



Basel Committee on Banking Supervision

BANK FOR INTERNATIONAL SETTLEMENTS

Chairman

Via email

Mr Hans Hoogervorst
Chairman
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30 Cannon Street
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Exposure Draft of the Conceptual Framework for Financial Reporting

Dear Hans

The Basel Committee on Banking Supervision welcomes the opportunity to comment on the International Accounting Standards Board's Exposure Draft (ED) of the Conceptual Framework for Financial Reporting.

The Committee has a strong interest in the quality of banks' financial reporting – and therefore the accounting standards applicable to banks – for at least two reasons. Firstly, accounting information provides the basis for the Committee's prudential capital framework and a focus for regulators' surveillance of banks. Secondly, the more transparent financial reporting is, the more effective market discipline can be, and the Committee regards effective market discipline as important. This interest in financial reporting means the Committee supports the timely development of well-designed, consistent accounting standards that are capable of being implemented in a high-quality way. The Committee believes the existence of an up-to-date and comprehensive conceptual framework makes the development of a well-designed, consistent set of accounting standards more likely. For these reasons the Committee is pleased to see the priority the Board is attaching to the completion of its Conceptual Framework project.

The Committee believes it important that there is a high degree of consistency in accounting practices around the world. We think that such consistency is more likely if there is as much agreement as possible between standard-setters on the accounting conceptual framework. We therefore encourage the IASB and other standard-setters to work on their frameworks in ways that make that consistency more likely and to do their best to avoid taking steps that make it less likely. We would also encourage the IASB and IAASB to co-operate on conceptual issues that are relevant to both parties.

When commenting on the discussion paper that preceded this ED, the Committee stated that it believed the paper provided "a good foundation" for development of the sort of accounting standards we believe are necessary. Our overall view is that the conceptual framework set out in the ED continues to provide a good foundation. We would in particular like to commend the IASB for:

- reintroducing the notion of stewardship into the framework, including the addition of the text in paragraphs 1.22 and 1.23 on the efficient and effective use of resources;
- reinstating the notion of prudence and describing it in the same way as it was described before the 2010 amendment (ie as involving the exercise of caution when faced with uncertainty). We support the notion that financial statements should be prepared on a neutral basis and agree that prudence as defined in the draft framework can contribute to that neutrality by bringing discipline into the preparation of financial information;
- the way in which measurement uncertainty has been dealt with in the draft. We agree with the draft framework's view that, although a "high level" of measurement uncertainty does not prevent the use of an estimate if that estimate provides the most relevant information (paragraph 2.13), measurement uncertainty can nevertheless affect the relevance of the information (paragraph 5.13(b)). In this context, we particularly welcome the importance that paragraph 2.20 attaches to disclosure about the uncertainties that affect measurement estimates significantly;
- reintroducing into the framework references to the importance of focusing on economic substance.

Nevertheless, it is the Committee's view that there are aspects of the draft framework that need to be further developed, primarily because they rely more than the Committee believes is appropriate on the notions of 'relevance', 'faithful representation' and 'usefulness'. Such reliance means that the framework will not necessarily in itself result in consistent standards or in consistent accounting policies being chosen when no Standard applies. In our view, finalisation of the framework should not however be delayed until this further development has taken place. This is discussed more fully in the appendix to this letter.

As also discussed in the appendix, the Committee believes that certain aspects of the draft framework need further consideration.

These comments 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.

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

Comments on the draft framework

The reliance placed in the framework on the qualitative characteristics

As the ED explains, the Conceptual Framework is intended to be a document that (a) assists the IASB in developing standards, (b) helps everyone to understand and interpret standards and (c) assists preparers in circumstances in which standards do not prescribe the accounting to be followed. We agree that this should be the objective of the framework.

We also recognise that, if the framework is to be successful, it will need to be a relatively high-level document and that means that more detailed material will be omitted. Hence the need to differentiate between concepts to be addressed in the framework and issues that are best left to the standards-level. Notwithstanding this, some parts of the draft framework seem more definitive and detailed than other parts.

