – B99 (particularly paragraph B98) of Appendix B to the AASB’s submission on the DP, the AASB construes references in the DP to ‘cost-based measurements’ as meaning historical cost.

- (c) in relation to the issue in (b) immediately above, it is unclear whether significant activities to locate purchasers – which are cited in paragraph 6.80(a) of the DP as a reason for (historical) cost-based measurement of inventories – would be considered by the IASB to occur if an entity sells inventories through an agent and:
 - (i) the inventories remain controlled by the entity until sold by the agent (i.e. as at the reporting date, the agent has yet to locate purchasers in relation to the entity’s own inventories); and
 - (ii) the entity pays significant amounts of sales commissions.

Some might consider that, because the agent – rather than the entity – locates purchasers of the entity’s inventories, there are no significant activities yet to be performed by the entity and therefore the inventories should be treated as directly generating cash inflows (i.e. measured consistently with traded commodities, as assets ‘held for sale’). Others might consider that, because the entity has yet to incur significant amounts of sales commissions, its inventories should be treated as indirectly generating cash inflows. They would probably consider that paying employees and paying agents in the future to locate purchasers are substantially the same actions, and therefore that inventories should be classified the same way for measurement purposes, regardless of whether they are sold by employees or agents. The AASB considers that this issue illustrates that classifying cash inflows from sales of inventories as ‘direct’ or ‘indirect’ according to the amount of selling effort required, and basing the measurement of inventories on that distinction, does not seem to be a robust measurement principle; and

- (d) it does not seem to be applied consistently in the DP. That is, paragraph 6.83 of the DP indicates that physical assets, other than inventories, that will be sold should be measured consistently with other assets held for sale, even though their sale might require significant activities to locate purchasers (which, as noted earlier in this paragraph, is an argument used in paragraph 6.80(a) of the DP for not measuring inventories consistently with assets held for sale).

S162 The other reason given in paragraph 6.80 of the DP for (historical) cost-based measurement of inventories is that using current market selling prices could obscure information about the entity’s margins on recurring sales of inventories [see paragraph 6.80(b)]. As indicated in paragraphs B93 – B99 of Appendix B to its submission on the DP, the AASB is concerned that the DP appears to treat current market selling price as the only alternative to (historical) cost-based measurements worth considering. As noted in paragraph S134 above, the AASB considers that current cost would generally be the most relevant basis on which to measure assets and liabilities. When inventories are measured at current cost, the concern expressed in paragraph 6.80(b) of the DP about the loss of information about the entity’s sales margins should not arise. As indicated in paragraphs 17, B117 – B125 and B128 – B130 of its submission on the DP, the AASB considers that current

margins (i.e. the margins between current income and related expenses measured using current input costs) are considerably more relevant for predicting an entity's future margins than are margins based on historical cost measurements of expenses, regardless of whether the assets consumed in generating that income contributed *directly* to the generation of cash inflows by the entity.

- S163 The AASB acknowledges that the 'held for use' category of assets discussed in paragraphs 6.79 – 6.82 of the DP includes "assets [that] contribute indirectly to future cash flows by being used in ... delivering assets or services that the entity sells" (paragraph 6.78 of the DP). Because inventories are consumed in delivering assets or services to customers, they qualify as 'held for use' assets under that quoted description. However, as a consequence, the distinction between 'held for sale' assets (which paragraph 6.83 of the DP argues should ideally be measured at a current exit price, perhaps after deducting costs to sell) and 'held for use' assets (which, as mentioned in paragraph S161 above, the DP says should be measured at historical cost), seems to lack meaning or substance. Paragraphs 6.78 – 6.85 of the DP seem to imply that the sale of assets generates cash inflows directly but the delivery of assets or services to customers does not, even though the delivery of assets or services is necessary to complete a sale. This seems a very narrow (and, arguably, non-substantive) distinction on which to base significantly different conclusions regarding whether assets should be measured on an historical cost basis or at current market selling prices⁴⁰.
- S164 The AASB agrees with the implication of paragraphs 6.80 – 6.81 of the DP that, in concept, inventories should not be measured at their current market selling prices. However, this agreement is based on a different reason than those provided in paragraphs 6.80 – 6.81 of the DP. That is, it is based on the AASB's view that an operating capability concept of wealth would be conceptually ideal (and, thus, assets should in concept generally be measured at their current market buying price), and not because of how inventories are classified as either *directly* or *indirectly* contributing to the generation of future cash flows by the entity.

Additional comments on Question 12(d): Assets the use of which the entity charges for

- S165 In relation to paragraph 6.94 of the DP, it is unclear to the AASB why the measurement basis considered most relevant in concept for assets held for charging others to use them should depend (in part) on the number of low-value assets composing that category of assets. The AASB acknowledges that, potentially, the greater the number of assets measured using current market prices, the greater the cost of measuring those assets. However, the AASB thinks addressing that cost is a standards-level assessment that should not be considered in identifying the conceptually ideal measurement basis for this category of assets (i.e. 'charge-for-use assets'). Similarly, the AASB notes that holding a large number of low-value assets might cause some of those assets not to warrant being revalued, because such revaluations would be immaterial. Again, the AASB thinks considerations of applying the concept of materiality do not belong in a Conceptual Framework.

⁴⁰ See the comment in paragraph S162 above regarding the DP appearing to treat current market selling prices as the only alternative to (historical) cost-based measurements worth considering.

(c) Financial assets that have insignificant variability in contractual cash flows and are held for collection

- S166 The AASB strongly disagrees with the preliminary view in paragraphs 6.87 – 6.88 of the DP that, if financial assets have insignificant variability in contractual cash flows, and are held for collection, a cost-based measurement is likely to provide relevant information about them (as mentioned in the footnote to paragraph S157(b) above, the AASB construes references to ‘cost-based measurement’ to mean historical cost-based measurement). This strong disagreement arises primarily because, as indicated in paragraph S131(b) above, the AASB considers that, in concept, for any assets or liabilities, (historical) cost-based measurements provide less useful information for investors and creditors than current market prices (particularly current market buying prices).
- S167 Paragraphs 6.87 – 6.88 of the DP argue the preliminary view referred to in paragraph S166 above, saying that, for financial assets that have insignificant variability in contractual cash flows and are held for collection, cost-based interest income, along with bad debt expense as estimated by management, is likely to provide relevant information about the effective yield and collectability of those financial assets. However, the AASB considers that measuring such financial assets at current market entry prices would lose none of that information value and would have the advantage of providing current measures of effective yield and collectability.
- S168 See also paragraphs S183 – S184 below in the comments on Question 14(b), regarding the significance of the variability of returns to how financial assets would be measured under the AASB’s preferred concept of wealth. The AASB’s view that current values (specifically, measurement bases that represent operating capability) are, in concept, more relevant than historical cost applies to all assets and liabilities and reflects the AASB’s focus on coherent application of its preferred concept of wealth, which is not dependent on whether contractual (or other) cash flows have significant variability.

Question 13

The implications of the IASB's preliminary views for the subsequent measurement of liabilities are discussed in paragraphs 6.97–6.109 of the Discussion Paper. The IASB's preliminary views are that:

- (a) cash-flow-based measurements are likely to be the only viable measurement for liabilities without stated terms.
- (b) a cost-based measurement will normally provide the most relevant information about:
 - (i) liabilities that will be settled according to their terms; and
 - (ii) contractual obligations for services (performance obligations).
- (c) current market prices are likely to provide the most relevant information about liabilities that will be transferred.

Do you agree with these preliminary views and the proposed guidance in these paragraphs? Why or why not? If you disagree, please describe what alternative approach you would support.

(a) Liabilities without stated terms

Cash-flow-based measurements

S169 The AASB thinks the revised IASB Conceptual Framework should not include the preliminary view in paragraph 6.99 of the DP that cash-flow-based measurements are likely to be the only viable measurement for liabilities without stated terms. This is because the AASB considers that:

- (a) measurement concepts for all liabilities should, consistent with the comment in paragraph S130(b) above, be based on an identified ideal concept of wealth. Consequently, whether particular liabilities have stated terms should not affect the fundamental measurement concepts for those liabilities; and
- (b) 'cash-flow-based measurements' refer to measurement techniques; practical issues regarding a lack of 'stated terms' for some liabilities (and the measurement techniques that should address those practical issues) should be addressed at a standards level only.

S170 In addition, the AASB has the following concerns about the preliminary view referred to in paragraph S169 above and the related discussion in paragraphs 6.51 – 6.54 and 6.110 – 6.130 of the DP. These concerns relate to the general role of 'cash-flow-based measurements' and the application of such measurements to liabilities without stated terms (referred to in paragraph 6.99 of the DP) and contractual liabilities with stated terms but highly uncertain settlement amounts (referred to in paragraph 6.100 of the DP).

General role of ‘other cash-flow-based measurements’

- S171 The AASB considers the measurement category of ‘other cash-flow-based measurements’⁴¹ referred to in paragraph 6.3(b)(iii) of the DP to be potentially confusing when set in contrast to the other categories in paragraph 6.3(b). Putting cash-flow-based measurements on an apparently equal ranking with cost, fair value and other current market prices seems inappropriate because discounted cash flows may be used to estimate fair value (using the ‘income approach’ in IFRS 13 *Fair Value Measurement*) or other current market prices. It seems important to separate the discussion of measurement bases (such as historical cost, current cost and fair value/current market selling price) from any discussion about measurement techniques or methods (such as discounted cash flows). An example of the lack of clarity of the DP’s discussion of cash-flow-based measurements is the discussion of financial assets and financial liabilities in paragraph 6.44 of the DP. The second sentence of paragraph 6.44 of the DP says “amortised cost measurement used for financial assets and financial liabilities could equally well be described as a cash-flow-based measurement ...”. This concern of the AASB about putting cash-flow-based measurements on an apparently equal ranking with cost, fair value and other current market prices is an example of the comment in paragraph 11 of the AASB’s submission on the DP that the DP “inappropriately elevate[s] measurement methods to the status of measurement attributes”.
- S172 In relation to the concern outlined in paragraph S171 above, the AASB notes that some commentators have criticised the existing IASB Conceptual Framework (paragraph 4.55) for treating ‘present value’ as a measurement basis [in addition to ‘historical cost’, ‘current cost’ and ‘realisable (settlement) value’]. The AASB notes that giving the above-mentioned category of ‘other cash-flow-based measurements’ the same ranking as cost, fair value and other current market prices would give rise to the same problem.
- S173 Paragraph 6.52 of the DP generally indicates that ‘cash-flow-based measurements’ are used when neither cost nor a current market price is appropriate or obtainable without excessive cost. However, paragraphs 6.110 – 6.130 of the DP indicate that ‘other cash-flow-based measurements’ might be determined in different ways (i.e. potentially based on a selection of various factors noted in paragraph 6.112). Because the overall nature of ‘other cash-flow-based measurements’ is not defined in the DP, the AASB is concerned that the nature of such measurements might not be ascertainable by users of financial statements. The AASB considers it essential that the nature of all measurements of financial statement elements is identifiable by users, and that disclosing the techniques used in a ‘cash-flow-based measurement’ would not be an adequate substitute for disclosing the nature of that measurement.
- S174 The second sentence of paragraph 6.110 of the DP refers to ‘custom-designing’ cash-flow-based measurements to fit a particular asset or liability, and “creat[ing] new measurements in each new Standard”. This raises the spectre of a possible array of new so-called measurement bases or attributes that are:

⁴¹ i.e. cash-flow-based measurements that are neither current market prices nor cost-based (see paragraph 6.51 of the DP).

- (a) not underpinned by an explicit concept of wealth or other broad measurement principle; and
- (b) limited only by the constraint in paragraph 6.110 of the DP that a ‘custom-designed measurement’ [basis/attribute] should be understandable and the resulting preliminary view in paragraph 6.35(e) of the DP (as referred to in Question 11(e) above⁴²) that “the number of different measurements used should be the smallest number necessary to provide relevant information”. The DP does not appear to provide conceptual underpinnings that would assist the IASB to identify relevant ‘custom-designed measurements’ that are the smallest number necessary.

S175 Paragraph 6.122 of the DP notes differences between cash-flow-based measurements in existing IFRSs. The AASB considers that, without an explicitly stated concept of wealth, it would seem infeasible to remove those inconsistencies without resorting to arbitrary rules.

S176 The second sentence of paragraph 6.127 says: “Entity-specific inputs would be relevant for unique and highly uncertain cash flows ...”. This statement about using entity-specific inputs (i.e. an ‘entity perspective’) rather than a ‘market perspective’ to measure an asset or a liability using a cash-flow-based-measurement seems to focus on the nature of available evidence for the estimated cash-flow-based measurement. The AASB thinks that, instead of being based on the availability of evidence, concepts for measurement bases should be ‘objective-based’—e.g. they should reflect a view about whether an ‘entity perspective’ or a ‘market perspective’ would provide the most relevant measure of an asset or a liability, regardless of the nature of the available evidence of that measure. This reflects the AASB’s view that, consistent with IFRS 13 *Fair Value Measurement*, a best estimate of fair value should be treated as fair value regardless of the nature of the available evidence to support that estimate – in other words, the objective of the estimate, rather than its supportability, should determine the nature of the measurement. To clarify this point, the AASB notes that, in its submission dated 19 July 2006 on the IASB Discussion Paper *Measurement Bases for Financial Accounting – Measurement on Initial Recognition* (November 2005), it disagreed with the proposal in that 2005 DP that an estimate of fair value should be treated as a ‘substitute measure’ for fair value (and not as ‘fair value’) in the absence of evidence described in Levels 1 and 2 of the measurement hierarchy proposed in that DP. The AASB is concerned that the above-mentioned comment in paragraph 6.127 of the Conceptual Framework DP, which emphasises the availability of evidence as a criterion for selecting a measurement basis, is more akin to the view in the 2005 DP (that the selection of a measurement basis should not be based only on the objective of the measurement basis) than to the IASB’s conclusion, reflected in IFRS 13, that a best estimate of fair value is fair value regardless of limitations on the evidence supporting that estimate⁴³.

⁴² See the AASB’s comments on that question in paragraphs S150 – S152 above.

⁴³ For the same reason, the AASB disagrees with the words in italics in the following quote from paragraph 6.34 of the DP: “... a highly uncertain estimate will be faithfully represented if it is properly described (for example, *not as a market price but as a highly uncertain estimate of a market price*)”.

Using ‘other cash-flow-based measurements’ for particular liabilities

- S177 The general comments in paragraphs S169 – S176 above also apply to the references to using ‘cash-flow-based measurements’ for particular liabilities in paragraphs 6.99 and 6.100 of the DP. Those references are:
- (a) the third and fourth sentences of paragraph 6.99 of the DP indicate that, for liabilities without stated terms, cost-based measurement is not possible, current market prices are likely to be difficult to determine and a cash-flow-based measurement may be the only possible option; and
 - (b) similarly, paragraph 6.100 of the DP indicates that, for some types of contractual liabilities with stated terms but highly uncertain settlement amounts, cost-based measurement is unlikely to provide relevant information, current market prices may be difficult to determine and a cash-flow-based measurement may provide the most relevant information.
- S178 In view of the undefined nature of ‘cash-flow-based measurements’ in Section 6 of the DP, the nature of the ‘cash-flow-based measurements’ referred to in paragraphs 6.99 and 6.100 of the DP is unclear. For the reasons in paragraphs S169 – S177 of this paper (and the sentence immediately above), the AASB considers that putting ‘cash-flow-based measurements’ (measurement techniques) on an apparently equal ranking with measurement bases, and apparently omitting to identify the measurement basis for liabilities without stated terms, is conceptually inappropriate.
- (b) Liabilities that will be settled according to their terms, and contractual obligations for services**
- S179 The AASB disagrees with the preliminary view in paragraphs 6.103 and 6.108 of the DP that an (historical) cost-based measurement will normally provide the most relevant information about liabilities that will be settled according to their stated terms and contractual obligations for services (performance obligations). As indicated in paragraph S131 above, the AASB considers that:
- (a) operating capability is the concept of wealth most useful for achieving the objective of financial reporting, including the provision of information useful for predicting the entity’s future cash flows; and
 - (b) historical cost-based measurements would not achieve the objective that measurements should provide the most useful information for predicting the entity’s future cash flows, except when those measurements do not differ materially from current market entry prices.

The AASB considers that measurement uncertainties should be disclosed when relevant to users of financial statements, but that those uncertainties do not change the nature of the measurement basis adopted.

S180 Consistent with the AASB view reiterated in paragraph S179 above, the AASB considers that all liabilities should, in concept, be measured at their current cost (see also paragraphs 14 – 18 of the AASB’s submission on the DP).

