Hong Kong Institute of
Certified Public Accountants
香港會計師公會

Our Ref.: C/FRSC

Sent electronically through the IASB Website (www.ifrs.org)

2 December 2015

Mr Hans Hoogervorst
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Hans,

IASB Exposure Draft ED/2015/3 *Conceptual Framework for Financial Reporting*

The Hong Kong Institute of Certified Public Accountants is the only body authorised by law to set and promulgate standards relating to financial reporting, auditing, and ethics for professional accountants, in Hong Kong. We are grateful for the opportunity to provide you with our comments on ED/2015/3.

We appreciate the IASB's effort to initiate a comprehensive revision of the *Conceptual Framework*. We are pleased to note that the IASB has responded to some of our recommendations in response to the Discussion Paper DP/2013/1 *A Review of the Conceptual Framework for Financial Reporting*.

We have raised a number of concerns on matters that we consider the IASB has not sufficiently addressed in ED/2015/3 or that we consider should be a priority. In particular:

- In our response to question 3, we consider the distinction between liabilities and equity is a fundamental conceptual issue that needs to be better addressed in the *Conceptual Framework* project as a matter of priority. We are aware that the IASB is undertaking a separate project to deal with this issue and urge the IASB to expedite this separate project.

- In our response to question 4 regarding the proposed description of a present obligation, we have serious concerns on what 'no practical ability to avoid the transfer' means in practice and how it is intended to differ from the requirements contained in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

- In our response to question 5, we request that the IASB provides additional guidance on how preparers can deal with the potential conflicting views between the revised *Conceptual Framework* and existing standards. When determining which view should take precedent, we suggest that cross-reference should be made to the hierarchy in paragraph 11 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* instead of directly to the revised *Conceptual Framework*.

- In our response to question 12, we urge the IASB to attempt to define what is meant by 'profit or loss' and provide a principle for what items should be included in OCI. We also consider that putting too much emphasis on a single measure is the source of the problems in reporting financial performance and that greater emphasis should

37th Floor, Wu Chung House,
213 Queen's Road East, Wanchai, Hong Kong
香港灣仔皇后大道東213號胡忠大廈37樓
Tel電話: (852) 2287 7228
Fax傳真: (852) 2865 6776
(852) 2865 6603
Website網址: www.hkicpa.org.hk
Email電郵: hkicpa@hkicpa.org.hk

therefore be placed on disaggregation within the performance statement, rather than on a single measure of profit or loss.

Our responses to the questions raised in the ED are explained in more detail in the Appendix.

If you have any questions regarding the matters raised in this letter, please contact me or Ben Lo, Associate Director in the Standard Setting Department, at ben@hkicpa.org.hk.

Yours sincerely,

CNg

Christina Ng
Head of Financial Reporting, Standard Setting Department

CN/BL

Encl.

Detailed comments on IASB ED/2015/3 *Conceptual Framework for Financial Reporting*

<u>Question 1 – Proposed changes to Chapter 1 and 2</u>

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 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. We consider the IASB has addressed the Institute's comments in response to DP/2013/1 *A Review of the Conceptual Framework for Financial Reporting*. Therefore, we support the IASB's proposals to:

   - give more prominence to the objective of assessing stewardship;

   - reintroduce an explicit reference to the notion of prudence as a supporting factor of neutrality and as defined in paragraph 2.18 as the exercise of caution when making judgements under conditions of uncertainty. We also support that the exercise of prudence means the assets/income are neither overstated nor understated and liabilities/expenses are neither understated nor overstated; and

   - reintroduce substance over form as a necessary component of faithful representation.

2. While we agree with the proposal to clarify that measurement uncertainty is one factor that can make financial information less relevant [Question 1(d)], we have concerns with the term 'capable' as used in paragraph 2.6. We think that incorrect financial information is also *capable* of 'making a difference in the decisions made by users' and therefore 'capable of making a difference in the decisions made by users' is not a unique identifier of relevant information.