For example, on some fundamental issues – including recognition, derecognition, measurement, the unit of account, presentation in other comprehensive income (OCI) and reclassification from OCI to profit and loss ('recycling') - the framework says that appropriate accounting should be determined by considering relevance, faithful representation and what is most useful to users.¹ We agree that the ultimate test is what is useful and we also recognise that, if the framework is to be completed in the near-future, it is probably not possible to be more detailed and definitive in these areas. However, we think it needs also to be recognised that a

¹ To be precise:

- Recognition – The proposal in the ED is that an element should be recognised only if recognition results in relevant information and a faithful representation and would meet a cost-benefits test (see paragraph 5.9).
- Derecognition – The ED proposes that the framework states that "normally" derecognition will occur when control is lost but, if that does not result in a faithful representation of both what has changed and what has been retained, "there may be a need to continue to recognise ...the transferred component" (emphasis added). See paragraph 5.32.
- Measurement – The proposal is that the framework should state that a measurement basis needs to be selected for each category of assets or liabilities and that choice will be based on what is most useful for users, bearing in mind the nature of the assets or liabilities concerned and the circumstances involved. The text explains what information different measurement bases might provide in different circumstances, but draws no conclusions from that.
- Unit of account – The ED states that there is a choice to be made as to the unit of account and that choice should be made on the basis of what is useful to users. The text expands on what this means in terms of relevance, faithful representation and cost-benefit, but draws no conclusions.
- The use of OCI & recycling – The ED proposes that the framework should state that all income and expenses should be recognised in the P&L unless both (a) they in effect result from current valuing the item and (b) excluding them from the P&L would enhance the relevance of the P&L information for that period. It also proposes the framework states that all items recognised in OCI should be reclassified to P&L when reclassification would enhance the relevance on the P&L information.

framework that places so much reliance on qualitative characteristics that are relatively lightly described in the framework, and therefore relatively subjective:

- will contribute to the development of well-designed, consistent accounting standards only if the standard-setter interprets and applies those characteristics consistently; and
- will not achieve the other objectives the IASB has for the framework unless there is widespread agreement outside the IASB as to how those qualitative characteristics are to be interpreted and applied.

To illustrate this point, consider asymmetry. Although the draft framework makes it clear that asymmetric prudence has no role in the conceptual framework, at the standards level there are numerous examples of asymmetric accounting. For example, under IAS 37 entities are required to be quicker to recognise liabilities than assets. The Basis for Conclusions explains that this asymmetry is the result of basing recognition on relevance. However, as it is not clear how exactly the asymmetrical accounting flows from the relevance test, it is not easy for standard-setters or preparers to reach consistent conclusions in analogous circumstances. On this particular issue:

- we recommend that the material on asymmetric accounting that is currently in the Basis for Conclusions is moved to the framework itself, and
- we think that material should be accompanied with material that helps the standard-setter and preparers to apply the thinking more generally and to understand why asymmetric accounting is consistent with the notion of neutrality described by the framework.

More generally, we think this heavy reliance in the framework on relevance, faithful representation and usefulness means that over the longer term either the areas of the framework we have listed need to be 'fleshed out' with some generalised conclusions reducing as to what the application of the qualitative characteristics will require - thereby the reliance placed on the characteristics - or the explanations of the qualitative characteristics need to be enhanced so they can be interpreted and applied consistently by all. We would not though hold up finalisation of this version of the framework for those enhancements.

In the event that further work on the use of OCI and recycling is done, we would like to confirm that the views expressed on the subject in our response on the framework discussion paper continue to apply. Those comments were that:

- we generally agree with the items currently accounted for through OCI;
- we view profit or loss as an established measure of performance that is central in financial reporting;
- we view the profit or loss total as high in informational value;
- in our view profit or loss and OCI should be separately reported; and
- in general we support recycling because we believe it provides enhanced informational value of profit or loss.

Other areas where we think the draft framework is not sufficiently detailed and definitive include the material relating to substance, faithful representation,

materiality and the distinction between equity instruments and liabilities. Those areas are discussed below.

