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INVESTMENT MATTERS

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24 November 2015

Dear Hans

RE: Exposure Draft: Conceptual Framework for Financial Reporting

The Investment Association represents the asset management industry in the UK. Our members include independent fund managers, the investment arms of retail banks, life insurers and investment banks, and the managers of occupational pension schemes. They are responsible for the management of £5.5 trillion of assets, which are invested on behalf of clients globally. These include authorised investment funds, institutional funds (e.g. pensions and life funds), private client accounts and a wide range of pooled investment vehicles. In particular, our members manage holdings amounting to just over 30% of the domestic equity market.

In managing assets for both retail and institutional investors, The Investment Association's members are major investors in companies whose securities are traded on regulated market and invest globally. Our latest annual Asset Management Survey shows that 32 per cent of UK asset managers' holdings were in UK equities, 23 per cent in other EU countries' equities and 45 per cent in equities of companies listed outside the EU. As such our members are the main users of companies' financial statements and have an interest in the standards governing how such information is prepared. They support high quality accounting standards that are applied consistently internationally in order to maximise the transparency and comparability of financial statements, and consider IFRS is the best means of achieving this.

We very much welcome the IASB revisiting the Conceptual Framework (CF) and bringing it up-to-date so that consistent concepts are applied when IFRS are developed or revised. The IASB has been struggling for too long to complete major projects within the existing Framework. As a result, some past proposals have been based on interpretations of that Framework and in other cases on concepts that are unclear and which have not been generally agreed. A new CF should ensure that new standards are based on clear principles that the IASB's stakeholders understand and support. Thus it should be a main priority – the CF underpins IFRS and provides guidance for reporting transactions that are not specifically covered by standards. It should also be completed in a timely manner, address issues comprehensively and not in successive phases, and only cover the financial statements.

We also welcome the CF addressing a number of the issues we raised in our response to the initial Discussion Paper. Nevertheless, we still have certain concerns about the current ED which we set out below and in the attached Annex, our answers to the specific questions raised.

Too long and complex. The ED, together with the Basis for Conclusions, runs to over 220 pages in total and in many instances is quite technical such that it is difficult to envisage what it will mean in practice. A conceptual framework should be principles based and have clearly articulated concepts so that a lay reader can determine what the objective is, and the basic concepts that underlie the preparation and presentation of financial statements. We urge the IASB to make the revised conceptual framework more concise. Moreover, this was an opportunity to move forward and address some of the more difficult questions around the purpose of financial statements and the reporting of performance. The ED misses these tough questions as set out below.

Primary users. In addressing conceptual solutions, the starting point should be to identify the primary audience for financial statements. We believe the current objective "to provide financial information that is useful to existing and potential investors, lenders, and other creditors" is too broad in that the primary audience should be the holders of ordinary shares. These are the ultimate owners of a company, the providers of the risk capital and bearers of the residual risk. Whilst reporting is expected to meet a growing set of needs and some consider it should also be aimed at other stakeholders, such as creditors – including purchasers of traded debt - employees, bankers, customers and suppliers, these other stakeholders are protected by contractual and other rights that are not shared by shareholders. If shareholders' needs are satisfied, then we believe the needs of other external users should be also. Moreover a focus on the needs of shareholders and the parent entity perspective; stewardship; and prudence would help in resolving some of the more thorny issues in the CF of recognition, measurement, presentation and disclosure (question 17).

The concept of stewardship.The CF still focuses on providing information that is decision useful. In this context, investors tend to base investment decisions on various sources of information; much of which is produced outside the annual reporting framework - via analyst briefings, investor meetings, strategy presentations, stock exchange announcements and certain non-financial information. In particular, financial statements are published some time after the events to which they relate and in looking backwards and focusing on past performance, they are essentially confirmatory.

Investors value financial statements in so far as they demonstrate management's accountability – it is entrusted with the assets of the entity and financial statements should show how effectively it put those assets to use, the business model adopted and the performance derived from that model. This is the concept of stewardship. Whilst we welcome more prominence being given to stewardship, it is still embraced within an overall objective of decision usefulness. We believe it should at least be equal in prominence to that of providing information that is decision useful. Not doing so falls short of the vision of providing information that enables investors to hold management to account as articulated in the IASB's mission statement of April 2015 (question 1(a)).

