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Mr Hans Hoogervorst
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Our ref MV/288
Contact Mark Vaessen

27 November 2015

Dear Mr Hoogervorst

Comment letter on ED/2015/3 *Conceptual Framework for Financial Reporting*

We appreciate the opportunity to comment on the International Accounting Standards Board's (IASB) ED/2015/3 *Conceptual Framework for Financial Reporting*. We have consulted with, and this letter represents the views of, the KPMG network.

We appreciate the Board's efforts in responding to the calls for a review of the Conceptual Framework and in establishing an ambitious timeline for the project. Many constituents, including ourselves, have had high hopes for this project – i.e. if the founding principles in the Conceptual Framework are robust, then they would lead to a set of internally consistent accounting standards that reduce complexity, improve comparability and lead to a faster, less controversial standard-setting process.

We acknowledge the progress made since the Discussion Paper in a number of areas, including liabilities, recognition and measurement. We also appreciate the magnitude of challenges that the Board is facing. The project is no small task. However, whilst we do favour a pragmatic and timely approach to the Conceptual Framework project, it seems that for the sake of a swift completion of the project, the Board chose to leave the weight of controversial and complex issues behind rather than try to resolve them.

We would have liked the Board to deal with some fundamental issues that are essential to the Conceptual Framework – such as performance reporting and the dividing line between equity and liabilities – in the Conceptual Framework itself, rather than in separate projects.

We considered the Conceptual Framework project a unique opportunity to settle the debate on performance reporting. We share the concerns of those Board members who did not support the proposals, that the Exposure Draft represents a missed opportunity to identity a conceptual basis for the use of other comprehensive income, with the Board effectively going forward with no better position than now.

The Exposure Draft is one step forward, but it cannot be the end of the journey, as in our view, further substantial work is needed. Key areas that we consider to be in need of further development include the reporting entity, definitions of assets and liabilities, derecognition model, principles for 'unit of account' and measurement.

We trust that our comments and suggestions included in Appendix 1 to this letter are helpful to the Board in focussing on what remains to be done to achieve its goals. As our comments in Appendix 1 cover all areas addressed in specific questions posed in the Exposure Draft, we have not provided separate answers to questions.

Please contact Mark Vaessen +44 (0)20 7694 8871 or Mike Metcalf +44 (0) 20 7694 8080 if you wish to discuss any of the issues raised in this letter.

Yours sincerely

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Appendix 1

Completed chapters of the Conceptual Framework

Recent years have seen renewed debate of prudence and stewardship and we welcome the Board's decision to reconsider these two matters.

We support the proposal to give more prominence to stewardship – i.e. to mention it explicitly as part of the Conceptual Framework. We believe that it is the founding principle of financial reporting – management's accountability to shareholders requires financial statements – and it deserves more prominence.

We also support the proposal to reinstate the explicit reference to prudence as defined in the pre-2010 Conceptual Framework. However, we are concerned that some may read the proposals to suggest that prudence is defined as neutrality, rather than as a separate qualitative characteristic. We acknowledge that different people may approach the concept of prudence differently and that some argue that it conflicts with neutrality. Therefore, we understand why the Board have decided to link these two concepts. However, the proposed wording in the Exposure Draft does not properly explain the relationship between prudence and the principle of neutrality.

We suggest that the Conceptual Framework explain that 'prudence' is a degree of caution when exercising judgement in conditions of uncertainty, e.g. when an objectively neutral answer is not achievable. In addition, we recommend that the Board consider whether the Conceptual Framework should explicitly state that prudence may also affect the selection of accounting policies. In part, this kind of prudence is already demonstrated by the Board in its standards; e.g. IAS 37 in the past and recently the Board's decision in the revenue project to limit recognition of variable revenue.

The reporting entity

We acknowledge that the Board has addressed some concerns that had been expressed on the previous proposals. We also welcome clarification that consolidated financial statements are not intended to provide information to a subsidiary's shareholders.

We generally support the Board's proposal that a reporting entity should be defined in the Conceptual Framework. Two issues point to the need for the IASB to build on this, however, possibly at standards level. Both of these arise from a reporting entity that is not a legal entity.

