Mr. Hans Hoogervorst
International Accounting Standards Board
London EC4N 6XH
United Kingdom

13 January 2014

Dear Sir,

IASB Discussion Paper on "A Review of the Conceptual Framework for Financial Reporting" dated July 2013 ("Discussion Paper")

I am writing in response to your letter dated 19 July 2013 requesting my comments on the above Discussion Paper.

Please note that I have retired from my position as the Head of Accounting Affairs of the Listing Division of The Stock Exchange of Hong Kong Limited. Nevertheless, I still follow with keen interest developments in accounting and I am pleased to contribute by sharing my views with you and the IASB.

In my earlier letters on discussion papers and exposure drafts issued by the IASB, I have stressed the need to revisit the Conceptual Framework (**"Framework**"). I am very pleased that this is now a key priority project but would stress that this important project should be given sufficient time for all the relevant issues to be thoroughly discussed and considered. The quality of the final product should not be compromised and the project should not be rushed.

I believe the Framework will be the most important document to be issued by the IASB as it will serve as a benchmark for revising the existing accounting standards and for developing new standards. The Framework should clearly and concisely set out the fundamental purpose of accounting and the core accounting concepts that should be followed in preparing financial statements. Once completed its use should ensure that all accounting standards issued by the IASB represent a coherent and consistent body of guidance.

I strongly believe that Framework is a document that must be read holistically. The parts that have been consulted on earlier will form an integral part of a larger whole and the tentative decisions previously made may need to be revisited. Below in **Appendix B** I include comments on some areas where I believe this is necessary.

The impression I obtained from reading the Discussion Paper was that it appeared to be an attempt to rationalise the treatment required under existing accounting standards and exposure drafts and to resolve the conflicts and problems arising, but without attempting to identify their underlying causes. Many of the preliminary conclusions of the IASB also leaned towards deferring the relevant issue for consideration at the detailed accounting standard level.

I believe that this approach is not appropriate and a more useful and meaningful approach would be to have an open mind and have a fundamental re-think of all relevant concepts and principles. We should start with a clean slate. We should take this valuable opportunity to reflect and openly question the requirements of existing accounting standards which may have been introduced without a conceptual backing.

We should also set aside any vested interests and rather look at what our hearts are saying and focus on the interests of the readers of financial statements as it is they for whom our work serves. Before any view is decided on I believe it should be sufficiently tested for its validity and soundness as only then will the Framework be a solid foundation for the future.

I have completed my review of the Discussion Paper and my preliminary views and comments are set out below.

Fundamental Issues

First, I set out in **Appendix A** under the heading of "FUNDAMENTAL ISSUES" what I believe are some of the key issues to be addressed in developing the revised Framework. These include:

- Scope of the Framework - "financial reporting" versus "financial statements"
- The information needs of users-which users ?
- Accounting - Is it primarily a "recording function" or a "valuation function" ?
- What should be accounted for ?
- Should we account for "hypothetical transactions" ?
- Should we account for "unrealised" gains and losses ?
- The importance of the "Reference Point"
- Lessons from the collapse of Enron
- Need to distinguish "Present obligations" from "Future obligations/ commitments
- Need to distinguish "Liabilities" from "Provisions"
- Is the Re-measurement of Liabilities appropriate?
- Bifurcation and Derecognition
- Greater emphasis to be placed on cash inflows and outflows?

You will note that some of these issues have not been specifically mentioned or discussed in the Discussion Paper but I believe they must be considered if the Framework is to be a robust document. Addressing these fundamental issues will change some of the questions currently set out in the Discussion Paper.

In my view, one key reason for the current problems and complexity is because there has been a loss of clarity on the primary role of accounting. My views on this are included in **Appendix A** under the heading "What should be accounted for?"

At this point I wish to express my significant concerns on the wider use and recognition of fair values in the primary financial statements. I believe this is a major factor contributing to complexity and difficulties in the interpretation and application of standards and this has in turn led to complexity and information overload in financial statements. Fair value changes are mandated to be recognised in profit or loss and now increasing in the "Other Comprehensive Income" ("**OCI**") without a clear conceptual rationale other than that the information is useful and relevant.

I agree that fair value information can be useful, but in my opinion such information should be provided as supplementary information outside the balance sheet and the profit or loss and OCI statement because it represents pro-forma "as if" information on transactions that have not actually occurred.

Re-measurement to fair value is in effect accounting for a sale and an immediate buy back. It is accounting for hypothetical transactions at hypothetical prices with a hypothetical counterparty and makes a major omission. It does not take into account the importance of the "reference point" of the two contracting parties which is required for a transaction to happen. It omits to consider the specific circumstances and position (both financial and non-financial) of the buyer and the seller; i.e. their specific "reference points".

Buyers and sellers have their own unique reference point before they make a decision to enter into a transaction. Their reference point is their unique circumstance, including their needs, preferences and financial position. A completed transaction reflects the meeting of the reference points of the two trading parties and unless the needs of both are satisfied, the trade would not occur. A trade thus represents a unique transaction between a willing buyer and seller. Those that have not traded are not willing buyers and sellers.

In my view by way of disclosure in supplementary notes to the financial statements fair value information can still be made available and it can continue to be taken into account in determining management remuneration. The information would also be more useful as where there is a significant difference between book carrying values and fair values, shareholders can ask management what action it intends to take.

Comments on the Specific questions

Included in **Appendix C** is a copy of the specific questions raised in the Discussion Paper and these are followed by my comments. Some of my comments will refer back to matters discussed in **Appendices A and B.**

For transparency, I hope that the future exposure draft of the revised Framework will address all the points mentioned in this letter so that all interested parties understand the issues and will be in a position to provide their views to the IASB.

As IFRSs are intended to be principle-based, moving forward I believe the IASB could consider adopting a governing principle that all its standards and official pronouncements should be concise, to the point and easy to read and understand. If extensive guidance is necessary, this will be a warning sign that the concept or principle is not clear or has not been articulated clearly enough. I believe core principles should be self-explanatory and should be easily understood from a first reading. There may be more than one method that can be used to meet a principle and it will be unreasonable to expect the IASB to be able to predict all possible methods and scenarios.

I hope you find my views in this letter useful in developing a revised Conceptual Framework. Although some views raise questions on the status quo I believe they are relevant and need to be addressed in developing a revised Framework that will help the IASB in developing robust detailed accounting standards that are well understood and consistent and will stand the test of time.

I look forward to seeing the exposure draft of the revised Conceptual Framework.

Yours sincerely,

Mr. Colin Chau

13 January 2014 , Hong Kong (contact rbcolini@gmail.com)

APPENDIX A

FUNDAMENTAL ISSUES

Scope of the Framework - "financial reporting" versus "financial statements"

Although in due course the Framework could deal with the wider topic of "financial reporting", I agree that it would be better to restrict its scope at this present stage to a framework for the preparation of "financial statements". I believe the Framework should be confined to something along the lines of "financial statements reporting" or "reporting in financial statements" and I would suggest that these or similar phrases be used throughout the Framework so that there is no misunderstanding.

The commonly understood meaning of "financial reporting" is significantly wider in scope and covers communicating financial information in other reports outside the financial statements such as in a directors' report, in an MD&A, in discussions on the company's business strategy and direction and in a corporate governance report, and also the newer sustainability and environmental reports. These cover a host of financial and other information that is outside the scope of what is normally included in "financial statements". In my opinion any attempt to include them in the Framework now would make the Framework unduly complex and the result will be a loss of focus. At a later stage the scope of the Framework could possibly be considered to cover a wider area of financial reporting.

The IASB should be mindful that information included in "financial statements" must also be auditable as they would normally be reported on by external auditors. Moreover, although it will be difficult, the IASB must also anticipate how financial information produced under its accounting standards and included in "financial statements" is incorporated in future integrated reports which are being promoted by the International Integrated Reporting Council.

The information needs of users- Which users ?

The Framework is intended to apply to financial statements that will meet the needs of users. There will be many parties who would wish to make use of the financial statements and their needs will likely be different. I believe the focus should be on the information needs of the primary users and the parties this group includes should be defined or specified. In my opinion, the primary users should be restricted to the shareholders and potential investors as a wider group will make the objective too cumbersome as there will be conflicting demands.

I presume that the financial statements referred to are the annual financial statements normally prepared for shareholders and potential investors, i.e. the primary users . Whether this is the case should be clearly stated in the Framework as this will ensure that the Framework is read in a proper perspective.

The Discussion Paper makes limited reference to any studies made which ask the target users what their information needs are and whether what is currently produced for them is clear, understandable, timely and useful.

In this respect, a survey conducted by PWC entitled " Measuring Assets and Liabilities - Investment Professional's Views" provides some useful insights into what investors found useful in financial statements at the time the survey was carried out in 2007.

For the purpose of its deliberations, it may be useful for the IASB to tabulate the information needs of users, say by category of readers and by the date and source from which the information need was identified, so that the IASB can determine if and how those needs should or can be satisfied via the financial statements.

For financial statements to be decision useful for their intended users, the information included them first and foremost must be reliable. I believe determining the reliability of the financial statements is one of the main purposes of an independent audit.

Accounting - Is it primarily a "recording function" or a "valuation function" ?

I believe the IASB must decide and set out in the Framework what is the primary function of accounting when preparing financial statements.

It must ask and answer the following fundamental questions:

Is accounting primarily concerned with recording transactions at the monetary values agreed between the contracting parties?

OR

Is accounting primarily concerned with providing updated values for assets and liabilities?

I believe that the primary role of accounting is the former and the role of investors and their investment advisors is to value a company as a whole and to determine an appropriate investment strategy but only after taking into account the particular circumstances of the investor at the time the investment decision is to be made. I call the particular circumstances as the "Reference Point" and shall further comment on this below.

I believe potential investors and shareholders are more interested in the value of the company as a whole and the ability of management to generate profits and future cash flows, and I believe that their investment decisions are primarily based on this. Valuing a company as a whole however is a distinct and separate exercise from valuing the company's separately identifiable assets and liabilities. The value of a company as a whole can be substantially more valuable than the aggregate value of its component parts and this added value is often seen in the amount of goodwill arising on business acquisitions.

The reverse may also be true and the value of a company which is broken up may be more valuable than the company as whole. However, where this occurs I believe the added value arises from employment of the company's assets under an alternative use and it should be the responsibility of management to identify such alternative use opportunities under their stewardship function.

