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A review of the IASB's Conceptual Framework for Financial Reporting,
ITC 29
DP/2013/1

Dear Sirs:

Many thanks for the opportunity to participate in the AASB Forum on the Conceptual Framework, discussing the IASB's Discussion Paper (DP) relating thereto.

Our concerns at a broad level reflect the general lack of both clarity and rationale for changes proposed by the IASB to the Conceptual Framework. At a more substantial level, we are concerned that the logical coherence of the existing Conceptual Framework (being an aspirational document) is being sacrificed as the DP moves the Framework toward being an imperfect toolbox. The DP would have a Conceptual Framework that retrofits existing practice, rather than leading standard setting.

We do not intend to provide detailed analysis of issues which the Boards (AASB and IASB) have thoroughly researched. Instead, we wish to focus on the salient points. We refer to the IASB proposed framework as the Conceptual Framework (CF) throughout.

1. **Motivation.** It has been asserted that the CF project is intended to address deficiencies in the existing CF. Unless it is made clear what these deficiencies are, it is not possible to evaluate whether the proposals in the Discussion Paper take a step forward over the current CF.

2. **Conceptual integrity.** A second general point: the DP seems to have abstracted away from concepts towards retrofitting current practice. This is a concern. A coherent CF that acts as an ideal for practice is optimal, as it articulates consistent principles. Departures from these principles would then be clearly flagged as exceptions, possibly politically motivated, or prompted by non-recurrent events of financial and economic significance, which amplify the problems in standard setting and implementation. The CF would nonetheless stand inviolate as a statement of the optimum. The proposed changes to the CF render it a political grab-bag of concepts.

This is especially the case in the proposed measurement "principles". Indeed, we see no principles. The theoretic link between a financial statement **element**, through the **attribute** being measured, to the **measurement basis** has been vitiated through a total omission of attribute discussion.

In our view, many questions need to be considered before measurement can be addressed sensibly. Even if an attribute or set of measured attributes can be decided upon, what approach should be taken? Should the measurement proceed from a stewardship perspective or user's perspective? Different perspectives will determine the way items are measured. Should the proposed CF be so specific about the measurement rules or should it be taking the stand of providing guidance at a broader level? In our opinion, the measurement part stands out as overtly inconsistent with the general principles that the rest of the CF is trying to provide.

A much more honest approach would be to admit that agreement cannot be achieved, and simply leave the measurement section of the CF incomplete. It could be addressed at a later date after further deliberation. That would be much more straightforward and intellectually honest than the incoherent grab-bag of measurement that the DP proposes.

The real reason we have lack of agreement on a measurement basis is that not all preparers can agree on what should be measured. The IASB would be better focussed on undertaking a financial attributes project. Once people have been exposed, over a period of years, to the idea that we need to select (an) attribute(s), perhaps choosing a measurement strategy will be a much more defensible step. But the preparatory work needs to be done on attributes first. Selecting a single measurement basis may be an uncomfortable choice – historical cost or fair value – but definitely requires more deliberation and discussion than the current DP provides.

3. **Asymmetry.** The proposed CF has asymmetric measurement rules. There is a tendency to recognise liabilities by removing the probability test, but the recognition of assets is much more conservative. For example, Views 2 and 3 on Liabilities require some assumption that the entity will be around to discharge these liabilities, hence they should be recognised.

   We recall the example mentioned in the Sydney Forum on 15th October. It related to recognising – as a liability – a levy from operating a train (where obligating events for the levy are all kilometres travelled beyond the 900 000th in the calendar year), even when only 600 000 km have been achieved by the end of the financial year. If there is an assumption that an entity will be around to pay the levy (hence the liability), why not also assume that we will be around to earn the income (hence record an asset)? Conservatism is not a reasonable argument for this. An accounting policy that has conservative effects on equity (reducing it) may not have conservative effects on ratios that use that number (e.g. ROE). The conservatism caused by asymmetry may in many cases yield over-optimistic performance measures.

4. **Inconsistent terminology.** "Income" is now used in the sense of revenue (i.e. "income" is *revenue* and *gains*). But it is also used in the traditional sense of "earnings" as in "Other Comprehensive Income". This results in terminological confusion which needs to be addressed.

5. The **new definitions** of assets and liabilities ostensibly remove the future and refer now only to the past and the present. This is great. Accounting should not reflect what preparers think might happen in the future.. The future is up to investors to consider for themselves, and – insofar as assets are concerned – this seems to be the view taken in the DP. In contrast, however, the guidance for liabilities **does** choose to look into the future, if either of Views 2 or 3 are to be considered seriously. This underscores the points made about asymmetry before. If we introduce a conservative bias into liabilities, then we also introduce an anti-conservative bias into derived measures, such as ROE. Because we cannot anticipate how our information is used, and/or whether conservatism will induce an optimistic bias, we should aim for neutrality rather than conservatism.