The first is that whilst the broad definition facilitates straightforward cases, e.g. a set of IFRS financial statements for a branch of a company, it is difficult to see where the limits lie. The purpose of IFRS is to ensure that the right assets and liabilities, and only those, are on a reporting entity's balance sheet. The reporting entity definition creates an inherent tension with that. It includes an element of self-selection: "a reporting entity is an entity [undefined] that … chooses to prepare general purpose financial statements," and the boundary must be set to provide relevant information and faithful representation (paragraph 3.11, 3.19); this opens up the possibility of selecting what are considered to be relevant assets and liabilities (and income and expense) and defining them as the reporting entity, i.e. selection rather than IFRS determining what is on or off balance sheet. To take one example, at face value the definition might be read as allowing a company to claim IFRS compliance for a set of general purpose financial statements that excluded its branch (or for a group that excluded some of its subsidiaries).

The second issue is that there is already diverse practice in this area, in particular varied national practices for historical financial information for the purposes of IPOs of parts of groups or combinations of parts of groups. These are very significant sets of financial statements. The practice is varied not only as to the boundary of the reporting entity. As the boundary moves further away from a legal entity or an IFRS 10 group of legal entities, the more it can seem relevant to make material allocations of transactions to this reporting entity or even to include amounts as if post-IPO transactions had also occurred pre-IPO (e.g. as if a shared facility that will be paid for (rented) in future was also rented in the past). There is significant variation in the extent to which such allocations and other amounts are included.

Assets

We note that the Board has largely reaffirmed the proposals included in the Discussion Paper in relation to concepts underlying accounting for assets without addressing some potential application challenges. Although overall we support the direction that the Board has taken, we are concerned that without such application challenges being addressed, it is difficult to determine whether the proposals are appropriate. Therefore, we reiterate our previous comments that we believe are still valid.

We understand that the proposal is that since a familiar ‘asset’ – such as property, plant and equipment – may be represented in law by a bundle of rights, in accounting terms each component right in the bundle may be a separate asset. So although they may be presented together for convenience in the balance sheet – e.g. as ‘property, plant and equipment’ – the asset is not the physical object, and, indeed, there may not be one asset but many. There is, we agree, a good deal of logic in this view: there are many transactions that seek to carve out or create component rights to financial instruments, intangible assets and even tangible assets. However, the ‘component rights’ approach has previously caused some challenges in developing new standards (e.g. the recent project on leases) and in applying existing standards that follow this approach, particularly when considering the implications for the closely linked topic of derecognition (e.g. accounting for financial instruments, such as repos).

One of the key issues with componentisation relates to the concept of the ‘unit of account’. We appreciate that in response to comments on the Discussion Paper the Board proposed some general guidance on the unit of account. Although this guidance is intended to cover a broad range of issues, it seems to be lacking a conceptual basis. The proposals do not seem to establish specific fundamental principles to guide the Board in setting standards beyond reference to ‘relevance’, ‘faithful representation’ and ‘cost vs benefit’. The heart of the issue – and the use of the ‘component rights’ approach transfers all of the accounting emphasis to this – is the question of how far one goes. We do not think that the proposals in the Exposure Draft would answer this question. For example, is the driver of ‘componentisation’ the simple fact that it is theoretically possible to create or carve out such a right? Alternatively, is ‘componentisation’ driven by a need to apply other accounting rules – e.g. recognition/derecognition, measurement – independently to different components (perhaps in order to avoid some mischief), overlaid by practical limits (theoretical separability, practical transferability, reliability of valuation, pricing of components, linkage)? We recommend that the Board reviews existing standards, projects in progress and matters on the future agenda to identify examples of unit-of-account problems that it can reflect on in order to move forward with this conceptual issue.

Derecognition

We understand that the Board has reaffirmed its proposal to replace the current derecognition concepts, based on transfer of risks and rewards, with concepts based on transfer of control. We also understand that this is largely driven by considerations of symmetry with the approach to the recognition of assets. We continue to agree that there is a good deal of logic behind that: the same position at a point in time would be portrayed by the same assets (and liabilities) regardless of the history of how that position was arrived at. A classic example is the credit guarantee. If an entity guarantees another’s exposure to credit risk of a specified or reference asset, without any prior involvement, then the accounting is a financial guarantee contract or credit derivative. The same result might be expected even if the reference asset had been transferred to the second entity by the first (i.e. by the reporting entity). Yet, we expect that many stakeholders – including some from each of users, auditors and preparers – would have at least some discomfort with the latter case resulting in just a credit derivative in the transferors’ financial statements.