In my opinion, accounting is primarily serving a recording function whereby the information on transactions entered into by an entity with outsiders is aggregated and presented in such a way as to be meaningful and useful to the reader. For the purpose of preparing financial statements for shareholders, I believe accounting is not and should not be primarily concerned with providing updated current values of a reporting entity's specific assets. The current values of specific assets and possible alternative uses is more the concern of management in deciding how it wishes to manage and run its chosen business.

If providing updated information on the value of specific assets and liabilities is useful to readers, the question the IASB needs to consider is how and where the information should be provided. The key and fundamental question is this:

What type of information on updated values of assets and liabilities should be reflected in profit or loss/ the income statement and the statement of financial position/ balance sheet and what type of information should be provided outside the two statements?

In answering this question the IASB must answer what is the intended purpose of the two statements. In particular, if the intention of the income statement is to reflect the financial performance of the reporting entity the IASB should define what performance means and which figure is the key measure of performance and what the other sub-totals represent or are intended to convey. In this connection the IASB should explain the principle adopted in deciding which items are reflected in the income statement and which should be presented in OCI.

What should be accounted for?

There is a multitude of information that may be regarded as useful to readers but the conceptual question is what and how can the information be best presented in a logical and consistent manner that is understandable and useful to the reader.

I believe there are two major categories of financial information in the broader meaning of accounting and these are linked to where the information is presented.

The first category requires asking the question:

What information should be provided in profit or loss/ income statement and the statement of financial position/ balance sheet?

I would refer to these two statements as the primary statements, and my comments in this letter will be focusing on these as the cash flow statement looks at the financial data of the company but from a different perspective. Presently, the purpose of the OCI statement is unclear.

The second category of information requires asking the question:

What information should be provided outside the primary statements and conveyed to readers by way of note(s) to the financial statements?

I believe these two aspects should be clearly articulated up front in the Framework as they relate to scope or boundary of what is to be recognised and therefore included in the income statement and balance sheet. It is therefore necessary to have clarity on what the two statements are intended to portray, both when looked at as a whole and when reading their content including how the elements are classified, aggregated, ordered and presented.

On the first category, there is the need to answer the fundamental and key question of:

What should be accounted for by being recognised in the primary statements?

> ***(a) Should we account for "<u>transactions</u>"; and are we primarily concerned with executed transactions, i.e. exchanges where the relevant parties have agreed explicitly or implicitly that performance obligations have been performed and there has been a transfer of risks and rewards?***
>
> ***OR***
>
> ***(b) Should we account for all obligation/commitments agreed under "<u>contracts</u>" at the contract signing date; and should we be accounting for all obligations/commitments under the contracts even though some or all of the performance obligations/commitments under the contracts have not been performed?***

The answer to the above question is fundamental as the answer will determine the scope of what should be included in the two primary statements.

The choice will ultimately drive the definitions of the financial information components or elements which will be recognised, measured and disclosed in the two primary statements. For the resulting information to clear and understandable, I believe the choice must be only one of the two alternatives and it must not be both. Currently, there is a mixture of the two and this has led to complexity and difficulties in understanding the information presented.

(a) Accounting for "completed" transactions

I believe the Conceptual Framework should explicitly discuss and address this key conceptual question and in my opinion the choice should be sub-paragraph (a) i.e. the purpose of accounting in the primary statements is to account for completed transactions. Entering into a contract normally results in one or a number of subsequent transactions to fulfill the contract and each transaction, once completed, should be accounted for separately. In contrast, information on unperformed obligations/commitments should conveyed to the reader by way of a note to the financial statements.

The meaning of a "completed transaction" however needs to be clearly defined so that it is applied consistently. In my view a completed transaction would be a completed "performance obligation" as agreed explicitly or implicitly by the transacting parties. In this respect, immediate payment of consideration for a good or service is not necessary if this is what was agreed. In other words, performance obligations would still be regarded as being "completed" where the supplier has granted a credit period for settlement of the amount due as this formed part of the agreed terms. A supplier that has agreed to grant credit bears the possible risk of default in payment.

I believe the occurrence of an agreed exchange of goods and services between two parties (i.e. between the reporting entity and an outside party) is fundamental and is the trigger point for all accounting i.e. the initial recording or recognition of matters in the two primary statements.

This however does not prevent an entity from also accounting for all its "internal activity" resulting from past transactions. If looked at closely, internal activity from an accounting perspective is effectively a re-grouping and renaming of past recorded transactions between the reporting entity and outsiders. To illustrate, where a company's business is to make wooden chairs for sale, the company's first transaction with an outsider would be with a timber merchant and this transaction results in the purchase of raw timber. The second transaction with an outsider would be paying wages to craftsmen for their labour to make the chairs. The information disclosed on transactions with outsiders moves from the holding of "raw timber" to "finished chairs." "Finished chairs" is just a re-grouping and renaming of the two transactions (raw timber purchase plus labor cost) and is shown as one aggregated cost.

(b) Accounting for "Events"

The next question is this.

What type of "events" should be accounted for and recognised in the primary statements?

The types of events which I believe should be recognised in the primary statements are those events or changes in circumstances arising from outside the company that affect the outcome of past transactions that have been already accounted for previously. In other words, those events that impact on the outstanding balances or carrying values still reflected in the balance sheet.

However, I believe the events to be recognised should be only those that meet the Prudence Concept, i.e. adjustments made to carrying values to ensure that assets are not overstated and expected losses are not understated. The Concept of Prudence has been removed from the revised first part of the Framework and I believe that it should be re-instated. I believe, the Prudence Concept is extremely important as it forms the conceptual basis for accounting for such events.

My further comments on this appear in **Appendix B** under the heading of "The Concept of Prudence".

At this point I believe that it is useful to mention the time-tested wisdom of a proverb that we may all remember but which we may have forgotten. I feel that it is quite fitting as it touches on the issue of what should be accounted for. The proverb is: *Do not count your chickens before they are hatched.* Reinstatement of the Prudence Concept will assist in restoring the time-tested wisdom to accounting.

Unfortunately the wisdom it prescribes has not been fully embraced (e.g. with the required re-measurements to fair value in some existing accounting standards and the recognition of fair value gains). This is discussed further below under the heading of "Should we account for 'hypothetical transactions' ?".

<u>(c) Accounting for other information, including future obligations and commitments under contracts</u>

Moving on to the question of what information should be disclosed outside the primary statements, I would expect that some previous academic studies or surveys have been made on this issue and the IASB could undertake an exercise to collate such information. Alternatively, if its deems fit, the IASB could organise a new survey to obtain more current views on what type of information is useful to readers.

One category of information which I presume should be useful to readers is information on future commitments, whether of a capital or operating nature, as it would provide them with information on risks and exposures with future cash flow implications.

Although information on future commitments (i.e. performance obligations which have yet to be performed and completed) under a contract is useful, I believe such information is secondary information as there has yet to be a completed transaction.

For this reason they should **not** be recognised in the two primary statements. However, information on them could be given by way of a note to the financial statements, and preferably in a single consolidated note. The disclosure should include the nature and amount of the exposure arising under the future commitment or obligation and the estimated timing when the obligation is expected to be fulfilled.

The information provided should be what the shareholders and potential investors expect to see in the financial and this is embodied in the overall principle that financial statements should show a true and fair view. My further comments on this appear in **Appendix B** below under the heading of "True and fair view or its equivalent should be an objective of financial statements".

Should we account for "hypothetical transactions" ?

A significant conceptual question that the IASB must seriously consider is whether "hypothetical transactions" should be recognised in the primary statements. This conceptual issue is linked to the issues arising from the current accounting requirements to re-measure some but not all assets and liabilities to their fair values.

The following fundamental question needs to be answered:

Where the monetary values or consideration for an exchange have already been agreed between contracting parties in an agreed currency and therefore the actual monetary cash flows have been effectively fixed, what is the conceptual reason or justification for subsequent re-measurements of assets and liabilities and the recognition of gains or losses arising from the re-measurement in the income statement, OCI or reserves?

In my opinion the re-measurement of assets and liabilities has the same effect as accounting for hypothetical transactions. For example re-measuring an asset such as a financial instrument or an investment property to its "fair value" (i.e. to its "exit value") has the same effect as accounting for a hypothetical transaction. The accounting for a hypothetical transaction leads to providing "as if'" or "pro forma" information in the primary statements. The question then is this.

Given the intended purpose of accounting is inclusion in the two primary statements appropriate or can the same information be provided elsewhere?

The accounting effect of a re-measurement is the same as accounting for a sale and a simultaneous buy-back. However, as there is no real identifiable buyer or counterparty, I believe it amounts to accounting for a hypothetical transaction.

I understand that the meaning of "re-measurement" is not entirely clear and there may be different interpretations and inconsistencies as to what it means when it is applied. I would therefore recommend that the IASB should consider clarifying what it is intended to mean to ensure that when used it is interpreted and applied consistently.

In my view, the current accounting requirements to re-measure many financial instruments to their fair value after their initial recognition amounts to a change in the accounting policy. Monetary amounts recognised on initial recognition should be at the monetary amounts agreed between the contracting parties. The exchange value is therefore an "entity specific value" and represents the specific cost of acquisition of the financial instrument. In contrast, fair values which are defined as exit values are "market values" and are therefore not entity specific values.

<u>Should we account for "unrealised" gains and losses ?</u>

The re-measurement issue is linked to a further conceptual question of whether gains and losses on holding assets and liabilities should be allowed even though there has been no actual transaction with outsiders. Put differently, the conceptual question is whether "unrealised" gains or losses should be recognised and the conceptual basis for doing so, and if the answer is a yes, when, how and where they should be recognised.

By not addressing this conceptual question problems and issues are surfacing particularly in connection with the recognition of unrealised gains and losses on certain items directly in the OCI statement, and the subsequent recycling of some but not all of those items to profit and loss.

Although there are mandatory re-measurements to fair value under existing accounting standards, the reporting entity may neither have the intention nor the ability to sell or transfer the item at the reporting date. More importantly, the re-measurements lead to the recognition of unrealised gains and losses and these may not eventually materialise as cash inflows and outflows. In other words, re-measurements result in the recognition of gains and losses that may be "temporary" and "reversible". I believe this has led to undue complexity in financial statements and this is most evident in issues that are arising from the use of the OCI statement and questions on when transfers can or cannot be made between the OCI and the income statement.

If the IASB decides that unrealised gains and losses should recognised, another conceptual question that needs to be addressed is this.

Should unrealised gains and losses be recognised for ALL assets and liabilities, and if not why not?