Prudence. We welcome the reinstatement of prudence. Whilst we support a mixed attribute measurement model, in cases of uncertainty investors would like more certainty, i.e. a higher threshold to apply, before income/assets are recognised than before expenses/losses are recognised, i.e. 'asymmetric' prudence. Whilst the Basis for Conclusions clarifies that accounting policies that treat gains and losses asymmetrically could be selected if the resulting information is relevant and a faithful representation, the term is not in the CF. We do not agree that only allowing asymmetric prudence in some cases should mean the term is rejected. The CF should acknowledge that asymmetric prudence may at times be necessary in order to provide relevant information (question 1(b)).

Reliability. The CF does not address reliability. Financial statements will always contain estimates that have a degree of uncertainty. Investors want to be able to depend on the information reported and these estimates should be the best in the circumstances in that a certain level of precision is necessary. We do not consider that "freedom from material error", which is in the definition of "faithful representation", necessarily captures this. Nor do we consider that measurement uncertainty should be an aspect of relevance. Reliability should be reinstated as a fundamental characteristic of information in financial statements and within this include measurement uncertainty and verifiability (question 1(d) and (e)).

Performance reporting. We continue to have concerns that the CF puts too much emphasis on the statement of financial position, as opposed to the statement of performance, and does not address performance reporting. Thus whilst the ED states that the profit and loss is the primary source of information about an entity's financial performance, it does not give any guidance on what this means in practice. We consider this needs to be addressed.

Moreover, there is a presumption in the ED that all items of income and expense go to profit and loss unless excluding them makes the profit and loss more relevant, but there is no explanation as to when that presumption would be overcome. Thus what is reported as performance in each new standard would depend on what the IASB judge to be relevant and could result in this varying from standard to standard. There need to be clearly articulated principles as to what performance is and a closer alignment between performance and the entity's business model. This will help shareholders hold management to account for their stewardship, including the execution of the entity's business model, the entity's performance and the creation of true shareholder value (question 12).

Moreover on the issue of recycling, the ED proposes that only income and expense from remeasurements can be in OCI and introduces a rebuttable assumption that all items in OCI will be recycled to profit and loss. Thus all items of income and expense will ultimately be part of performance. We do not consider there is any basis for this in the absence of a clear articulation of what performance is. We also fear that recycling could be used arbitrarily and result in users not having clarity over the quality of the underlying earnings (question 14).

Departures. The introduction to the CF states that the IASB may sometimes depart from the CF and that any departures will be explained in the Basis for Conclusions[1]. We consider it important that any such departures are infrequent, are subject to due process and are explained clearly.

I trust that the above and the attached are self-explanatory but please do contact me if you require any clarification of the points in this letter or if you would like to discuss any issues further.

Yours sincerely

Liz Murrall
Director, Stewardship and Corporate Reporting

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[1] IN3

Chapters 1 and 2 – Objective and qualitative characteristics

1 – Proposed changes to Chapters 1 and 2. Do you support the proposals:

(a) to give more prominence, within the objective of financial reporting, to the importance of providing information needed to assess the management's stewardship of the entity's resources;

(b) to reintroduce an explicit reference to the notion of prudence (described as caution when making judgements under conditions of uncertainty) and to state that prudence is important in achieving neutrality;

(c) to state explicitly that a faithful representation represents the substance of an economic phenomenon instead of merely representing its legal form;

(d) to clarify that measurement uncertainty is one factor that can make financial information less relevant, and that there is a trade-off between the level of measurement uncertainty and other factors that make information relevant; and

(e) to continue to identify relevance and faithful representation as the two fundamental qualitative characteristics of useful financial information?

Why or why not?

1(a) Stewardship

Whilst the IASB did not initially propose changing Chapters 1 and 2 of the CF on objectives and qualitative characteristics, we welcome the fact that it has sought to address one of our key concerns and has given greater emphasis to stewardship.

