HM TREASURY

Financial Reporting Advisory Board Paper

IASB Conceptual Framework for Financial Reporting

Issue:	IASB is publishing its revised Conceptual Framework in March 2018. This paper summarises the Exposure Draft and subsequent IASB meetings about proposed amendments to the Conceptual Framework
Impact on guidance:	None proposed at this stage
IAS/IFRS adaptation?	No
IPSAS compliant?	There is a separate conceptual framework for IPSAS. It is broadly aligned with the IFRS conceptual framework with exceptions for the public sector context.
Interpretation for the public sector context?	The FReM interprets elements of the conceptual framework for the public sector context or to align with the Companies Act 2006
Alignment with National Accounts	N/A
Impact on budgets/Estimates?	N/A
Recommendation:	The Board is asked to note the proposals by the IASB and invite views from members on implications for public sector financial reporting.
Timing:	The Conceptual Framework due to be published in March 2018 with an effective date of 1 January 2020.

DETAIL

Introduction

1. The *Conceptual Framework for Financial Reporting* describes the objectives and concepts of general purpose financial reporting. It is a practical tool that helps the International Accounting Standards Board (IASB) develop requirements in IFRS Standards based on clear and consistent principles. These principles, in turn, should result in the IASB developing IFRS Standards that require entities to present more relevant, comparable and transparent information in financial statements.

2. The IASB decided that the current Conceptual Framework needed to be updated due to unclear, incomplete, and outdated guidance. The Conceptual Framework has not been revised since 2010.

3. The Board has previously received a paper summarising the outcome of the discussion paper and changes proposed by the IASB (FRAB 125, March 2015). This paper reminds the Board of the major changes to the Conceptual Framework highlighted in the 2015 Exposure Draft and provides a further update following subsequent IASB meetings.

Summary of Proposed Changes

4. The IASB issued a discussion paper in 2013, with an Exposure Draft for public comment (see Annex A for a summarisation of responses) in May 2015. It proposed several enhancements and structured the Conceptual Framework into an introduction and eight chapters (see Annex B). The revised Conceptual Framework is expected to be published on the same basis as the Exposure Draft, with only minor changes, in March 2018 with a proposed transition period of 18 months.

Definition of assets and liabilities

5. The revised Conceptual Framework is expected to update definitions of assets and liabilities in line with the ED.

Current definition	Proposed definition
An **asset** is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.	An **asset** is a present economic resource controlled by the entity as a result of past events. An economic resource is a right that has the potential to produce economic benefits.
A **liability** is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.	A **liability** is a present obligation of the entity to transfer an economic resource as a result of past events.

6. The Exposure Draft proposes that the definitions of assets and liabilities should not require an 'expected' or 'probable' inflow or outflow - It should be sufficient that a resource or obligation has the potential to produce or transfer economic benefits.

7. Under the proposed definition, an asset could be an individual *right to use* an asset rather than the asset itself and therefore recognised in this way. This concept can be found in the new leasing standard, IFRS 16.

8. The Exposure Draft proposes that the framework's concept of control be in line with its definition of an asset. "An entity controls an economic resource if it has the present ability to direct the use of the economic resource and obtain the economic benefits that flow from it".

9. The Exposure Draft also makes explicit references to the control of economic resources. It gives the example of an entity having a proportionate share of a property without controlling the entire property. In such cases, the Exposure Draft states that the entity's asset is the "share in the property, which it controls, not the property itself, which it does not (control)".

10. The existing and proposed definitions of liabilities both refer to a present obligation as a result of past events. The Exposure Draft proposes that two conditions must be met for a present obligation to exist;

- "The entity has no practical ability to avoid the transfer"
- "The obligation has arisen from past events, i.e. the entity has received the economic benefits, or conducted the activities, that establish the extent of its obligations"

11. In February 2017, the IASB discussed minor comments received on the concepts supporting the definitions of an asset and a liability. The IASB noted that these comments either do not give rise to action or it can be addressed in the final draft.

