THE UNIVERSITY OF MELBOURNE
FACULTY OF BUSINESS & ECONOMICS

Kris Peach
Chair
Australian Accounting Standards Board
PO Box 204
Collins Street West Victoria 8007
AUSTRALIA

Dear Kris,

Re: Submission on ED 264 "Conceptual Framework for Financial Reporting"
Introduction

1. These comments are submitted by academic staff of the Department of Accounting at the University of Melbourne[1]. The comments include those on the implications of the proposals from a teaching perspective and from an empirical research perspective. Appendix A sets out our views on the questions included in the ED by the AASB.

Overview of comments

2. The Conceptual Framework ("CF") is particularly important to us in teaching and researching financial reporting and auditing. It provides the broad concepts that give context to students for the topics we teach, which are necessarily simplified from the level confronted by practitioners. At the research level, the CF provides a context for evaluating standards, practice and proposals. It also provides a set of assertions which can themselves be evaluated.

3. Whilst the existing CF is a somewhat limited document, it has been extensively used for the above purposes. Its limitations have almost exclusively related to a lack of coverage of certain key areas (for example, measurement). What the CF has addressed has been largely acceptable as a basis for teaching and to some degree researching. One might describe it as a "safely aspirational" rather than adventurous document that has a distinctly different content than found in standards, though the criteria for such a difference remains implicit. We do see the current CF as being aspirational in that it is relatively coherent in theory when compared with the content of individual standards. This has assisted teaching and inspired reflection and research.

[1] One member of the staff is also a member of the Firm, Stevenson McGregor, and so there are some sections of this submission which are common with that Firm's submission.

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4. Our overall reaction to the proposed CF is that it has become a mixture of concept and rule making, often without a clear expose of the principles behind proposals made and often addressing matters we would have expected to see debated in the development of standards. Whilst that might provide a fertile ground for research into assertions and apparent inconsistencies, it will make teaching and learning far more difficult.

5. The IFRS Foundation has promoted a conceptual framework based approach to teaching financial reporting. We do not think the proposed CF is as suitable in that regard as the current CF. If the proposed CF is finalised in its current form, we expect that teachers will have to construct versions of the document to try to distinguish principles from rules and to try to draw out the implicit compromises.

6. Whilst we do see some merit in some of the refinements of the definitions of the elements, we disagree with most of the extensions of the current CF and believe that significant gaps in the existing CF will remain.

7. From an empirical research viewpoint, we see no evidence in the Basis for assertions about the usefulness of the proposals relating to Other Comprehensive Income (OCI), or indeed for any of the major proposals. Given the support which the IASB has given to researchers to provide evidence for standard-setting, there is little if any evidence in the proposals that the research literature has been used.

8. Taken as a whole, we do not think that the proposed CF is an improvement on the existing CF and think that considerable more debate and work should take place before most of the proposals are modified and advanced.

More Detailed Comments

9. We have chosen to follow the CF in terms of comments rather than the specific questions included in the ED.

Definition of Financial Reporting

10. It is critical when establishing any framework to define the subject. In this regard we believe that the proposed CF has not addressed the critical issue of what constitutes financial reporting. This is surprising given the rise of integrated accounting and the general debates about what should be included within financial reporting and what should fall outside of it. We do not think that avoidance of this topic on the grounds that expectations of financial reporting are changing is an adequate response.

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Definition of Reporting Entity

11. There have been considerable debates in Australia as to which entities should report. This question has come to the fore in the area of differential reporting and in the extension of accounting standards into the public and not-for-profit sectors. The IASB has so far only considered the borders of the reporting entity and not when should one exist. This is left to local jurisdictions to consider, except that the dividing line drawn between IFRS and SME accounting has effectively deemed publicly listed entities to be reporting entities. However, there is no exploration of whether very small entities should account on the same basis as SMEs. Conceptually, the IASB must have some implicit idea of when an entity should be a reporting entity. We would have expected that when there is a range of users dependent upon general purpose financial reports to make decisions about allocating scare resources that the entity should be, prima facie, a reporting entity.

Objective of Financial Reporting

(i) Stewardship

12. We are not in favour of the proposed inclusion of references to stewardship. This seems to be no more than a semantical strategy to overcome conservative commentators. Management has a responsibility to report on the financial position and performance of the entity in a manner that enables users to make economic decisions. We cannot see any other purpose that stewardship could imply. It is a redundant upon the current CF or, at most, a description of a responsibility of management to report in accordance with the CF.

(ii) Primary users

13. We note the discussion of the role of common information needs in the ED on Materiality and think it better explained there than in the proposed CF. We see no purpose for identifying primary and other users once that concept is in place.

Qualitative Characteristics

Prudence

14. We disagree with the inclusion of this topic in the proposed CF. It reflects poorly on the IASB that it enters into semantical compromises that unbalance the CF and take it away from economic decision-making. We see the push for prudence as nothing more than a cloak for promotion of conservatism.