The Exposure Draft is consistent with the Board’s previous work on the subject, including the recent revenue project and the 2009 proposals on derecognition of financial instruments. As experience has shown, it may be quite challenging to introduce a pure control-based derecognition model: in the revenue project, risks and rewards were re-introduced as an indicator of transfer of control; and the 2009 financial instruments proposals have not been taken forward. As previously stated in our comment letter on the Discussion Paper, the Board needs to examine the previous concerns and address them in testing and shaping the derecognition principles in the Conceptual Framework.

In addition, for the derecognition model to be functional and free from potential abuse, further work is needed on a number of areas, including approaches to partial derecognition and accounting for any retained interest. The Exposure Draft explains what the issues are but does not propose principles that the Board could use when facing these challenging issues.

Finally, transactions seem to us to be a particularly important area for further consideration. One might characterise transaction-based accounting as follows: is a change in rights and obligations sufficient to say that a transaction has occurred and hence warrant an accounting change? For example, we believe that the widespread discomfort with the off-balance sheet treatment of ‘repo’ transactions might be explained in such terms. At the level of the broader canvas, we should ask whether the Conceptual Framework project has yet offered an analysis of these two apparently competing visions: a transactions-basis of accounting vs one that is a period-end stock-take of component rights.

Liabilities

We acknowledge the progress made by the Board in relation to the definition of a liability and the approach to liabilities that are conditional on an entity's own future actions. Overall, we support the 'practically unconditional' approach proposed by the Board and consider it the most fruitful avenue. However, the approach is as yet still not sufficiently developed and further work is needed, specifically around the concept of 'no practical ability to avoid'. It is not clear whether the proposals would solve some of the existing issues. The following are just a few examples.

- *Levy charged on an entity that operates as a bank at the end of the reporting period*: It remains unclear whether under the proposals an entity would recognise not only the current year levy but also the next several years' levies if the entity does not have the practical ability to stop operating for quite some time after the end of the reporting period. Conversely, the past event test (paragraph 4.36) might suggest that there is no liability for any levy at all: e.g. if the levy is triggered by activity in the market on a future date – say, one was preparing interim financial statements and the levy test date was the full year's end date – as the activity has not yet been conducted or, at the least, it is difficult to see how the point about activities conducted over time, leading to a steady accumulation of liability, lends itself to a liability that is actually incurred at a point-in-time.

- *Variable payments that depend on the purchaser's future activity*: The Board and the IFRS Interpretations Committee experienced challenges in developing guidance in this area and it has been on the agenda for quite some time. As noted by the IFRIC staff in the papers for the Committee's November 2015 meeting, while the proposals provide some additional clarity, they do not provide a definitive answer that would direct the Committee to conclude whether variable payments that depend on the purchaser's future activity meet the definition of a liability.

In addition, 'no practical ability to avoid' raises questions about the unit of account: for example, an entity might avoid maintaining any one aircraft in the fleet, and hence have no overhaul liability, but probably cannot avoid maintaining the whole fleet; so the unit of account can make a significant difference in the outcome.

We have two further comments about the definition of a liability.

- The proposed definition of a liability has two components – the 'past event' and the 'practical ability to avoid'. It seems that these two components have different focus – i.e. the 'practical ability to avoid' component focuses on the future, whilst the 'past event' component focuses on the past. We understand what the Board was trying to achieve and why, but it doesn't seem to resolve the issues (e.g. see above).

- It is not clear why and how the *amount* of an obligation (paragraph 4.37) plays a role in determining if an obligation exists. The logic seems to be in a reverse order.

Finally, we acknowledge that the words 'economic compulsion' have been removed from the main body of the Exposure Draft. However, the role of 'economic compulsion' and its interaction with constructive obligations remain unclear. In addition, considering that the test of 'no practical ability to avoid the transfer' is intended to capture both legal and constructive obligations, we are not sure whether this distinction is necessary going forward.

Recognition

We acknowledge that in the Exposure Draft the Board has addressed a number of concerns in relation to recognition proposals, specifically about low probability items.

We understand that the Exposure Draft is trying to take an even-handed approach to recognition – i.e. neither require recognition of all assets and liabilities nor set specified criteria – and also understand the arguments for that. Therefore, we generally support the proposals on conceptual grounds.