Currently some financial instruments are required to be re-measured to their fair values but the conceptual question is why other assets, such as inventories, are not also re-measured to their fair values at the reporting date as they too are held for trading or are relatively liquid assets. If the justification for re-measurement is that fair value information is useful the questions that need to be addressed include the following:

- What is the conceptual basis for re-measurements?

-Does usefulness and relevance of information <u>alone</u> justify recognition in the primary statements?

- What is the criteria for deciding whether the re-measurement is to be reflected in:-
- profit or loss/ the income statement OR
-Other Comprehensive Income OR
-a revaluation reserve/or another named reserve or account balance

and what is the criteria to support recycling or no recycling between any of the above accounts?

In my opinion, information can be presented in many ways and can still be useful. Where the re-measurements are presented however does have a different impact on readers as they will convey different messages.

In my view, re-measurements to fair value required under the existing standards and particularly unrealised gains should not be recognised in the primary statements. If such "as if" information is deemed useful it can still be presented and in my view the best way is by a separate note to the financial statements.

Unrealised gains arising on re-measurement do not arise from real and actual transactions with outside parties and thus their recognition represents accounting for hypothetical transactions. I believe a pre-requisite for recognising gains should be the existence of a counterparty who is real and one who has agreed to the exchange price used in determining the gain.

In contrast, I believe recognition of expected losses is appropriate under the Prudence Concept. The account balance subject to impairment arose out of a past real transaction where there was a real counterparty. Moreover the making of an impairment allowance can be made without the need for any agreement of the counterparty as asking for the counterparty's agreement would not be in the interest of the reporting entity. By making an impairment allowance the reporting entity has taken the view that there is a "realised" loss but he hopes nevertheless that the debtor will settle the debt in full.

If the IASB determines that "unrealised gains" and "unrealised losses" should be recognised, it should clearly define what the two terms mean and set out the conceptual rationale. The reasons should be something more than the information being useful.

<u>The importance of the "Reference Point"</u>

I have significant concerns on the wider use of fair values which is contributing to difficulties in the interpretation and application of standards and complexity in financial statements.

I agree that fair value information can be useful, but in my opinion it should only be provided as supplementary information because it is only pro-forma "as if" information on something that has not occurred. Re-measurement to fair value is in effect accounting for a sale and immediate buy back. It is accounting for hypothetical transactions at hypothetical prices with a hypothetical counterparty and makes a major omission. It does not take into account the "reference points" of the two parties which is required for a transaction to happen. It omits to consider the specific circumstances and position (both financial and non- financial) of the buyer and the seller; that is, their specific "reference points".

Buyers and sellers have their own unique reference point before they make a decision to enter into a transaction. Their reference point is their unique circumstance, including their preferences and financial position. A completed transaction reflects the reference points of the two trading parties and unless the needs of both are satisfied, the trade would not occur. A trade thus represents a unique transaction between a willing buyer and seller. Those that have not traded are not willing buyers and sellers.

The quoted price of an asset such as shares on a stock market at the reporting date which is used to calculate the fair values may not be the price at which the seller wishes to trade and in fact the seller may not have the ability nor the intention to trade. If the trade is forced upon the seller it will represent a forced trade and this in my opinion is not one carried out at fair value.

In other words, quoted market values of assets at a balance sheet date do not necessarily represent the fair values of the assets to the reporting entity. The quoted prices at the balance sheet date only represent the fair values of those that have actually traded but they do not represent the fair values of those that have not traded. Quoted market prices are only indicators of expected cash flows and quoted prices will change and do change significantly within a very short period of time.

Lessons from the collapse of Enron

In considering the above specific conceptual questions I believe that we should learn the lessons arising from the collapse of Enron in 2002. We should not waste the lesson. In a documentary film about the collapse one of the reasons that contributed to Enron's downfall mentioned was allowing the company to adopt an accounting policy of marking-to-market. Its equivalent is now included in many accounting standards which require assets and liabilities to be re-measured to their market exit or values at the reporting date.

The CEO of Enron at the time appears in the documentary and a method of accounting for generating profits as and when needed. He called it Hypothetical Future Value Accounting. It is quite astounding that something very similar is now embraced in IFRS in the form of fair value accounting.

The documentary can be found by typing "**The Smartest Guys in the Room**" in an internet search. In particular, the specific issue of marking-to-market starts at about

20 minutes into the film. The film contains other accounting related lessons and I would recommend IASB members and staff to view the whole documentary.

<u>Need to distinguish "Present obligations" from "Future obligations/ commitments"</u>

The Discussion Paper proposes a new definition for a liability and retains the use of the term "present obligation". I believe that it is vital to distinguish a "<u>present</u> obligation", that is, a "liability" from a <u>future</u> commitment or obligation which may not necessarily result in a liability and the outflow of resources. I believe that when the original Framework was developed the word "present" was intentionally added to distinguish <u>present</u> obligations from <u>future</u> obligations and this should be clearly explained in the revised Framework as it is key in determining when a liability exists.

I believe that an obligation is merely a "deliverable" or a duty to act. It only becomes a present obligation of the reporting entity when the duty to act is "delivered" or it has become a current duty and thus the obligation becomes "owed" immediately. Only obligations and commitments that have crystallised into present obligations should be recognised as it is only then that an obligation has turned into a present obligation, i.e. a liability. Non present obligations are future obligations and commitments and these should not be recognised, but if material, should be disclosed in the notes to the financial statements.

I suggest the revised Framework should clearly and fully explain what a "present obligation" means and also provide illustrative examples. For example, the signing of a guarantee creates an obligation and a possible "deliverable" but a present obligation will only arise when the obligation to pay is triggered when the original debtor fails to pay. If the original debtor repays the creditor, a present obligation or the need to make an outflow of resources by the guarantor is not created.

In developing guidance on accounting for liabilities, the IASB should clarify and explain the following:-

- ***What is an obligation?***
- ***When is an obligation created?***
- ***What is a <u>present</u> obligation? / What is a liability?***
- ***When is a <u>present</u> obligation created?***
- ***When is a <u>present</u> obligation settled?***
- ***Can a <u>present</u> obligation be varied, and, if so, by whom?***
- ***Does a variation in a <u>present</u> obligation represent the immediate settlement of the present obligation and the creation of a new present obligation or the creation of a new future obligation that may become a new present obligation in the future?***

To illustrate the above, consider the case of an employer who hires a person on a three-year employment contract with a monthly salary of HK$50,000 which will be paid at the end of each month. The contract allows three months notice by either side for termination.

The contract does create obligations but the key questions are:

Is the <u>present</u> obligation the one obligation to pay the salary for all three years and should the amount for the entire three years be recognised as a liability on the date on which the employment contract was entered into; and if so, what are the accounting entries? OR

Does a <u>present</u> obligation of the employer only arise after the staff provides the service and an amount representing one month's salary should be recognised as a liability at month end?

I believe "IFRIC Interpretation 21 - Levies" lays down useful basic principles. It provides an analysis of how to identify an "obligating event" that triggers the crystallisation of an obligation into a "present obligation", i.e. the creation of a "liability" which in turn triggers its recognition in the primary statements. I would recommend that the IASB incorporate the principles included in IFRIC 21 in the Framework.

I would also like to add two points. First, the basic principles for the determination of when a liability exists will have an impact on "IAS 12 - Income Taxes", as it calls into question whether deferred tax is in fact a liability. Second, it calls into question the requirement of paragraph 23 of "IFRS 3 - Business Combinations" under which "contingent liabilities" assumed in a business combination are required to be recognised as a liability contrary to "IAS 37 - Provisions, Contingent Liabilities and Contingent Assets." I do not see any clear conceptual rationale why the mere fact of an acquisition would change the nature of the contingent liability. In my opinion, the existence of the contingent liability of the acquiree would have been factored into the purchase consideration for the acquisition. The acquirer would have asked for a reduction in the asking purchase price of the seller to compensate him for taking up the potential risk of a loss attached to the contingent liability.

<u>Need to distinguish "Liabilities" from "Provisions"</u>

I believe that the issue of making "provisions" is a separate issue from determining the existence of a "liability". In my opinion, a "provision" is not a "liability" and the current accounting literature mixes the two. Currently, under IAS 37 the standard defines a provision as "liabilities of uncertain timing or amount". Paragraph 14 of IAS 37 also says a provision should be recognised when and only when:-

"(a) an entity has a present obligation (legal or constructive) as a result of a past event;

(b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and

(c) a reliable estimate can be made of the amount of the obligation."

I believe that the guidance is confusing. I believe that if criteria (a) above is met, i.e. there is a present obligation, this fact alone means that a liability exists and if this is the case the liability should be recognised. If there are difficulties in measurement how the amount was determined could be disclosed so that readers understand that the amount is an estimate and the degree of reliance that can be placed on it.

The existence of a present obligation by definition means that should be an outflow of resources. There is no issue concerning whether there will be a probability of the outflow of resources.

I believe the Framework should distinguish a "provision" from a "liability". I believe that making a "provision" represents early recognition of an expected future liability, i.e. a future obligation that has a high probability of crystallization into a liability. Making a provision need not be contractual, i.e. it does not require the agreement from another party. The recognition of a "provision" is an implementation of the Prudence Concept and this is a reason why I believe the concept should be re-instated in the Conceptual Framework.

Is the Re-measurement of Liabilities appropriate?

I believe that the re-measurement of liabilities does not provide useful information and in fact results in the production of misleading information and should not normally be allowed. The only exception would be where the contractual agreement with the counterparty stipulates that the amount payable is to vary in accordance with certain specified and agreed criteria, such as those relating to insurance policies.

I believe the key principle should be that liabilities should represent and be measured at the amount that reflects the amounts payable as agreed between the two contracting parties effective at the reporting date. The time value of money is already factored into the agreed terms, such as the price and credit terms. I believe that in most circumstances liabilities are easily quantified and a specific amount is agreed at the outset between the debtor and creditor. It is only when a transaction is of a non-monetary nature or the obligation amount is agreed to be variable that there is a need to exercise judgment to determine the "best estimate" of the amount due.

Bifurcation and Derecognition

I believe that on initial recognition the principle should be that all assets and liabilities should be recognised under the unit of account agreed between the transacting parties. It would be inappropriate to bifurcate the transaction into separate component parts and to account for each component differently unless that was the intention of both parties. See my response to Question 24 in **Appendix C.**

I believe that for de-recognition the best test is a transfer of "risks and rewards" test.

Greater emphasis to be placed on "future" cash inflows and outflows?

It is often mentioned that users of financial statements need information to assess the "future cash inflows and outflows" of the reporting entity.