Substance

We are pleased to see the ED propose the re-introduction into the framework of references to the need for financial reports to provide information about “the substance of an economic phenomenon instead of merely providing information about its legal form”. Unless financial reports faithfully represent the substance of the transactions and other arrangements a reporting entity has entered into and the financial position that entity is in, they risk being misleading at the very least.

However, our impression is that the term ‘substance’ is open to a range of different interpretations. We note that the ED states that focusing on substance means (a) ignoring contractual terms that have no commercial substance, (b) sometimes accounting for more than one contract as a single contract and (c) sometimes accounting for a single contract as a series of contracts. We agree – although we would encourage the IASB to explore whether (b) and (c) might also or instead be examples of how the unit of account might be tackled in certain circumstances - but think the notion involves other things as well. For example:

- we believe that things can often be learnt about the substance of a transaction by considering its business purpose (see also the discussion later under the heading ‘How an entity conducts its business activities’);
- in the ED’s discussion of derecognition, it is suggested that, where part of an existing asset is transferred and the part retained contains “disproportionate risk”, a faithful representation of what has been retained and of the change that has resulted from the transaction might not be achieved by derecognising what has been transferred and continuing to recognise what has been retained. It is also suggested that, when an entity transfers some or all of an asset and also enters into an arrangement to receive back what it has transferred in the future, a faithful representation might not be achieved by derecognising the transferred asset and recognising the right to receive it back in the future. We suggest the IASB considers whether these are further examples of the framework’s focus on substance and, if they are, whether the examples could be generalised in some way. We also suspect that the notion of substance would be enriched by an explanation of how the continued recognition of assets that have been transferred – in other words, the continued recognition as assets of items that do not seem to represent rights - can be reconciled to paragraph 7.2(a), which appears to suggest that only items that meet the definition of assets, liabilities or equity are recognised in the statement of financial position; and
- we are aware that some commentators distinguish between ‘economic substance’ and ‘legal substance’, terms that to them mean very different things. The ED uses the term ‘economic substance’, but its limited description is similar to the notion those commentators refer to as ‘legal substance’.

In our view, if the re-introduced references are to have a predictable effect on standard-setting and accounting practice, the IASB should look for opportunities in due course to develop the ED’s discussion of the notion of ‘the substance of an economic phenomenon’ so that a single, clear understanding of the notion

emerges. We recommend that further research is carried out on the subject and that this part of the framework is reviewed in the light of that research. In the meantime and for the avoidance of doubt, we would strongly support the references in the ED being retained.

Faithful representation

One of the changes the IASB made to its framework in 2010 was to replace the qualitative characteristic of 'reliability' with 'faithful representation'. Although we are aware that some commentators are arguing for the return of 'reliability', we are comfortable with the 2010 change, particularly bearing in mind the material on 'verifiability' (which was introduced in 2010) and the material on 'measurement uncertainty' that it is now being proposed should be added to the framework.

However, we think more needs to be done to ensure the term is fully understood by the IASB's stakeholders. We would therefore support enhancing the framework's discussion of the characteristic and how it should be used. For example, it is unclear from reading the framework's description of the objective of financial statements that, when assets are transferred the objective should be not only to faithfully represent the assets and liabilities retained but also the change in the assets and liabilities. Indeed, some would not have understood that doing the former might not result in the latter. Yet paragraph 5.26 makes it clear that the objective should be to represent faithfully both the assets and liabilities retained and the change in assets and liabilities, and the subsequent discussion makes it clear that it is possible to represent faithfully one but not the other.

We suggest later in this letter that more material be included in the framework on the issue that the ED refers to as "how an entity conducts its business activities". We think it is particularly important to understand how it is envisaged that the way in which an entity conducts its business activities is to be faithfully represented.