However, stewardship is still embraced within an overall objective of decision usefulness. Decision useful information is often understood to be information that supports investment decisions to buy, hold and sell shares. In this context, investors tend to base investment decisions and their assessment of future prospects on various sources of information; much of which is produced outside the annual reporting framework - via analyst briefings, investor meetings, strategy presentations, stock exchange announcements and certain non-financial information.

Moreover, financial statements are published some time after the events to which they relate and in looking backwards and focusing on past performance, they are essentially a confirmatory document to the market. Investors value them in so far as they demonstrate management's accountability – it is entrusted with the assets of the entity and financial statements should show how effectively it put those assets to use, the business model adopted and the performance derived from that model. This is the concept of accountability or stewardship. Whilst the objectives of financial reporting in Chapter 1 encompass this concept, we believe it should at least be equal in prominence to that of providing information that is decision useful and a separate objective. Not doing so also falls short of the vision of providing information that enables investors to hold management to account as articulated in the IASB's mission statement of April 2015.

ANNEX

THE INVESTMENT ASSOCIATION'S ANSWERS TO THE SPECIFIC QUESTIONS RAISED

1(b) Prudence

We also welcome the re-introduction of the concept of prudence. The pre 2010 Conceptual Framework described 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".*

We agree with this but in cases of uncertainty we believe there should be more certainty, i.e. a higher threshold to apply, before income/assets are recognised than before expenses/losses are recognised, i.e. 'asymmetric' prudence.

In this context, the Basis for Conclusions[2] considers 'cautious prudence' and 'asymmetric prudence'. It states that accounting policies that treat gains and losses asymmetrically could be selected under the ED if the resulting information is relevant and faithfully represents what it purports to represent, but that the IASB thinks the CF should not refer to asymmetric prudence as a necessary characteristic[3]. We disagree that only applying asymmetric prudence in some cases should result in a rejection of the term. The CF should acknowledge that asymmetric prudence may at times be necessary in order to provide relevant information. Moreover, asymmetric prudence is already applied by the IASB in setting standards, for example:

- Revenue is to be recognised over time, but losses are recognised up front if the contract is onerous (i.e at unfavourable terms).
- Liabilities must be recorded when probable, for example, guarantees or warranties, even when they have not yet been called in, and yet a contingent asset has to be virtually certain.
- Inventory is typically carried at lower of cost or net realisable value.
- Asset impairment tests are required to ensure that the carrying amount in the statement of financial position is not greater than the [market] value of the asset, with no corresponding requirements to recognise gains in value.

In this context, we consider cautious prudence is more a matter for preparers, not standard setters, and we believe that this should be made clear in the framework. Investors want companies to err on the side of caution, i.e. be prudent, at an individual item level in the face of uncertainty.

1 (c) Substance over form

We support substance over form being reintroduced as a component of faithful representation. This is a well understood concept and to represent faithfully transactions and other events, it is necessary that they are presented in accordance with their substance and economic reality and not just their form or appearance.

1 (d) Measurement uncertainty

The CF requires information to be a faithful representation and includes within this "freedom from material error". The ED also proposes that measurement uncertainty should be an aspect of relevance. We disagree in that we consider measurement uncertainty relates to whether information is reliable. Financial statements will always contain estimates that have a degree of uncertainty. What is important is that investors can depend on the information reported and these estimates should be the best in the circumstances in that a certain level of precision is necessary. This can be

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[2] BC2.9 to BC2.15.

[3] BC2.14.

captured by reinstating reliability as a fundamental qualitative characteristic and within this include measurement uncertainty and verifiability.

1 (e) Relevance and faithful representation.

The description of faithful representation in the ED does not include any discussion of reliability. As noted above, reliability needs to be reinstated.

Chapter 3 –Financial Statements and the Reporting Entity

2 – Description and boundary of a reporting entity

Do you agree with:

(a) the proposed description of a reporting entity in paragraphs 3.11-3.12; and

(b) the discussion of the boundary of a reporting entity in paragraphs 3.13-3.25?

Why or why not?

The Investment Association agrees that a reporting entity is not necessarily a legal entity and that an entity should be able to prepare both individual and consolidated financial statements. As set out in the covering letter, we believe the primary audience for financial statements should be the equity shareholders, as the providers of the risk capital and bearers of the residual risk. From the perspective of shareholders we agree that "consolidated financial statements are more likely to provide useful information to users of financial statements than unconsolidated financial statements"[4].