Although a cash flow statement provides information on "past" cash flows, I believe it is important to have clarity on what "future" cash flows actually means and this should be clearly defined.

If users are more interested in "future" cash flows, a legitimate question the IASB should ask is whether the current cash flow statement is a good starting point which satisfies their needs, whether changes are needed and what type of information will readers require in estimating future cash flows of the reporting entity.

APPENDIX B

EARLIER PARTS OF THE FRAMEWORK TO BE REVISITED

"True and fair view" or its equivalent should be an objective of financial statements

Company law or legislation in most jurisdictions normally require that the financial statements prepared for shareholders should present a "true and fair view" (or their equivalent) of the results and financial position of the reporting entity.

Because of this, in my opinion "true and fair" should be regarded as one of the main objectives of financial statements. The importance of the term "true and fair" or its equivalent should be given greater prominence by being discussed and included in the Framework. The concept true and fair should be elevated and just mentioning it in IAS 1 is insufficient.

I believe support for this recommendation should also come from external auditors as they are required to independently opine on whether the financial statements prepared by the directors do in fact give a true and fair view.

The Reporting Entity

I believe that the discussions and analysis in the Framework should be first directed at the preparation of financial statements at the individual legal entity level as these are the essential ingredients for the preparation of consolidated financial statements. I believe that if attention is first made at the legal entity level, the accounting principles that are developed will have greater clarity.

Currently the approach adopted by the IASB in developing specific IFRS takes the opposite approach and focuses on group financials and as a result I believe this creates confusion in understanding concepts. The preparation of consolidated financial statements requires the consideration of many more complex issues that do not apply at the individual company level.

I believe a main source of added complexity is how the meaning of "control" is being extended and modified. I believe that the meaning of control is being modified to support the objective of requiring consolidation of more entities.

I believe this approach of focusing on amending the meaning of control is inappropriate as there are different levels of control. The proposed revised definition of control as set out in paragraph 3.23 on page 42 of the Discussion Paper is as follows:

"An entity controls an economic resource if it has the present ability to direct the use of the economic resource so as to obtain economic benefits that flow from it".

There can be several levels of control and it is possible that you control but you do not possess "majority or full control". For example, joint control in a joint venture means that direction of use of the economic resource requires agreement from the other joint venture party. Control cannot be exercised unilaterally.

The Concept of Prudence

Although this concept has been removed, I believe it should be re-instated and given greater prominence. It however needs to defined clearly. Because the concept may have been abused does not justify its removal as it is important and relevant in the preparation of financial statements.

If applied properly the concept of prudence should result in a fair representation of a company's true financial position. Moreover it is good corporate governance to be cautious and to recognise likely losses as early as possible. In fact after the 2008 financial crisis both investors and regulators are calling for more prudence as they want impairment allowances to be based on an expected loss model rather than an incurred loss model.

I would add that the prudence concept could be seen as a re-measurement of an asset and the recognition of unrealised losses. However, my view is that making an impairment provision or allowance is the recognition of what is regarded as a permanent rather than a temporary loss in value and would interpret an impairment loss as one that is regarded as realised.

The Concept of Neutrality

I believe that this concept should be reassessed and further explained as information presented can never be totally free from bias. Moreover, if the IASB believes that accounting should adopt the approach from the perspective of management, i.e. how assets are managed which is used to justify the accounting treatment for some financial instruments, it can never be truly neutral. Similarly a decision on whether an asset will be classified as held for sale or held for the long term and used in its operations is a business decision that is entity specific and is not neutral. All decisions made by the directors or management will always be entity specific and are made with the primary purpose of benefiting the company. To require something else would be contrary to the fiduciary duty of the directors.

The key issue which I believe the IASB is rightly concerned with is whether the information presented in financial statements is biased and especially towards being too optimistic.

The requirement of external auditors to provide their independent opinion on the financial statements, should provide an adequate safeguard to shareholders.

The Concept of Substance

I understand that it has been removed as it was considered that it is embodied in the new term of "faithful representation".

I believe that the concept of substance has served us well and should be reinstated as it captures an essential requirement to look through any structuring and window-dressing. It requires looking through structured transactions and arrangements made with a purpose of conveying a different picture than is actually the case.

In my opinion, the meaning of faithful representation is more restrictive and is likely to be applied when considering individual transactions but the concept of substance is much wider and requires looking at the bigger picture.

In my view, the concept of substance is one of the concepts supporting the preparation of consolidated financial statements as rather than just showing investments in subsidiaries, the underlying assets and liabilities of the subsidiaries are disclosed.

The Accruals Concept, the Matching Concept and principles concerning offsetting

Accruals, matching and the ability to offset are all inter-related issues and I believe discussion of their interrelationship deserves greater elaboration in the Framework to support hedge accounting. See my comments to Question 20 in Appendix C.

APPENDIX C

RESPONSES TO THE QUESTIONNAIRE

Below I respond to the specific questions asked but these should be read together with my comments in the covering letter and in **Appendices A** and **B.**

Question 1

Paragraphs 1.25-1.33 set out the proposed purpose and status of the *Conceptual Framework*. The IASB's preliminary views are that:

a) **the primary purpose of the revised *Conceptual Framework* is to assist the IASB by identifying concepts that it will use consistently when developing and revising IFRSs; and**

b) **in rare cases, in order to meet the overall objective of financial reporting, the IASB may decide to issue a new or revised Standard that conflicts with an aspect of the *Conceptual Framework*. If this happens the IASB would describe the departure from the *Conceptual Framework*, and the reasons for that departure, in the Basis for Conclusions on that Standard.**

Do you agree with these preliminary views? Why or why not?

I agree to paragraph (a) as this is its primary purpose for IASB. This does not preclude others from using it as a guide for other purposes.

On paragraph (b) I believe that the departure from the Framework and the principle reason(s) for the departure should be briefly mentioned in the standard itself so that it is clear up front that there has been a departure. The detailed reasons can be further discussed in the Basis for Conclusions.

In addition, to minimize possible departures from the Framework becoming the norm, the Framework should set out only a limited number of circumstances where a departure would be justified. This would encourage the development of accounting principles rather than accounting rules catered for specific industries or vested groups.

Question 2

The definitions of an asset and a liability are discussed in paragraphs 2.6-2.16. The IASB proposes the following definitions:

a) **an asset is a present economic resource controlled by the entity as a result of past events.**

b) **a liability is a present obligation of the entity to transfer an economic resource as a result of past events.**

c) **an economic resource is a right, or other source of value, that is capable of producing economic benefits.**

Do you agree with these definitions? Why or why not? If you do not agree, what changes do you suggest, and why?

I appreciate the efforts in making proposals to revise and improve the definitions which is a difficult task. At first sight the definitions appear to be better than the current definitions but after testing them I found that they do not always work, can be interpreted quite widely and thus may raise further questions.

For example on the asset side, goodwill arising from an acquisition would appear not qualify as an asset as goodwill by itself is incapable of producing economic benefits and relies on the cash generating abilities of other assets. Similarly, a deferred expense that is not linked to any other physical asset or instrument would also appear to fall out of the revised definition of an asset as the economic resource has been passed to another party. On the liability side, deferred income, deferred tax and provisions for losses would appear to not fall under the definition of a liability. Moreover, equity which has not been defined would appear to fall under the definition of a liability.

The above thus raises the need for a re-consideration of the proposed revised definitions. More importantly I believe there is a need for a fundamental re-consideration of the equation (ASSETS less LIABILITIES = EQUITY) which is currently used when looking at the composition of elements included in a balance sheet.

In my view, there is a need to comprehensively re-consider the principle components that appear in the balance sheet. Trying to fit all possible balance sheet components into the two definitions of an asset and a liability makes the definitions too unwieldy.

If the IASB decides to retain and only revise the existing defined terms my suggested definitions, which may be better understood by lay shareholders and potential investors, would be as follows:

Definition of an "Asset" - *Something valuable which is effectively owned (legal ownership, by contract or by other means) and controlled by the reporting entity for which the entity bears the risks and rewards of ownership.*

You will note that my proposed definition does not focus on "control" but refers to bearing the risks and rewards of effective ownership which I believe is key. Possession of control may result in obtaining benefits but does not always mean that the holder bears the risks and rewards of effective ownership.

In my opinion the proposed definition of an asset included in the Discussion Paper can be interpreted widely. For example, it could be interpreted to mean that a bus driver who has been hired to drive a bus by a bus company could regard the bus as his own asset. The bus driver controls the bus and gets benefits from its use.

Definition of a "Liability" - *The monetary amount owed by the reporting entity to another party at the reporting date.*

An intrinsic characteristic of the above two suggested definitions is that an asset and a liability must have a value. In other words, you cannot separate their existence from value; they are intertwined. I believe this is reflected in the proposed revised definition by inclusion of the term "economic resource" which is linked to value.

If something does not have a value it is not something that is valuable and thus it is not an asset. Likewise, a liability's intrinsic characteristic is that it must have a monetary amount or value. Value is inherent in the words "economic resource" and the words "economic benefits" are used to describe what is a an "economic resource"

However, a future obligation or a commitment to do something in the future only represents something that is executory in nature, i.e. something that has yet to be performed and there has yet to be the creation of something of value. A liability or an obligation to pay an amount will only arise after the performance of a promised act has been executed. I suspect that some will disagree with this and would say that mere signing a contract creates value but to me a signed contract without subsequent performance is empty.

Equity

Rather than defining Equity as being the residue of Assets less Liabilities, I believe the Framework could explain that Equity is in fact a liability. Equity, comprising paid up share capital, retained earnings or other reserves in substance represents the amounts owed by the reporting entity to its shareholders in their capacity as shareholders.

I believe that if the reporting entity is looked at from the perspective as a separate entity the following equation ASSETS = LIABILITIES could replace the existing equation of ASSETS less LIABILITIES = EQUITY.

The equation ASSETS = LIABILITIES means OWN = OWE. In other words, what the entity effectively owns and controls equals what it owes to outside parties. Put differently, the equation explains that its shareholders and other creditors have claims over the company's assets.

Definition of a "Provision"

In addition to the above two definitions it may be useful to include a definition for a "provision" for expected losses which are made when applying the Prudence Concept. See my comments on the Concept of Prudence in **Appendix B**.