Materiality

The ED proposes that the framework might be revised on completion of the various pieces of work the IASB is carrying out on materiality as part of the Disclosure Initiative. We think this approach is reasonable and want to emphasise:

- the importance we attach to the framework containing a fully developed section on materiality as soon as possible,
- our desire that the IASB give its work on materiality a high priority, and
- our strong support for the IASB returning to this section of the framework when its other work on materiality is complete.

The distinction between equity instruments and liabilities

We note that there is an inconsistency between the framework and some of the standards-level literature on the distinction between equity instruments and liabilities. We recognise that, in developing its standards, the IASB needs to take into account not only the framework but also operational, practical and cost considerations and that as a result inconsistencies between standards and the framework might exist. We note that the IASB is carrying out further research into the issue and might, when that work is finished, then revise the framework or the standards. We encourage the IASB to give this work a high priority and to commit

to addressing any significant conceptual inconsistencies between the framework and standards on this particular matter as soon as possible.

Probability thresholds

In our comment letter on the preceding discussion paper, we expressed concern about the implications of the removal of the so-called “probability thresholds” from the definitions of ‘assets’ and ‘liabilities’ and from the recognition criteria set out in paragraph 5.9 because we thought the result could be the recognition of assets of “little economic substance”. We therefore welcome the inclusion of the material in paragraph 5.13 about separability, low probability and measurement uncertainty. However, as mentioned earlier, we think it would be helpful for the framework itself to say more about how the concepts in the framework can result and are consistent with the asymmetric accounting practices that currently exist in a number of areas.

The liability definition and recognition criteria more generally

We have several general concerns about existing liability accounting that we hope the framework will to address, either directly or by making it possible for the standards-level material to be revised.

- The existing distinction between equity instruments and liabilities – We mentioned above the conceptual inconsistencies that exist on this issue. We think that, when the IASB starts to address those inconsistencies, it would be worth carrying out a reasonably broad piece of work that asks whether standards draw the distinction between equity and liability in the right place and in a way that captures the substance of the arrangements underpinning the more complex types of capital instruments.
- The partial recognition of expected losses on litigation, conduct redress and regulatory actions – Now that we have an impairment standard that requires some credit losses to be provided for when they are expected rather than incurred, it seems reasonable to ask whether IAS 37 results in litigation, conduct redress and regulatory action provisions that are too little and too late and, if that is the case, to ask whether the problem lies with the framework or the standard. We think the changes made to the probability threshold (in the definition of a liability and in the recognition criteria) might accelerate such provisioning a little, but we think more could probably be done. For example, we think it worth considering whether there might be a unit of account issue involved because, if one looks at each piece of litigation against the reporting entity individually one might conclude that it is more likely than not that each will be won by the reporting entity, but if one looks at them together one might conclude that it is more likely than not that at least one will be lost. We encourage the IASB to explore this matter further; it will lead to a better understanding of the issue and of the implications of what it is proposed in the ED and might help to address the ‘too little, too late’ issue that exists in relation to such provisions.
- Economic compulsion – Until now, it has been clear that the IASB’s framework ignores what is commonly referred to as ‘economic compulsion’ unless it also results in a constructive obligation. Whilst we recognise the risks that would arise were the door opened inappropriately

to economic compulsion, we are concerned that the inability to take economic compulsion into account when distinguishing between equity and liabilities can result in instruments that will have in effect the same economic consequences for the issuer being accounted for very differently. For that reason we were interested to see an IASB slidedeck that suggested that under the draft framework it would be possible to take the notion of economic compulsion into account in at least some equity/liability classification decisions. We note that there is no mention of this in the ED – only the Basis of Conclusions refers to ‘economic compulsion’. We think it important that the framework is clear as to whether economic compulsion should be taken into account and if so in what circumstances. Until then, it is difficult to comment on this aspect of the framework other than to say we are open in principle to the idea that some circumstances involving economic compulsion might be treated as creating present obligations. However, we would not be very comfortable with the idea that present rights – or at least rights that qualify as a recognisable asset – arise for the ‘counterparty’.