(c) Liabilities that will be transferred

S181 The AASB disagrees with the preliminary view in paragraph 6.107 of the DP that current market prices are likely to provide the most relevant information about liabilities that will be transferred. This is because:

- (a) as mentioned in paragraph S162 above, the AASB is concerned that the DP appears to treat current market selling price as the only alternative to (historical) cost-based measurements worth considering. In the context of liabilities, the AASB construes the reference in paragraph 6.107 of the DP to ‘current market prices’ as referring to the exit prices (i.e. transfer prices) of the liabilities in question;
- (b) as indicated in paragraph S180 above, the AASB considers that all liabilities should, in concept, be measured at their current cost (rather than, for example, at their transfer prices: see (a) immediately above); and
- (c) the above-mentioned preliminary view in paragraph 6.107 of the DP seems to make the measurement of liabilities “that will be settled by transfer” dependent on management intentions regarding the mode of settlement – the AASB considers instead that measurement bases should reflect an ideal concept of wealth. In addition, the reference in paragraph 6.107 of the DP to liabilities “that *will* be settled by transfer” (emphasis added) seems to presume that entities will know, at the reporting date, the manner in which liabilities will be settled after that date. The AASB observes that this might not be known by the date when the financial statements are authorised for issue, in which case entities would need to predict how the liability will be settled.

S182 The AASB also notes that the rationale for the preliminary view in paragraph 6.107 of the DP that current market prices are likely to provide the most relevant information about liabilities that will be transferred seems inconsistent with the rationale for the preliminary view in paragraph 6.108 of the DP that an (historical) cost-based measurement will normally provide the most relevant information about contractual obligations for services (performance obligations). This is because:

- (a) paragraph 6.107 of the DP argues that a current market price (with or without adjustment for transaction costs) is the most relevant measure of a liability that will be settled by transfer because it is an estimate of the cash that will be paid to settle the liability (based on that liability’s mode of settlement); but
- (b) paragraph 6.108 of the DP argues that an (historical) cost-based measurement will normally provide the most relevant information about performance obligations because of the alleged relevance of margins on historical cost for predicting future margins. However, there is not a direct

connection between the historical cost of a performance obligation and the amount of cash that will be paid to settle the performance obligation. Therefore, if the rationale referred to in (a) immediately above were applied to performance obligations, it seems a different preliminary view than that set out in paragraph 6.108 of the DP would be warranted.

Question 14

Paragraph 6.19 of the Discussion Paper states the IASB’s preliminary view that for some financial assets and financial liabilities (for example, derivatives), basing measurement on the way in which the asset contributes to future cash flows, or the way in which the liability is settled or fulfilled, may not provide information that is useful when assessing prospects for future cash flows. For example, cost-based information about financial assets that are held for collection or financial liabilities that are settled according to their terms may not provide information that is useful when assessing prospects for future cash flows:

- (a) if the ultimate cash flows are not closely linked to the original cost;
- (b) if, because of significant variability in contractual cash flows, cost-based measurement techniques may not work because they would be unable to simply allocate interest payments over the life of such financial assets or financial liabilities; or
- (c) if changes in market factors have a disproportionate effect on the value of the asset or the liability (ie the asset or the liability is highly leveraged).

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

S183 The AASB agrees that (historical) cost-based information about the financial assets and financial liabilities with the features referred to in sub-paragraphs (a) – (c) of Question 14 (e.g. derivatives) [would⁴⁴] not provide information that is useful when assessing prospects for future cash flows. However, the AASB considers that (historical) cost-based measurements of any assets or liabilities would provide less useful information than current values (particularly, as indicated in paragraph S134 above, current costs) for assessing the entity’s prospects for future cash flows. This reflects the AASB’s focus on coherent application of its preferred concept of wealth (i.e. operating capability), which is not affected by the factors identified in sub-paragraphs (a) – (c) of Question 14.

S184 As indicated in paragraph A17(b) of Appendix A to the AASB’s submission on the DP, the AASB observes that the preliminary view that the measurement of financial assets held for collection should significantly depend on the degree of variability of the contractual cash flows (paragraphs 6.19 and 6.89(a) of the DP) contradicts the preliminary view that the measurement of a particular asset should differ according to whether that asset is expected to contribute directly or indirectly to the generation of future cash flows (paragraphs 6.16, 6.78 – 6.80 and 6.83 of the DP) and thus indicates a lack of robustness of the latter preliminary view.

⁴⁴ Question 14 uses “may”, but the AASB would be more categorical.

S185 Similarly, the AASB observes that the exceptions in paragraph 6.19 of the DP to the preliminary view in paragraph 6.35(d) of the DP that the selection of a measurement for a particular liability (in particular, as noted in paragraph S149 above, the decision whether to measure a liability at historical cost or a current market price) should depend on how the entity will settle or fulfil that liability also indicate a lack of robustness of the latter preliminary view.

Question 15

Do you have any further comments on the discussion of measurement in this section?

Measurement of liabilities under the historical cost basis

S186 The AASB notes that the DP does not clarify the meaning of ‘cost’, and subsequent measurement considerations, in relation to liabilities that are subject to variable or contingent pricing. For example, if a liability subject to variable pricing has previously been recognised, in the IASB’s view, would it represent a departure from the historical cost basis to remeasure the liability for changes in the factor(s) that reprice the liability? The AASB recommends addressing this issue in the process of developing an Exposure Draft (ED) of the Measurement chapter of the revised IASB Conceptual Framework.

S187 In addition, the AASB recommends that the ED mentions that a weakness of the historical cost basis is that it does not cater effectively for liabilities specified to be extinguished with non-cash consideration. The value of non-cash consideration the entity is obliged to sacrifice in extinguishing a liability might change between reporting periods. Arguably, the fair value of the non-cash consideration at the time of initially recognising the liability would be treated as the historical cost of the liability and, under the historical cost basis, would not subsequently be remeasured when the fair value of that non-cash consideration changes⁴⁵. However, measuring a liability at an historical value of non-cash consideration:

- (a) would not provide relevant information about the burden that the liability represents (and its implications for the entity’s future cash flows); and
- (b) arguably would not represent faithfully changes in the entity’s financial position, because the non-cash consideration has a changing value but is measured as if its value were fixed.

⁴⁵ The liability might be remeasured if it becomes ‘onerous’. However, this would be a departure from the strict application of the historical cost concept.

Section 7—Presentation and disclosure

Question 16

This section sets out the IASB's preliminary views about the scope and content of presentation and disclosure guidance that should be included in the *Conceptual Framework*. In developing its preliminary views, the IASB has been influenced by two main factors:

- (a) the primary purpose of the *Conceptual Framework*, which is to assist the IASB in developing and revising Standards (see Section 1); and
- (b) other work that the IASB intends to undertake in the area of disclosure (see paragraphs 7.6–7.8 of the Discussion Paper), including:
 - (i) a research project involving IAS 1, IAS 7 and IAS 8, as well as a review of feedback received on the Financial Statement Presentation project;
 - (ii) amendments to IAS 1; and
 - (iii) additional guidance or education material on materiality.

Within this context, do you agree with the IASB's preliminary views about the scope and content of guidance that should be included in the *Conceptual Framework* on:

- (a) presentation in the primary financial statements, including:
 - (i) what the primary financial statements are;
 - (ii) the objective of primary financial statements;
 - (iii) classification and aggregation;
 - (iv) offsetting; and
 - (v) the relationship between primary financial statements.
- (b) disclosure in the notes to the financial statements, including:
 - (i) the objective of the notes to the financial statements; and
 - (ii) the scope of the notes to the financial statements, including the types of information and disclosures that are relevant to meet the objective of the notes to the financial statements, forward-looking information and comparative information.

Why or why not? If you think additional guidance is needed, please specify what additional guidance on presentation and disclosure should be included in the *Conceptual Framework*.

General comments

S188 As indicated in paragraph S1 above, the AASB disagrees with the preliminary view in the DP that the primary purpose of the *Conceptual Framework* should be to assist the IASB to develop and revise IFRSs. Therefore, the AASB would not support any intention to limit the concepts for presentation and disclosure to those expected to be reflected in requirements of IFRSs, if the IASB were to conclude that some

aspects of presentation and disclosure should not, at any time, be addressed by IFRSs⁴⁶.

Unaddressed issues

S189 The stated purpose of Section 7 of the DP is to identify principles that underlie decision-making by the IASB regarding presentation and disclosure. However, as indicated in paragraphs 20 and A39 – A41 of its submission on the DP, the AASB considers that:

- (a) the section is more a catalogue of existing requirements of IFRSs and recent IASB thinking. For example, whilst paragraph 7.26 of the DP says the IASB believes classification and aggregation into line items and subtotals should be based on similar properties, such as an item's function or nature, or how it is measured, the reasons for identifying these bases for classification and aggregation (and reasons for not identifying other bases) are not provided. Another example is the reference in Table 7.1 on page 143 of the DP to the usefulness of disclosing 'roll-forwards' of line items in the primary financial statements, without an evident rationale in the DP for disclosing those 'roll-forwards'; and
- (b) accordingly, the AASB considers this largely descriptive section would be unlikely to satisfy the demands of users of financial reports for a meaningful disclosure and presentation framework. Nor does it seem sufficient to help the IASB decide how to streamline excessive disclosures and make information more relevant. The AASB considers that, instead of documenting the accounting constructs currently employed, it is important to explain the ways to determine disclosures that more directly and efficiently link with the objective of financial reporting, focusing on the common information needs of users.

S190 As indicated in paragraph A42 of the AASB's submission on the DP, an example of how common information needs of users could be used to better focus presentation and disclosure requirements is given in [AASB Essay 2013-1 Rethinking the Path from an Objective of Economic Decision Making to a Disclosure and Presentation Framework](#) (August 2013). The AASB considers that, as argued in that Essay, there is a gap in the Conceptual Framework between the objective level and the lower levels, which should be filled by identifying the generic types of information about an entity (stocks and flows) that are relevant to users for making decisions about the allocation of scarce resources. Filling that gap is necessary if the Conceptual Framework is to provide a sound conceptual basis for developing better targeted presentation and disclosures that help meet the common information needs of users.

S191 A symptom of the gap in the Conceptual Framework between the objective level and the lower levels is that, in the context of presentation and disclosure, paragraph 7.34 of the DP says:

⁴⁶ The AASB thinks such an intention would seem unlikely. Therefore, it includes this concern for completeness.

- (a) the information provided by the notes to the financial statements needs to help users of financial statements understand the amount, timing and uncertainty of an entity's future net cash inflows; and
- (b) in doing so, it should help users understand how the entity's assets, liabilities, equity, income, expenses, changes in equity and cash flows reflect actions taken by management to discharge their responsibilities to use the entity's assets.

S192 Whilst the above-mentioned statement in paragraph 7.34 of the DP links providing particular information about the elements of financial statements with the overall objective of helping users predict an entity's future cash flows (referred to in paragraph OB3 of the IASB Conceptual Framework), neither paragraph 7.34 nor (apparently) other paragraphs of the DP explain which information about the elements of financial statements should be provided to meet the overall objective. The AASB considers that identifying the generic types of information about an entity (stocks and flows) that are relevant to users for making decisions about the allocation of scarce resources would overcome that concern.

S193 The comments in paragraphs S189 – S192 above are elaborated on in paragraphs 20 – 21 and A39 – A43 of the AASB's submission on the DP.

Terminology: 'disclosure' and 'presentation'

S194 The AASB notes that the DP refers to 'disclosure' and 'presentation', describing 'disclosure' as "the process of providing useful financial information about the reporting entity to users" (paragraph 7.11) and 'presentation' as "the disclosure of financial information on the face of an entity's primary financial statements" (paragraph 7.10). Thus, it seems that the DP treats 'disclosure' as an overarching term.

S195 The AASB considers that, ideally, 'display' should be used as the overarching term encompassing the structure of financial reports, the nature and amount of information shown in financial reports and the manner in which that information is set out. This would complement describing 'presentation' in the same way as paragraph 7.10 of the DP and describing 'disclosure' as the display of information in notes (i.e. complementing information presented on the face of the primary financial statements). The AASB considers that using three terms for the subject matter of Section 7 of the DP (i.e. 'display', 'presentation' and 'disclosure') would have the advantage of providing a term that succinctly and specifically describes being displayed in the notes (and thus is distinct from the more general notion of 'display'). [Despite the AASB's view that three terms should ideally be used for the subject matter of Section 7 of the DP, the other comments on Section 7 in the AASB's submission on the DP and this Supplementary Paper to that submission refer only to 'presentation' and 'disclosure', to avoid confusion.]

S196 In relation to paragraph S195 above, the AASB would support the use of a similar term to 'display': the AASB's more important concern is that three distinct terms are used. The AASB suggests 'display' as an overarching term because it is a plain

English term and, as a term for the revised IASB Conceptual Framework, has less connotations than other terms relating to particular aspects of practice.

Relationship with the IASB's 'Disclosure Initiative' project

S197 As indicated in paragraph 22 of the AASB's submission on the DP, the AASB is concerned that, until the IASB's Disclosure Initiative (including its medium-term research project to review IAS 1, IAS 7 *Statement of Cash Flows* and IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*) is more substantially progressed, it is difficult to gain an overview of the relationship between that work and Section 7 of the DP. The AASB considers it is important to ensure all concepts for presentation and disclosure are set out in the revised IASB Conceptual Framework, even if some of them are also articulated in particular IFRSs as a consequence of the IASB's Disclosure Initiative.

Additional comments on specific aspects

(a) Presentation in the primary financial statements

S198 Paragraph 7.14 of the DP notes the statements that presently compose 'primary financial statements'. However, the DP does not discuss whether additional primary financial statements might be warranted by the information that should, in concept, be presented and disclosed in financial reports. As indicated in paragraph S190 above, the AASB considers that this information should be composed of, or based on, the generic types of information about an entity (stocks and flows) that are relevant to users.

(b) Disclosure in the notes to the financial statements

Forward-looking information

S199 The AASB disagrees with the preliminary view in paragraph 7.39 of the DP that the IASB should require forward-looking information to be included in the notes to the financial statements *only if* it provides relevant information about assets and liabilities that existed at the end of the reporting period or during the reporting period. The AASB considers that limitations should not be placed on presenting or disclosing forward-looking information, in view of the IASB Conceptual Framework:

- (a) defining the objective of general purpose financial reporting as the provision of information useful for investment and credit decisions (paragraph OB2), which are inherently forward-looking; and
- (b) indicating that relevant financial information in general purpose financial reports has predictive value, confirmatory value, or both (paragraphs QC6 – QC7).

S200 The DP does not seem to relate the preliminary view referred to in paragraph S199 above to the objective of general purpose financial reporting; i.e. it does not seem to

explain why some information useful for making assessments about the future in making resource allocation decisions should not be reported in the notes.

S201 The preliminary view referred to in paragraph S199 above:

- (a) seems to imply the requirement to disclose future-oriented information about ‘non-adjusting events after the reporting period’ (as defined in paragraph 3(b) of IAS 10 *Events after the Reporting Period*) would not be conceptually supported. If so, the reason for that view is not apparent to the AASB. An example of a disclosure that apparently would not be conceptually supported under that preliminary view is disclosure of an announcement, after the reporting period, of a plan to discontinue or restructure an operation; and
- (b) potentially also implies disclosure would not be conceptually warranted of information about conditional obligations accompanying unconditional obligations to stand ready to sacrifice economic resources if an uncertain future event occurs. An example of such information is the amount at risk under a conditional obligation to compensate another entity for losses that have not occurred, where that obligation accompanies the reporting entity’s unconditional obligation under a financial guarantee contract. (In identifying this potential implication, the AASB notes that paragraph 7.39 of the DP describes forward-looking information as information about ‘prospects’; i.e. it is very broad.) The amount at risk is not the liability that exists at the end of the reporting period; that liability is the unconditional stand-ready obligation (the amount of which might be measured as the premium for the guarantee).

S202 The AASB considers that the types of information described in paragraphs S201(a) and S201(b) would be relevant to users of financial statements, and therefore the AASB would not agree with implying that disclosure of such information should not be conceptually supported, if that were the IASB’s intention.

S203 The AASB notes that paragraph 7.40 of the DP says “other types of forward-looking information [implicitly, forward-looking information that does not provide relevant information about assets and liabilities that existed at the end of the reporting period or during the reporting period] may provide relevant information and could be presented outside the financial statements, for example, in management commentary if the entity prepares one”. The AASB would not agree with the IASB indicating relevant information should be excluded from a set of financial statements on the grounds that it would be reported in another type of report. The corollary of this AASB comment is that, if information is relevant to report in another form of financial report, it seems illogical to exclude that information from financial statements. The issue of reporting relevant information outside financial statements is commented on more generally in paragraphs S204 – S205 below.

