



Basel Committee on Banking Supervision

BANK FOR INTERNATIONAL SETTLEMENTS

Chairman

Via email: commentletters@iasb.org

Mr Hans Hoogervorst
Chairman
International Accounting Standards Board
30 Cannon Street
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Discussion paper - A Review of the Conceptual Framework for Financial Reporting

Dear Mr Hoogervorst

The Basel Committee on Banking Supervision welcomes the opportunity to comment on the Discussion Paper: *A Review of the Conceptual Framework for Financial Reporting* ("DP") published by the International Accounting Standards Board.

The Committee acknowledges the IASB's significant undertaking in restarting its Conceptual Framework project in response to its 2011 agenda consultation that identified this as a priority project. The Committee believes that the resumption of work on the Conceptual Framework will build on the significant joint efforts the IASB and the Financial Accounting Standards Board completed in 2010.

The Committee has a strong interest in promoting sound and high quality standards for the preparation and presentation of financial statements for banks, and believes that the DP provides a good foundation for developing and revising International Financial Reporting Standards vis-à-vis transparency and greater internal consistency.

Notwithstanding the significant effort involved in developing this DP, it is the Committee's view that certain key issues deserve reconsideration as the project progresses. We set out below two high-level points on the (i) *Objectives and Qualitative Characteristics of Financial Information* and (ii) *Status of the Conceptual Framework*. Additional technical comments are provided in the appendix.

Objectives and Qualitative Characteristics of Financial Information

The 2010 Conceptual Framework concluded that faithful representation should replace reliability as a fundamental qualitative characteristic. Faithful representation is defined as information that is complete, neutral and free from error. Prior to this shift, both neutrality *and* prudence co-existed in the definition of

reliability, with prudence being defined as the inclusion of a degree of caution in the exercise of judgements where uncertainty exists.

We agree with the pre-2010 definition of prudence¹ and believe this would require preparers to use reasonable and well balanced professional judgement in conditions of uncertainty in the estimation process. In our view, prudence is not in conflict with neutrality and does not require preparers to deliberately reflect overly conservative and unrealistic estimates. Moreover, we do not see the addition of prudence as obscuring transparency or reducing the ability of financial reports to capture the economic substance of a transaction. Instead, prudence embeds a degree of caution when a significant judgement is required. Our experience is that the removal of prudence from the Conceptual Framework in 2010 was interpreted by entities as removing the ability to exercise caution in developing estimates or in managing uncertainty. However, in our view, caution is necessary, for example, when a range exists for accounting estimates.

There are many existing standards that reflect the concept of prudence under the current Framework, such as the different recognition criteria applied to deferred tax assets and liabilities in IAS 12. As such, the Committee believes it is essential to reinstate the clearly articulated concept of prudence as it was in the previous Conceptual Framework. We believe this will allow for the continued development of standards on a consistent and conceptually sound basis.

We further note that the post 2010 framework considers verifiability as an enhancing qualitative characteristic rather than a component of faithful representation. We view verifiability as a fundamental qualitative characteristic as it impacts both recognition and measurement and the ability to audit reported financial information.

The 2010 Conceptual Framework also removed explicit reference to the term “stewardship” from the discussion of the objectives of financial reporting, while continuing to note that users need information on how efficiently and effectively the entity’s management and governing board have discharged their responsibilities to use the entity’s resources. We consider the provision of information on accountability/stewardship of the entity’s management an important objective of financial reporting, and as such we recommend that it be reinstated to co-exist with decision-usefulness as a primary objective of financial reporting.

Status of the Conceptual Framework

We agree with the Board’s view that the Conceptual Framework should not override any specific Standard or Interpretation and that where there is a conflict, the requirements of the Standard should prevail over the Framework.

The Committee is of the view that while the Framework should *ideally* guide the development of standards to promote a consistent conceptual foundation for financial reporting, there must also be flexibility at the standards level to address instances where a departure is needed for practical reasons and for unique accounting issues, including those that affect specific industries. In these

¹ The pre-2010 Conceptual Framework defined prudence as “the inclusion of a degree of caution in the exercise of the judgements needed in making the estimates required under conditions of uncertainty, such that assets or income are not overstated and liabilities or expenses are not understated.”

instances we agree with the Board that it is very important that any departures from the Framework and the reasons for such are described in the Basis for Conclusions of that standard.