Users of general purpose financial reports

We note that the draft framework’s statement in paragraph 1.10 that general purpose financial reports are directed primarily at investors and creditors rather than for example regulators. However, we do not think it follows that the information needs of regulators can simply be ignored by standard-setters and preparers. Indeed, the statement that general purpose financial reports are directed primarily at the information needs of investors and creditors implies that other information needs are relevant in determining the form and content of those reports, and we believe the framework should be improved to acknowledge that the information needs of regulators are one such relevant factor.

We think the ED implies that, because regulators have the power to require firms to provide special purpose financial reports, regulators do not have information needs in respect of general purpose financial reports. Yet there are considerable advantages – for both regulators (in terms of for example governance and context/association) and preparers (in terms of cost) – in regulators obtaining key pieces of information they need from general purpose financial reports (and in particular general purpose financial statements) and from the books and records from which those reports and statements are prepared rather than special purpose financial reports. That is why regulators use accounting information as the basis for their prudential capital framework.

We would in particular like to see the comment in paragraph 1.10 (that regulators may also find general purpose financial reports useful”) corrected to make it clear that the general purpose financial statements contain information that is of vital importance to regulators around the world.

How the entity conducts its business activities

Paragraphs BCIN.28 to BCIN.34 in the Basis for Conclusions to the draft framework explain that the IASB has chosen not to define and use the term ‘business model’ in the framework; instead it uses the phrase ‘how the entity conducts its business activities’. We understand the thinking behind that choice.

Those paragraphs also explain why the IASB has also chosen not to include a general discussion of the role played in financial reporting by how an entity conducts its business activities; choosing instead to discuss just how it affects the unit of account, the selection of measurement basis, presentation (including the use of OCI) and disclosure. We believe that how the reporting entity conducts its business activities has a more pervasive impact on financial reporting.

For example, as already mentioned in this letter we think it has an impact on how the qualitative characteristic of faithful representation is applied and it has implications for the how economic substance is determined. When we think of activities such as macro-hedging, we suspect that it also has implications for recognition. The ED talks about the impact that how the entity conducts its business activities has on presentation in terms of the use of OCI and the classification of assets, liabilities, income and expenses. We think it also for example has implications for the structure of the cash flow statement. We also believe more thought needs to be given to the implications for financial reporting of an operating cycle that is longer than the reporting period.

Minor comments

Stand-ready obligations

The draft framework's definition of a liability is, like the existing liability definition, founded on the existence of a present obligation. This leads into a brief discussion of stand-ready obligations. Our recollection is that, when the IASB tried to introduce the notion of a stand-ready obligation into its standards-level literature through proposed changes to IAS 37, there was considerable uncertainty as to how exactly the notion should be applied. (To take the simple example of a car that exceeds the speed limit, does a stand ready obligation and therefore a liability exist because the law is breached, because a law breach is detected, or because a detected law breach is going to be punished?) We encourage the IASB to ensure that, if this notion is to remain in the framework, it is explained in greater detail.

Chapter 6's discussion of measurement bases

Chapter 6 starts with a discussion of various types of measurement bases.

- It discusses 'current cost' under the heading 'historical cost'. 'Current cost' is a cost-oriented measure, but is not a historical cost. If the point the draft is trying to make is that current cost is, like historical cost, an entry value rather than an exit value, the chapter should use the headings 'entry value' and 'exit value' rather than 'historical cost' and 'current value'.
- The term 'current cost' is used in the draft framework to mean 'current replacement cost'; historically international accounting standards have used the term 'current cost' to mean 'value to the business' or 'deprival value', of which only one component is current replacement cost.
- The discussion of current value focuses exclusively on different types of current exit value; the only current entry value discussed is current cost and that is discussed under another heading.

Chapter 8's discussion of concepts of Capital and capital maintenance

We recognise that the text on concepts of capital and capital maintenance has been largely carried forward unamended from the previous version of the framework. If these concepts have a role to play in the modern framework, the text needs to be updated (to reflect for example the use of OCI and recycling) and the material should be integrated with the rest of the framework. On the other hand, if the concepts no longer have a role to play, the text should be omitted.