However, the CF asserts that "financial statements are prepared from the perspective of the entity as a whole instead of from the perspective of any particular group of investors, lenders or other creditors[5]". In this context, shareholders support the parent entity approach where the assets and liabilities of an entity, even if that entity is not full owned, are consolidated in full and minority or non-controlling interests, together with transactions with non-controlling interests, are separately identified. This enables shareholders to assess management's stewardship. In this context, the needs of other users are likely to be different. For example, lenders are likely to be more interested in the separate financial statements of the entity that has borrowed than in the consolidated statements.

On other matters raised in this chapter, The Investment Association considers that:

- The CF should be consistent and focus on financial statements. At present certain parts of the framework focus on financial reporting whereas this chapter focuses on financial statements.
- The chapter should address the statement of cash flows – this is not currently mentioned.

Chapter 4 – The Elements of Financial Statements

3 – Definitions of elements

Do you agree with the proposed definitions of elements (excluding issues relating to the distinction between liabilities and equity):

[4] Paragraph 3.23.
[5] Paragraph 3.29.

(a) an asset, and the related definition of an economic resource;

(b) a liability;

(c) equity;

(d) income; and

(e) expenses?

Why or why not? If you disagree with the proposed definitions, what alternative definitions do you suggest and why?

The Investment Association generally agrees with the proposed definitions of assets and liabilities. These are clearer than the existing definitions. However, we consider that defining the key elements of income and expense as changes in assets and liabilities gives too much priority to the statement of financial position. The statements of financial performance and financial position should be of equal importance.

Moreover, the existing Conceptual Framework clarification that income includes revenue and gains, and expenses include losses is not being taken forward. Not all items in the profit and loss or in OCI are necessarily income or expense and the CF should refer to gains and losses. In this context, we consider it important that ordinary activities are defined. As noted in our response to the Discussion Paper, investors would like clarity around profit or loss reporting performance from ordinary activities and OCI, however determined, reporting other results for the period.

Lastly, we disagree with the CF stating that if one party has an obligation to transfer an economic resource, it follows that another party has a right to receive that economic resource[6]. For example, an entity could decide to undergo a restructuring where will incur legal expenses but has not yet decided which lawyers it will engage. According to this statement the fact that no lawyers would accrue the asset would mean that the entity would not recognise a liability for the costs of the restructuring. We believe this is illogical and is inconsistent with our interpretation of prudence and the need for asymmetric prudence.

4 – Present obligation

Do you agree with the proposed description of a present obligation and the proposed guidance to support that description? Why or why not?

The Investment Association agrees that liabilities should include constructive obligations rather than simply those obligations that are enforceable legally or by equivalent means. Investors need information on likely future cash flows from economic realities.

We also agree that a 'present' obligation should be wider than one that is strictly unconditional, and welcomes the further analysis of where there is no practical ability of avoiding an obligation.
That said, the interpretation of "no practical ability" is restricted to extreme situations such that any action necessary to avoid the transfer would cause significant business disruption or economic consequences that are more significant than the transfer itself[7]. We consider an obligation would exist where any action available to an entity to avoid it is more adverse – even if this is by a small

[6] Paragraph 4.25.
[7] Paragraph 4.32.

amount – and that there should be no requirement for this to be significant. Similarly, where an entity can avoid an obligation by making a smaller transfer, an obligation for that smaller transfer exists.

Moreover, it appears that the approach may confuse the existence of a liability with its measurement by referring to the extent of the obligation[8]. We consider that it may be better to leave this to individual standards to determine and we question the need to refer to the "the extent of".

5 – Other guidance on the elements

Do you have any comments on the proposed guidance?

Do you believe that additional guidance is needed? If so, please specify what that guidance should include.

The CF considers that only items that meet the definition of an element are recognised in financial statements. We consider it important that contributions and distributions of equity are defined as elements. We also consider that the CF should define elements for the statement of cash flows in that it is important to retain the requirement to provide a cash flow statement with prominence equal to that of the other primary financial statements.

We welcome the guidance on executory contracts and the fact that the IASB does not intend to revisit trade date accounting[9].