We further recommend that the introductory material in the revised framework clarify how the IASB proposes to use the revised framework going forward. As noted above, our preference is that inconsistencies between an individual standard and the framework, alone, are not regarded as sufficient reasoning to revisit a standard. The Committee recognises the significant work the Board and stakeholders have undertaken to revise or replace certain standards in the wake of the financial crisis. We also agree with the message heard by the Board through its 2011 agenda consultation that these extensive accounting changes should be followed by a period of relative calm. As such, we caution the Board against reopening standards that are almost completed or have recently closed solely to address changes made to the Conceptual Framework. Nevertheless, when an existing standard is being reviewed, the possibility of eliminating inconsistencies between that standard and the Framework could be considered.

The Committee also supports the development and publication of a list outlining misalignments between the Framework and current/developing standards.

The comments in this letter and in the appendix have been prepared by the Committee's Accounting Experts Group, chaired by Rene van Wyk, Registrar of Banks, South African Reserve Bank and have been approved by the Committee. The Committee trusts that you will find its comments useful and constructive. The Committee looks forward to contributing further to the various phases of the Conceptual Framework project.

If you have any questions regarding our comments, please contact Mr van Wyk (+27 12 313 3601) or Xavier-Yves Zanota at the Basel Committee Secretariat (+41 61 280 8613).

Yours sincerely



Stefan Ingves

Appendix

This appendix provides the Committee's views on selected areas of the Discussion Paper: *A Review of the Conceptual Framework for Financial Reporting* (DP), which were identified as being of particular importance to its members.

Derecognition

The DP describes two approaches to derecognition: control vs. risks and rewards and suggests instances where control would prevail over risk and rewards. Indeed, some believe that it is a mis-characterisation to view the control vs. risks and rewards issue as an “either or” debate; in their view a focus on risks and rewards can be an effective way of better understanding the control notion when it is applied in the context of financial instruments.

The Committee recognizes that this was a very difficult topic that was well debated at the standards level in the past. We believe it is premature to conclude that control is the appropriate approach and recommend that the Board do more work to analyse the implications and impact of the various approaches to derecognition, including both control and risks and rewards. The control approach can work well in some circumstances, however in other circumstances there is merit to focusing on risks and rewards instead, as there are circumstances when the risks and rewards approach produces an accounting outcome that more faithfully represents the substance of a transaction (i.e. for repurchase transactions, or other complex transactions).

Until these issues have been resolved in a high-quality and consistent way at the standards level, we believe it would be unwise to include in the Framework, material that would narrow the flexibility at the standards level without a good understanding and broad agreement on the implications.

We also encourage the IASB to explore the “unit of account” concept as this is critical in addressing the issue of partial derecognition; however consistent with our messages in the covering letter in respect of the status of the Framework, we continue to recommend that any specific accounting requirements be determined at the standards level.

Distinction between Liabilities and Equity Instruments

Though the Committee agrees with the existing definition of equity, which provides that equity is the residual interest in the net assets of an entity, we recognize that this was a project for which it was extremely difficult to gain consensus, given the complexities of directly defining equity. We expect that addressing this issue through the Framework will be equally difficult. The Committee appreciates that a positive definition for all three categories (ie assets, liabilities and equity) would be extremely challenging to achieve, would introduce additional interpretation difficulties and reduce comparability and add complexity. For example, defining all three categories could result in orphan items that do not meet any of the definitions.

Nevertheless, the Committee notes that in developing the Conceptual Framework, the IASB could also explore principles on equity characteristics which could be

used to affirm equity instruments such as: the ability to absorb losses on a going concern basis, the absence of features that would impair the permanence of the instrument (including any relevant economic compulsion on the issuer to redeem the instrument), and subordination to other claims on the entity. We also note that any new definitions of equity and liabilities could impact the current classification of items, thus the implication of new definitions on an instrument's classification should be well understood and explained (ie such as impacts on the classification of convertible instruments into a variable number of shares).

Defining OCI and Recycling

The Committee acknowledges the complexity and challenge in developing a robust and complete set of principles to govern the items classified in other comprehensive income (OCI) versus profit or loss. It is the Committee's view that further research into the conceptual basis and purpose of profit and loss and OCI is required to ensure the longevity of principles established in distinguishing these statements and to determine the corresponding recycling requirement for amounts measured through OCI.

Nevertheless, consistent with the Committee's longstanding position, we generally agree with the items currently accounted for through OCI. Therefore, we are in favour of Approach 2B (broad approach to OCI),² with recycling in profit or loss when relevant, while recognising that there is merit to the Board conducting further research on the conceptual distinction between OCI and profit or loss.