Referring to the presentation of information outside financial statements

- S204 As mentioned in paragraph S203 above, paragraph 7.40 of the DP refers to presenting some relevant information outside the financial statements. The AASB thinks neither the revised IASB Conceptual Framework, nor IFRSs, should include comments that particular disclosures can be provided outside financial statements (with or without a cross-reference from the financial statements). This is because:
- (a) there is no concept driving the physical location of data. The revised IASB Conceptual Framework and IFRSs should focus on the information that should be disclosed, rather than the location of that information;
 - (b) permitting disclosure of required information outside the financial statements may reduce the level of assurance that can be placed on the information, if the information outside the financial statements is not subject to audit. For example, this might occur if standing data available on an entity's website is not subject to periodic audit; and
 - (c) relocating information would not reduce the burden of disclosures on preparers, because the information must still be prepared.
- S205 In addition, the AASB considers it is not the role of the IASB to indicate where disclosures are required or permitted to be located, and that decisions about the location of information should be a matter for standard setters and regulators in each jurisdiction. Whilst the primary focus of the AASB's comments on this issue is the revised IASB Conceptual Framework, the AASB notes in passing that comments in IFRSs that particular disclosure requirements can be met by cross-reference from the financial statements to another source (e.g. comments in paragraph B6 of IFRS 7 *Financial Instruments: Disclosure*) are a potential barrier to incorporating IFRSs in domestic Standards without any amendments to their wording (because, for example, such cross-referencing might be unacceptable to the domestic regulator).

Not necessarily enabling users to recalculate the amounts recognised in the primary financial statements

- S206 The AASB broadly agrees with the comment in paragraph 7.36 of the DP that the objective of disclosure guidance in IFRSs is not to have entities provide information that enables a user of financial statements to recalculate the amounts recognised in the primary financial statements. (However, the AASB suggests clarifying that information relevant for making resource allocation decisions might also be relevant for this purpose—i.e. if the AASB understands correctly the intended point, it would be helpful to indicate that the objective of disclosure guidance in IFRSs is not to have entities provide *all of* the information that would enable users of financial statements to recalculate the amounts recognised in the primary financial statements.) The AASB broadly agrees with that comment because adopting a disclosure objective to provide all of the information that would enable users of financial statements to recalculate the amounts recognised in the primary financial statements would be likely to result in disclosure overload and impair the effectiveness of the financial statements in communicating the 'key messages' about

the economic phenomena affecting the entity. The AASB is concerned that examples of useful disclosures, set out in Table 7.1 on page 143 of the DP, include “description of measurement methodologies, including key assumptions and inputs” and “description and quantification of alternative measurements”. The AASB’s concern in this regard is that, without clarification, those examples of useful disclosures might seem inconsistent with the above-mentioned comment in paragraph 7.36 of the DP.

Question 17

Paragraph 7.45 of the Discussion Paper describes the IASB’s preliminary view that the concept of materiality is clearly described in the existing *Conceptual Framework*. Consequently, the IASB does not propose to amend, or add to, the guidance in the *Conceptual Framework* on materiality. However, the IASB is considering developing additional guidance or education material on materiality outside of the *Conceptual Framework* project.

Do you agree with this approach? Why or why not?

S207 The AASB agrees with the preliminary view in paragraph 7.45 of the DP that the concept of materiality is clearly described in the existing IASB Conceptual Framework and, consequently, the guidance on materiality in the Conceptual Framework should not be amended or added to. The AASB’s comments on whether additional guidance or education material on how to apply the concept of materiality should be developed outside of the Conceptual Framework project will be set out in its submissions on IASB ED/2014/1 *Disclosure Initiative* and any subsequent due process documents dealing with materiality developed as part of the IASB’s Disclosure Initiative.

Question 18

The form of disclosure requirements, including the IASB’s preliminary view that it should consider the communication principles in paragraph 7.50 of the Discussion Paper when it develops or amends disclosure guidance in IFRSs, is discussed in paragraphs 7.48–7.52 of the Discussion Paper.

Do you agree that communication principles should be part of the *Conceptual Framework*? Why or why not?

If you agree they should be included, do you agree with the communication principles proposed? Why or why not?

Disclosure objective

S208 Regarding the preliminary view in paragraph 7.48 of the DP that each Standard with disclosure and presentation requirements should have a clear objective, to guide entities in identifying the best disclosures and presentation to meet the objective, the AASB considers that Standards-based objectives for disclosure and presentation should be developed by the IASB within the context of (higher) conceptual-level purpose-driven disclosure objectives. This is because:

- (a) as indicated in paragraph A42 of the AASB's submission on the DP (see paragraph S190 above), the AASB agrees with the recommendation in [AASB Essay 2013-1](#) to identify the generic types of information about an entity (stocks and flows) that are relevant to users for making decisions about the allocation of scarce resources;
- (b) purpose-driven disclosure and presentational approaches could flow from attempts to faithfully represent those stocks and flows, and help streamline disclosures and make reported information more relevant; and
- (c) if Standards include objectives that scope purpose-driven disclosure and presentational approaches to particular topics, the benefits of identifying the above-mentioned stocks and flows could flow through to each Standard.

S209 If Standards-based objectives for disclosure and presentation are topic-driven (i.e. are not based on broader principles developed from identifying relevant stocks and flows), those objectives would seem likely to:

- (a) be limited to repeating the objective of financial reporting and some or all qualitative characteristics within the context of the topic(s) covered by the Standard; and/or
- (b) refer to specific features of the elements within the scope of the Standard, without (in the absence of purpose-driven objectives) identifying overarching principles that would help entities determine the features most useful to disclose and present to users of financial reports.

S210 Regarding paragraph S209(a) above, if objectives for disclosure and presentation were limited to repeating the objective of financial reporting and some or all qualitative characteristics, those disclosure and presentation objectives would seem unlikely to be sufficiently specific to significantly assist entities in determining disclosure and presentation approaches that would help users in making resource allocation decisions. Regarding paragraph S209(b) above, if objectives for disclosure and presentation were to refer to specific features of the elements within the scope of the Standard, without identifying overarching principles for determining the features most useful to users in making resource allocation decisions, entities' determinations of the features to disclose and present in meeting those objectives would seem likely to be made on an ad hoc basis.

Communication principles

S211 The AASB agrees with the preliminary view in paragraph 7.50 of the DP that communication principles should be part of the revised IASB Conceptual Framework, and broadly agrees with the communication principles proposed in sub-paragraphs (a) – (f) of paragraph 7.50 of the DP. The AASB considers that these communication principles should complement identification of the generic types of information about an entity (stocks and flows) that are relevant to users for making decisions about the allocation of scarce resources (see paragraph S190 above), rather than be regarded as a substitute for identifying those stocks and flows.

Section 8—Presentation in the statement of comprehensive income—profit or loss and other comprehensive income

Question 19

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 of the Discussion Paper.

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?

S212 As indicated in paragraphs 23(a) and 24 of its submission on the DP, the AASB strongly disagrees with the IASB’s preliminary view that comprehensive income should necessarily be bifurcated into profit or loss and other comprehensive income (OCI), and that profit or loss (stripped of items presented in OCI) should be treated as providing the primary source of information about an entity’s return on its economic resources, because:

- (a) the AASB considers it would be conceptually inappropriate to classify continuous variables as if they were discrete. That is, binary classification of economic (‘comprehensive’) income should not be adopted, given the range of ways in which economic income could (and should) be classified with differentiated implications for predicting the entity’s future cash flows;
- (b) the notion of OCI is not part of an integrated theory of presentation of financial performance; and
- (c) the AASB considers that the DP does not establish a coherent principle for determining when it is more relevant to present an item in OCI rather than in profit or loss. Furthermore, it seems unlikely that such a principle could be developed.

S213 The AASB considers that, rather than adopting a binary classification of economic (‘comprehensive’) income, the IASB should develop principles for a multi-faceted disaggregation of economic income that facilitate classifying items of economic income (supported by disclosures) according to their different implications for predicting the amount, timing, uncertainty and velocity of future cash flows. In making these predictions, users need information about the volume, direction, pace of change, variability and predictability of changes in the entity’s economic resources and claims on the entity’s economic resources. In this regard, the distinction between profit or loss and OCI, if made at all, should be a matter of sub-classification of items recognised once (and only once) in the statement of comprehensive income (see the AASB’s response to Question 20 below, particularly in paragraphs S215 – S216).

S214 The comments in paragraphs S212 – S213 above are elaborated on in paragraphs 23 – 25 and A44 – A67 of the AASB’s submission on the DP.

Question 20

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, ie recycled, is discussed in paragraphs 8.23–8.26 of the Discussion Paper.

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?

General comments

S215 As indicated in paragraphs 23(b) and 26 of its submission on the DP, the AASB:

- (a) fundamentally disagrees with 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 recycled to profit or loss in a later period; and
- (b) considers that introducing recycling to the Conceptual Framework would represent a significant backward step from the existing Conceptual Framework. This is because the existing Conceptual Framework identifies as elements of financial statements only economic phenomena. Recycling would involve an entity reporting in its financial statements 'events' that are not economic phenomena of the period in which they are reported. It would involve recognising particular economic phenomena (inflows and outflows of economic resources) twice in one component or another of comprehensive income. Recycling items previously recognised in OCI would report as income and expenses in profit or loss items that are not inflows or outflows of economic resources of the period in which they are reported (because those inflows/outflows occurred when they were previously recognised in OCI)⁴⁷. The AASB would regard the weakening of the Conceptual Framework's approach of reporting only economic phenomena affecting an entity as a fundamental flaw.

S216 As indicated in paragraph S213 above, the AASB considers that the distinction between profit or loss and OCI, if made at all, should be a matter of sub-classification of items recognised and presented once (and only once) in the statement of comprehensive income. This view is generally consistent with 'Approach 1' discussed in paragraphs 8.25, 8.27 and 8.29 – 8.31 of the DP.

⁴⁷ See the examples in paragraph S220 below.

Mismatched remeasurements (including hedges of forecast transactions)⁴⁸

- S217 Although the AASB's submission on the ED commented on the various 'Approaches' to presenting an entity's profit or loss and OCI discussed in Section 8 of the DP, that submission did not comment specifically on 'mismatched remeasurements'⁴⁹ (with the exception of commenting in broad terms on hedge accounting: see paragraph S219 below).
- S218 The AASB disagrees with the preliminary view in paragraph 8.62 of the DP that, in some cases, an item of income or expense represents a linked set of items so incompletely that recognising that item in profit or loss would provide little relevant information about the return the entity has made on its economic resources during the period and would consequently diminish the understandability and predictive value of the amounts included in profit or loss. The AASB considers that, in concept, rather than excluding an item of income or expense from profit or loss (and including it in OCI) on the grounds of its relationship with an item not recognised during the period, the relationship between that item and the item not recognised during the period should be communicated through note disclosure. (As mentioned in paragraphs A47 – A48 of Appendix A to the AASB's submission on the DP, the AASB would not object to presenting totals for 'profit or loss' and 'OCI' as part of a multi-faceted disaggregation of economic income based on an integrated theory of presentation of financial performance. However, the AASB considers that being a 'mismatched remeasurement' would not be an adequate reason to exclude an item of income or expense from profit or loss.)

Hedges of forecast transactions

- S219 The AASB notes that the first example of a 'mismatched remeasurement' given in the DP is a gain/loss on remeasuring a derivative that hedges a forecast transaction. Paragraph 8.63 of the DP notes that, under IFRSs, to the extent that the hedge is effective and qualifies for hedge accounting, the entity reports in OCI the gain/loss on remeasuring the derivative that is determined to be an effective hedge of the 'hedged risk' (as a mismatched remeasurement), and subsequently recycles the gain/loss into profit or loss when the forecast transaction affects profit or loss. However, as mentioned in paragraph A73 of Appendix A to the AASB's submission on the DP, the AASB considers that all forms of hedge accounting should be excluded from the revised IASB Conceptual Framework. The AASB considers that hedge accounting is an accounting response to shortcomings in accounting for economic phenomena (e.g. an accounting mismatch arising from

⁴⁸ Because the identification and treatment of 'mismatched remeasurements' is not solely related to recycling, the comments in paragraphs S217 – S231 logically belong in the AASB's response to Question 19. However, because cash flow hedge accounting is an example of 'mismatched remeasurements', and Question 20 asks for views on cash flow hedge accounting, the comments in paragraphs S217 – S231 are included in the AASB's response to Question 20.

⁴⁹ Paragraph A54(c) of Appendix A to the AASB's submission noted that 'mismatched remeasurements' are not commented on in that submission, given the narrow range of items that seem likely to qualify as mismatched remeasurements.

remeasuring one asset or liability but not another⁵⁰) or to hedging an economic exposure that does not relate to a recognised asset or liability (e.g. a hedge of a forecast transaction), and in either case is conceptually inappropriate. This is because:

- (a) conceptually, recognised assets and liabilities should be remeasured on a consistent basis and, accordingly, an accounting mismatch should not arise (as indicated in paragraphs S133 – S134 above, the AASB considers that, in concept, all assets and liabilities should be measured under a single current value measurement model that adopts an operating capability concept of wealth); and
- (b) hedge accounting, in effect, nets (or offsets) flows of separate economic phenomena (i.e. changes in hedged and hedging items), and thus obscures the effects of the decision to hedge an exposure. This comment (which does not apply to fair value hedges in relation to the gains/losses on hedging instruments, and the gains/losses attributable to the hedged risk of hedged items, recognised simultaneously in profit or loss in accordance with paragraph 6.5.8 of IFRS 9 *Financial Instruments*) is illustrated in the examples of hedges of forecast transactions discussed in paragraph S220 below.

S220 As mentioned at the beginning of paragraph S219 above, paragraph 8.63 of the DP notes that, under IFRSs, for a hedge of a forecast transaction, to the extent that the hedge is effective and qualifies for hedge accounting, the entity reports in OCI the gain/loss on remeasuring the derivative that is determined to be an effective hedge of the ‘hedged risk’ (as a mismatched remeasurement), and subsequently recycles the gain/loss into profit or loss when the forecast transaction affects profit or loss. Hedges of forecast transactions can, depending on the nature of the transaction, give rise to different accounting treatments under IFRS 9, which involve a different form of netting of economic phenomena. This is explained in (a) and (b) immediately below:

- (a) as mentioned in paragraph 8.65 of the DP, recycling would occur in relation to a mismatched remeasurement arising from a hedge of a forecast sale of inventories. For example, if a cumulative loss had been recognised in OCI on the hedging instrument, when the hedged sales occur, that cumulative loss would be reversed in accordance with paragraph 6.5.11(d)(ii) of IFRS 9 by crediting OCI and debiting sales revenue. Thus, the cumulative loss on the hedging instrument arising in periods prior to the sale of the inventories would effectively be netted against the revenue recognised when the inventories are sold. From a disclosure perspective, within comprehensive income, netting does not occur, because the recycling of OCI and the resulting reduction in revenue would be disclosed separately as a

⁵⁰ For example, an accounting mismatch would arise if a derivative is measured at fair value through profit or loss under paragraph 4.1.4 or paragraph 4.2.1(a) of IFRS 9 *Financial Instruments* and a loan receivable or payable to which the derivative is related is measured on an amortised cost basis under paragraphs 4.1.1 – 4.1.2 or paragraph 4.2.1 of IFRS 9, even though, economically, both are affected by price changes reflecting changes in economic conditions.

reclassification adjustment under paragraphs 92 – 95 of IAS 1. However, from a recognition perspective, the amounts are effectively netted, inappropriately, because:

- (i) the amount of sales revenue (the value of the sales proceeds received or receivable) is reduced by the amount of a different economic phenomenon, i.e. the hedging losses; disclosure of that netting of different economic phenomena does not remedy the fact that sales revenue is understated because the hedging losses (despite having a different character) are embedded within that revenue amount; and
 - (ii) the hedging losses are recognised in profit or loss when the inventories are sold⁵¹, rather than when they arose (and were initially recognised by remeasuring the hedging instruments). As mentioned in (i) immediately above, the inflow of economic benefits to the entity in the period during which the inventories were sold⁵² is the value of the sales proceeds received or receivable. Consequently, the recycling of the cumulative hedging loss from OCI to profit or loss is an accounting entry that does not faithfully represent an economic phenomenon occurring in the period in which the recycling occurs; and
- (b) in relation to a hedge of a highly probable forecast purchase of inventories, netting occurs in accordance with paragraph 6.5.11(d)(i) of IFRS 9 when the inventories are initially recognised. If, for example, a cumulative gain was recognised in OCI on remeasuring the hedging instruments before initial recognition of the inventories, this netting occurs in the form of reversing that cumulative gain by debiting OCI and crediting the initial carrying amount of the inventories. This netting reduces the carrying amount of the inventories relative to their spot price when they are initially recognised and, consequently, reduces the amount of expenses recognised in profit or loss when the inventories are sold⁵³. The AASB considers these manifestations of netting are conceptually inappropriate because:
- (i) the recycling (reversal) of OCI when the inventories are acquired recognises an item of expense (in OCI) although an outflow of economic benefits does not occur when that recycling occurs. At that point, the entity's wealth remains enhanced to the extent of the cumulative gain on the hedging instruments. However, the financial statements depict the entity as being no better off, because the cumulative amount recognised within comprehensive income has been fully reversed; and

⁵¹ The reversal of the cumulative hedging losses from OCI has the effect that, over time, those losses were not recognised in OCI and were only recognised in profit or loss.