3. Therefore, we consider the IASB should re-consider whether the term *capable* is appropriate in such circumstance. Instead, we suggest that 'relevance' should be associated with whether the information is 'appropriately useful' in decision-making.

<u>Question 2 – Description and boundary of a reporting entity</u>

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?

4. We generally agree with the discussion contained in the ED regarding the proposed description and the boundary of a reporting entity.

5. In particular, we welcome the discussion contained in paragraph 3.24, which states that "consolidated financial statements of the parent are not intended to provide information to users of a subsidiary's financial statements". We consider this statement provides justification to the Institute's request[1] to the IASB in 2014 to delete paragraph 4(a)(iv) of IFRS 10 *Consolidated Financial Statements*[2]. Our rationale for deleting the paragraph in IFRS 10 is we 'cannot see the relevance of the type or availability of financial statements prepared by the ultimate parent to the question of the usefulness of company level information prepared by the intermediate holding companies (IHC). In many cases, specific financial information relating to the IHC or its subsidiaries will not be identifiable from the consolidated financial statements of the ultimate parent as the IHC is just one of many sub-groups within the larger group, and in all cases any intra group transactions involving the IHC or its subsidiaries and the larger group will be eliminated in those ultimate parent financial statements. This lack of information pertaining to the IHC sub-group will typically be the case irrespective of whether or not the ultimate parent follows IFRS or some other GAAP.' Accordingly, we request that the IASB amends IFRS 10 in due course to reflect the thinking contained in paragraph 3.24.

6. While we consider the principles for the boundary of reporting entity in paragraph 3.18 are sound, we suggest that:

   (a) parameters should be set in paragraph 3.17 as to when it is appropriate to prepare combined financial statements. In practice, combined financial statements are typically prepared to reflect common control group or capital re-organisations in a capital transaction (for example, for pre-IPOs when the group

[1] The Institute's letter to the IASB regarding the proposal to delete paragraph 4(a)(iv) of IFRS 10 is available at < http://www.hkicpa.org.hk/file/media/section6_standards/standards/FinancialReporting/submission-pdf/2014/sub_ifrs10.pdf >.

[2] Paragraph 4(a)(iv) of IFRS 10 states that one of the conditions that a parent need not present consolidated financial statements is 'its ultimate or any intermediate parent produces consolidated financial statements that are available for public use and comply with IFRSs'.

to be listed will be headed by a newly incorporated company which was not in existence as of the latest reporting date in the IPO track record period); and

(b) some discussion in paragraph 3.18 on circumstances where there is no parent-subsidiary relationship, and how that relates to the boundary of reporting entity, would be useful. A common circumstance where there is no parent-subsidiary relationship is joint control. The discussion in the ED seems to concentrate on the element of direct and indirect control but we consider some discussion on joint control is relevant for the accounting for joint operations and joint ventures.

<u>Question 3 – Definitions of elements</u>

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

(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?

7. We generally agree with the proposed definitions of elements except for the guidance on assets arising from a constructive obligation of another party (please refer to our explanation in response to question 4).

8. However, we note that paragraph 4.30 seems to imply that an obligation to transfer economic resources for a variable number of shares would be considered as an equity claim. This is contrary to existing accounting principles, under which such an obligation would represent a financial liability. We are therefore concerned that such a statement appears to be pre-empting the outcome of the IASB's research project (Financial Instruments with Characteristics of Equity). The IASB should therefore expedite its FICE research project and should not restrict its scope to current application issues that have arisen in relation to IAS 32 *Financial Instruments: Presentation* as is implied in paragraphs AV8-AV14 of the Basis for Conclusions accompanying ED/2015/3.

<u>Question 4 – Present obligation</u>

Do you agree with the proposed description o*f a present obligati*on and the proposed guidance to support that description? Why or why not?

9. We found the proposed new definition of 'present obligation' to be problematic and can be interpreted in more than one way.