A possible definition for a Provision could be:

-A monetary amount set aside by the reporting entity at the reporting date for
(a) a loss or a monetary claim that is regarded as realised ; and/or
(b) expected future liabilities that are regarded as crystallised at the reporting date]

When these provisions have been charged against profit or loss, the amount of retained earnings owed to shareholders is reduced. Under double-entry book-keeping the credit side is seen on the same side of the balance sheet, represented by the cumulative amounts provided and this represents amounts that will be paid to outside creditors in due course. The equation ASSETS = LIABILITIES thus remains true.

Question 3

Whether uncertainty should play any role in the definitions of an asset and a liability, and in the recognition criteria for assets and liabilities, is discussed in paragraphs 2.17-2.36. The IASB's preliminary views are that:

a) **the definitions of assets and liabilities should not retain the notion that an inflow or outflow is 'expected'. An asset must be capable of producing economic benefits. A liability must be capable of resulting in a transfer of economic resources.**

b) **the *Conceptual Framework* should not set a probability threshold for the rare cases in which it is uncertain whether an asset or a liability exists. If there could be significant uncertainty about whether a particular type of asset or liability exists, the IASB would decide how to deal with that uncertainty when it develops or revises a Standard on that type of asset or liability.**

c) **the recognition criteria should not retain the existing reference to probability.**

Do you agree? Why or why not? If you do not agree, what do you suggest, and why?

I have not interpreted the use of the word "expected" used in the existing definitions of an asset and a liability to refer to the type of uncertainty as explained in the Discussion Paper.

Rather, I have interpreted the phrase to mean that there <u>was in fact certainty</u> that there <u>should be</u> cash inflows for assets and cash outflows for liabilities in the <u>normal course of business</u>.

I believe that the inclusion of the words, "... are <u>expected</u> to flow to the entity..." in the definition for an asset and "...is <u>expected</u> to result in an outflow.. " in the definition of a liability, was to reflect the possibility that an asset subsequently may be impaired or that the reporting entity may not be able to settle the liability when due.

An alternative in the original drafting would have been to use the words "...<u>will</u> flow to the entity" in the definition of an asset and "... <u>will</u> result in an outflow... " for the definition of a liability but if such words were used it would be difficult to apply as certainty would need to be absolute for the recognition of an asset or liability. The use of the word "expected" thus removes the need to prove absolute certainty.

Moreover I have concerns on the definition of the new term "economic resource" which includes the reference to the phrase "capable of producing economic benefits". My understanding is that the phrase is to overcome the problems in using the word "expected" in the existing definition. However, in my opinion the change does not resolve the issue. In fact it raises the question of how can you determine that something is in fact capable of producing economic benefits. At best you can only "expect " that it is capable.

In addition, in the definition of an "economic resource" there is a reference to "...rights, or other source of value..." The reference to "rights" may be pre- mature and there is a need to debate what are "rights" and which types can be included. The exposure draft on leases introduced the new concept of "right of use" or "right to use" which divides a single physical asset into a bundle of rights to the economic resource or it service potential. The nature of such rights needs a detailed conceptual debate. You will see in my comment letter to the lease exposure draft that I believe that a lease contract does not create an asset or a liability. I would add that everything on this earth is an economic resource made available free by a super being or god and the "right" to the resources is a human creation.

In the case of a liability, I believe there is no issue concerning whether there will be an outflow of economic resources as this is an inherent characteristic of a liability. The existence of a present obligation means that there is an obligation to pay and there is no issue concerning whether there will be a <u>probability</u> of an outflow of resources. There may be a rare circumstance where a debt is waived by a creditor but if there is a waiver, the existence of the liability is a pre-condition. In other words , you cannot waive a debt that was not already there in the first place.

I believe that it is vital to distinguish a present obligation from future obligations or commitments and my comments on this are set out in **Appendix A** under the heading "Need to distinguish 'Present obligations' from 'Future obligations/ commitments' ". Current accounting literature mixes the two. The word "liability" is used too liberally.

<u>Question 4</u>

Elements for the statement(s) of profit or loss and OCI (income and expense), statement of cash flows (cash receipts and cash payments) and statement of changes in equity (contributions to equity, distributions of equity and transfers between classes of equity) are briefly discussed in paragraphs 2.37-2.52.

Do you have any comments on these items? Would it be helpful for the *Conceptual Framework* to identify them as elements of financial statements?

Yes, I agree it would be helpful to identify them as elements in the financial statements.

I believe that it is particularly important to explain why transactions with shareholders should not normally result in the recognition of a gain or loss or income or an expense. Currently there are inconsistencies and the most significant one relates to the treatment of share options which are recognised as an expense even though the share purchase is with a person in his capacity as a shareholder although the option may have been granted because he was an employee.

The fundamental questions are:

- When is a cost actually incurred at grant date or on exercise of the option?
- Is the granting a share option a cost to the reporting entity or is it in fact a cost to the existing shareholders through dilution of their interests, but if and only if, the share options are exercised?

The issue is linked to the appropriateness of recognising "**opportunity costs**" or the benefits the reporting entity <u>could have</u> received through taking alternative action. These "as if" scenarios are also seen when there are re-measurements of assets and liabilities to fair value and the use of imputed interest and effective interest rates.

<u>Question 5</u>

Constructive obligations are discussed in paragraphs 3.39-3.62. The discussion considers the possibility of narrowing the definition of a liability to include only obligations that are enforceable by legal or equivalent means. However, the IASB tentatively favours retaining the existing definition, which encompasses both legal and constructive obligations and adding more guidance to help distinguish constructive obligations from economic compulsion. The guidance would clarify the matters listed in paragraph 3.50.

Do you agree with this preliminary view? Why or why not?

Some guidance distinguishing constructive obligations from economic compulsion already exists in "IFRIC 21 - Levies"

I believe that there should be more guidance on what is the meaning of a <u>present</u> obligation and how it is different from a future obligation as this is a key issue. The IASB should explain the difference between a constructive obligation and a <u>present</u> constructive obligation. My initial view is that a constructive obligation is not a present obligation. Nevertheless, an entity may make a "provision" for it . See my comments to Question 2.

In the long term, the IASB may wish to consider using another term such as "Claims against the entity" as an all encompassing term to cover all items now included under Liabilities + Equity. It could then be free to define the sub elements. For example, the meaning of a "liability" could be restricted to claims that are legally enforceable and "present constructive obligations" could refer to non legally enforceable claims but agreed obligations due to past practice of the reporting entity. Other elements could include items such as accrued expenses, provisions for losses and future liabilities, deferred income, etc that may fall out of any of the earlier defined sub elements.

<u>Question 6</u>

The meaning of 'present' in the definition of a liability is discussed in paragraphs 3.63-3.97. A present obligation arises from past events. An obligation can be viewed as having arisen from past events if the amount of

the liability will be determined by reference to benefits received, or activities conducted, by the entity before the end of the reporting period. However, it is unclear whether such past events are sufficient to create a present obligation if any requirement to transfer an economic resource remains conditional on the entity's future actions. Three different views on which the IASB could develop guidance for the *Conceptual Framework* are put forward:

(a) View 1: a present obligation must have arisen from past events and be strictly unconditional. An entity does not have a present obligation if it could, at least in theory, avoid the transfer through its future actions.

(b) View 2: a present obligation must have arisen from past events and be practically unconditional. An obligation is practically unconditional if the entity does not have the practical ability to avoid the transfer through its future actions.

(c) View 3: a present obligation must have arisen from past events, but may be conditional on the entity's future actions.

The IASB has tentatively rejected View 1. However, it has not reached a preliminary view in favour of View 2 or View 3.

Which of these views (or any other view on when a present obligation comes into existence) do you support? Please give reasons.

I support View 1 but without the second sentence. I view "avoiding the transfer through future actions " is looking into the <u>future</u> but the important issue is we should be looking at the present. The future is not a relevant consideration. A <u>present</u> obligation in my view means that the obligation is due without conditions. View 2 and View 3 are similar. "Practically unconditional" in view 2 means that in substance it is "conditional".

I understand that View 3 may have arisen when considering obligations to restore the environment in a mining operation. I believe the crux of the issue is what is the obligating event. If the obligating event to restore arises after the mining has been completed a present obligation to restore arises only at that time.

The issue then is during the years the mine is in operation can some restoration costs be recognised even though there is no present obligation, i.e. there is no liability. In my view, recognising such costs should be allowed under the Matching Concept where all costs in respect of generating revenue are accrued and recognised during the years the mine is in operation. It would also be implementation of the Prudence Concept where the objective is not to overstate profits. A "provision" for restoration costs which represents amounts set aside for "expected" future liabilities should be allowed.

See also my comments to Question 2 and Question 5.

Question 7

Do you have comments on any of the other guidance proposed in this section to support the asset and liability definitions?

See my comments to the earlier questions and **Appendix A** on the fundamental issues that will impact on what should be recognised.

Question 8

Paragraphs 4.1-4.27 discuss recognition criteria. In the IASB's preliminary view, an entity should recognise all its assets and liabilities, unless the IASB decides when developing or revising a particular Standard that an entity need not, or should not, recognise an asset or a liability because:

(a) **recognising the asset (or the liability) would provide users of financial statements with information that is not relevant, or is not sufficiently relevant to justify the cost; or**

(b) **no measure of the asset (or the liability) would result in a faithful representation of both the asset (or the liability) and the changes in the asset (or the liability), even if all necessary descriptions and explanations are disclosed.**

Do you agree? Why or why not? If you do not agree, what changes do you suggest, and why?

I agree that the time and cost to prepare financial statements should be a consideration and this is especially relevant to listed entities with diverse operations and they are required to report more regularly than just once per year. Entities should also not be forced to find a value where it is not reliably measureable or where there is no supporting actual transaction to support the value.

Estimated materiality is a valid consideration as ultimately an asset is something that is useful and valuable to the entity. Likewise a liability is an amount owed by the entity to other parties and if there is no evidence of a valid claim there is no liability worth recording and there is no information value in their disclosure.

Question 9

In the IASB's preliminary view, as set out in paragraphs 4.28-4.51, an entity should derecognise an asset or a liability when it no longer meets the recognition criteria. (This is the control approach described in paragraph 4.36(a)). However, if the entity retains a component of an asset or a liability, the IASB should determine when developing or revising particular Standards how the entity would best portray the changes that resulted from the transaction. Possible approaches include:

(a) enhanced disclosure;

(b) presenting any rights or obligations retained on a line item different from the line item that was used for the original rights or obligations, to highlight the greater concentration of risk; or

(c) continuing to recognise the original asset or liability and treating the proceeds received or paid for the transfer as a loan received or granted.

Do you agree? Why or why not? If you do not agree, what changes do you suggest, and why?