⁵² Ignoring the effects of unrelated transactions and other unrelated events.

⁵³ The recognition principle in IFRSs, noted in the penultimate sentence of paragraph 8.63 of the DP, that gains or losses on the hedging instrument are recycled from OCI into profit or loss when the forecast transaction affects profit or loss, is applied by recognising a reduced expense for 'cost of inventories sold' in profit or loss when the inventories are sold.

- (ii) effectively netting the cumulative gain on the hedging instrument against the expense recognised in profit or loss when the inventories are sold anticipates part of the ‘cost of inventories sold’ expense incurred when the inventories are sold, and recognises that expense prematurely as an item of OCI when the inventories were acquired.

The AASB agrees with the following criticism of adjusting the initial carrying amounts of assets or liabilities for the amount of related hedging gains or losses, made by the Financial Instruments Joint Working Group of Standard Setters:

“Adjusting the recorded amount of a transaction by the amount of a gain or loss on a hedging instrument results in not recording the transaction at the fair value of the consideration given or received. To ... ‘basis adjust’ the amount actually paid for the hedged asset, or received for assuming the hedged liability, has the effect of measuring that asset or liability as if it had been acquired or issued when the hedging instrument was acquired, rather than when the hedged transaction actually took place.”⁵⁴

S221 The AASB considers that, conceptually:

- (a) remeasuring recognised assets and liabilities on a consistent basis (with full remeasurement of each asset and liability) would faithfully represent the economic events affecting those assets and liabilities each period; and
- (b) instead of applying hedge accounting, an entity should disclose by way of note the relationships between items, including relationships between unrecognised and recognised elements.

Other potential examples of mismatched remeasurements identified in the DP

S222 Paragraphs S225 – S231 below discuss potential examples of mismatched remeasurements identified in the DP, other than hedges of forecast transactions (which are discussed in paragraphs S219 – S221 above).

S223 As indicated in paragraphs S212 and S215 above, the AASB strongly disagrees with the preliminary view in paragraph 8.22 of the DP that comprehensive income should necessarily be bifurcated into profit or loss and OCI⁵⁵, and fundamentally disagrees with the preliminary view in paragraph 8.26 of the DP that the Conceptual Framework should permit or require items of income and expense previously recognised in OCI to be recycled to profit or loss in a later period. In the context of the AASB’s fundamental disagreement with recycling items of OCI into profit or loss, paragraphs S225 – S231 below note the AASB’s concerns about the logic of

⁵⁴ Financial Instruments Joint Working Group of Standard Setters, *Accounting for Financial Instruments and Similar Items – an Invitation to Comment on the JWG Draft Standard*, December 2000, paragraph 7.11(c).

⁵⁵ That is, with profit or loss (stripped of items presented in OCI) treated as providing the primary source of information about an entity’s return on its economic resources.

applying the notion of mismatched remeasurements to those potential examples, and about potentially applying that logic to other items of income or expense.

S224 However, given that the AASB disagrees with the fundamental premises upon which the notion of mismatched remeasurements in the DP is based, paragraphs S225 – S231 below do not evaluate whether the items described in the DP as potentially being treated as mismatched remeasurements should be identified as such if that notion were to be incorporated into the revised IASB Conceptual Framework.

Investments in foreign operations

S225 The AASB notes that an example of a ‘mismatched remeasurement’, given in paragraph 8.64 of the DP, is an exchange gain/loss “resulting when an entity translates an investment in a foreign operation into its presentation currency”,⁵⁶. Paragraphs 8.64 and 8.66 of the DP argue that such an exchange gain/loss would be a mismatched remeasurement that should initially be recognised in OCI and then recycled into profit or loss on disposal of the operation because:

- (a) the exchange gain/loss does not capture the effect of the change in exchange rates on:
 - (i) the value of unrecognised assets, particularly goodwill and intangible assets, and therefore provides an incomplete depiction of how the change in exchange rates affected the value of the entity’s investment in a foreign operation; and
 - (ii) the value, expressed in the foreign currency, of non-monetary assets or liabilities that are measured using a (historical) cost-based measurement; and
- (b) the cumulative amount of exchange gains/losses at the date of disposal provides relevant information about the cumulative impact of the entity’s exposure to foreign currency arising from its foreign activities.

S226 The DP’s rationale referred to in paragraph S225(a)(i) above seems similar, in substance, to arguing that changes in the assets and liabilities of a subsidiary should, in consolidated financial statements, be accounted for in a manner that tracks changes in the value of the parent entity’s investment in that subsidiary. The AASB disagrees with that argument because the AASB considers that, in concept, the accounting for a particular reporting entity (e.g. the economic entity comprising a

⁵⁶ The AASB assumes this quote refers to a more specifically described item in paragraph 32 of IAS 21 *The Effects of Changes in Foreign Exchange Rates*, namely, exchange differences arising on a *monetary item that forms part of a reporting entity’s net investment in a foreign operation*. Paragraph 32 of IAS 21 requires such exchange differences to initially be recognised in OCI in the consolidated financial statements of the group reporting entity that includes the foreign operation, and subsequently to be recycled to profit or loss on disposal of the net investment. That is, the AASB assumes paragraph 8.64 refers to characterising such an item of OCI as a ‘mismatched remeasurement’.

parent and its subsidiaries) should not be influenced by changes in the value of an investment in an entity within that reporting entity.

S227 The AASB disagrees with the DP's rationale referred to in paragraph S225(a)(ii) above, because the translation of monetary items (on which exchange differences are recognised) and non-monetary items under IAS 21 *The Effects of Changes in Foreign Exchange Rates* is separate and fundamentally different, whereas the DP's rationale referred to in paragraph S225(b) above implies they should be linked. Applying the DP's rationale could imply treating all other exchange differences on monetary items as items of OCI, in conflict with paragraph 28 of IAS 21, which the AASB would not support. In addition, in respect of that rationale, even if non-monetary items forming part of an entity's net investment in a foreign operation were revalued, such a revaluation would not be recognised in profit or loss (nor would the exchange rate change embedded in the revaluation increase/decrease be accounted for separately as an exchange difference). Thus, the AASB perceives the real reason for recognising in OCI exchange differences arising on a monetary item that forms part of a reporting entity's net investment in a foreign operation is that it results in a form of 'matching', which the AASB regards as an inadequate conceptual reason for OCI classification.

S228 The AASB observes that the argument in paragraph 8.66 of the DP repeated in paragraph S225(b) above seems to be circular and therefore does not seem to add anything to the IASB's reasons referred to in paragraph S225(a) above. In other words:

- (a) the AASB thinks the real issue in relation to that argument is why profit or loss should only include the *cumulative* impact of the entity's exposure to foreign currency arising from its foreign activities (when the foreign operation is disposed of) and not each period's impact of that foreign currency exposure; and
- (b) the issue referred to in (a) immediately above is addressed implicitly by the IASB's reasons referred to in paragraph S225(a) above and commented on in paragraphs S226 – S227 above.

Changes in financial liabilities designated at fair value through profit or loss

S229 The AASB notes that Table 8.2 on page 169 of the DP indicates that changes in financial liabilities designated at fair value through profit or loss, when attributable to a change in the issuer's own credit risk, could be a mismatched remeasurement that should initially be recognised in OCI and then recycled into profit or loss if the liability is transferred prior to maturity. The reason for initially recognising in OCI changes in particular financial liabilities attributable to changes in the issuer's own credit risk, given in Table 8.2 of the DP, is that:

- (a) there is an inverse relationship between an entity's own credit risk and the value of the entity's goodwill; but
- (b) the effect on the value of goodwill is not recognised because internally generated goodwill is not recognised.

S230 In relation to the argument noted in paragraph S229 above [and the rationale in paragraph S225(a)(i) above], the AASB is concerned that initially recognising items of income or expense in OCI (as ‘mismatched remeasurements’) when they arise because they relate to unrecognised internally generated goodwill, and then recycling them into profit or loss if the liability is transferred prior to maturity, would inappropriately:

- (a) incorporate a standards-level assumption in the revised IASB Conceptual Framework (i.e. an assumption that a nexus exists between a gain or loss recognised during the period and a change in the value of internally generated goodwill). For example, the DP’s argument noted in paragraph S229(a) above seems to disregard the possibility that a deterioration of the entity’s own credit risk would be expected by investors to ultimately result in lenders and other creditors accepting partial settlement of amounts the entity owes them, and therefore would not necessarily give rise to a commensurate reduction in the entity’s internally generated goodwill; and
- (b) set a precedent for classifying a range of expenses (such as salaries of marketing staff and advertising costs) as items of OCI on the basis that they relate to enhancing the entity’s unrecognised internally generated goodwill. In other words, basing a classification of an item of income or expense on an omission to recognise corresponding purported effects on internally generated goodwill would not be a robust concept, because applying that rationale to other transactions and events would result in classifications that would be inappropriate and presumably were not intended by the IASB.

S231 For the reasons outlined in paragraphs S217 – S230 above, the AASB considers that the potential examples of ‘mismatched remeasurements’ identified in the DP do not provide convincing reasons to recognise particular items of income and expense in OCI and subsequently recycle them to profit or loss.

S232 The comments in paragraphs S215, S216 and S219 above are elaborated on in paragraphs 23, 26, A44 and A68 – A74 of the AASB’s submission on the DP.

Question 21

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 of the Discussion Paper) and a broad approach (Approach 2B described in paragraphs 8.79–8.94 of the Discussion Paper).

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.

S233 For the reasons set out in paragraphs S215 – S216 above, the AASB fundamentally disagrees with both of ‘Approaches’ 2A and 2B to OCI, and considers that, of the

three ‘Approaches’ to profit or loss and recycling discussed in Section 8 of the DP, ‘Approach 1’ is the only conceptually appropriate approach.

Section 9—Other issues

Question 22

Chapters 1 and 3 of the existing Conceptual Framework

Paragraphs 9.2–9.22 of the Discussion Paper 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*.

S234 As indicated in paragraph 3(b) of its submission on the DP, the AASB supports the IASB’s intention not to fundamentally reconsider Chapters 1 and 3 of the Conceptual Framework for the reasons given in paragraph 9.2 of the DP. In particular, the AASB:

- (a) considers it would be unnecessary and inappropriate to amend Chapter 1 to give greater emphasis to stewardship (the reasons for these views of the AASB are elaborated on in paragraphs S236 – S249 below);
- (b) considers it would be inappropriate to reintroduce the qualitative characteristic of reliability to Chapter 3 (the reasons for these views of the AASB are elaborated on in paragraphs S254 – S264 below); and
- (c) would strongly disagree with reintroducing the qualitative characteristic of prudence to Chapter 3 (the reasons for these views of the AASB are elaborated on in paragraphs S265 – S270 below).

S235 However, the AASB recommends other amendments to Chapters 1 and 3 of the IASB Conceptual Framework. These recommended amendments are set out in paragraphs S250 – S253 and S271 – S280 below.

Stewardship (or accountability)

S236 The AASB agrees with the approach in the IASB Conceptual Framework of:

- (a) identifying a single objective of financial reporting, namely, to provide information useful for making⁵⁷ resource allocation decisions; and
- (b) as noted in paragraph 9.7 of the IASB DP, implicitly incorporating the notion of stewardship in the guidance in paragraph OB4 of the IASB Conceptual Framework on the information users need to make resource allocation decisions.

The AASB also considers that sufficient guidance on stewardship and accountability is already provided in the IASB Conceptual Framework (see paragraph S250 below for an elaboration).

S237 A Bulletin issued by the European Financial Reporting Advisory Group (EFRAG), the French Autorité des Normes Comptables (ANC), the Accounting Standards Committee of Germany (ASCG), the Organismo Italiano de Contabilità (OIC) and the United Kingdom Financial Reporting Council (FRC), entitled *Getting a Better Framework: Accountability and the Objective of Financial Reporting* (September 2013) discusses different views regarding the role of stewardship/accountability and whether the IASB Conceptual Framework gives stewardship/accountability adequate acknowledgement in its guidance. Some aspects of that Bulletin, and views of others on this topic, are discussed in paragraphs S238 – S247 below, to clarify the AASB’s reasons for its views in paragraph S236 above.

S238 The Bulletin on Accountability (referred to in paragraph S237 above) notes that some parties consider that the provision of information on an entity’s stewardship/accountability should be identified as either the primary objective of financial reporting or at least an additional objective to the objective, identified in paragraph OB2 of the IASB Conceptual Framework, of providing information useful for making resource allocation decisions⁵⁸. Those parties hold those views because they think providing information on an entity’s stewardship/accountability is an essential function of general purpose financial reporting, and that providing information useful for making resource allocation decisions would not provide all of the information necessary for assessing an entity’s stewardship/accountability. Examples of reasons for those views noted in the Bulletin on Accountability are set out in paragraphs S239 – S246 below, together with the AASB’s views on those examples.

⁵⁷ However, see the AASB’s recommended clarification of ‘decision making’ in paragraphs S251 – S253 below.

⁵⁸ The Bulletin also notes that “there is a very significant overlap between accountability and decision-usefulness” (paragraph 24).

Whether providing information useful for making resource allocation decisions would provide all of the information necessary for assessing an entity's stewardship/accountability: arguments noted in Bulletin and by others, and the AASB's responses

S239 The Bulletin on Accountability says:

“One of the main arguments for providing information on accountability is that it enables investors to oversee management behaviour. Although management are appointed by the shareholders, the interests of management and shareholders may diverge. For example, management may have an incentive to undertake risky investments where their entitlement to bonus payments is linked to profits but they do not share in any losses. Or management may prefer to avoid the work that would be required by restructuring the business. Financial statements that fulfil an accountability objective can assist shareholders in detecting where the business is not being managed in accordance with their objectives.” (paragraph 11)

S240 However, the AASB observes that information relating to the examples given in paragraph 11 of the Bulletin on Accountability would be relevant for decisions about whether to change management's existing arrangements or plans (e.g. in voting on management's remuneration arrangements, management's plans not to restructure a business or whether to change management) and thus would be relevant for resource allocation decisions.

S241 The Bulletin on Accountability says:

“Decisions as to whether to buy, sell or hold a security are often taken with a short time horizon. They are based on today's price and an opinion of what tomorrow's price is likely to be. Information that is adequate for such decisions may not provide adequate information for accountability purposes, as an assessment of accountability requires a longer-term perspective.” (paragraph 21)

“Rational decisions can only be made on the basis of future prospects. Financial statements prepared with an objective of decision-usefulness therefore need to focus on the future. In contrast, information that is useful for accountability purposes emphasises the need for an account of the events that have occurred in the reporting period. ...” (paragraph 22)

S242 Further to its comment in paragraph 22 (quoted above), the Bulletin on Accountability notes the view that:

“Accountability requires that the financial statements are complete. This implies that, for example, a loss needs to be disclosed, even if steps have been taken to ensure that it cannot recur, because it has implications for an assessment of management's competence. Its irrelevance to future cash flows cannot be used to justify its omission or concealment.” (Appendix, paragraph A2)

S243 In relation to those comments in paragraphs 21, 22 and A2 of the Bulletin on Accountability (see paragraphs S241 and S242 above), the AASB:

- (a) considers the time-horizon-based argument in paragraph 21 for a distinction between information useful for resource allocation decisions and for accountability assessments is not justified. Decisions as to whether to buy, sell or hold a security logically would take account of the amount, timing and uncertainty of cash flows over the life of the security. The price of a security today and the likely price of that security tomorrow would both impound market participants' expectations about all future cash flows from the security; and
- (b) disagrees with the implication in paragraphs 22 and A2 that information useful for (future-oriented) resource allocation decisions might exclude information about some past events. Such an implication would overlook the point, made in paragraph QC7 of the IASB Conceptual Framework, that relevant information has predictive value, confirmatory value⁵⁹, or both.