12. In the public sector context, it is anticipated the conditions attached to the present obligation of liabilities would provide additional clarity for preparers when assessing novel liabilities.

Recognition and derecognition

13. The existing recognition measures relate to the probability that any future economic benefits flow to or from the entity and it has cost/ value that can be reliably measured. The IASB had found that the application of probability by reporting entities has been inconsistent under the current recognition criteria.

14. The Exposure Draft defines recognition as the "process of capturing, for inclusion in the statement of financial position, or the statement(s) of financial performance, an item that meets the definition of an element".

15. The Exposure Draft states than an entity would recognise and asset or liability if recognition provides users of the financial statements with:

- "Relevant information about the asset or the liability and about any income, expenses or changes in equity"

- "Faithfull representation of the asset or the liability and of any income, expense or changes in equity"

- "Information that results in benefits exceeding the cost of providing that information"

16. The IASB has recognised that there have been inconsistent approaches applied to derecognition and a previous lack of guidance. The Exposure Draft defines derecognition as the "removal of all or part of a previously recognised asset or liability from an entity's statement of financial position". Derecognition is not appropriate when an entity has retained control of an economic resource.

17. The Exposure Draft proposes that accounting requirements for derecognition should aim to represent faithfully both:

- The assets and liabilities retained after the transaction or other event that led to derecognition; and

- The change in an entity's assets and liabilities as a result of that transaction or other event.

18. The Exposure Draft also proposes guidance on how to account for modifications of contracts. It states that the accounting may differ depending on whether the rights and obligations that are added by a modification of a contract are distinct from those created by the original terms of the contract.

19. In December 2016, the IASB tentatively decided to confirm the derecognition concepts and retain the discussion of contract modifications in the Exposure Draft. However, when considering whether new rights or obligations added by contract modification should be accounted for as new assets or liabilities, the notion that those rights and obligations should be distinct as proposed in the Exposure Draft will be replaced with a reference to the concepts on the unit of account.

Measurement

20. The IASB decided that multiple measurement approaches are more appropriate than a single measurement basis. The Exposure Draft describes two categories of measurement bases: historical cost and current value. The Exposure Draft comments that equity is not directly measured but is the total of all the recognised assets less the total of all the recognised liabilities.

Historical Cost

21. Historical cost measures the past transaction/ event that created an asset, liability, income, or expense.

- For an asset, the historical cost at initial recognition is "the value of all the costs incurred in acquiring or constructing the asset, including both the consideration given and the transaction costs incurred".

- For a financial liability, this cost is the value of the liability less transaction costs.

22. This measure is subsequently adjusted for consumption, impairment, and fulfilment changes but not for price changes. Therefore, if the price changes are significant then the historical cost measurement can be less relevant.

23. The Exposure Draft suggests that income or expenses measured at historical cost can have predictive value (i.e., an entity can assess the impact of those changes on future cash flows or margins). They can also have confirmatory value when an entity compares them with previous estimates of cash flows or margins.

Current Value

24. Current values include fair value and value in use for assets and fulfilment value for liabilities.

25. The Exposure Draft indicates that it can be predictive to measure assets and liabilities at fair value since such measurement considers the markets expectations about "the amount, timing and uncertainty of the cash flows." Such measurement can also be confirmatory "by providing feedback about previous estimates".

26. The Exposure Draft suggests that if the business activities do not involve selling an asset or transferring a liability, the fair value measurement of income and expenses may not constitute useful information. However, the measurement of identical assets and liabilities at fair value increases comparability since such assets or liabilities are measured at the same amount regardless of when they are acquired or incurred.

27. While fair value is market-specific, value in use and fulfilment value are entity-specific. The Exposure Draft defines value in use as the "present value of the cash flows that an entity expects to derive from the continuing use of an asset and from its ultimate disposal." Further, fulfilment value is defined as "the present value of the cash flows that an entity expects to incur as it [fulfils] a liability".