10. In particular, we have serious concerns on what 'no practical ability to avoid the transfer' means in practice and how it is intended to differ from the requirements contained in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. The proposed wording in paragraphs 4.31-4.35 appears to be intended to be very definitive on when a present obligation would be said to arise and that it would include situations involving economic compulsion or obligations that are in theory avoidable but only by ceasing to operate.

11. One way to interpret the intention of paragraphs 4.31-4.35 is, for example, immediately on entering into a stand ready arrangement such as a guarantee or a bank overdraft facility, the guarantor/bank would be considered as having no practical ability to avoid the transfer an economic resource. Following the ED, it could be argued that the guarantor/bank would be required to recognise and measure the guaranteed amount or the overdraft facility immediately upon issuing these arrangements. If this were the case, we would not agree with this understanding and consider this would contradict existing IFRS requirements.

12. It is also clear from paragraphs BCE9-BCE10 that the IASB has intentionally proposed the 'present obligation' definition to be different from the recently issued IFRIC 21 *Levies*. While the IASB presumably has some intended change in mind behind the proposed definition, there is no testing of the wording mentioned in paragraph 11 of this Appendix against common fact patterns (for example, in the examples in IAS 37) to communicate how the IASB would intend practice to change. Therefore, as long as the IASB does not clarify the fundamental question of when to recognise a liability, as opposed to when to regard an economically unavoidable situation as being part of future operating losses or when to regard the situation as a contingent liability, we are uncomfortable with supporting such wording in the ED.

13. Regarding the definition of an asset, we have concerns with paragraph 4.8(b), in particular where it states that rights that constitute economic resources may arise 'from a constructive obligation of another party'. If a constructive obligation is one which is not enforceable by law and simply rests on expectations of how an entity is likely to act, then it seems inconsistent to assert that a counterparty could have a 'right', and therefore an asset, arising from such a situation.

<u>Question 5 – Other guidance on the elements</u>

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.

14. We consider the *Conceptual Framework* should be a high-level fundamental concepts and principles document with simple-to-understand objectives; and that the standards should be based on the *Conceptual Framework*, not the reverse.

15. In light of some conflicting views between the revised *Conceptual Framework* and existing standards, in particular, regarding the proposed definition of a liability, we request that the IASB provides additional guidance on how preparers should deal with the conflicting views. For example, because the definition of a 'present obligation' would be considered different from the requirements in IFRIC 21, we

foresee a potential diversity in practice if preparers were to use the revised *Conceptual Framework* when designing accounting policies for such transactions, ahead of any revision to IAS 37.

16. If the IASB were to provide guidance as we suggested, the guidance should emphasise the need to follow the hierarchy in paragraph 11 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. That is, preparers should make reference to the requirements in existing IFRSs that deal with similar and related issues before referring to the revised *Conceptual Framework* (our comments here are consistent with our response to ED/2015/4 regarding the cross-reference to the revised *Conceptual Framework*).

<u>Question 6 – Recognition criteria</u>

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?

17. We generally agree with the proposed recognition criteria. We think that detailed recognition criteria should be considered at the standards level.

18. We note the international debate about the inconsistent guidance in the ED when recognising an asset when there is 'existence uncertainty' or 'a low probability of an inflow or an outflow of economic benefits'. We consider disclosures, instead of recognition, in financial statements would be appropriate in these circumstances.

<u>Question 7 - Derecognition</u>

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?

19. We generally agree with the IASB's view that derecognition should be considered as the mirror image of recognition. While we note that the element of derecognition could be a challenging aspect of accounting, on balance, we consider the draft discussion in this area is reasonable at the *Conceptual Framework* level. Same as our response to question 6, we believe detailed derecognition criteria should be considered at the standards level.

<u>Question 8 – Measurement bases</u>

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 and disadvantages? If not, how would you describe the information provided by each measurement basis, and its advantages and disadvantages?

20. We agree with the discussion contained in the ED in relation to the identification of measurement bases and their advantages and disadvantages.

Question 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?