   We are aware that prudence is no longer a guiding issue. However, it still implicitly underlies much practice.

6. **Control.** In a preliminary comment, the AASB seems to be of the view that control may be more appropriate as merely a recognition criterion. We do not agree with this. Either control or ownership must be present in the definition. The key elements of an asset are not merely that the resource exists, but that it is somehow related to the entity.

7. **Recognition criteria.** There should be no reference to recognising "*unless information is not relevant or insufficiently relevant to justify cost"*. This is – in a sense – reflecting materiality and/or the cost-benefit trade-off. For immaterial information, standard application is irrelevant – do we really need to say this? If so, does it belong in recognition criteria, or in the discussion of the qualitative characteristics of accounting information?

   Removing probability from the recognition criteria is consistent with 5 above. This leaves only reliability (in its form as the current jargon-de-jour, *faithful representation*) as a recognition criterion. However, unless we clarify what the attributes of assets and liabilities being measured are, how can we decide whether a particular measurement or recognition decision results in them being faithfully represented?

8. **What recognition criteria?** Having made the comments above in support of removing probability (from the definitions), we wish to underline that we are not in support of removing it from the recognition criteria. If reliability and probability go, then the remaining recognition rule seems to be: record everything unless there are measurement problems. We are not sure what this means.

9. **Statement of Changes in Equity**. The idea that we should be measuring changes in the value of equity is misguided. It is tantamount to suggesting that preparers are better at understanding how information about equity is used than the information intermediaries who use it themselves. For example, one variable for determining the potential presence of growth options is the *market to book* ratio. By attempting to reflect market, we are contaminating the ratio and eliminating this analysis route. Moreover, the idea – that preparers know best about what users of this information want – risks taking us down the same route as the IAS33/AASB133 fiasco.

10. **Secondary equity claims.** We have a fundamental problem with the idea that secondary equity claims are always equity even if they are really liabilities. For example, the proposed CF would classify as equity a liability (say a share-based payment) where settlement is for a variable number of equity instruments to meet a fixed quantum of currency units. Now, whether something is an asset does not depend on whether the benefits inherent in that item are realised in cash, services or chickens. Why then should an obligation be classified variously as debt or equity depending on the mechanism of settlement? This is a conceptually flawed suggestion.

    The chief difference between equity and debt superficially has two aspects. They lie in different parts of the risk spectrum; and, more importantly, a liability is a fixed claim whereas equity is a residual. Of course, something may be partly residual (e.g. certain liabilities with variable payouts, such as a variable rate loan). So ultimately, the only thing that matters is the risk spectrum. Nonetheless, the example cited (a Share Based Payment payable in shares but at a rate specifying a fixed and determinable cash equivalent) is clearly at the low-risk/liability end of the spectrum. We must first strengthen the definition of liabilities; then the definition of the residual (equity) follows implicitly.

11. **Seeing equity where there is none.** A more significant concern stems from the existence of entities where there is no equity: i.e., certain types of trust structures, and Defined Contribution Pension schemes. The DP would have the "most subordinated" liability recorded as equity. We are not convinced that this makes sense. Although trusts and DCP entities are not (yet) within the remit of existing IASB standards, they (a) are within the remit of "AusIASB", i.e. AASB standards, and (b) may be addressed by the IASB in future. Changing this definition of equity will have unforeseen flow-on effects when and if these issues are addressed.

12. **Other Comprehensive Income (OCI).** There is no clear conceptual basis for, or definition of, OCI. Therefore, we cannot determine what should be in or out of OCI without knowing OCI's presumed information role. As in days of yore, it seems to be trying to achieve a parking place for things that various people from time to time will argue as "inconvenient" for performance. Any such dividing line is arbitrary at best.

    Let's be honest. OCI is just the latest reincarnation of the *abnormal items/extraordinary items* issue. However, even with the existence of OCI, we still see companies making up their own non-GAAP numbers and using them to communicate performance to shareholders/investors. We have seen a proliferation of concepts such as "cash earnings", "pro forma earnings", "underlying earnings", etc. No matter what we do with OCI, and however we redefine the concept, we will leave some people unhappy.

    There is a fundamental tension between reporting total wealth change of shareholders, and allowing managers to point at a number which reflects what they control versus what they don't. Underlying all these arguments about *extraordinaries/abnormals* or OCI, and about the way OCI is interpreted in particular standards, is this same latent issue. This issue can only be addressed at the standard level, not the CF level; set a standard for reporting an adjusted profit that allows managers to point to a number and say "this is what you should hold us accountable

for, because it reflects things that we control". By keeping managers and boards happy with one of these numbers, you will find that they care little about which parts of total wealth change are called Profit, and which are called OCI.