Chapter 5 – Recognition and derecognition

6 – Recognition criteria

Do you agree with the proposed approach to recognition? Why or why not? If you do not agree, what changes do you suggest and why?

As noted under question 1, The Investment Association considers that the CF should:

- Address asymmetric prudence.
- Reinstate the concept of reliability – in that measurement uncertainty relates to whether information is reliable rather than whether it is relevant.

Whilst we broadly consider that the material on recognition is satisfactory, it would need to be revised if the above are taken into account. In addition, it would be helpful if the CF emphasised that the alternative to recognising an asset or liability is to disclose it rather than omit the item altogether.

7 – Derecognition

Do you agree with the proposed discussion of derecognition? Why or why not? If you do not agree, what changes do you suggest and why?

The Investment Association welcomes the clarification that "exposure to positive or negative variations in the amount of economic benefits produced by an economic resource" is exposure to the

[8] Paragraph 4.31(b).
[9] BC 4.91(b).

risks and rewards of ownership. We consider that both control and risks and rewards need to be considered in any approach to derecognition in the CF in that considering risks and rewards in determining whether control is maintained helps identify the substance of a transaction.

Chapter 6 – Measurement

8 – Measurement bases

Has the IASB:

(a) correctly identified the measurement bases that should be described in the Conceptual Framework? If not, which measurement bases would you include and why?

(b) properly described the information provided by each of the measurement bases, and their advantages? If not, how would you describe the information provided by each measurement basis, and its advantages and disadvantages?

The Investment Association welcomes the CF providing guidance on measurement in that this was a gap in the existing framework. We support the mixed measurement basis and the clarity provided by restricting this to historical cost and current value, as now defined, in that cash flow techniques are no longer a separate basis but are used to estimate the measure of an asset on a particular basis rather than a separate basis. That said, this approach results in current cost – a form of current value accounting – being considered as part of historical cost and we consider this is confusing.

We broadly agree with the description of the information provided by each of the measurement bases.

9 – Factors to consider when selecting a measurement basis

Has the IASB correctly identified the factors to consider when selecting a measurement basis? If not, what factors would you consider and why?

The Investment Association considers further research is needed in this area and that the CF, as currently drafted, is largely incomplete. There needs to be clear guidance and principles as to when a particular measurement basis should be selected in a standard. As was the case with the Discussion Paper, the ED bases its discussion on measurement on the objectives of financial reporting and the qualitative characteristics of financial information. What investors really want to know is what management has generated from its operations and the resources allocated to it in the period. As noted elsewhere in this response, we consider more work is needed on performance reporting, including the distinction between profit and loss and OCI. Further work on measurement would complement this in that some of the more difficult issues relate to changes in the carrying value of assets that are measured at current value and whether they should be in the profit and loss.

10 – More than one relevant measurement basis

Do you agree with the approach discussed in paragraphs 6.74-6.77 and BC6.68? Why or why not?

The Investment Association welcomes the emphasis on the business model. We also agree that in some cases a different measurement basis should be used for the statement of financial position and statement of profit and loss[10]. In this later instance, if an item has a different measurement basis in

[10] Paragraph 6.76.

the profit and loss from the statement of financial position, then the remaining balance should be in OCI[11].

Chapter 7 Presentation and Disclosure

11 – Objective and scope of financial statements and communication

Do you have any comments on the discussion of the objective and scope of financial statements, and on the use of presentation and disclosure as communication tools?

The Investment Association agrees with the discussion of the objective and scope of financial statements, and on the use of presentation and disclosure as communication tools. In this context, it would be helpful if the ED was clear as to what is meant by presentation and what by disclosure as they can be used inconsistently in standards. Moreover, whilst we recognise that disclosure is to be addressed in the separate disclosure framework project, we consider that the CF should include high-level principles as to when disclosures are required.

12 – Description of the statement of profit or loss

Do you support the proposed description of the statement of profit or loss? Why or why not?

If you think that the Conceptual Framework should provide a definition of profit or loss, please explain why it is necessary and provide your suggestion for that definition.