As mentioned in Question 2 above on my suggestions on the definition of an asset I believe that just looking at "control" is not sufficient but it is necessary to also look at whether there has been a loss of effective ownership.

The IASB should establish principles in the Framework on whether an asset can be partially recognised or derecognised and when this is appropriate. I believe relegation of these issues to be considered only at the standard level is not an appropriate approach as this will result in a rules-based approach and the production of rules that have no conceptual backing.

Recognition and derecognition is also a "unit of account" issue and the Framework should develop principles in identifying what should be the unit of account and if and when it can be changed. I have concerns on "components" and the exposure draft on leases shows how this will create complexity.

<u>**Question 10**</u>

The definition of equity, the measurement and presentation of different classes of equity, and how to distinguish liabilities from equity instruments are discussed in paragraphs 5.1-5.59. In the IASB's preliminary view:

(a) the *Conceptual Framework* should retain the existing definition of equity as the residual interest in the assets of the entity after deducting all its liabilities.

(b) the *Conceptual Framework* should state that the IASB should use the definition of a liability to distinguish liabilities from equity instruments. Two consequences of this are:

(i) obligations to issue equity instruments are not liabilities; and

(ii) obligations that will arise only on liquidation of the reporting entity are not liabilities (see paragraph 3.89(a)).

(c) an entity should:

(i) at the end of each reporting period update the measure of each

class of equity claim. The IASB would determine when developing or revising particular Standards whether that measure would be a direct measure, or an allocation of total equity.

(ii) recognise updates to those measures in the statement of changes in equity as a transfer of wealth between classes of equity claim.

(d) if an entity has issued no equity instruments, it may be appropriate to treat the most subordinated class of instruments as if it were an equity claim, with suitable disclosure. Identifying whether to use such an approach, and if so, when, would still be a decision for the IASB to take in developing or revising particular Standards.

Do you agree? Why or why not? If you do not agree, what changes do you suggest, and why?

I believe that it is worthwhile to have a fundamental rethink of what is regarded as "Equity" and in my opinion defining "Equity" as a residual of Assets less Liabilities is not very meaningful as it just describes its computation.

As mentioned previously there are many items included in the balance sheet that may not fall into the strict definitions of an "asset" and a ""liability".

As explained in my comments to Question 2, I believe it may be worthwhile for the IASB to explore the possibility of adopting the equation of OWN = OWE as a key concept as it may be easier to understand.

If the "claims" approach is adopted it would provide a conceptual basis for the transfer of claims between different claimants and also movements between claim balances that are described differently but which belong to the same claimant. It would also provide clarity of why claims can sometimes be "re-measured" such as in the case of life insurance businesses where amounts owed by an insurance company to insurance policy holders do not remain fixed but may rise or fall based on the terms of the policy and so long as the insurance policy remains in force.

In any event, I believe the best starting point for any analysis would be to look at the issues from the standpoint of the reporting entity being a separate legal entity, which is the norm for most companies that will adopt IFRSs, and what would happen if the entity is dissolved. After this analysis is clear, the analysis can then be extended to consolidated financial statements where many different considerations apply. Lastly the analysis can deal with other types of entities such as partnerships, associations and clubs where also many different considerations are relevant, such as no limitation in liability, the entity has no objective to make profits and where members who have contributed capital are not entitled to a share of surpluses.

Question 11

How the objective of financial reporting and the qualitative characteristics of useful financial information affect measurement is discussed in paragraphs

6.6-6.35. The IASB's preliminary views are that:

(a) the objective of measurement is to contribute to the faithful representation of relevant information about:

(i) the resources of the entity, claims against the entity and changes in resources and claims; and

(ii) how efficiently and effectively the entity's management and governing board have discharged their responsibilities to use the entity's resources.

(b) a single measurement basis for all assets and liabilities may not provide the most relevant information for users of financial statements;

(c) when selecting the measurement to use for a particular item, the IASB should consider what information that measurement will produce in both the statement of financial position and the statement(s) of profit or loss and OCI;

d) the relevance of a particular measurement will depend on how investors, creditors and other lenders are likely to assess how an asset or a liability of that type will contribute to future cash flows. Consequently, the selection of a measurement:

(i) for a particular asset should depend on how that asset contributes to future cash flows; and

(ii) for a particular liability should depend on how the entity will settle or fulfill that liability.

e) the number of different measurements used should be the smallest number necessary to provide relevant information. Unnecessary measurement changes should be avoided and necessary measurement changes should be explained; and

f) the benefits of a particular measurement to users of financial statements need to be sufficient to justify the cost.

Do you agree with these preliminary views? Why or why not? If you disagree, what alternative approach to deciding how to measure an asset or a liability would you support?

My initial thoughts are that I generally agree to the preliminary views but qualified as follows:

(a) I do not agree that the measurement basis of a liability should depend on how the entity will settle or fulfill that liability. A liability is a monetary amount payable and the method of subsequent settlement should not be relevant in the measurement of the amount due or payable. Adopting the IASB's preliminary view will mean that there will be a change in the measurement basis and I believe this amounts to a change in the accounting policy and under IAS 8 this requires retrospective adjustments and the restatement of prior year figures. I believe changes to accounting policies should be the exception rather than the norm.

(b) The IASB will need to clarify what is the meaning of "measurement" and what is the meaning of "re-measurement" so there is clarity on their meaning. See my earlier comments "re-measurements" and the use of "fair values".

(c) The IASB must reassess and determine the conceptual rationale why the consideration amount used for an exchange is amended in some circumstances but not in others (e.g. under the existing accounting standards where a property is acquired the contracted price is used to account for the exchange at the completion of the transaction but in the case where shares are used as consideration the value placed on the shares exchanged is not the value as agreed at the time of the contract is signed but the market value of the shares at the time the exchange is completed).

(d) The IASB should have a hierarchy of measurement bases and the IASB should list all those that are allowed. I would prefer cost as the default followed by fair value being the deemed cost where the transaction involves barter or non-monetary items. I understand that new measures may be introduced to cater for macro-hedging and insurance businesses and these should be approached with caution.

Question 12

The IASB's preliminary views set out in Question 11 have implications for the subsequent measurement of assets, as discussed in paragraphs 6.73-6.96. The IASB's preliminary views are that:

(a) **if assets contribute indirectly to future cash flows through use or are used in combination with other assets to generate cash flows, cost-based measurements normally provide information that is more relevant and understandable than current market prices.**

(b) **if assets contribute directly to future cash flows by being sold, a current exit price is likely to be relevant.**

(c) **if financial assets have insignificant variability in contractual cash flows, and are held for collection, a cost-based measurement is likely to provide relevant information.**

d) **if an entity charges for the use of assets, the relevance of a particular measure of those assets will depend on the significance of the individual asset to the entity.**

Do you agree with these preliminary views and the proposed guidance in these paragraphs? Why or why not? If you disagree, please describe what

alternative approach you would support.

See my comments to Question 11.

Usefulness and relevance of information is a consideration in determining what type of information is presented to the reader. However, such considerations do not necessarily call for a particular measurement basis nor for a need to re-measure and use a different measurement basis. A key consideration is what is "profit", what it means and how it is computed.

In my view usefulness and relevance of information, such as current exit prices for assets that contribute to cash flows by being sold, does not necessarily mean that such assets should be re-measured to their exit price or fair value at each reporting date. Useful information can be provided in the notes to the financial statements rather than being recognised in the balance sheet, profit or loss or OCI.

In particular, re-measurement without a real sale to an identifiable counterparty would mean than there would be accounting for hypothetical transactions. See my comments in **Appendix A** which questions whether it is conceptually correct to account for hypothetical transactions.

Moreover, if the asset was initially accounted for based on cost which is an enterprise specific value, this would not be equivalent to the asset's fair value. Fair value is defined in IFRS as being a market determined price and this cannot be entity specific.

If re-measurement from cost to fair value is required the conceptual questions that need to be addressed are:

Can you recognise day one gains/losses?

If the answer is yes, should such day one gains/losses be recognised for ***"all"*** *types of transactions and if not why not?*

If yes, how is the day one gain/loss computed and where should the day one gain/loss be recognised?

Question 13

The implications of the IASB's preliminary views for the subsequent measurement of liabilities are discussed in paragraphs 6.97-6.109. The IASB's preliminary views are that:

(a) cash-flow-based measurements are likely to be the only viable measurement for liabilities without stated terms.

(b) a cost-based measurement will normally provide the most relevant information about:

(i) liabilities that will be settled according to their terms; and

(ii) contractual obligations for services (performance obligations).

(c) current market prices are likely to provide the most relevant information about liabilities that will be transferred.

Do you agree with these preliminary views and the proposed guidance in these paragraphs? Why or why not? If you disagree, please describe what alternative approach you would support.

See my comments to Questions 2, 10 and 11.

In my view, the meaning of a "liability" is the amount owed by the reporting entity to an outside party.

I believe that the amounts payable <u>cannot be reduced unilaterally</u> by the reporting entity <u>without prior agreement</u> from the counterparty. For example, in the case of a limited liability company, on making their capital contribution on buying shares in the company, the shareholders have acknowledged and pre-agreed that the amount contributed in the form of share capital and their share of any retained earnings and reserves may be lost. What is owed to them is subject to the amounts that can be realised on the disposal of the reporting entity's assets and the settlement of the prior claims of other creditors.

It is also possible that variations in liabilities may be pre-agreed in contracts which have been initiated (e.g. under life insurance contracts and guaranteed minimum profits to an acquirer on a business that has been sold) and there may also be legitimate claims made against the entity.

In summary, liabilities once created are expected to be paid in full. It is misleading to regularly re-measure liabilities to their fair value which is not based on a real transaction, and especially to recognise a gain where the credit standing of the reporting entity has deteriorated. In my view, recognising any re-measurement gain in OCI is equally inappropriate to its recognition in profit and loss.

See also my comments in Question 2 on Provisions. Reductions of provisions, which represent early recognition of estimated expected future liabilities made under Prudence Concept would be acceptable if there was sufficient new evidence indicating that earlier estimate of losses will not eventuate.

<u>Question 14</u>

Paragraph 6.19 states the IASB's preliminary view that for some financial assets and financial liabilities (for example, derivatives), basing measurement on the way in which the asset contributes to future cash flows, or the way in which the liability is settled or fulfilled, may not provide information that is useful when assessing prospects for future cash flows. For example, cost-based information about financial assets that are held for collection or

financial liabilities that are settled according to their terms may not provide information that is useful when assessing prospects for future cash flows:

(a) if the ultimate cash flows are not closely linked to the original cost;

(b) if, because of significant variability in contractual cash flows, cost-based measurement techniques may not work because they would be unable to simply allocate interest payments over the life of such financial assets or financial liabilities; or

(c) if changes in market factors have a disproportionate effect on the value of the asset or the liability (i.e. the asset or the liability is highly leveraged).