S244 Specifically in respect of the comment in paragraph A2 of the Bulletin on Accountability (quoted in paragraph S242 above), the AASB considers that a loss that is not expected to recur is nonetheless relevant to resource allocation decisions because it has confirmatory value to help users confirm or correct prior assessments. As the Bulletin on Accountability notes, a loss that is not expected to recur also has implications for an assessment of management's competence. The AASB thinks such a factor would logically be assessed when making predictions about the entity's possible future cash flows. Furthermore, a non-recurring loss affects an entity's prospects for generating future cash flows by reducing the economic resources available to produce goods or services. Accordingly, the AASB does not consider the example in paragraph A2 of the Bulletin on Accountability illustrates information that is not useful for assisting resource allocation decisions by users but nonetheless is relevant for assisting an entity to discharge its stewardship/accountability.

S245 The Bulletin on Accountability also notes the view that:

“An accountability objective may also be relevant to asset valuations. A company may be able to derive significant benefit from a custom-made machine, which might be best portrayed by entity-specific values such as value in use or current or historical cost. A decision-useful objective ... might suggest that a market-based exit value should be used, which reports the value that market-participants would attach to the machine rather than the benefits that will accrue to its current owner. ...” (Appendix, paragraph A7)

S246 The AASB does not consider that a decision-usefulness objective should imply measuring assets at their exit value, as canvassed in paragraph A7 of the Bulletin on Accountability. As indicated in paragraphs 15, 17, B119 and B128 of its

⁵⁹ Paragraph QC9 of the IASB Conceptual Framework says: “Financial information has confirmatory value if it provides feedback about (confirms or changes) previous evaluations.”

submission on the DP, the AASB considers that measuring assets at current cost would provide useful information for predicting an entity's future cash flows, and would provide information that is generally more relevant than information provided by measuring assets at their exit prices. Consistent with the AASB's view, set out in paragraph S249(a) below, that the information useful to meet a stewardship/accountability objective would be indistinguishable from the information useful for resource allocation decisions, the AASB considers that current cost is more relevant than exit prices for discharging an entity's stewardship/accountability (as well as for making resource allocation decisions).

S247 The AASB notes some parties other than the authors of the Bulletin on Accountability argue that resource allocation decisions are limited to investment or voting decisions and therefore some users making assessments of stewardship/accountability would not be interested in making resource allocation decisions. The AASB disagrees with the view that resource allocation decisions are limited to investment or voting decisions. For example, regardless of whether users have voting rights, they will make decisions about resource allocations involving particular entities; for example, whether to lend to them, do business with them, be employed by them, or to attempt to influence decision making by the reporting entity's governing body by formally or informally lobbying—or even publicly agitating—for changes in resource allocation decisions they make. Information presented for stewardship/accountability purposes may lead to a debate or commentary on an entity's performance or, alternatively, users might decide to take no further action in the light of the information presented. Even if a user of a general purpose financial report takes no action as a result of assessing an entity's stewardship/accountability, this reflects the user's decision not to act.

Summary of AASB's views on whether the provision of information on an entity's stewardship/accountability should be identified as either the primary objective of financial reporting or at least an additional objective to that identified in the IASB Conceptual Framework

S248 The AASB agrees that discharging an entity's stewardship/accountability is an important role of general purpose financial reporting. However, it thinks discharging an entity's stewardship/accountability should be viewed as a means of facilitating resource allocation decisions, and therefore does not support identifying stewardship/accountability as either the primary objective, or an additional objective, of financial reporting. In other words, the AASB thinks assessing management's stewardship/accountability is not performed by users for its own sake, but performed for the purpose of making decisions about the allocation of scarce resources. In forming that view, the AASB considered and rejected those arguments for a contrary view that are noted in:

- (a) the Bulletin on Accountability and reproduced in paragraphs S239 – S246 above; and
- (b) paragraph S247 above.

S249 The AASB considers that identifying a single objective of general purpose financial reporting helps with identifying the financial information needs of users that general purpose financial reports should strive to meet and that Standards should be developed to require. Other reasons why the AASB does not support identifying stewardship/accountability as an additional objective are that:

- (a) the information useful to meet a stewardship/accountability objective would be indistinguishable from the information that is useful for resource allocation decisions. Therefore, it is unclear how identifying stewardship/accountability as an additional objective would affect the remainder of the IASB Conceptual Framework or help the IASB identify information that should be required by IFRSs, in ways that identifying resource allocation decisions as a single overarching objective would not; and
- (b) stewardship/accountability is an imprecise notion. Therefore, if it were identified as an additional objective, it could unintentionally open up general purpose financial reporting to providing all kinds of information. Whilst the AASB acknowledges the interrelationship between objective(s) and scope, the intended scope of general purpose financial reporting should be addressed directly rather than defining it inadvertently through articulation of the objective.

AASB's view on whether to add more conceptual guidance on stewardship/accountability

S250 The AASB also considers that the IASB Conceptual Framework adequately explains in paragraphs OB4 and BC1.24 – BC1.28 how stewardship/accountability is subsumed within the 'resource allocation decisions' objective, and therefore does not warrant including additional discussion of that issue. However, as discussed in paragraphs S251 – S253 below, the AASB considers that the description of the objective of general purpose financial reporting in the IASB Conceptual Framework should be expanded in a manner that would make more apparent the link between providing financial information for stewardship/accountability and for meeting the 'resource allocation decisions' objective.

Evaluating decisions

S251 The AASB recommends that, in the first sentence of paragraph OB2 of the IASB Conceptual Framework, the description of the objective of general purpose financial reporting should:

- (a) refer to "making *and evaluating* decisions about providing resources to the entity" (additional words italicised); and
- (b) elaborate on that reference by describing it, in full, as "evaluating possible resource allocations, making decisions about such allocations and re-evaluating those decisions over time".

Its reasons for these recommendations are set out in paragraphs S252 – S253 below.

S252 As mentioned in paragraph S243(b) above, the description of ‘relevance’ in paragraph QC7 of the IASB Conceptual Framework includes confirmatory value (which financial information possesses if it confirms or changes previous evaluations). The AASB considers that referring to “making *and evaluating* decisions” in the description of the ‘objective’ would promote a better understanding of the importance of the confirmatory value of financial information useful for meeting that objective (as part of a feedback loop in the process of making predictions that underpin resource allocation decisions). Referring to ‘evaluating decisions’ is particularly important because many users of financial reports also rely on information from other sources (typically, information that becomes available before financial reports are issued) to make decisions in their capacity as resource providers, and use financial reports to confirm their previous evaluations and provide input to future evaluations.

S253 Another reason for adding a reference to ‘evaluating decisions’ in the ‘objective’ in paragraph OB2 of the IASB Conceptual Framework is to make more apparent the link between providing financial information for stewardship/accountability and for meeting the ‘resource allocation decisions’ objective. Adding that reference should make that link more apparent because:

- (a) in making past evaluations about whether to provide resources to an entity, users of the entity’s financial reports would have formed particular expectations about how efficiently and effectively the entity’s management would discharge their responsibilities to use the entity’s resources. Financial information with confirmatory value would provide feedback on those previous evaluations (in addition to providing feedback on other previous forward-looking evaluations); and
- (b) referring to ‘evaluating decisions’ would make more prominent the link between the objective set out in paragraph OB2 of the IASB Conceptual Framework and the need of users for information about how efficiently and effectively the entity’s management have discharged their responsibilities to use the entity’s resources, which is referred to in paragraph OB4 of the IASB Conceptual Framework. Because paragraph OB4 is important in explaining that stewardship/accountability is subsumed within the ‘resource allocation decisions’ objective, the AASB considers that adding a reference to ‘evaluating decisions’ in the ‘objective’ in paragraph OB2 might help in responding to concerns expressed by some commentators that the important role of general purpose financial reporting in discharging an entity’s stewardship/accountability is insufficiently acknowledged in the IASB Conceptual Framework.

Reliability

S254 The AASB considers it would be inappropriate to reintroduce the qualitative characteristic of ‘reliability’ to Chapter 3 of the revised IASB Conceptual Framework, for the reasons in paragraphs 9.11 – 9.14 of the DP and the reasons discussed in paragraphs S255 – S264 below. In forming that view, the AASB considered and rejected the arguments for a contrary view noted in a Bulletin issued

by the EFRAG, ANC, ASCG, OIC and UK FRC, entitled *Getting a Better Framework: Reliability of Financial Information* (April 2013).

S255 The Bulletin on Reliability discusses different views regarding whether the replacement of ‘reliability’ with ‘faithful representation’ as a qualitative characteristic in the 2010 revision of the IASB Conceptual Framework was appropriate. Some aspects of that Bulletin, including its examples of reasons why ‘reliability’ should be reintroduced as a qualitative characteristic, are discussed in paragraphs S256 – S264 below, to clarify the AASB’s reasons for its view in paragraph S254 above.

Whether ‘reliability’ should be reinstated as a qualitative characteristic (in place of ‘faithful representation’): arguments noted in the Bulletin, and AASB’s responses

S256 The Bulletin on Reliability says the 2010 revision of the IASB Conceptual Framework eliminated all references to a potential trade-off between relevance and reliability (the Bulletin discusses this issue in paragraphs 1 – 3, 8 and 10 – 14).

S257 The AASB considers that the IASB Conceptual Framework (as revised in 2010) adequately addresses the ‘trade-off’ between relevance and the replacement qualitative characteristic for the notion of reliability (i.e. faithful representation) by stating that:

- (a) “Information must be both relevant and faithfully represented if it is to be useful.” (paragraph QC17); and, consistent therewith,
- (b) if the most relevant information about an economic phenomenon cannot be faithfully represented, the entity selects the next most relevant information about that economic phenomenon that can be faithfully represented (paragraph QC18). Implicitly, this indicates a trade-off between relevance and faithful representation, in the sense that the most relevant information would not be reported if it cannot be faithfully represented.

These points are alluded to in paragraph 10 of the Bulletin on Reliability, in one of the viewpoints on this issue acknowledged in the Bulletin.

S258 The AASB agrees with the statements in Chapter 3 of the IASB Conceptual Framework referred to in paragraph S257 above, and notes that the IASB might wish to consider addressing the concern referred to in paragraph S256 above in its Basis for Conclusions on its forthcoming ED of a revised Conceptual Framework.

S259 The Bulletin on Reliability notes the viewpoint on measurement uncertainty, in the context of reliability, that:

“... an important aspect of reliability as described in the pre-2010 Framework has been diluted in the move to faithful representation: measurement uncertainty. The pre-2010 Framework stated clearly that ‘in certain cases, the measurement of the financial effects of items could be so uncertain that entities generally would not recognise them in financial statements’, giving internally generated goodwill as an example. This

discussion of measurement uncertainty leads directly to the recognition criterion that elements should be recognised only if they have a cost or value that can be measured with reliability. The 2010 Framework notes that ‘if the level of uncertainty in an estimate is sufficiently large, that estimate will not be particularly useful’. However, it also states that ‘a representation of [an] estimate can be faithful if the amount disclosed is described clearly and accurately as being an estimate, the nature and limitations of the estimating process are explained, and no errors have been made in selecting and applying an appropriate process for developing the estimate’ and that ‘if there is no alternative representation that is more faithful, that estimate may provide the best available information’.” (paragraph 15)

- S260 However, the AASB observes that paragraph 4.25 of the DP includes a preliminary view that “the Conceptual Framework should state that the IASB might decide in developing or revising particular Standards that an entity need not, or should not, recognise an asset or a liability ... (b) if no measure of the asset (or the liability) would result in a faithful representation of the asset (or the liability) ... even if all necessary descriptions and explanations are disclosed”. Therefore, under this preliminary view in the DP (with which the AASB broadly agrees: see paragraph S65(a) above), it would appear that omitting the ‘reliable measurement’ recognition criterion would not result in the recognition criteria failing to address measurement uncertainty. (As indicated in paragraphs A1 – A3 of the attachment to this paper, the AASB recommends rephrasing the ‘faithful representation’ recognition criterion described in paragraph 4.25 of the DP while retaining its general meaning. In addition, as indicated in paragraphs S78 – S81 above, the AASB considers that most of the examples, in paragraph 4.26 of the DP, of purported indicators that recognition of an asset or a liability might not provide relevant information should instead be characterised as examples of where the ‘faithful representation’ recognition criterion might not be met.)
- S261 The Bulletin on Reliability (paragraph 17) notes the viewpoint on verifiability, in the context of reliability, that:

“Related to this lack of concern over reliability is the relegation in the 2010 Framework of verifiability to an enhancing, rather than fundamental, characteristic.⁷ ... A crucial aspect of the context in which financial information is used is that financial statements are audited. Information in financial statements therefore has to be capable of some level of verification.

⁷ ... the previous Framework (1989) did not explicitly include verifiability as an aspect of reliability, but ... the Framework (1989) contained the phrase ‘and can be depended upon by users’, which implies that users need assurance on the information.”

- S262 The AASB disagrees with the view noted in the Bulletin on Reliability that verifiability should be a fundamental characteristic. This is because:
- (a) whilst information cannot be useful if it lacks relevance or does not faithfully represent an economic phenomenon, information can be useful if it is not verifiable. Therefore, it is logical to regard verifiability as an enhancing characteristic; and

- (b) some relevant information might be incapable of verification. As paragraph QC28 of the IASB Conceptual Framework says: “It may not be possible to verify some explanations and forward-looking financial information until a future period.” (This point is elaborated on in paragraph BC3.36 of the IASB’s Basis for Conclusions on Chapter 3 of its Conceptual Framework.) The AASB considers it would be inappropriate, in concept, to exclude such information from financial reports because it cannot be verified in the current period, which would be implied if verifiability were to be treated as a fundamental qualitative characteristic.

S263 The Bulletin on Reliability notes the viewpoint on measurement bases, in the context of reliability, that:

“There is substantial academic literature that supports the view that reliability is an important and desirable characteristic of financial information. This view was also illustrated in the IASB Discussion Paper on extractive industries, which explained that users do not find fair value information about oil reserves useful because of the lack of reliability in their measurement.” (paragraph 18)

S264 The Bulletin implies the replacement of ‘reliability’ with ‘faithful representation’ would lead to inadequate conceptual attention to the subjectivity of measurement estimates. However, the AASB considers it would be inappropriate for the selection of measurement bases to be conditioned by the qualitative characteristics. To do so would create an overlap between the qualitative characteristics and measurement sections of the revised IASB Conceptual Framework. The IASB’s adoption of ‘faithful representation’, instead of ‘reliability’, as a qualitative characteristic should help avoid misunderstandings in this regard, because the guidance on faithful representation is more precise. For example:

- (a) a fair value estimate is capable of faithful representation even if, in the circumstances, it requires subjective judgements; but
- (b) a ‘reliable’ estimate of fair value might be read as an estimate that does not involve much subjectivity.

Prudence

S265 The AASB strongly disagrees with the view of some that the qualitative characteristic of ‘prudence’ should be reintroduced into Chapter 3 of the revised IASB Conceptual Framework, for the reasons discussed in:

- (a) paragraphs 9.18, 9.21 and 9.22 of the DP, which refer to paragraphs BC3.27 – BC3.29 of the IASB’s Basis for Conclusions on Chapter 3 of its Conceptual Framework; and
- (b) paragraphs S267 – S270 below.

S266 The AASB broadly agrees with the arguments against reintroducing ‘prudence’ to the IASB Conceptual Framework in a paper by J. McCahey and W. McGregor

entitled *Risk of reinstating prudence in the IASB's Conceptual Framework* (February 2014)⁶⁰.

- S267 The AASB observes that 'prudence' has different meanings to different people. This was illustrated in the varying responses to a Bulletin issued by the EFRAG, ANC, ASCG, OIC and UK FRC, entitled *Getting a Better Framework: Prudence* (April 2013). Some respondents to that Bulletin argued in effect that 'prudence' means caution without a conservative bias⁶¹, whilst others argued in effect it means conservatism⁶². Therefore, reintroducing 'prudence' to the IASB Conceptual Framework could lead to inconsistent interpretations of that notion.
- S268 The AASB notes that paragraph 33 of the Bulletin on Prudence says: "Prudence also requires that assets are not written up unless there is adequate evidence of the increase in value." The AASB is concerned that this implies a higher degree of evidence to support 'writing up' assets than 'writing them down'; i.e. it implies a conservative bias. The AASB also notes that a response letter to the Bulletin on Prudence (from the Belgian Accounting Standards Board) argues that measuring assets or liabilities at fair value if the evidence available to support the fair value estimates is at level 3 of the fair value hierarchy fails to reflect prudence—again, a conservative bent.
- S269 The AASB would not support a view that, because of 'prudence', current value measurements should be excluded from financial reports. Such an approach would make prudence superior to relevance as a qualitative characteristic. (As indicated in paragraph A34 of Appendix A to its submission on the DP, the AASB considers that current values of assets and liabilities would always be more relevant than historical cost-based measurements.) For the same reason, the AASB would not support precluding the measurement of assets or liabilities at fair value if the evidence available to support the fair value estimates is at level 3 of the fair value hierarchy. The AASB also observes that, if level 3 estimates of fair value were to be precluded, some assets and (if the same evidence criteria were applied to liabilities) some liabilities would fail to qualify for *initial* recognition. This is because, to initially measure at fair value assets and liabilities acquired in a business combination or 'basket purchase', it might be necessary to use level 3 estimates of fair value. Moreover, similar types of estimates (to those involved in level 3 estimates of fair value) are often necessary to measure assets and liabilities at another amount than fair value, under conditions of considerable uncertainty. For example, estimates of the cash flows necessary to settle some long-term provisions are subject to significant revision. Consequently omitting to recognise such

⁶⁰ <http://ifrs.wiley.com/news/risk-of-reinstating-prudence-in-the-iasb-s-conceptual-framework>

⁶¹ For example, HSBC's response letter on the Bulletin argued that prudence should implicitly be applied in standards on recognition and measurement, but only in a manner compatible with neutrality, and therefore should not be explicitly considered in the Conceptual Framework. The responses of Baker Tilly and The Institute of Chartered Accountants in England and Wales argued that prudence should be explicitly covered in the Conceptual Framework, but described in a neutral manner.