Measurement

We acknowledge the progress made in relation to measurement proposals compared to those in the Discussion Paper. We also acknowledge that the Board has addressed a number of comments and concerns. However, we do not agree with the Board's proposed approach to addressing some issues, in particular with the Board's decision to remove the objective of measurement instead of making it more specific. We believe that for the Conceptual Framework to be a useful and practical tool, the objective of measurement should be included and that objective needs to be sufficiently specific.

We agree with the Board not to limit measurements to a single basis and support the proposed approach based on the concept of the business model – i.e. a measurement of an asset should reflect how that asset contributes to future cash flows and a measurement of a liability should reflect how the entity will settle or fulfil that liability. We believe that measurement of assets and liabilities based on the entity's business model would result in the most relevant information for users of the financial statements, and we suggest that the Conceptual Framework explicitly refers to this concept as a measurement principle, rather than one of the factors, and gives it sufficient priority.

We are concerned that the proposals would lead to measuring transactions with holders of equity claims at current value – e.g. inter-company transfers, including business combinations under common control, and other related party transactions. It is one thing to bifurcate over-payments, dealing with part as a distribution or contribution, but this would also involve grossing up under-payments. As well as involving a great deal of time and cost on valuations (generally without observable inputs), that would make the financial statements hypothetical, particularly given the prevalence within groups of transactions that are unlikely to be on idealised as-if arms-length terms. Moreover, the most significant inter-company transactions are business combinations under common control, and it seems premature to prejudice the outcome of the Board's long-awaited deliberations on those.

Finally, we note that an entity's own credit risk has been a controversial issue in standard setting and we believe that the Conceptual Framework should specifically address it. We acknowledge that 'own credit risk' is mentioned in the Exposure Draft in discussing fair value; however, its role should be explained more clearly – e.g. whether it depends on the measurement objective and whether it affects measurement bases other than fair value.

Presentation of profit or loss and other comprehensive income

The question of performance has been a perennial one for standard setters and accounting bodies, and none has made headway. We understand and appreciate the difficulties faced, yet the problem remains too important to 'work around' rather than settle directly. The question 'what is performance?' is at the heart of the debate about the dividing line between profit or loss and other comprehensive income (OCI): is profit or loss performance and OCI not performance, or are they both performance and the split is presentational disaggregation? It is at the heart of the debate about whether and, if so, when to recycle: intuitively one should not report the same performance twice; yet if OCI is performance, then we do report performance twice for some items. The problem is one factor behind the rise of non-GAAP measures, and the lack of an answer leaves stakeholders feeling that OCI is a 'dumping ground' for anything controversial.

We would have liked the Board to deal with some fundamental issues that are essential to the Conceptual Framework, including performance reporting, in the Conceptual Framework itself. We, as well as we believe many others, considered this project a unique opportunity to settle the debate on performance reporting. We share the concerns of those Board members who did not support the proposals, that the Exposure Draft represents a missed opportunity to identity a conceptual basis for the use of other comprehensive income, with the Board effectively going forward with no better position than now.

As previously stated in our comment letter on the Discussion Paper, we believe that the first step to develop founding principles for the dividing line between profit or loss and OCI, as well as principles for recycling (or not), should be a proper debate around the notion of performance. The Conceptual Framework project provides a unique opportunity to settle that debate; renewed efforts are required. We recommend that the following areas be explored in developing principles around the notion of performance:

- Should financial statements give the user sufficient inputs to assess performance however the user wishes to define it, or present a standardised assessment?

- Should performance drive measurement (i.e. non-performance should not be recognised) or should measurement drive performance? There are three possible approaches:

  – changes in assets and liabilities drive performance;

  – changes in assets and liabilities drive performance and non-performance; and

  – performance drives changes in assets and liabilities.

- Should performance reflect changes in market conditions outside management's control?

- What is the right driver for 'performance' (or its disaggregation) – stewardship, the business model or changes in value?

- Whose performance should financial statements reflect – i.e. entity's, management's or performance of individual assets or liabilities?

We hope that investigating these matters could help to arrive at principles that would provide a potential conceptual basis of performance that then leads to a rational basis for the distinction between profit or loss and OCI and would address the issue of recycling.