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15. We believe that there is evidence that conservatism is not cost-free and note that the IASB has effectively recognised this in their arguments for the adoption of IFRS to remove premiums for accounting risk[2]. Allowing conservatism to regain a foothold, within IFRS, will be counterproductive given the purpose of financial reporting set down in the CF.

Reliability

16. We support the Board's position on retaining faithful representation as the qualitative characteristic and not returning to reliability.

Reporting on Risk

17. We quote here form the classic text of Edwards and Bell:

"...present accounting practices would be fully valid only if prices, quantities, and qualities of both factors of products were unchanging over time, i.e., if there were a stable general price level...stable individual prices...and perfect certainty about the future....The certainty it implies bars by definition the very existence of profit as a return for bearing uncertainty. The implicit assumptions of accounting eliminate that which it has set out to measure." (Page 9, The Theory and Measurement of Business Income" 1961).

18. Whilst the thrust of this comment had to do with the failings of accounting to deal with changes in values (i.e., measurement), the other message in the quote is that uncertainty, or risk, is critical to management and users. Accounting standards have recognised risk in various ways (eg in relation to exposures to financial risk through financial instruments and in some aspects of the qualitative characteristics, measurement (eg in discounting) and disclosure, the CF has not squarely discussed risk. Also attention tends to have been mainly given to financial risk and less to operational risk (perhaps appropriately so). It seems to us that acceptance of the economic idea that profit is the return for undertaking risk should see a much greater focus on the role of risk and how to report on it[3].

19. Our comments on this topic can be linked to our criticisms below of the absence of concepts of capital and income and the effect of those absences on the Board's ability to report cohesively on financial position or performance.

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[2] See Asymmetric Timeliness and the Resolution of Investor Disagreement and Uncertainty of Earnings Announcements. Mary E Barth (1), Wayne R Landsman (1), Vivek Raval (2) and Sean Wang (2). August 2015. Working Paper. (1)Stanford University and (2) University of North Carolina.

[3] See "Simultaneously Discovering and Quantifying Risk Types from Textual Risk Disclosures", Yang Bao and Anindya Datta. Management Science> April, 2014. National University of Singapore.

Financial Position and Performance

20. We are of the view that the CF should have attempted to set down some principles upon which these phrases could be based. In essence the absence of discussion of financial position, and any meaningful consideration of concepts of capital, means that we do not know what we mean by the term "financial position" in IAS 1 and elsewhere, or in director assertions and audit reports.

21. The corollary is that we do not know what we mean by performance.

22. We too readily are prepared to discuss possible components that might comprise the aggregations that financial position and performance without considering the meanings intended for them.

Other Comprehensive Income

23. Without a concept of performance, we find the discussion of other comprehensive income (OCI) largely non-conceptual and ill-placed in a proposed CF. We agree with the Board members who have dissented on this topic.

24. It seems to us that there is an unstated difference of view prevailing among board members. Some think that profit or loss is the only real measure of income and that OCI is a means of excluding "noise" from income until it is quietened. Others think that income should simply be a function of the definitions of the elements. Implicitly different concepts of income are being held.

25. We can understand presentations of income being designed to assist users in understanding the possible persistence of various components of earnings[4][5]. But we do not understand how "other income" can be measured and put aside until something else happens to convert it into "real" income. Either the elements have changed or they have not.

26. We believe that "recycling" of income is always going to contrary to a CF based in economics and that any role that OCI could play must follow logically from a concept of performance.

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[4] See "Other Comprehensive Income: A Review and Directions for Future Research" Dirk E Black. August 2015. Working Paper. Dartmouth College.

[5] See Academic Research and Standard-Setting: The Case of Other Comprehensive Income. Lynn L Rees and Philip Shane. Accounting Horizons, Vol 26, No4, pp 789-815.

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27. We do not accept the non-articulation of the balance sheet and income statement. We see this as a playing out of conservatism on the part of the Board. In appears to us that the Board has accepted a view that volatility in reported income numbers needs to be guarded against.

Definitions of the Elements

Assets

28. We support the refinements to the definition of an asset which places a focus on the right controlled. We do think that control should be part of recognition rather than definition. We also think that all of the elements should be defined in terms of economics and not in terms of the accounting response to their existence. In other words, assets can exist outside of the balance sheet, excluded because they fail to meet the recognition criteria. Financial reporting has gradually improved its ability to recognise assets and we should not confuse the state of that ability with the existence of the economic phenomena that should be defined as elements.

Liabilities

29. We do not support the retention of the vague idea of constructive obligations. We believe that there needs to be a right to enforceability open to the party or parties to whom the obligation is owed. We think that the elimination of the notion of economic compulsion from the definition of a financial liability at the standards level was correct and that "constructive obligation" is not sufficiently precise.