⁶² For example, the Federation of European Accountants argued prudence should be reflected in asymmetric thresholds for the recognition of assets and liabilities [paragraph (4) of its response letter on the Bulletin]. The Belgian Accounting Standards Board argued for reintroducing prudence to the Conceptual Framework, but also that prudence and neutrality cannot both be consistently achieved.

provisions would not be a ‘prudent’ outcome, but the logic of excluding level 3 estimates would imply that treatment.

S270 The reference to ‘prudence’ in paragraph 37 of the superseded IASB Conceptual Framework emphasised the uncertainties that surround many events and circumstances affecting an entity. In relation to risks and uncertainties, whilst disagreeing with including references to ‘prudence’ in the revised IASB Conceptual Framework, the AASB would agree with:

- (a) using diligence by taking care to obtain and assess the best available evidence (while achieving an appropriate balance between costs and benefits) of the economic phenomena being depicted, in providing a complete depiction of those economic phenomena and in making unbiased estimates of the amounts of those items; and
- (b) disclosing risks, uncertainties and key assumptions relevant to users’ resource allocation decisions.

However, neither (a) nor (b) immediately above warrants adopting ‘prudence’ as a qualitative characteristic.

Possible amendments to Chapter 3 of the IASB Conceptual Framework relating to other matters

Materiality

S271 The first sentence of paragraph QC11 of the existing IASB Conceptual Framework says: “Information is material if omitting it or misstating it could *influence* decisions that users make on the basis of financial information about a specific reporting entity” (emphasis added). The AASB considers that, in a description of ‘material’, “influence” is, of itself, a directionless term that warrants complementing with more precise expression⁶³. This is because the omission of immaterial information could (and should) favourably influence users’ decision making by avoiding clutter in the financial report⁶⁴. Clearly, in the context of the description of ‘material’ in paragraph QC11 of the existing IASB Conceptual Framework, insignificant information is not intended to be identified as material on the grounds that its omission would favourably influence users’ decision making. However, such information would appear literally to be identified as ‘material’ under that description. Therefore, to reflect the apparent intended meaning of that description, the AASB recommends amending that description along the lines marked up below:

“Information is material if omitting ~~it~~ or misstating it could adversely influence decisions that users make ...”.

⁶³ The AASB notes that “influence” is also used without qualification in the definition of ‘material’ set out in paragraph 7 of IAS 1 and paragraph 5 of IAS 8. The AASB suggests also considering this issue at a standards level within the IASB’s Disclosure Initiative project.

⁶⁴ Note that in paragraph S76 above, the AASB recommends that the revised IASB Conceptual Framework should state that recognition of immaterial classes of assets and liabilities should not occur to the extent that users of financial reports would be impeded from identifying the information that is important for making resource allocation decisions.

Measurement uncertainty

S272 Paragraph QC16 of the IASB Conceptual Framework includes:

“However, if the level of uncertainty in such an estimate is sufficiently large, that estimate will not be particularly useful. In other words, the relevance of the asset being faithfully represented is questionable. If there is no alternative representation that is more faithful, that estimate may provide the best available information.”

S273 Consistent with those words in paragraph QC16 of the IASB Conceptual Framework, paragraph 4.26 of the DP provides a number of examples of possible guidance on circumstances in which recognition of an asset or a liability might not provide sufficiently relevant information to justify the cost of recognition, because of the level of uncertainty in identifying the asset or liability or in the best estimate of a measure of that asset or liability.

S274 However, the AASB is concerned that:

- (a) the first two sentences quoted above from paragraph QC16 of the IASB Conceptual Framework imply the relevance of a measure or disclosure can be dependent on the circumstances, i.e. entity-specific. Such an implication would contradict the distinction made between relevance and materiality in the IASB Conceptual Framework. As noted in paragraph S74(a) above, paragraph QC11 of the IASB Conceptual Framework says: “materiality is an entity-specific aspect of relevance”. Relevance does not pertain to particular reporting entities, but pertains to information about particular classes/types of economic phenomena. For example, information about leases is generally relevant, although it might be immaterial for a particular reporting entity; and
- (b) as indicated in paragraphs S78 – S81 above and explained in paragraphs A5 – A13 of the attachment to this paper, the AASB thinks most of the examples in paragraph 4.26 of the DP regarding whether recognition would provide sufficiently relevant information to justify the cost should instead be treated as examples of considering whether the ‘faithful representation’ criterion would be met.

S275 Therefore, the AASB recommends amending paragraph QC16 of the IASB Conceptual Framework to indicate that, if the level of uncertainty in an estimate is particularly large, the estimate might not faithfully represent the measurement basis applied to the asset or liability being measured. In addition, the AASB recommends including in paragraph QC16 the point implicit in paragraph 4.25(b) of the DP that, before identifying a measure as failing to provide a ‘faithful representation’, all necessary descriptions and explanations pertaining to the measure should be disclosed. The AASB considers that failing the ‘faithful representation’ criterion should occur only rarely.

S276 If the IASB were to decide not to amend the wording of paragraph QC16 of the IASB Conceptual Framework in response to the AASB’s concern in

paragraph S274 above, the AASB recommends that the IASB at least makes those quoted sentences consistent. Presently, those sentences are inconsistent because:

- (a) the first of them says “that estimate *will not be particularly* useful” (emphasis added) but the next two seem less categorical (in addition, the use of “particularly” seems to create ambiguity); and
- (b) the first of them refers to the relevance of an uncertain estimate (i.e. an accounting response), but the second of them refers to the relevance of an asset (i.e. an economic phenomenon).

S277 To address the inconsistencies mentioned in paragraph S276 above, the AASB recommends that (if the wording of paragraph QC16 of the IASB Conceptual Framework is not amended in response to the AASB’s concern in paragraph S274 above) the first two of those sentences be amended along the lines marked up below:

“However, if the level of uncertainty in such an estimate is ~~sufficiently~~ particularly large, that estimate ~~will~~ might not be ~~particularly~~ useful. In other words, the ~~relevance estimate~~ of the asset being faithfully represented is questionable might fail the relevance criterion for inclusion in the financial report.”

Costs and benefits

S278 As indicated in paragraphs S68 and S72 – S73 above, the AASB considers that the revised IASB Conceptual Framework should note that the IASB – rather than entities – should assess the relevance of recognising particular classes/types of elements in financial statements and whether recognition of those classes/types of elements would be likely to provide information that is sufficiently relevant to justify the cost. This view is elaborated on in paragraphs S279 – S280 below.

S279 The AASB acknowledges that the IASB included the following text in a new paragraph QC39 to its Conceptual Framework (added subsequently to its May 2008 Exposure Draft including its proposed chapter on the Qualitative Characteristics) in response to comments from the AASB and others:

“Because of the inherent subjectivity, different individuals’ assessments of the costs and benefits of reporting particular items of financial information will vary. Therefore, the Board seeks to consider costs and benefits in relation to financial reporting generally, and not just in relation to individual reporting entities.”

S280 However, paragraph QC39 of the IASB Conceptual Framework seems to focus only on how the IASB assesses the costs and benefits of particular items of financial information. The AASB thinks it is important that the IASB Conceptual Framework includes the corollary of the comment in paragraph QC39 that “the Board seeks to consider costs and benefits in relation to financial reporting generally”—namely that:

- (a) if assessments of costs and benefits were to be made by individual reporting entities, the assessments would be likely to be specific to the entity and not to have regard to the benefits of financial reporting generally (including the benefits of comparability between entities); and
- (b) consequently, only the IASB (through standards) – rather than individual reporting entities (through the implementation of standards) – should assess the costs and benefits of reporting particular items of financial information⁶⁵ in financial reports.

Question 23

Business model

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

Summary/Introduction

S281 The AASB notes that the discussion of ‘business model’ in paragraphs 9.23 – 9.34 of the DP seems to focus on whether the ‘business model’ concept should play a significant role in standard setting. However, the AASB considers that the issue is more nuanced. That is, the AASB thinks the appropriateness of using the ‘business model’ concept in standard setting depends on the aspects of a financial report to which the ‘business model’ concept might be applied. In this regard, the AASB’s initial thinking on the topic is that the IASB:

- (a) should not invoke the business model concept when it develops or revises recognition or measurement requirements in particular Standards; but
- (b) should invoke the business model concept when it develops or revises presentation and disclosure requirements in particular Standards. In this context, the AASB thinks it is unlikely that a definition of ‘business model’ would be necessary.

⁶⁵ Paragraph S73 above refers to assessing the costs and benefits of recognising particular classes/types of elements in financial statements, in the context of that paragraph’s discussion of the DP’s preliminary views on recognition criteria. The AASB’s recommendation in this paragraph is not restricted to recognition.

S282 In its comments on Question 23 of the DP, the AASB uses ‘business model’:

- (a) with the meaning implied for that term in paragraph 9.29 and Question 23 of the DP (i.e. “how an entity conducts its business activities”); and
- (b) to collectively refer to either a single business model, or multiple business models, of the entity (except where a narrower meaning is specifically indicated).

S283 The AASB’s initial thinking is that, to the extent that an entity’s ‘business model’ has affected the economic phenomena pertinent to the entity (i.e. the entity’s economic resources, claims on its economic resources, and changes in those economic resources and claims), an entity’s financial statements should reflect the effects of the entity’s ‘business model’. In other words, financial reports that provide relevant and representationally faithful information about the economic phenomena affecting an entity would reflect the economic effects (consequences) of the entity’s business model.

Recognition/derecognition and wealth (measurement)

S284 The AASB’s initial thinking is that:

- (a) assets and liabilities (and changes in them), and the wealth they embody, are economic phenomena that are independent of the entity’s plans and of the implications of the entity’s existing business model for the entity’s future flows of cash and other resources;
- (b) it would be inappropriate for information (an accounting response) about the consequences of how management conducts the entity’s business activities (economic phenomena) to depend on how management conducts the entity’s business activities. Such a dependency would seem to undermine the stewardship/accountability aspect of the objective of reporting information useful for resource allocation decisions; and
- (c) therefore, an entity’s business model should not be a factor in identifying the economic phenomena to be recognised in financial statements or how the wealth embodied in those economic phenomena is measured.

Recognition/derecognition

S285 The AASB notes that adopting a business model approach to recognition and derecognition was canvassed, among other approaches, in an IASB staff paper for a standards-level project (Leasing). Specifically, IASB Agenda Paper 3C *Lessor Accounting Model* for the IASB-FASB meeting held in March 2014 canvassed an approach to lessor accounting (‘Approach 3’) under which a lessor’s lease classification (as ‘Type A’ or ‘Type B’) would be based on the lessor’s business model. The two broad lessor accounting business models described in that agenda paper were:

- (a) the lessor prices leases based on estimates of the value of the asset at the beginning and end of the lease to obtain a desired return; and
- (b) the lessor prices leases to obtain a desired return on their total investment in the underlying asset over the entire period that the lessor intends to hold the asset, which is typically much longer than the period of any individual lease (paragraph 43 of IASB Agenda Paper 3C).

Depending on which of these business models was employed by the lessor, the lessor would derecognise the underlying asset and recognise a right to receive lease payments, or continue to recognise the underlying asset.

S286 The AASB also notes that, at their joint meeting in March 2014, the IASB and FASB tentatively decided not to adopt a business model approach to recognition and derecognition of assets by lessors. The AASB would agree with not basing concepts for recognition and derecognition by lessors on the entity's business model, because a lessor's rights existing after entry into a lease depend on the terms of the lease and on whether any pre-existing rights to use the underlying resource remain after entry into the lease contract—and not on the lessor's business model.

Wealth (measurement)

S287 As indicated in paragraph B140 of Appendix B to the AASB's submission on the DP, the AASB considers that an entity's business model would not (and should not) determine which measurement basis to apply, in concept, to an asset or a liability. In the context of whether to remeasure assets and liabilities, this view is consistent with the AASB's view that, in concept, historical cost is irrelevant as a measurement basis for assets and liabilities.

S288 An example of the AASB's view described in paragraph S287 above is that the AASB disagrees in concept with treating an entity's business model for managing financial assets as a factor in determining whether to measure those assets at amortised cost or fair value, as occurs under paragraphs 4.1.1 and 4.1.2 of IFRS 9 (paragraph 9.24 of the DP refers).

S289 The AASB considers that price changes affecting an entity's wealth should not be disregarded simply because an entity's business model:

- (a) does not respond to those price changes by the entity entering into particular transactions; or, similarly,
- (b) does not result in those price changes *directly* affecting the amount of cash flows from the asset or liability affected by the price change (see paragraphs S290 – S291 below for an elaboration).

S290 Paragraph 9.33(a) of the DP notes that the way in which an entity conducts its business activities is reflected in the preliminary view in paragraph 6.35(d) of the DP that, in deciding on an appropriate measurement method for an asset or a liability, the IASB should consider:

- (a) how the asset contributes to future cash flows [paragraph 6.35(d)(i)]; and
- (b) how the liability will be settled or fulfilled [paragraph 6.35(d)(ii)].

S291 However, as indicated in paragraphs 19 and B90 – B125 of its submission on the DP, the AASB strongly disagrees with the manner in which paragraphs 6.16, 6.78 – 6.80 and 6.83 of the DP elaborate on the preliminary view in paragraph 6.35(d)(i) of the DP, by stating that the selection of a measurement for a particular asset should differ according to whether that asset is expected to contribute *directly* or *indirectly* to the generation of future cash flows (see also paragraphs S148, S157 – S164 and S184 above).

S292 In relation to the issue of whether an entity’s ‘business model’ should be a factor in identifying measurement concepts for assets and liabilities, the AASB notes that paragraph 5.27 of the Research Paper *The role of the business model in financial statements* issued in December 2013 by the EFRAG, ANC and UK FRC (and supported by the Denmark FSR – danske revisorer and the Slovenski Institut za Revizijo, Slovenia) says:

“Consideration of the business model may be useful in considering the value to be assigned to assets. Imagine three identical vans, one is owned by the manufacturer, another by a dealer and a third has just been purchased by a plumber for use in its trade. As the vans are all identical, would comparability not require each entity to report them at the same amount? This is not present practice nor informative: the manufacturer can produce vans at the manufacturing cost. The dealer can generally obtain vans at the wholesale price. The plumber has to pay the retail price. Cost (whether viewed in historical or current replacement terms) varies between the three entities, because their business models provide different opportunities. The vans may be identical but the cost to each owner is different.”

S293 The AASB considers that the argument for applying the ‘business model’ notion to the measurement of assets, set out in paragraph 5.27 of the Research Paper, is unconvincing. This is because the fact that the historical cost of a particular asset (in this example, a van) differs for different purchasers operating in different circumstances does not require the ‘business model’ notion to be applied in order to faithfully reflect that the historical cost differs. Furthermore, historical cost can differ for different entities with identical business models, due to different bargaining power (based on differing volumes of purchases). Therefore, the AASB considers that the need to apply the ‘business model’ notion to measurement is not established by paragraph 5.27 of the Research Paper.

Operating capability

S294 As indicated in paragraph B140 of Appendix B to the AASB’s submission on the DP, the AASB considers that adopting operating capability as the ideal concept of wealth would address, to a significant degree, the conceptual role of the entity’s business model. An entity’s operating capability takes into account how management has chosen to ‘configure’ the entity’s capability to provide goods and

services, while measuring it using current market buying prices⁶⁶ (rather than ascribing the entity's own values to that capability⁶⁷). However, an entity's business model would not determine which measurement basis to apply, in concept, to an asset or a liability. Using an entity's business model to decide when and how to remeasure an asset or a liability would be incompatible with adopting operating capability (or, for that matter, any other current value) as the ideal concept of wealth.