Do you agree with this preliminary view? Why or why not?

There is a need to clearly define what is the meaning of "future cash flows".

In my view this should mean the contracted and agreed monetary amounts that will be made without taking into account expected inflation and the time value of money as these would have already been taken into account when determining the exchange price for the transaction and the allowed credit period for settlement. In other words, the effect of inflation and the time value of money would have been factored into the contract price and the terms of the contract. The impact of inflation and the time value of money are relevant considerations <u>before</u> a contract is entered into.

I believe the primary purpose of accounting is to record the execution of transaction(s) arising from a contract based on the monetary amounts agreed. See my comments in **Appendix A** under the heading of "What are we accounting for?"

Information on the effect of inflation could be more clearly presented if viewed from the perspective of the company as a whole rather than being reflected by re-measurement of each individual asset and liability. I believe the effects of inflation, if significant, is best presented by showing price index comparatives as supplementary notes. Legal obligations and contracted obligations should be reflected in the primary statements.

An alternative approach to providing information on the time value of money could be for the IASB to re-consider the basis of classifying and presenting information. For example, the meaning of a "current" asset or liability under IFRS is not related to a particular period of time such as a twelve months block which a reader could usefully use but makes reference to the company's business cycle and this cycle can vary between companies and industries. Moreover in the case of financial institutions, the information presented in their balance sheets is normally based on the order of liquidity.

If the objective is to depict the amount and timing of cash flows, I believe the IASB should reconsider the terms "current" and "non-current" and perhaps introduce further specific time bands into which assets and liabilities must be grouped and indicating when the cash inflows and outflows relating to the balance is contracted or expected to happen (e.g. bands of 1-12,13- 24,25- 36, 37- 48 months etc.) In this way in addition to showing the expected amount and the periods in which cash flows are expected to flow, any mismatches of maturing assets and liabilities and the risks this may impose on the entity should be clearly evident. The best way such information could be presented is in a simple tabular format.

See my comments to Question 11.

<u>Question 15</u>

Do you have any further comments on the discussion of measurement in this section?

See my comments above on "re-measurements" and those in **Appendix A.**

<u>Question 16</u>

This section sets out the IASB's preliminary views about the scope and content of presentation and disclosure guidance that should be included in the *Conceptual Framework*. In developing its preliminary views, the IASB has been influenced by two main factors:

(a) the primary purpose of the *Conceptual Framework*, which is to assist the IASB in developing and revising Standards (see Section 1); and

(b) other work that the IASB intends to undertake in the area of disclosure (see paragraphs 7.6-7.8), including:

(i) a research project involving IAS 1, IAS 7 and IAS 8, as well as a review of feedback received on the Financial Statement Presentation project;

(ii) amendments to IAS 1; and

(iii) additional guidance or education material on materiality.

Within this context, do you agree with the IASB's preliminary views about the scope and content of guidance that should be included in the *Conceptual Framework* on:

(a) presentation in the primary financial statements, including:

(i) what the primary financial statements are;

(ii) the objective of primary financial statements;

(iii) classification and aggregation;

(iv) **offsetting; and**

(v) **the relationship between primary financial statements.**

(b) disclosure in the notes to the financial statements, including:

(i) **the objective of the notes to the financial statements; and**

(ii) **the scope of the notes to the financial statements, including the types of information and disclosures that are relevant to meet the objective of the notes to the financial statements, forward-looking information and comparative information.**

Why or why not? If you think additional guidance is needed, please specify what additional guidance on presentation and disclosure should be included in the *Conceptual Framework*.

I generally agree with the preliminary views and look forward to seeing the detailed proposals. The IASB should seek to develop disclosure principles for inclusion in the Framework. See my comments to Question 14.

<u>Question 17</u>

Paragraph 7.45 describes the IASB's preliminary view that the concept of materiality is clearly described in the existing *Conceptual Framework*. Consequently, the IASB does not propose to amend, or add to, the guidance in the *Conceptual Framework* on materiality. However, the IASB is considering developing additional guidance or education material on materiality outside of the *Conceptual Framework* project.

Do you agree with this approach? Why or why not?

As materiality is central to the application of all accounting standards, I believe that the best place for setting out the governing principles is to set them out in the Framework itself as that is the purpose of the Framework.

Although, it may amount to a rule rather than a principle , I believe some quantitative guidance should be given. Moreover, materiality is linked to the objective of financial statements and the issue of "True and Fair" which I mention in **Appendix B**.

I do not believe that inclusion of guidance in educational material gives the guidance the weight it deserves and including it in particular standards would appear to be deferral of the issue. Paragraph 7.46 of the Discussion Paper indicates that the issue of materiality has been a major cause of the disclosure problems and the criticisms on information overload.

<u>Question 18</u>

The form of disclosure requirements, including the IASB's preliminary view that it should consider the communication principles in paragraph 7.50 when it develops or amends disclosure guidance in IFRSs, is discussed in paragraphs 7.48-7.52.

Do you agree that communication principles should be part of the *Conceptual Framework*? Why or why not?

If you agree they should be included, do you agree with the communication principles proposed? Why or why not?

I agree that communication and disclosure principles should appear in the Framework.

I would also suggest that the information needs of the entity's shareholders or potential shareholders be the main focus as the financial statements are prepared for them.

<u>Question 19</u>

The IASB's preliminary view that the *Conceptual Framework* should require a total or subtotal for profit or loss is discussed in paragraphs 8.19-8.22.

Do you agree? Why or why not?

If you do not agree do you think that the IASB should still be able to require a total or subtotal profit or loss when developing or amending Standards?

I agree but the IASB must first define what the terms "profit" ,"loss" and "financial performance" mean and are intended to portray.

Many listed companies in Hong Kong and I suspect elsewhere disclose non GAAP measures in their annual reports. Although such disclosures may not be given more prominence to the IFRS figures the fact that they are included is an indication that the companies believe that the IFRS figures are not sufficient or do not result in the focus on the figures management believes are equally or perhaps more important. For example, listed companies which have significant holdings in investment properties usually show a profit figure which excludes the fair value changes in the investment properties. Another notable example is the latest annual report of Prudential Plc which on page 47 of its annual report for the year ended 31 December 2012 includes the following statement: "Accounting under IFRS alone does not, in Prudential's opinion, fully reflect the value of future profit streams." As a result Prudential's annual report included a substantial amount of supplementary information.

The issue links to the wider question of reporting on stewardship and what factors and type of information are relevant. Quantitative measures such as profit or loss are just one component and other issues such as relationships with employees and customer satisfaction may be other measures for financial performance.

The exact meaning of profit and financial performance is also important to external auditors as they too are required to opine on it.

Question 20

The IASB's preliminary view that the *Conceptual Framework* should permit or require at least some items of income and expense previously recognised in OCI to be recognised subsequently in profit or loss, i.e. recycled, is discussed in paragraphs 8.23-8.26.

Do you agree? Why or why not? If you agree, do you think that all items of income and expense presented in OCI should be recycled into profit or loss? Why or why not?

If you do not agree, how would you address cash flow hedge accounting?

Before the issue of re-cycling can be considered it is first necessary for the IASB to establish the different purpose for which the OCI statement and the profit or loss statement are prepared. There is a need for a conceptual basis for determining why and what type of gains/losses should be included in "profit or loss" vis-a-vis "other comprehensive income". This should resolve the question of whether two statements or one combined statement is appropriate as allowing alternatives adds to confusion on what they are intended to portray.

See my comments in **Appendix A** on the issue of "unrealised gains and losses" and accounting for "hypothetical transactions".

Hedge accounting

I believe hedging accounting is essentially a deferral of gains/losses issue and draws together a number of principles and in particular those relating to accruals, matching, the right of offset and the grouping of transactions for the purpose of disclosure.

I believe three fundamental conceptual issues require addressing. First, the appropriate basis for measuring assets and liabilities on initial recognition and whether or not there should be subsequent re-measurement and if so how they should be reflected in the financial statements. Second, whether transactions can be accounted for differently because they have a designated hedging relationship. Third, whether a different accounting treatment for a portion of a transaction (i.e. a "component") is appropriate. See my comments in **Appendix A.**

I believe the key questions for hedging accounting are:

(a) When can a gain/loss arising and attributable to one transaction be deferred and,

(i) be set off with the gain/ loss arising from another transaction(s); ***OR***
(ii) accounted for as part of the cost in another separate transaction

especially where the counterparties to the relevant transactions are with different parties, and the transactions are made at different times?

(b) Should the deferred gains/losses be recognised in profit or loss, OCI, equity or a "temporary holding account" in another section in the balance sheet?

I believe that hedge accounting is essentially a designation issue. A hedging relationship only exists where an entity chooses to make a designation that two (or perhaps more) <u>separate transactions</u> should be considered together as they are somehow linked.

I believe that the designation of a hedging relationship should not normally lead to a change in the accounting policy adopted for the recognition and measurement of transactions. I believe separate transactions should normally be accounted for independently as the counterparties to the relevant transactions are with different parties and the transactions are made at different times.

The real issue is when can gains or losses relating to the hedge transaction and the hedging instrument can be deferred and offset or grouped.

I believe the hedging transaction (the hedging instrument) should be the latter transaction as its purpose is to reduce exposures created from an earlier transaction. (the hedged item). Nevertheless, I would accept that if two transactions were intended to be and were entered into <u>simultaneously</u>, the two transactions could be accounted as a single transaction.

An oddity that is presently allowed is that a contract may be entered into and be regarded as the hedging instrument even though the hedged item transaction has yet to occur but was a transaction that was anticipated and regarded as highly probable to occur. Below is an extract from the amendments made to IFRS 9 in late 2103. I have underlined key words and bolded the ones for greater emphasis those which I believe indicate that current hedging rules seem to be at odds with what is normally regarded as proper accounting. It shows that what was not previously recognised is subsequently recognised because a hedge designation has been made. I would add that this is just one aspect of the many complicated rules on hedges.

" Appendix B

Application guidance

This appendix is an integral part of the HKFRS. In Appendix B, paragraphs B3.1.2, B4.1.30, B4.3.8 and B5.7.2 are amended.