30. In our view working harder on the implications of the definition of a liability can lead to accounting which is not far from what people seek through intuitive approaches such as those that are thought to be provided by constructive obligations. For example, pension and long service leave entitlements can be argued to be written real options in which the employees hold the rights that they can control through meeting their obligations to serve.

Equity vs Liabilities

31. The ED has failed to provide any ways to resolve the distinction between liabilities and equity. We do not accept that this is a standards-level issue, though the principles involved may well need support at that level. Again we agree with the views of the dissenting board members.

32. We do not support the possibility of remeasuring equity which seems to be implicit in some of the board's thinking. Such a re-measurement would be evidence of unreconciled differences as to the concept of capital and income. It also is another example of the consequences of not pursuing common information needs.

Measurement

33. We strongly agree with the points made by Mr Finnegan in AV 17. In both the DP and the ED the Board has shown little appreciation for the literature on accounting for price changes, the alternative concepts of capital and income and how measurement should articulate with the definitions of the elements and the issues of recognition and de-recognition.

34. The poor grasp on the literature in this area is highlighted by the classification of a model based in current market buying prices (and which would use the equivalent of current fulfilment values) as a cost model and a model based in current selling prices as a current value model (to be placed alongside fulfilment values!).

35. The Board continues to use the phrase "amount, timing and uncertainty of cash flows" without really addressing how that phrase articulates with the objectives of measurement. It would rather pursue a smorgasbord approach to selecting different measurement attributes in different circumstances, yielding up financial statements that are in no way capable of meaning at aggregated levels.

36. We understand that considerable political pressure has been exerted on the Board in relation to the use of fair values and other current values (eg fulfilment values). In our view one of the most significant reasons for a lack of progress in the use of current values has been a failure to bed their selection in clearly expressed concepts of capital and income.

37. In turn, the inconsistency in measurement bases has eroded the ability of the board to address or develop any meaningful concepts of financial position or performance.

38. From a research viewpoint, we would like to see the IASB review the value relevance literature to see the relationships that have been drawn out between current values and stock prices. We would also like to see any evidence that the IASB has considered that would support the usefulness of historical costs when they differ materially from historical costs. Further, we do not believe that the IASB will be able to point to evidence that proves any superiority for a mixed measurement model over a coherent measurement model as a predictor of the

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amount, timing and uncertainty of cash flows.

Unit of Account

This issue is another left by the CF to the standards level. In a sense this could be seen to be an intermediate aggregation issue that falls between the definition of an element and the levels of aggregation we see in financial statements. The difference is that we actually sometimes vary the recognition and measurement rules (usually through off-setting) when certain units of account are thought important. On other occasions we have recourse to the notion of unit of account simply out of the necessity to deal with volumes of transactions or items. We would have thought that some high level principles could be developed for at least these two broad categories of "unit of account" issues.

Yours Sincerely

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Appendix A

Australian Specific Questions

(1) whether, and to what extent, the IPSASB Conceptual Framework should be incorporated into the AASB Conceptual Framework for Financial Reporting

1. We support the AASB's traditional approach of retaining a transaction neutral approach to the CF and individual standards. The IPSASB framework does not, in our view, offer any superior answers to the IFRS framework and Australian reporting entities are long past worrying about issues of lexicon.

(2) whether there are any regulatory issues or other issues arising in the Australian environment that may affect the implementation of the proposals, particularly any issues relating to:

(a) not-for-profit entities; and

(b) public sector entities, including GAAP/GFS implications

2. We do not see any regulatory issues but would see that the Board will need to include some Australian specific paragraphs, as in the past, to ensure that the different sectors understand the CF in their context.

(3) whether, overall, the proposals would result in financial statements that would be useful to users

3. Though we are broadly opposed to the ED, we do not think this question is provoked. Individual standards flowing from the proposals may well be contentious. But we do not see the proposed CF affecting financial statements in those circumstances in which the CF is in active play in the hierarchy of accounting precedents.

(4) whether the proposals are in the best interests of the Australian economy

4. We do not support recourse to this criterion when evaluating proposals for changes in IFRS. We understand the AASB is obliged to consider it, but think that such changes should be considered within the context of financial reporting principles and practices, not some unspecific other criterion.

(5) unless already otherwise provided in your response, the costs and benefits of the proposals relative to the current requirements, whether quantitative (financial or non-financial) or qualitative. In relation to quantitative financial costs, the AASB is particularly seeking to know the nature(s) and estimated amount(s) of any expected incremental costs, or cost savings, of the proposals relative to the existing

requirements.

5. At the level of the proposed changes to the CF, it is hard to judge the costs and benefits other than by technical merit and logic. However, we do not see any of the proposed changes leading to undue cash costs. We are quite doubtful about the accounting merit of the changes discussed above.

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