Even if the above is unpalatable, something must be done about OCI. There is no one characteristic that is constant across all OCI numbers. Realisation? What if we have market-to-market financial instruments that are so liquid that they may as well be cash-like?

In general, there seems to be no coherent concept of what OCI should be. It is argued by one of our colleagues in a separate submission that OCI should catch items from "mismatches". However, the idea of "matching" (and consequently of "mismatches") has died long ago. There is no coherent argument for separating Profit from OCI. If the argument is a quality-of-recognition argument, then it is not an argument about OCI, but an argument about recognition.

13. **OCI as a Rubbish Dump.** To summarise the argument from 12: Everyone we have heard speak about OCI describes it as the place to put items that do not reflect performance. The only problem is that each person wants to place different things there. OCI serves the same role as *pro-forma profit* or *underlying earnings*; it helps us define the profit we "want to report", rather than a comparable and consistent profit. It is the "extraordinary items" of our day; i.e., it is where we park inconvenient rubbish.

14. **Recycling.** OCI articulates Profit to the Balance Sheet. Although cross-statement articulation may be important, time-series articulation can be argued to be just as important (especially for analysts who attempt to construct predictive models). If neither the *sum of Profit* on the one hand, or the *sum of Profit plus OCI* on the other, yields the total profit over the life of the business, then users' ability to sensibly determine (let alone interpret) trends is vitiated. If we must have this OCI monstrosity, then at least do not undermine articulation; recycle everything or nothing. Using a consistent recycle all or nothing is a more comparable alternative to piecemeal treatment.

15. **An alternative to OCI.** Keith Reilly made a proposal at the Sydney Forum on 15th October, which is consistent with 12 above. The proposal has merit: report a Comprehensive Income measure that does not differentiate between normal profit and OCI; then let companies report a second number/statement where they can say "Hey! This is the number you should be looking at." These second numbers can be argued against on the basis that they would just be "profit without the bad bits". However, such numbers are already out there: *pro-forma profit, underlying earnings* and *cash earnings* are rubbish. All that OCI does is take the right to generate rubbish away from individual firms, and give it to the standard setters (in effect: stakeholders who can be bothered lobbying strongly enough, inconsistently from issue to issue).

16. **OCI and volatility/accountable performance.** Excluding items such as gains/losses of pension funds, even though they have a real economic effect on companies (e.g. General Motors) may be convenient, but it hides performance. You can say that the volatility of pension funds is not something that should be reflected in performance. Managers can tell these stories. But I am not sure that users (shareholders or taxpayers) of financial information buy these stories. Just because users are too

disparate to participate in standard setting does not mean that we should show them such callous disregard. "*Promote disclosure of useful entity-specific information*" seems to justify information overload without considering how users use reports.

17. **Presentation.** Under presentation, references to nature/function and so forth in the objective of financial statements seem to exemplify unnecessary micromanagement in the CF of issues which should properly be dealt with in substantive standards.

18. **Existing primary statements.** We are generally happy but, if the IASB is to insist on the existence of OCI, then we strongly object to the ability to report OCI in a separate statement from Income. Total changes in the wealth of shareholders due to the operations of the business should be reported on a single statement, preferably on one page. The best performance statement ever, in our opinion, was the last Australian pre-IFRS Income statement. Everything was profit, except for three exceptional categories: revaluation, foreign currency translation changes and fair value hedges. Even so, they were reported on same page as the Income Statement.

19. **Uncertainty.** One argument for OCI is the idea that some information is of lesser quality, because of problems with realisation or (in the case of hedges) accounting not reflecting economic reality. If these are the problems, then address them directly not indirectly. If a hedge of a forecast transaction is a real economic hedge, then find a way of recording the notional gain/loss from which the hedge insulates the entity. If information quality is an issue, then how about thinking outside the box?

    An alternative profit measure as already discussed can easily be generated from well-designed accounting systems.

In summary, the DP would move the CF backwards. The IASB has identified something that is broken – without specifying exactly how – and has moved to address these unspecified deficiencies by hitting the CF with a sledge hammer (breaking it some more) rather than seeking to improve it. These are changes for changes' sake.

We have already squandered coherence by adopting the artificial American bifurcations firstly between revenue and gains, and secondly between losses and other expenses. Although this has moved us closer to the FASB, the usefulness of the bifurcations is doubtful. As long as OCI exists, it allows people to dump items they don't like into OCI on an inconsistent standard-by-standard basis.

We are not ideological puritans. The fundamental problem with the DP is that it proposes a set of changes without a coherent explication of what is wrong with the current CF. As such, it is difficult to measure whether the DP looks like succeeding. .

Up until now, there has been a semblance of principle and conceptual integrity in the CF. These proposed revisions to the Conceptual Framework vitiate this.

Sincerely,

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