Implicit presumption regarding the concept of income (capital maintenance)

S295 One of the reasons argued in the Research Paper (referred to in paragraph S292 above) for using a 'business model' concept for measurement is that, otherwise, particular remeasurements of assets or liabilities would inappropriately be included in the calculation of the profit or loss for the period. The Research Paper explains this with the following example:

“Suppose an entity purchases a quantity of cotton for CU100. It still owns the cotton at the reporting date, when it is worth CU120 (and the entity could readily sell it at that price). If the entity is a shirt manufacturer and will use the cotton in its operations, current practice would be simply to report the cotton as 'inventory' at its cost of CU100. But if the entity is a commodity trader that seeks to make profit from short-term price movements, that accounting may not reflect fairly the entity's financial position or financial performance: current practice reflects this view by stating the asset at its current selling price of CU120, with the gain of CU20 included in profit. ... Thus the nature of an entity's business may affect the measurement of assets ...” (paragraph B.7)

“Providing information reflecting events that are not likely to occur, or using valuations that do not reflect the most likely way an entity will realise its cash flows does not help users in assessing future cash flows. For instance, including the gain of CU20 in profit in the case of the shirt manufacturer in the example presented above does not reflect how the asset is used and how he makes money.” (paragraph B.16)

S296 However, these words quoted from paragraphs B.7 and B.16 of the Research Paper seem to presume, implicitly, that remeasurements would automatically be included in the calculation of the profit or loss for the period. As indicated in paragraph B144 of Appendix B to the AASB's submission on the DP, the AASB considers that there are strong arguments for adopting a concept of income that excludes various remeasurements from an entity's profit or loss for the period (and, instead, treats those remeasurements as capital maintenance adjustments recognised directly in equity).

⁶⁶ Current market buying prices are used, except when an asset's recoverable amount is less than its current market buying price.

⁶⁷ Current market buying prices represent the prices other market participants currently demand for providing the entity's economic resources.

S297 In contrast with paragraphs B.7 and B.16 of the Research Paper, paragraph 5.56 of that Paper says: “If current replacement costs are to be used, consideration needs to be given to the reporting of holding gains.” This important issue [i.e. whether to recognise remeasurements as capital maintenance adjustments (outside economic income)] is not acknowledged in the Research Paper in the context of its shirt manufacturer example. The AASB considers that the Research Paper’s arguments regarding the importance of an entity’s business model to the choice of measurement basis (quoted above from paragraphs B.7 and B.16 of the Research Paper) are based on an assumption that is premature, because the ideal concept of economic income (capital maintenance) has yet to be debated conceptually by the IASB.

Definition of ‘business model’

S298 The AASB’s initial thinking is that it would be inherently difficult to define ‘business model’ with sufficient clarity that it could provide a solid foundation for concepts regarding information that helps users make predictions about an entity’s future cash flows. This initial thinking reflects the broad nature of the implied meaning of ‘business model’ in the DP (see paragraph S282(a) above) and the broad nature of the description of ‘business model’ in the Research Paper referred to in paragraph S292 above⁶⁸. Related to this, the AASB thinks it would also be difficult to define how many business models an entity might have, which seems likely to create challenges for consistent application of the business model notion. These concerns seem to be shared by the authors of the Research Paper. In relation to defining ‘business model’, paragraph 5.19 of the Research Paper says:

“It could be difficult to arrive at a universally acceptable definition of the term so that it could be consistently applied by those who prepare financial information and adequately understood by those that use financial information. Moreover, there is no agreement as to whether there are just a few business models such as a trading and a holding model or an infinite number of business models that reflect how each entity tries to differentiate itself from its competitors.”

S299 If the ‘business model’ notion were invoked by the IASB when it develops or revises requirements for the recognition/derecognition and measurement of assets and liabilities in particular Standards, the apparently vague nature of the ‘business model’ notion seems likely to present serious challenges to the IASB in developing requirements that are logically consistent. If the ‘business model’ notion were to be a bridge between:

- (a) the objective, qualitative characteristics and definitions of assets and liabilities set out in the revised IASB Conceptual Framework; and

⁶⁸ The Research Paper says: “Our assumed meaning of the term ‘business model’ focuses on the value creation process of an entity, i.e. how the entity generates cash flows. In the case of non-financial institutions, it represents the end-to-end value creation process or processes of an entity within the business and geographical markets it operates.” (paragraph B.12)

- (b) the requirements for the recognition/derecognition and measurement of those assets and liabilities,

there is a risk that the ‘business model’ notion might nullify or significantly weaken the concepts referred to in (a) immediately above, and thus become a *de facto* framework to consider when developing or revising Standards. The AASB’s initial thinking is that this risk is an important reason to proceed extremely cautiously when considering whether to invoke the ‘business model’ notion when developing or revising Standards.

S300 Even if the IASB could describe the ‘business model’ notion in a sufficiently specific manner (in the context of the particular asset or liability being accounted for) to address concerns regarding the generally vague nature of an entity’s business model, the concern would remain that it would be difficult to develop requirements in different Standards that are logically consistent with each other. Arguably, this is the case with the reference to ‘business model’ in the measurement requirements for financial assets in paragraphs 4.1.1 and 4.1.2 of IFRS 9.

S301 As indicated in paragraph S190 above, the AASB considers there is a gap in the Conceptual Framework between the objective level and the lower levels, which should be filled by identifying the generic types of information about an entity (stocks and flows) that are relevant to users for making decisions about the allocation of scarce resources. The AASB considers that identifying those stocks and flows would in turn identify comprehensively the consequences of an entity’s business model that are relevant for meeting the common information needs of users. This applies to all aspects of reporting information about the elements of financial statements (i.e. definition, recognition/derecognition, measurement, presentation and disclosure).

Presentation and Disclosure

S302 In relation to the comment in paragraph S281(b) above that the IASB should invoke the business model concept when it develops or revises presentation and disclosure requirements in particular Standards, the AASB considers that it would assist users, when making predictions about the amount, timing and uncertainty of future cash flows, if aspects of the presentation of economic phenomena and disclosures about those economic phenomena were to provide insights into the entity’s business model. This is presently reflected in IFRSs with respect to:

- (a) the classification of non-financial assets as, for example, inventories, investment properties and items of property, plant and equipment (as mentioned in paragraph 9.27 of the DP);
- (b) the management approach to segment reporting (as mentioned in paragraph 9.28 of the DP);
- (c) the classification of assets and liabilities as current or non-current, providing insights into the implications of the entity’s business model for the timing of future cash flows (in this regard, the requirements of paragraph 69 of IAS 1

affecting the classification of liabilities include a combination of ‘business model’ considerations and contractual terms); and

- (d) the distinction between revenue and other income according to whether the inflow of economic benefits arose in the course of the entity’s ordinary activities, in the definition of ‘revenue’ in paragraph 7 of IAS 18 *Revenue*⁶⁹.

S303 As mentioned in paragraphs S283 and S284(a) above, the economic phenomena that presently exist (assets and liabilities) or have occurred (changes in assets and liabilities, including income and expenses) reflect the consequences of the entity’s business model and can be observed independently of the entity’s business model. Different ways of presenting and disclosing (grouping and disaggregating) those economic phenomena complement the faithful representation of those economic phenomena, and are essentially future-oriented. Therefore, the AASB’s initial thinking is that, where it provides useful information, presenting and disclosing those economic phenomena according to the entity’s business model is compatible with the AASB’s thinking that an entity’s business model should not be used in decisions regarding the recognition/derecognition and measurement of those economic phenomena.

S304 The AASB’s initial thinking is that disclosure of the entity’s business model could provide useful information to users of financial reports for predicting the amount, timing, uncertainty and velocity of an entity’s future cash flows. It should be borne in mind that such disclosures would not involve the same transaction being treated differently depending on the entity’s business model. The same applies to separate disclosures about an entity’s operating, investing and financing activities. Paragraph 5.31 of the Research Paper referred to in paragraph S292 above says:

“The business model could have a role in the various ways in which items of income and expense can be disaggregated, ordered, grouped and totalled. This may help separate recurring and non-recurring items and assist users in distinguishing between items more relevant in making assessments about future earnings and cash flows.” (paragraph 5.29)

“... the IASB-FASB joint project on Financial Statements Presentation ... proposed that separation be made into operating, investing and financing activities, based on the nature of the assets and liabilities but also on the economic role they played in the activities of the entity. ...” (paragraph 5.31)

S305 As indicated in paragraph S281(b) above, the AASB thinks it is unlikely that a definition of ‘business model’ would be necessary for presentation and disclosure. This is because multi-faceted disclosures that reflect an entity’s business model, can be focused more precisely on particular aspects (e.g. the expected future timing of cash flows), as illustrated in paragraph S302(c) above.

⁶⁹ This list is illustrative only, and not purported to be a complete inventory of the uses of the ‘business model’ notion in the presentation and disclosure requirements of IFRSs.

S306 The AASB considers that the concerns about a loss of comparability between entities when the ‘business model’ concept is applied (as noted in paragraph 9.31(a) of the DP) have most validity in relation to recognition/derecognition and measurement of the elements of financial statements. This is because the essence of the wealth of entities, composed of the economic resources and present obligations of those entities, arguably does not differ significantly between entities, regardless of their business models. Presentation and disclosure, arguably, have more facets. Accordingly, arguably, differences between entities regarding how they present and disclose information about their economic resources and present obligations have fewer implications for the comparability of financial reports.

Other Comment on Paragraphs 9.23 – 9.34 of the DP

S307 The AASB disagrees in concept with the comment in IFRS 9, repeated in paragraph 9.25(b) of the DP, that: “an entity’s business model is not a choice but is instead a matter of fact that can be observed by the way an entity is managed and information is provided to its management”. The AASB agrees with the statement in that quote that an entity’s business model is observable from the entity’s behaviour, and notes that business models are developed and applied at a higher level than on an asset-by-asset basis or liability-by-liability basis (e.g. the AASB agrees with the comment in paragraph 9.25(d) of the DP that, in contrast with a business model, management’s intentions can relate to a single financial instrument). Nevertheless, the AASB disagrees in concept with the quoted words in the first sentence of this paragraph because it considers that, at any time, an entity’s management can typically choose (albeit subject to any legal constraints) to change the entity’s business model, even though it might be irrational to do so. The comment repeated in paragraph 9.25(b) of the DP seems to extend the point in paragraph 9.25(d) of the DP to an unjustified extent.

Question 24

Unit of account

The unit of account is discussed in paragraphs 9.35–9.41 of the Discussion Paper. The IASB’s preliminary view is that the unit of account will normally be decided when the IASB develops or revises particular Standards and that, in selecting a unit of account, the IASB should consider the qualitative characteristics of useful financial information.

Do you agree? Why or why not?

S308 The AASB disagrees with the preliminary view in paragraph 9.38 of the DP because the AASB considers it is inappropriate to focus on the level (i.e. concepts or standards) at which ‘unit of account’ decisions will ‘normally’ be made. In this regard:

- (a) the AASB observes that the IASB’s conceptual decisions on some issues discussed in the DP will have significant implications for the ‘unit of account’ identified (whether explicitly or implicitly) in concept. Emphasising that the IASB’s decisions regarding the ‘unit of account’ will

normally be made in standards-level projects would seem to insufficiently acknowledge those implications of other conceptual decisions;

- (b) the AASB considers that the ‘unit of account’ is a topic on which both conceptual and standards-level guidance should be developed⁷⁰. Therefore, there is no apparent reason why either the conceptual level or standards level should be emphasised as the ‘normal’ level at which guidance will be developed; and
- (c) emphasising that the IASB’s decisions regarding the ‘unit of account’ will normally be made in standards-level projects could result in a default position or presumption that particular ‘unit of account’ issues will be addressed at a standards level, when the appropriate level of guidance for particular ‘unit of account’ issues should be assessed by the IASB on a case-by-case basis (with, as mentioned in paragraph S308(b) above, any standards-level guidance being supported by conceptual guidance).

S309 As an example of (a) in paragraph S308 above, the AASB notes that concepts for derecognition of assets and liabilities will have important implications for the unit of account. The AASB agrees with the comment in paragraph 9.38 of the DP that “the selected unit of account must ... faithfully represent what it purports to represent”. As indicated in paragraph S103 above, the AASB considers that, if an entity retains a component of an asset or a liability after a transaction or other event, it would be conceptually inappropriate to apply the possible treatment (referred to in paragraph 4.50(c) of the DP) of continuing to recognise the original asset or liability, and treating the proceeds received or paid for the transfer as a loan received or granted. This is because it would not be representationally faithful to recognise in full an asset or a liability that has partially been transferred to another entity.

S310 As referred to in paragraph S190 above, the AASB’s submission on the DP argues that, consistent with the thesis of [AASB Essay 2013-1 *Rethinking the Path from an Objective of Economic Decision Making to a Disclosure and Presentation Framework*](#) (August 2013), there is a gap in the Conceptual Framework between the objective level and the lower levels, which should be filled by identifying the generic types of information about an entity (stocks and flows) that are relevant to users for making decisions about the allocation of scarce resources. Paragraph A43 of the AASB’s submission indicates the AASB does not argue that the stocks and flows identified in AASB Essay 2013-1 necessarily represent the only set of generic information types on which to base presentation and disclosures. The AASB considers that identifying the stocks and flows that, in concept, are useful for meeting the common information needs of users would have ramifications for all levels of the IASB Conceptual Framework below the ‘objective’ level, and therefore should be a precursor to all decisions regarding concepts for the ‘unit of account’.

⁷⁰ Paragraphs A7 and A8(f) of Appendix A to the AASB’s submission on the DP identify the ‘unit of account’ as an issue that should not be addressed only at a standards level without conceptual underpinnings to guide those standards-level decisions.

- S311 The AASB considers it would be useful to acknowledge the ‘unit of account’ implications of the proposal in paragraph 3.4 of the DP to define ‘economic resource’ as “a right, or other source of value, that is capable of producing economic benefits”. As indicated in paragraph S16 above, adopting this proposal would confirm a shift away from traditional notions of accounting for physical objects and toward accounting for different rights (or other sources of value) composing economic resources. This shift should be particularly helpful over time in developing a deeper understanding of the economic substance, and accounting implications, of different rights (or other sources of value) composing economic resources. This shift might, in turn, lead over time to greater disaggregation of non-financial resources into their component rights (or other sources of value)⁷¹.
- S312 As indicated in paragraph D1 of Appendix D to the AASB’s submission on the DP, ‘unit of account’ is a topic on which conceptual guidance might take a long time to fully develop. The AASB considers that, at this relatively early stage of conceptual consideration of that topic, it would be inappropriate to specifically take account of cost/benefit considerations (as referred to in paragraph 9.39 of the DP), over and above the general implications of the guidance on cost/benefit considerations in Chapter 3 of the IASB Conceptual Framework. That is, it would seem difficult to make sound conceptual decisions about the level of aggregation that might be warranted for cost/benefit reasons until each of the other potential factors affecting the ‘unit of account’ topic is conceptually explored.
- S313 Subject to the comments in paragraphs S308 – S312 above, the AASB broadly agrees with the other aspects of the discussion of ‘unit of account’ in paragraphs 9.35 – 9.41 of the DP.

Question 25

Going concern

Going concern is discussed in paragraphs 9.42–9.44 of the Discussion Paper. The IASB has identified three situations in which the going concern assumption is relevant (when measuring assets and liabilities, when identifying liabilities and when disclosing information about the entity).

Are there any other situations where the going concern assumption might be relevant?

- S314 The AASB has not identified circumstances, other than those mentioned in paragraph 9.43 of the DP, in which the going concern assumption would affect an entity’s financial statements. In relation to the comment in paragraph 9.43 of the DP that “whether an entity is or is not a going concern could affect the disclosures that are made by that entity”, the AASB considers that the revised IASB Conceptual Framework should include a comment similar to the following statement in paragraph 25 of IAS 1:

⁷¹ In this paragraph, the term ‘economic resources’ is used to encompass treating a set of rights as either a single economic resource or multiple economic resources, consistent with the discussion of economic resources in paragraph 3.7 of the DP.

“When management is aware, in making its assessment [of the entity’s ability to continue as a going concern], of material uncertainties related to events or conditions that may cast significant doubt upon the entity’s ability to continue as a going concern, the entity shall disclose those uncertainties.”⁷²

S315 The AASB considers that this guidance should be included in the revised IASB Conceptual Framework because of the fundamental importance of these disclosures to users’ assessments of the amount, timing and uncertainty of the entity’s future cash flows.