Initial recognition (section 3.1)

…

B3.1.2 The following are examples of applying the principle in paragraph 3.1.1:

(a) Unconditional receivables and payables **are** recognised as assets or liabilities when the entity becomes a party to the contract and, as a consequence, has a legal right to receive or a legal obligation to pay cash.

(b) Assets to be acquired and liabilities to be incurred as a result of a firm commitment to purchase or sell goods or services are generally **not** recognised until at least one of the parties has performed under the agreement. For example, an entity that receives a firm order does not generally recognise an asset (and the entity that places the order does not recognise a liability) at the time of the commitment but, rather, delays recognition until the ordered goods or services have been shipped, delivered or rendered**. If** a firm commitment to buy or sell non-financial items is within the scope of this Standard in accordance with paragraphs 5–7 of HKAS 39, its net fair value **is** recognised as an asset or a liability **on the commitment date** (see B4.1.30(c)). In addition, **if** a **previously unrecognised** firm commitment is designated as a hedged item in a fair value hedge, any change in the net fair value attributable to the hedged risk **is recognised** as an asset or a liability **after** the **inception of the hedge** (see paragraphs 6.5.8(b) and 6.5.9)"

I suspect that currently some hedges may be entered into primarily because fair value accounting requires certain financial instruments to be re-measured at fair values.

Reflecting the results of risk management activities does not necessarily mean that information must be included in profit or loss or OCI, depending on which portion is ineffective or effective, which are the current rules. Any attempt to recognise effectiveness, and therefore also any ineffectiveness, before the settlement date may be seen as misrepresenting the facts as the reporting entity has no contractual obligation or intention to settle the hedged item and the hedging instrument on the earlier date. Whether a hedge is effective or not can only be ascertained when the hedged item and hedging instrument are both settled.

Although hedge accounting is not directly related to the issue of offsetting, I believe there are similarities in the relevant issues and considerations and the IASB should ensure that the principles on offsetting are also consistent with the principles on hedging.

Question 21

In this Discussion Paper, two approaches are explored that describe which items could be included in OCI: a narrow approach (Approach 2A described in paragraphs 8.40-8.78) and a broad approach (Approach 2B described in paragraphs 8.79-8.94).

Which of these approaches do you support, and why?

If you support a different approach, please describe that approach and explain why you believe it is preferable to the approaches described in this Discussion Paper.

See my comments to Question 20. There is a need to determine first what is the purpose of the OCI.

<u>Question 22</u>

***Chapters 1 and 3 of the existing* Conceptual Framework**

Paragraphs 9.2-9.22 address the chapters of the existing *Conceptual Framework* that were published in 2010 and how those chapters treat the concepts of stewardship, reliability and prudence. The IASB will make changes to those chapters if work on the rest of the *Conceptual Framework* highlights areas that need clarifying or amending. However, the IASB does not intend to fundamentally reconsider the content of those chapters.

Do you agree with this approach? Please explain your reasons.

If you believe that the IASB should consider changes to those chapters (including how those chapters treat the concepts of stewardship, reliability and prudence), please explain those changes and the reasons for them, and please explain as precisely as possible how they would affect the rest of the *Conceptual Framework*.

I believe that the concept of prudence, stewardship and reliability should be reinstated as they are essential concepts if the information provided in financial statements is to serve its purpose of being useful and will be used by its readers. See my comments in **Appendix B**.

<u>Question 23</u>

Business model

The business model concept is discussed in paragraphs 9.23-9.34. This Discussion Paper does not define the business model concept. However, the IASB's preliminary view is that financial statements can be made more relevant if the IASB considers, when developing or revising particular Standards, how an entity conducts its business activities.

Do you think that the IASB should use the business model concept when it develops or revises particular Standards? Why or why not?

If you agree, in which areas do you think that the business model concept would be helpful?

Should the IASB define 'business model'? Why or why not?

If you think that 'business model' should be defined, how would you define it?

I do not believe that it is worthwhile to further develop the 'business model " concept although the term has been employed in justifying revisions to IAS 39.

To me the term "intended use" is preferable as it is more self-explanatory and is easier to understand. The term "business model" will always require further elaboration of what the model is and what it is supposed to do.

I believe an "intended use" must come first and only when it is applied consistently on a number of similar items or assets it then it becomes the entity's "business model". In other words, "intended use" is the core of any "business model". "Intended use" has the advantage that it can be used as a guiding principle even when where there is only one or very few similar transactions. It is scalable, i.e. it can be applied to an individual asset and also to a group of assets.

It is possible for management to change their intended use and a change will also be possible for a business model. I believe that looking for an advantageous change in intended use and business model should be one of management's responsibilities as it may be a way to maximize the use of assets and returns for shareholders.

If the IASB is concerned with earnings management by the directors by changing an "intended use" this concern will equally apply to a "business model" concept. In my opinion the most transparent way to deal with changes of intention is through disclosures about the change and if the change results in a new measurement basis to only allow the new measurement basis to be applied prospectively.

Question 24

Unit of account

The unit of account is discussed in paragraphs 9.35-9.41. The IASB's preliminary view is that the unit of account will normally be decided when the IASB develops or revises particular Standards and that, in selecting a unit of account, the IASB should consider the qualitative characteristics of useful financial information.

Do you agree? Why or why not?

I believe that principles on what the "unit of account" is, how it is determined, and if and when it can be changed is essential and should be set out in the Framework.

It is an essential element of measurement and I do not believe that such principles should be deferred and set out later at the detailed standards level. The detailed standards may be able to give additional guidance but the key principles and concepts must be included in the Framework.

In particular, the issue of "unit of account" is linked to the issue of whether "bifurcation" should be allowed and the conceptual question is this:

Where a transaction including different components is regarded as a "single whole" and there are other continued obligations relating to the transaction, can the transaction be bifurcated and accounted for as separate components and each measured differently, and if so why?

Question 25

Going concern

Going concern is discussed in paragraphs 9.42-9.44. The IASB has identified three situations in which the going concern assumption is relevant (when measuring assets and liabilities, when identifying liabilities and when disclosing information about the entity).

Are there any other situations where the going concern assumption might be relevant?

I believe the going concern assumption is always relevant so long as the entity still exists, normally as a separate legal entity, i.e. it is still "alive". In my opinion an entity is a going concern even when it is inactive or dormant. It may be just holding assets but may not be actively doing anything with them.

The meaning of going concern has normally been interpreted to mean that the entity remains in operation and in particular has a free hand in what it wants to do. It is not forced to do anything and has the choice and ability to wait for the right time or opportunity to act. It is not forced to sell anything.

For this reason, I have concerns with the use for fair values as a measurement basis and for recognition in the primary statements as conceptually this is at odds with the Going Concern Assumption where an entity is not forced to do or sell or liquidate anything. The accounting effect of fair value re-measurements at each reporting date is effectively to account for a forced sale and buy back.

The IASB should explain what should be the basis of preparing financial statements when the going concern basis is not appropriate as currently the detailed accounting standards have been drafted on the assumption that the entity is a going concern.

In due course, the IASB may wish to develop a separate standard specifically dealing with this as it would appear that if the going concern basis was not used the entity and its auditors could not opine that the financial statements were in full compliance with IFRS. The specific standard could perhaps require all assets to be shown at their exit price or fair values.

<u>Question 26</u>

Capital maintenance

Capital maintenance is discussed in paragraphs 9.45-9.54. The IASB plans to include the existing descriptions and the discussion of capital maintenance concepts in the revised *Conceptual Framework* largely unchanged until such time as a new or revised Standard on accounting for high inflation indicates a need for change.

Do you agree? Why or why not? Please explain your reasons.

I believe the IASB should reconsider it plans as the theory of capital maintenance does not just deal with the issue of high inflation but goes to the heart of what is "profit" and what it means and how it is determined. The meaning of "profit" in turn will determine the definitions of "income" and "expense" and "gains" and "losses".

It is important to be clear on what "profit" and/or what "financial performance" means as many jurisdictions including Hong Kong are moving away from having par value shares. Moreover, clarity is essential as in most jurisdictions the directors and external auditors are required to opine on it and they will not be able to do so if what it means is not clear.

Currently, there are two major sub totals in the profit or loss and OCI statement, namely "Profit for the year" and "Total Comprehensive Income". The question then is which figure is being referred to when there is a reference to "profit" or "financial performance". In my view specificity is required.

The issue links to the other important issue of what profits can be regarded as "realised" or "unrealised", what amounts should be presented in profit or loss and what should appear in OCI, what can be re-cycled and ultimately what profits are available for distribution to shareholders.

I would draw attention to paragraphs 4.63 and 4.64 of the current text of the Framework which appear below (with the words underlined for emphasis).

"4.63 Under the concept of financial capital maintenance where capital is defined in terms of nominal monetary units, profit represents the increase in nominal money capital over the period. Thus, increases in the prices of assets held over the period, conventionally referred to as holding gains, are, conceptually, profits. <u>They may not be recognised as such, however, until the assets are disposed of in an exchange transaction</u>. When the concept of financial capital maintenance is defined in terms of constant purchasing power units, profit represents the increase in invested purchasing power over the period. Thus, only that part of the increase in the prices of assets that exceeds the increase in the general level of prices is regarded as profit. The rest of the increase is treated as a capital maintenance adjustment and, hence, as part of equity.

4.64 Under the concept of physical capital maintenance when capital is defined in terms of the physical productive capacity, profit represents the increase in that capital over the period. All price changes affecting the assets and liabilities of the entity are viewed as changes in the measurement of the physical productive capacity of the entity; hence, they are treated as capital maintenance adjustments that are part of equity and not as profit."

My understanding is that under paragraphs 4.63 and 4.64 the recognition of holding gains/ losses arising from changes in the price of assets shall not be recognised under either the financial capital maintenance or the physical capital maintenance concepts. Despite this, such gains and losses are currently required to be recognised under some accounting standards (e.g. IAS 39, IAS 40 and IAS 41).

I would urge careful re-consideration of the above and other standards and in particular explanation of the conceptual basis why changes in value of some assets such as financial instruments are required to be recognised at each reporting period end whereas similar requirements do not apply to all assets.

In my opinion the wider recognition of fair value changes in the profit or loss statement, OCI, and sometimes directly to a revaluation reserve in equity without a sound conceptual basis does not improve financial statements reliability and usefulness but in fact contributes to making financial statements more complex, and in some cases non-auditable. Recognition of fair value changes facilitates the easier earnings management which in turn may lead to financial instability which is not in the long term interests of investors, financial markets and economies as a whole.

END