We continue to have concerns that the CF puts too much emphasis on the statement of financial position, as opposed to the statement of performance, and does not address performance reporting. The ED states that the profit and loss is the primary source of information about an entity's financial performance but does not give any guidance on what this means in practice. We consider this needs to be addressed.

Moreover, there is a presumption in the ED that all items of income and expense go to profit and loss unless excluding them makes the profit and loss more relevant, but there is no explanation as to when that presumption would be overcome. Thus what is reported as performance in each new standard would depend on what the IASB judge to be relevant and could result in this varying from standard to standard. There needs to be clearly articulated principles as to what performance is and a closer alignment between performance and the entity's business model. This will help shareholders hold management to account for their stewardship, including the execution of the entity's business model, the entity's performance and the creation of true shareholder value

13 – Reporting items of income or expenses in other comprehensive income

Do you agree with the proposals on the use of other comprehensive income? Do you think that they provide useful guidance to the IASB for future decisions about the use of other comprehensive income? Why or why not?

If you disagree, what alternative do you suggest and why?

The ED progresses the issue of when income and expense should be in OCI. However, we consider that this is largely incomplete and that, as noted in question 12, there need to be clearly articulated principles as to what is in profit and loss and what in OCI. We consider the profit and loss should report items that measure the entity's performance so that management can be held accountable for

[11] Paragraph 6.77.

what it has done and OCI should include other items. In summary, more work is needed on these concepts.

14 – Recycling

Do you agree that the Conceptual Framework should include the rebuttable presumption described above? Why or why not?

If you disagree, what do you propose instead and why?

The ED introduces a rebuttable assumption that all items in OCI will be recycled to profit and loss. Thus all items of income and expense will ultimately be part of performance. We do not consider there is any basis for this in the absence of a clear articulation of which income and expense should be reported in profit and loss as part of performance and which in OCI. We also fear that recycling could be used arbitrarily and result in users not having clarity over the quality of underlying earnings. If profit and loss is to reflect performance for the period then items should only be recycled when they are relevant to measuring that performance.

Chapter 8 – Concepts of capital and capital maintenance

The IASB has not asked any specific questions on this chapter. Investors value disclosures around capital maintenance but in our view this chapter is largely incomplete and needs to be considered more widely than just in relation to accounting for high inflation. Moreover, it is not linked to the remainder of the CF. As such, we consider it should be deleted.

Other issues

15 – Effects of the proposed changes to the Conceptual Framework

Do you agree with the analysis in paragraphs BCE.1-BCE.31? Should the IASB consider any other effects of the proposals in the Exposure Draft?

The Investment Association has no comments to make on this analysis but does not necessarily believe it has identified all the inconsistencies between the proposed CF and existent standards.

16 – Business activities

Do you agree with the proposed approach to business activities? Why or why not?

The Investment Association welcomes the CF acknowledging the important role the business model has to play in financial reporting. The business model already has a role in financial reporting and will be particularly important when addressing the distinction between profit and loss and OCI.

17 – Long-term investment

Do you agree with the IASB's conclusions on long-term investment? Why or why not?

The Investment Association agrees with the conclusions on long term investment. However, from the perspective of long-term investors we believe that the current objective in the CF "to provide financial information that is useful to existing and potential investors, lenders, and other creditors" is too broad in that the primary audience should be the holders of ordinary shares. These are the ultimate owners of a company, the providers of the risk capital and bearers of the residual risk. Whilst reporting is expected to meet a growing set of needs and some consider it should also be aimed at other stakeholders, such as creditors – including purchasers of traded debt - employees, bankers, customers and suppliers, these other stakeholders are protected by contractual and other rights that are not shared by shareholders. If shareholders' needs are satisfied, then we believe the needs of other external users should be also. Moreover a focus on the needs of shareholders and the entity perspective; stewardship; and prudence would help in resolving some of the more thorny issues in the CF of recognition, measurement, presentation and disclosure.

18 – Other comments

Do you have comments on any other aspect of the Exposure Draft? Please indicate the specific paragraphs to which your comments relate (if applicable).

As previously noted, the IASB is not requesting comments on all parts of Chapters 1 and 2, on how to distinguish liabilities from equity claims (see Chapter 4) or on Chapter 8.

The Investment Association has no other comments to make.