28. It was agreed for the introduction of IFRS 13 that exit values are not appropriate for most public sector assets, because they are specifically held for service potential. HM Treasury therefore sought to identify those situations where fair values are appropriate and to restrict the use of IFRS 13 to those circumstances.

29. Value in use and fulfilment value have predictive value since they contain information about the estimated cash inflows and outflows of the asset or liability. Both have confirmatory value because they allow an entity to compare previous values with actual outcomes.

Selecting a measurement basis

30. The Exposure Draft states that a measurement basis "must be relevant and it must faithfully represent what it purports to represent". Factors for an entity to consider when selecting measurement bases include the way an asset or a liability will impact future cash flows, the characteristics of the asset/ liability, and the measurement uncertainty.

31. In January 2017, the IASB tentatively decided that the Conceptual Framework would; state that more than one measurement basis might sometimes be selected to provide information about an asset, liability income or expense as proposed in the Exposure draft; and require that both the relevance and faithful representation of information about an asset, liability, income or expense are considered when more than once measurement basis is selected.

32. It should be noted that the FReM has a pre-existing adaptation for the measurement basis of property plant and equipment. Assets which are held for their service potential (i.e. operational assets) and are in use should be measured at current value in existing use. For non-specialised assets, current value in existing use should be interpreted as market value for existing use. Assets which are not held for their service potential should be valued in accordance with IFRS 5 or IAS 40 depending on whether the asset is actively held for sale. Where such assets are, surplus and do not fall within the scope of IFRS5 or IAS 40, they should be valued at fair value applying IFRS13.

Reintroduction of 'prudence'

33. In May 2016, the IASB tentatively decided to confirm that the revised Conceptual Framework should include a reference to prudence, described as the exercise of caution when making judgements under conditions of uncertainty as proposed in the Exposure Draft.

34. The IASB has since decided that there was no need to explain in the Basis for Conclusions on the Conceptual Framework that the notion of prudence cannot be used by preparers to override the requirements of the IFRS standards because the Conceptual Framework already has a reference to this.

35. The Basis for Conclusion distinguishes between two types of prudence; cautious and asymmetric prudence.

- 'cautious prudence'—a need to be cautious when making judgements under conditions of uncertainty, but without needing to be more cautious in judgements relating to gains and assets than those relating to losses and liabilities. It is in this sense that the IASB proposes to reintroduce prudence in the Conceptual Framework.

- 'asymmetric prudence'—a need for systematic asymmetry: losses are recognised at an earlier stage than gains are. The Board thinks that the Conceptual Framework should not identify asymmetric prudence as a necessary characteristic of useful financial information. However, it explained that accounting policies that treat gains differently from losses could be selected in accordance with the proposals in the Exposure Draft.

36. In October 2016, the IASB tentatively decided that Chapter 2 - Qualitative characteristics of useful financial information of the revised Conceptual Framework - should acknowledge that the exercise of prudence does not imply a need for asymmetry. For example, a need for more persuasive evidence to support the recognition of assets than of liabilities or to support the recognition of income than of expenses. Nevertheless, in financial reporting standards such asymmetry may sometimes arise because of requiring the most useful information.

37. Public sector entities prepare both individual and group accounts, as well as the Treasury's production of the Whole of Government Accounts (WGA). Asymmetry can cause issues with elimination for intra government transactions and balances. Although the public sector has developed suitable policies to address these with the intra government eliminations qualification removed from WGA in 2015-16.

Substance over form

38. The Exposure Draft proposes to state explicitly that a faithful representation represents the substance of an economic phenomenon instead of merely representing its legal form:

- Financial reports represent economic phenomena in words and numbers. To be useful, financial information must not only represent relevant phenomena, but it must also faithfully represent the phenomena that it purports to represent. A faithful representation provides information about the substance of an economic phenomenon instead of merely providing information about its legal form. Providing information only about a legal form that differs from the economic substance of the underlying economic phenomenon would not result in a faithful representation.