21. We generally agree with the discussion in relation to the factors to consider when selecting a measurement basis. However, the IASB should be careful with the way paragraph 6.52 is written as it would advocate the use of a consistent measurement basis at both initial and subsequent recognition, which we think may not be useful in all circumstances.

22. For the proposed measurement basis in paragraph 6.69 in relation to transactions with holders of equity claims, we are of the view that the measurement basis should be based on which item (the asset or the equity) has a more reliable measurement instead of measurement based on the current value of the asset received.

Question 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?

23. We broadly agree with the IASB's view that it may be appropriate to use one measurement basis for the statement of financial position and a different measurement basis for the statement of profit or loss. However, we strongly urge the IASB to provide a conceptual justification for items that are eligible to be recognised in other comprehensive income by allowing different measurement basis in different statements.

24. We consider the IASB should consider exploring the alternative views contained in paragraphs AV2-AV7 of the Basis for Conclusions accompanying ED/2015/3 or EFRAG's paper "Profit or Loss versus OCI"[3] to provide justification for the use of OCI.

25. As mentioned in our response to question 20 of DP/2013/1, we urge the IASB to address the inconsistency in accounting treatment for changes in fair value under the revaluation model in IAS 16 *Property, Plant and Equipment* and the fair value model in IAS 40 *Investment Property* as a matter of priority. This is explained in more detail in our response to question 14 below.

Question 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?

26. We agree with the proposals included in the ED on the objective and scope of financial statements and communication. However, we find it strange that chapter 7

[3] EFRAG paper is available at < http://www.efrag.org/files/EFRAG%20public%20letters/Conceptual%20Framework/Bulletin%20Profit%20or%20loss%20versus%20OCI/EFRAG_Bulletin_Profit_or_loss_versus_OCI.pdf >.

only refers to the statement of financial position and the statement of financial performance (see e.g. paragraph 7.2), and does not refer to the statement of cash flows and the statement of changes in equity.

<u>Question 12 – Description of the statement of profit or loss</u>

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.

27. We acknowledge the challenges in defining what is meant by the term 'profit or loss'. But we would like to still urge the IASB to attempt to set out clearer principles for which items should be included in profit or loss and which items should be included in OCI, as we do not consider that paragraphs 7.19 to 7.27 are sufficiently clear on the distinction between the two classifications.

28. For example, paragraph 7.20 states that the purpose of the statement of profit or loss is to "depict the return that an entity has made on its economic resources" and paragraph 7.21 states that "income and expenses included in the statement of profit or loss are the primary source of information about an entity's financial performance for the period". Yet, per paragraph 7.24 income and expenses are to be excluded from the statement of profit or loss and included in OCI if it would "enhance the relevance of the information that statement". We consider OCI should be described in a more positive way and therefore a principle for what items to be included in OCI should be described, rather than describing what should be excluded from 'profit or loss' to make it 'more relevant'. Such a negative description reinforces the view that OCI is just a dumping ground/dark corner for volatility that preparers would prefer users not to think about.

29. Moreover, we consider that the use of a single EPS measure as required in IFRS could also be the reason why preparers have put strong emphasis on profit or loss and seek to have items which do not reflect well on their performance included in OCI. We believe that there could be more than one source of information about an entity's financial performance. In fact, we consider the statement of performance should provide a range of relevant and useful measures to assist users in making decisions so as to ease the concerns of some stakeholders, for example, including a comprehensive income EPS measure that includes items of OCI.

30. In this regard, we agree with the following alternative views:

- Paragraph AV2 of ED/2015/3 states that the ED does not provide "an adequate basis for the IASB to make decisions about the presentation of income and expenses, and in particular on what amounts should be reported in OCI and whether and when they should be subsequently reclassified to profit or loss (recycled)".

- Paragraph AV3 states that, in particular, "identifying the statement of profit or loss as the primary source of information about financial performance, but without actually defining financial performance or specifying the characteristics of income and expenses that require their presentation in OCI, will leave the IASB in effectively the same position that it is now"..