Although we believe that this area requires further research, the Committee continues to view profit or loss as an established measure of performance that is central in financial reporting³ and agrees with the statement in the DP that the profit or loss total has high informational value. As such, the Committee maintains the view that profit or loss and OCI should be separately reported. In addition, the Committee in general supports recycling as we believe recycling provides enhanced informational value of profit or loss.

Presentation and Disclosure

Presentation

Question 4 of the Discussion Paper asks whether it would be helpful to identify cash receipts and cash payments as elements of the cash flow statement. Consistent with the Committee's previous comments⁴ on the IASB's Financial Statement Presentation project, we are concerned that a presentation approach that classifies cash flow items into operating, financing, and investing activities is not a meaningful distinction for banks. Thus in our view, merely identifying cash receipts and cash payments as elements of the cash flow statement and then defining these elements would not, in and of itself, yield the conceptual underpinnings for a more meaningful statement of cash flows. The Committee

² See paragraphs 8.79 through 8.94 of the DP.

³ Basel Committee on Banking Supervision letter September 30, 2010: www.bis.org/bcbs/commentletters/iasb29.pdf

⁴ Basel Committee on Banking Supervision letter April 14, 2009: www.bis.org/bcbs/commentletters/iasb25.pdf

would be grateful if further work were to be undertaken on the cash flow statement to develop a more decision-useful presentation for banks.

Disclosure

The Committee supports enhanced disclosures with the objective of improving transparency and understandability in financial reporting and we generally agree with the suggested scope and content of the disclosure section of the Conceptual Framework. The DP sets out a number of communication and disclosure principles in paragraph 7.50 which in large part are consistent with the Committee's view on this topic.

Nevertheless, we are concerned that this section of the DP may be misinterpreted as implying that an entity would be permitted to omit disclosures that are deemed immaterial from a purely quantitative perspective, as materiality does not only concern the size of the number. During the financial crisis, the market demanded that banks disclose amounts relating to specific risks (ie such as non-exposure to certain risks), even though these were immaterial at the entity level from a quantitative perspective.

In addition, while the determination of materiality may be less complex for quantitative disclosures, it remains unclear how to apply the concept of materiality to qualitative disclosures in practice. The Committee encourages the IASB to develop additional guidance on materiality and its application to disclosures and believes there is value to including materiality in the IASB's research project on disclosure.

Measurement

The Committee agrees with the IASB's preliminary views that a single measurement basis for all assets and liabilities does not provide the most relevant information for users. This reinforces the importance of a mixed measurement model and aligns with the Committee's view⁵ that banking transactions should be portrayed in a manner consistent with their economic substance and should reflect the entity's underlying business model, while considering the characteristics of the instruments, as well as the appropriate unit of account.

Definitions and Recognition of Assets and Liabilities

On the definition of assets and liabilities, the Committee generally agrees with the removal of the probability threshold (ie the probability of those inflows/outflows reaching a minimum threshold before the underlying resource/obligation meets the definition of an asset/liability), but supports asymmetrical recognition criteria for assets and liabilities as, for example, in IAS 37.

With respect to assets, we are concerned that the DP replaces the term "expected" with "capable" in the definition, and at the same time removes the probability threshold for their recognition (ie the DP proposes that an asset should be recognised if it is capable of generating inflows of economic benefits) as this could result in assets that have little economic substance being recognised. In

⁵ Basel Committee on Banking Supervision guiding principles for the replacement of IAS 39: www.bis.org/publ/bcbs161.pdf

particular, we are concerned that the proposed definition and recognition criteria may widen the items recognised on a balance sheet to include certain internally generated intangible assets and other assets with high degrees of measurement uncertainty. Furthermore, while we agree that it is well placed that assets and liabilities are defined within the Conceptual Framework, we believe it is more appropriate that principles for the recognition and measurement of assets and liabilities are defined only at a general level in the Framework in a way that would not prevent them to be developed more precisely at the standards level (ie individual standards should deal with specific cases of existence uncertainty through recognition criteria and with specific cases of outcome uncertainty through measurement criteria).

Going Concern

The Committee believes that the Conceptual Framework should include additional guidance for reporting entities when the going concern assumption is no longer valid. The Conceptual Framework should discuss when a change from the going concern basis of accounting should occur in order to provide financial statement users with more useful financial information for liquidation-imminent entities and businesses. In this regard, we note that the FASB has recently published its Accounting Standards Update: Liquidation Basis of Accounting.