39. In May 2016, the IASB tentatively decided to confirm that it would include in the Conceptual Framework an explicit statement that a faithful representation represents the substance of an economic phenomenon instead of merely representing its legal form.

40. The FReM interprets faithful representation to mean true and fair view to align with the Companies Act 2006.

Next Steps

41. The IASB expects the revised Conceptual Framework to be published in March 2018. We will highlight to the Board any further issues or matters arising not identified in this paper following publication.

Recommendation

42. **We ask the Board to note the proposals by the IASB and seek the Board's views on any other implications for public sector financial reporting.**

HM Treasury
15th March 2018

Annex A: Responses to Exposure Draft

Response to the Exposure Draft

The IASB received 233 comment letters on the 2015 Exposure Draft[1]. Some of the comment letters have been summarised below:

EFRAG	EFRAG believes that the Exposure Draft provides some but not all the solutions to problem areas. • EFRAG believe the Conceptual Framework should acknowledge the trade-off between relevance and faithful representation, with measurement uncertainty potentially affecting faithful representation • EFRAG believes prudence is not an element of neutrality and the Conceptual Framework should acknowledge the possibility of asymmetric outcomes • Recognition/derecognition: the implications of the entity approach when an obligation is present, how to determine the unit of account, when to provide note disclosures and, how to distinguish between presentation and disclosure.
ICAEW	The ICAEW have welcomed the emphasis on "prudence" but cautious that the debate will be overshadowed by prudence and stewardship rather than a focus on fundamental issues of financial reporting
FRC	FRC's Accounting Council has so far welcomed the changes but would like further improvements to the proposals including: • Stewardship – it should either identify the provision of information or expand its discussion of the issue • Asymmetric prudence – the concept should be reflected in the Conceptual Framework itself (rather than Basis for Conclusions) to allow its consideration in the development of individual standards • Idea of "reliability" should be reinstated in the description of faithful representation – i.e. that the information can be depended on by users • Further clarification and changes in emphasis around terms used in the definitions of elements and inclusion of more items within the term "elements"

[1] http://www.ifrs.org/-/media/feature/meetings/2016/march/iasb/conceptual-framework/ap10-feedback-summary-overview.pdf

Deloitte	Believe that further improvements are necessary before the revised Conceptual Framework is issued. Specifically; • The proposed section on derecognition seems to have been written with collateralised borrowings (i.e. repo-type transactions) in mind, rather than addressing more general derecognition principles. • The exposure draft proposal will not provide guidance, criteria or indicators that would help the Board decide between a current value and a cost-based amount.

Annex B: Overview of the Exposure Draft

Chapter	Title	Proposed Revisions
1	The Objective of General Purpose Financial Reporting	Limited changes emphasizing the importance of information for assessing management's stewardship of an entity's resources.
2	Qualitative Characteristics of Useful Financial Information	Limited changes reintroducing a reference to the notion of prudence and providing guidance on the concept of substance over form and the impact of measurement uncertainty
3	Financial Statements and the Reporting Entity	New chapter describing the role of financial statements, including the going-concern assumption, and the definition of a reporting entity.
4	The Elements of the Financial Statements	New chapter proposing conceptual definitions of assets, liabilities, equity, income, and expenses.
5	Recognition and Derecognition	New chapter proposing recognition criteria and discussing the aim of derecognition requirements.
6	Measurement	New chapter describing measurement bases and factors for an entity to consider when selecting a measurement basis.
7	Presentation and Disclosure	New chapter proposing high-level concepts about information included in the financial statements and how the information is presented and disclosed as well as guidance on reporting comprehensive income and the use of other comprehensive income.
8	Concepts of Capital and Capital Maintenance	Minor changes to the existing IASB framework.