S316 If such a comment were to be included in the revised IASB Conceptual Framework, the AASB thinks it would be useful for the IASB to consider providing guidance on whether such disclosures would generally be limited to entity-specific information. For example, arguably, expectations about future general economic conditions would not warrant disclosure, because users do not rely on financial reports to assess such matters and disclosing such expectations would add clutter to the financial report. In contrast, an entity’s particular vulnerability to a predicted downturn in economic activity – for example, because of stringent conditions in borrowing covenants, might be relevant information to users.

Question 26

Capital maintenance

Capital maintenance is discussed in paragraphs 9.45–9.54 of the Discussion Paper. The IASB plans to include the existing descriptions and the discussion of capital maintenance concepts in the revised *Conceptual Framework* largely unchanged until such time as a new or revised Standard on accounting for high inflation indicates a need for change.

Do you agree? Why or why not? Please explain your reasons.

S317 As indicated in paragraph B142 of Appendix B to its submission on the DP, the AASB strongly disagrees with the preliminary view in paragraph 9.49 of the DP that the topic of capital maintenance should be addressed at a standards level in the context of accounting for high inflation. This is because the AASB considers that:

- (a) concepts of capital maintenance are important regardless of the type of economic environment in which the reporting entity operates (i.e. whether highly inflationary or otherwise);

⁷² However, these words should be modified for expression as a concept instead of a requirement of an IFRS. In addition, the AASB’s recommendation does not focus on the precise wording of this quote from IAS 1. For example, it does not address the question raised recently by the International Auditing and Assurance Standards Board regarding the relationship between ‘significant doubt’ and ‘material uncertainty’. In addition, the AASB wrote to the IASB on 17 January 2014 regarding the IASB’s agenda decision in relation to ‘Disclosure requirements about an assessment of going concern’ [see http://www.aasb.gov.au/admin/file/content102/c3/AASB_Submission_to_IASB_Going_Concern_Jan14.pdf].

- (b) every measurement basis adopted for the various elements in a set of financial statements, and the treatment of any changes in the carrying amounts of those elements, implicitly reflects concepts of capital and capital maintenance. The AASB thinks it is preferable to have explicit coherent concepts of wealth and changes in wealth ('capital' and 'capital maintenance') than implicit and potentially conflicting concepts for those matters; and
- (c) for the reasons in (a) and (b) immediately above, the issue is so pervasive that it should be addressed in the Conceptual Framework rather than a standards-level project.

S318 As indicated in paragraph B146 of Appendix B to the AASB's submission on the DP, the AASB's concerns in paragraph S317 above are not allayed by the proposal in paragraph 9.50 of the DP to retain the existing Conceptual Framework's discussion of concepts of capital maintenance largely unchanged until any project on accounting for high inflation indicates a need for change. This is because the discussion of concepts of capital maintenance in the existing Conceptual Framework is descriptive and does not indicate which concept of capital maintenance is conceptually ideal.

S319 These comments in paragraphs S317 – S318 above are elaborated on in paragraphs B142 – B148 of the AASB's submission on the DP.

Other issues raised by the DP

S320 In addition to its responses above to the specific matters for comment in the DP, the AASB has the following comments on other issues raised (explicitly or implicitly) by the DP.

Relationship between the IASB Conceptual Framework and IAS 8

S321 As indicated in paragraph B10 of Appendix B to its submission on the DP (within its comments on the broader issues addressed by Question 1 in the DP), the AASB recommends the IASB considers how to better describe the relationship between its Conceptual Framework and the requirement in paragraph 11(b) of IAS 8 that, in the absence of an IFRS that specifically applies to a transaction, other event or condition, management, in using its judgement in developing an appropriate accounting policy, shall refer to, and consider the applicability of the definitions, recognition criteria and measurement concepts in the Framework.

S322 The AASB considers that the IASB Conceptual Framework should explicitly distinguish:

- (a) concepts that should presently be considered by management when applying paragraph 11(b) of IAS 8; from

- (b) concepts that signal a pathway to future best practice. These concepts should be identified overtly as aspirational.

S323 These comments in paragraphs S321 – S322 above are elaborated on in paragraphs B10 – B17 of the AASB’s submission on the DP.

‘Non-controlling interests’ in a group entity’s equity

S324 As indicated in paragraph B82 of Appendix B to its submission on the DP, the AASB observes that paragraph 5.21 of the DP seems to presume that separate presentation of non-controlling interests (NCI) in a group entity’s equity would continue under the revised IASB Conceptual Framework. The DP does not discuss the issue of whether, *in concept*, it is appropriate to continue such separate presentation, even if the presentation requirements for NCI were retained in IAS 1. The AASB considers that the DP should have discussed this issue because:

- (a) the existing IASB Conceptual Framework does not include a reference to the presentation of NCI; and
- (b) a parent/NCI distinction apparently reflects a parent perspective, rather than an entity perspective, to a group entity’s financial reporting.

S325 The AASB considers that it would be inappropriate for the IASB’s ED of its revised Conceptual Framework to propose that NCI in a group entity’s equity should be presented separately in that entity’s financial statements.

S326 These comments in paragraphs S324 – S325 above are elaborated on in paragraphs B82 – B86 of the AASB’s submission on the DP.

Attachment to AASB Supplementary Paper on IASB DP/2013/1

Elaboration of Response to Question 8: Recognition Criteria

Obtuse description of the ‘faithful representation’ recognition criterion (paragraph 4.25(b) of the DP)

- A1 In relation to paragraph 4.25(b) of the DP, the AASB considers that expressing a ‘faithful representation’ recognition criterion in relation to whether an asset or liability (or changes in the asset or liability⁷³) would be faithfully represented is obtuse, and consequently raises relevance considerations (thus confusing the distinction between the recognition criteria based on relevance and faithful representation). For example:
- (a) sufficient evidence might exist to enable faithful representation of the depreciated/amortised historical cost of an asset or a liability, but some might consider that this historical cost-based measure does not faithfully represent ‘the asset or liability’ (e.g. the asset might be land acquired fifty years ago); and
 - (b) sufficient evidence might exist to enable faithful representation of the fair value of an asset or a liability, but some might consider that measuring the asset at fair value at the beginning and end of the period would not faithfully represent pertinent changes in the asset or liability during the period because it gives rise to volatility that they consider is not reflective of the entity’s business model.
- A2 In both paragraphs A1(a) and A1(b) above, the described views that some might hold would be views regarding the *relevance* of the measurement bases that can be faithfully represented in the circumstances. The AASB considers that whether a measurement basis applied to an asset or a liability provides sufficiently relevant information should not determine whether that asset or liability (or, consequently, a change in that asset or liability) is recognised—instead, it should be addressed only in the Measurement chapter of the revised IASB Conceptual Framework.
- A3 For the reasons in paragraphs A1 – A2 above, the AASB considers that the ‘faithful representation’ recognition criterion should be worded more specifically, and independently of relevance considerations. That is, the criterion should require, in concept, that the asset or liability possesses a measure that is consistent with what it purports to represent. For example, the criterion in paragraph 4.25(b) of the DP could be reworded along the following lines: “if no measure of the asset or liability can be faithfully represented, even if all necessary descriptions and explanations are disclosed”.

⁷³ The AASB’s concern regarding the clarity of the proposed recognition concept that changes in an asset or a liability must be faithfully represented are discussed separately in paragraphs S85 – S89 of this Supplementary Paper, and are not repeated here.

An entity “need not” or “should not” recognise an asset or a liability (paragraph 4.25 of the DP)

- A4 The AASB considers that it is inappropriate to say, as paragraph 4.25 of the DP does, that, in the circumstances in both sub-paragraphs of that paragraph, “an entity need not, or should not, recognise an asset or a liability”. This is because the AASB considers the ‘thresholds’ applicable to each of sub-paragraphs (a) and (b) of that paragraph should be different. Specifically:
- (a) in the circumstances described in sub-paragraph (a), particularly if recognition of the asset or liability in question would not provide users of financial statements with information that is sufficiently relevant to justify the cost, “need not” seems more apt—that is, recognising the asset or liability when the costs exceed the related ‘relevance’ benefits would not necessarily detract from the qualitative characteristics of the financial information reported⁷⁴; and
 - (b) in contrast to (a) immediately above, in the circumstances described in sub-paragraph (b) of paragraph 4.25, only “should not” seems apt, because if no measure of the asset or liability would achieve faithful representation, the asset or liability should not, in concept, be recognised.

Specific comments on draft guidance on whether recognition of an item meeting the definition of an asset or a liability might not provide relevant information (paragraph 4.26 of the DP)

- A5 Paragraphs A6 – A13 below discuss the draft guidance in each sub-paragraph of paragraph 4.26 of the DP regarding “indicators that recognition might not provide relevant information”. As indicated in paragraphs S78 – S81 of this Supplementary Paper, the AASB considers that most of the examples in paragraph 4.26 of the DP would seem to relate to entity-specific circumstances and therefore relate to faithful representation, rather than relevance.
- A6 In relation to **paragraph 4.26(a)** of the DP, the AASB considers that an economic resource or a present obligation for which it is probable that any future economic benefit associated with that item will flow to or from the entity⁷⁵ should rarely

⁷⁴ Consistent with its comments in paragraphs S72 – S74 of this Supplementary Paper, the AASB considers that the IASB’s determinations of whether recognising an asset or a liability would provide information that is not relevant, or not sufficiently relevant to justify the cost (consistent with the preliminary view in paragraph 4.25(a) of the DP), should be assessed in respect of classes/types of assets or liabilities. Accordingly, the AASB considers that paragraph 4.25(a) of the DP should not have implications for the materiality of assets and liabilities that might be recognised in the financial statements. It should also be noted that the AASB considers that the revised IASB Conceptual Framework should state that recognition of immaterial classes of assets and liabilities should not occur to the extent that users of financial reports would be impeded from identifying the information that is important for making resource allocation decisions (see paragraphs S75 – S76 of this Supplementary Paper).

⁷⁵ See paragraphs S21 – S27 of this Supplementary Paper, which outline the AASB’s disagreement with the preliminary view in paragraph 2.35(c) of the DP that probability should be deleted from the recognition criteria.

warrant non-recognition on account of having an extremely wide range of possible outcomes for which the likelihood of each outcome is exceptionally difficult to estimate. The AASB is concerned that:

- (a) non-recognition of an asset or a liability is effectively the same as recognition at a nil amount; and
- (b) recognition of an asset or a liability at a nil amount would generally be less representationally faithful than recognition at the best estimate of the amount of that asset or liability, determined consistently with the measurement basis adopted for the class of assets or liabilities to which that asset or liability belongs.

A7 In relation to paragraph A6 above, the AASB considers that, when the likelihood of different outcomes within a range of possible outcomes is exceptionally difficult to estimate, this problem can be overcome if the entity can reasonably estimate either:

- (a) a best single-point (modal) estimate of the item; or
- (b) the boundaries of the range of possible outcomes.

This is because, if the skewness of the distribution of possible outcomes is unknown, it is arguably reasonable to assume that the distribution is normal (in which case, the modal estimate or central point in the range of possible outcomes would be reasonably supported by the evidence as the best estimate of the asset or liability).

A8 Nevertheless, the AASB notes that, for some economic resources or present obligations, an amount receivable or payable might be unspecified and evidence might not exist (through prior experience of either the reporting entity or other entities with similar economic resources or present obligations) on which to base an estimate. For example, this might be the case with a unique litigation case involving unspecified damages. Therefore, the AASB considers that non-recognition of an economic resource or a present obligation might be warranted in rare instances of the circumstances described in paragraph 4.26(a) of the DP.

A9 As mentioned in paragraph S81 of this Supplementary Paper, **paragraph 4.26(b)** of the DP refers to an asset or a liability that exists but there is only a low probability that an inflow or outflow of economic benefits will result. In its submission on the DP, the AASB's recommendations related to such circumstances are that the 'probable' criterion as worded in paragraph 4.38(a) of the existing IASB Conceptual Framework should be retained and 'probable' should be defined as "more likely than not" (see paragraph B23 of Appendix B to the AASB's submission on the DP, as referred to within paragraphs S21 – S25 of this Supplementary Paper). In addition, the AASB:

- (a) emphasises the point, made in paragraphs B26 – B29 of Appendix B to its submission on the DP, that the reference to "any future economic benefit associated with the item" in the 'probable' criterion in paragraph 4.38(a) of the existing IASB Conceptual Framework is, appropriately, much broader

than the reference to the “ultimate inflow or outflow” of economic benefits in paragraph 2.35(c) of the DP; and

- (b) notes that, although paragraph 2.35(c) of the DP sets out a preliminary view that probability should be deleted from the recognition criteria, the first sentence of paragraph 4.26(b) of the DP implies the IASB might apply at a standards level a form of ‘probability’ criterion that instead is portrayed in the DP as a relevance test [it says: “if ... there is only a low probability that an inflow (or outflow) of economic benefits will result: in some such cases, the IASB might conclude that users of financial statements would be unlikely to include information about that inflow (or outflow) directly in their analysis”]. In this regard:
 - (i) the AASB is concerned that paragraphs 2.35(c) and 4.26(b) of the DP seem to treat probability inconsistently, albeit that paragraph 4.26(b) of the DP indicates any consideration of probability would be made by the IASB alone; and
 - (ii) as indicated in paragraph B33 of Appendix B to the AASB’s submission on the DP, if probability is to be a factor in some recognition decisions, “the AASB considers it would be preferable to include a ‘probable’ criterion in the revised IASB Conceptual Framework. Addressing any form of probability-based recognition criterion in standards only would increase the risk that different, and potentially biased, recognition criteria would be set out in different standards (e.g. a higher recognition hurdle for assets than liabilities)”.

A10 In relation to **paragraph 4.26(c)** of the DP, the AASB is not convinced that the degree of difficulty of identifying an economic resource or a present obligation would of itself be a reason for non-recognition of that resource or obligation. Generally, the existence of an entity’s rights and obligations should not be particularly difficult to identify (the most problematic area might be legal disputes, where differences of opinion might exist regarding the facts). The greater difficulty would seem to pertain to measurement of the economic resources or present obligations, particularly (in the case of economic resources) with internally generated economic resources. In the case of acquired economic resources, the purchase contract would be expected to specify the rights acquired, enabling separate identification of those rights. In addition, the transaction price would provide evidence for measuring the historical and current cost of the rights acquired, either individually or in aggregate (as part of a ‘basket purchase’ price). For acquired economic resources, difficulties in separately identifying different economic resources would seem to be more pertinent to the unit of account adopted than to whether the economic resources should be recognised (i.e. those economic resources might be recognised, but without being separately identified due to insufficient evidence of their separate price). For internally generated economic resources, the lack of specific transactions providing evidence of their value (either separately or as part of a larger unit of account) might in some cases make it too difficult for the entity to faithfully represent a measure of those resources.

- A11 For the reasons in paragraph A10 above, the AASB considers it would be typical for ‘difficulties in identifying an economic resource or a present obligation’ to more accurately be characterised as difficulties in faithfully representing a measure of that economic resource or present obligation. Thus, the AASB considers that the circumstances described in paragraph 4.26(c) of the DP are not significantly different from those described in paragraph 4.26(a) of the DP. As indicated in paragraph A8 above, the AASB considers that only in rare instances would non-recognition of an economic resource or a present obligation be warranted due to difficulties with faithfully representing the amount of that economic resource or present obligation.
- A12 In relation to **paragraph 4.26(d)** of the DP, the AASB considers that unusually difficult or exceptionally subjective allocations of cash flows that do not relate solely to the item being measured should only be a potential reason for non-recognition of an economic resource or a present obligation when that resource or obligation:
- (a) possesses neither:
 - (i) an identifiable cost (e.g. an economic resource is internally generated and ‘cost accumulation’ techniques would involve extremely arbitrary allocations of costs to that economic resource⁷⁶); nor
 - (ii) a market price that can be observed or of which a representationally faithful estimate can be made; and
 - (b) does not qualify for recognition within a larger group of assets or liabilities.
- A13 In relation to **paragraph 4.26(e)** of the DP, the AASB considers that only rarely, if ever, would recognition of an asset be unnecessary for meeting the objective of financial reporting (i.e. lack relevance). As mentioned in paragraph S72(b)(ii) of this Supplementary Paper, the AASB notes that paragraphs 4.9(c) and 4.26(e) of the DP cite internally generated goodwill as an example of such an asset. The AASB’s comments on the DP’s discussion of whether internally generated goodwill should be recognised as an asset are set out in paragraphs S90 – S93 of this Supplementary Paper.

⁷⁶ Bearing in mind that cost allocations involving a degree of arbitrariness in the assumptions made commonly occur under any type of cost-based measurement model, even for some assets acquired in purchase transactions.