- Paragraph AV4 states that "the conceptual foundation for performance reporting should be based on principles of separate presentation of income and expenses with different characteristics…such disaggregation should be done within profit or loss, either on the face of the statement or in the notes…there may be some circumstances in which disaggregation may be best done by recognising some components of income and expenses in OCI and not in profit or loss".

- Paragraph AV30 states that "the root of the debate between historical cost and current value lies in the existing focus of preparers and users on the use of a single statistic – profit or loss – to reflect performance for that period".

31. Other than the above-mentioned comments, we are of the view that the drafting of Chapter 7 of the ED seems to be putting too much emphasis on the element of performance whereas the discussion on other elements is limited. We also have concerns in paragraph 7.19 on why efficiency and effectiveness are considered as important attributes to communicate information about financial performance to users. Instead, we consider the focus should be on qualitative characteristics of useful financial information.

<u>Question 13 – Reporting items of income or expenses in other comprehensive income</u>

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?

32. As mentioned in our response to Question 12, we consider the IASB has missed the opportunity on providing a conceptual justification for the use of OCI. We continue to encourage the IASB to develop a principle on what items are eligible for recognition in OCI and when they should be recognised.

<u>Question 14 – Recycling</u>

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?

33. As the IASB has not developed a principle for what items should be included in OCI, we decline to comment on whether the *Conceptual Framework* should include the rebuttable presumption or whether the rebuttable presumption is sound.

34. We do however consider that, if the IASB maintains the view that 'profit or loss' and OCI should be retained, then the revised *Conceptual Framework* should provide a conceptual justification for the use of recycling if recycling as a concept were to also be retained. We consider that the ED currently lacks guidance on recycling.

35. As mentioned in our response to question 20 of DP/2013/1, we would like to reiterate to the IASB that there are currently some fundamental inconsistencies between the accounting treatment for changes in fair value arising under the revaluation model in IAS 16 and the fair value model in IAS 40. These are:

    (a) the requirement under IAS 16 to compute depreciation of a revalued asset based on its revalued amount and to charge that depreciation to profit or loss, even though the revalued amount is required to be updated at each reporting date with the surplus arising from the revaluation recognised in other comprehensive income;

    (b) the prohibition in IAS 16 on recycling the revaluation amounts accumulated in equity to profit or loss at the time of disposal of the asset; and

    (c) the requirement in IAS 40 to recognise revaluation gains on investment properties directly in profit or loss rather than initially in other comprehensive income until realised.

    We consider that it would be simpler and easier to understand if IAS 16 were to apply the full fair value model.

<u>Question 15 – Effects of the proposed changes to the Conceptual Framework</u>

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?

36. We suggest the IASB should be prepared for how to deal with the situation as mentioned in paragraph BCE.27 (that is, when the Interpretations Committee is faced with inconsistencies between a standard, including those developed on the basis of the existing *Conceptual Framework*, and the concepts in the revised *Conceptual Framework*). This is particularly important as the changes proposed for the definition of a liability would be intentionally contrary to some of the existing standards and interpretations.

37. As noted in our response to question 5 of this ED and question 1 of the ED/2015/4, we consider that interpretative issues under the current accounting standards should refer primarily to the principles in IAS 8.11. That is, entities should refer to existing IFRSs that deal with similar and related issues before making reference to the *Conceptual Framework*.

<u>Question 16 – Business activities</u>

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

38. We agree with the IASB's view contained in paragraphs BCIN.28-BCIN.34 that business activities is a relevant factor to consider in determining the unit of account, selection of a measurement basis and it might affect presentation and disclosure. We also believe that there is a role for business model at the standards level but not at the *Conceptual Framework* level.

Question 17 – Long-term investment

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

39. We agree with the conclusion that the ED provides sufficient tools for the IASB to make appropriate standard-setting decisions on long-term investment in future.

Question 18 – Other comments

Do you have comments on any other aspect of the Exposure Draft? Please indicate the specific paragraphs or group of 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.

40. We have no other comments on the proposals.

~ End ~