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To: Peter Clark, Director of Research, IASB 12 January 2014

Dear Peter

Discussion Paper DP/2013/1: *A Review of the Conceptual Framework for Financial Reporting*

I am writing to meet your deadline of 14 January for comment on the *Discussion Paper* issued in July 2013. This letter complements the letters I wrote on 30 November 2010 about the *Exposure Draft on Insurance* and on 17 October 2013 about the *further Exposure Draft* issued in June 2013; and on 21 October 2010 about the *Exposure Draft on Revenue Recognition* (as the issues are intimately interlinked).

I am preparing a more extensive discussion of the main issues in a paper for *China Journal of Accounting Studies* and will send you a copy when it is finalised.[1] In the meantime I would emphasise the following main factors.

1. The project's objective

IASB's consultees regard completion of the Conceptual Framework ['CF'] as a priority. IASB's objective for the project is to provide 'a complete and updated set of concepts to use when it develops or revises IFRS' (*Snapshot, p.1*).This 'second attempt' at a CF is perhaps what Samuel Johnson might have labelled a 'triumph of hope over experience',[2] given that the FASB first started developing its CF in the 1970s and it has not yet approached completion (Macve, 1997).[3] It seems unlikely therefore that the revised CF will be able to do much to assist standard setters in enhancing comparability along the dimensions of recognition and measurement.

[1] See also Macve, R. (2010). 'Conceptual frameworks of accounting: some brief reflections on theory and practice'. *Accounting and Business Research,* Vol.40. No.3: 303-308.
[2] http://www.searchquotes.com/search/The_Triumph_Of_Hope_Over_Experience/
[3] Macve, R. (1997). *A Conceptual Framework for Financial Accounting and Reporting: Vision, Tool or Threat?* New York & London: Garland.

A different kind of CF is surely now needed: one that is more realistic about what can be achieved and which focusses on identifying the key questions that IASB must ask when considering a new standard, including why it would be better than existing conventions (Macve, 1997; Bromwich *et al*. 2010). In this respect, completing the *Discussion Paper* itself, and thereby setting out the issues that the Board needs to address and steer through when considering a new standard, or changing an existing one, is probably as much as can be realistically be expected.

Concepts certainly help to structure discussion but, at least in accounting, there are conceptual ambiguities that have long been recognised as irresolvable. Accounting practice comprises conventions that have evolved at different times and places for different reasons and the most promising approach is not to look for concepts that can replace conventions (as FASB/IASB proposed at the start of the joint revision in 2005)[4] but to understand the reasons for existing conventions and then critically evaluate whether they are still useful for the objectives of financial reporting (Bromwich *et al*., 2010). And as the IASB's scope extends to more and more countries with different business and financial cultures, differing roles for accounting and auditing, and different regulatory systems and cultures, it is unavoidable that the attempt to achieve global uniformity may in itself reduce genuine comparability (e.g. Zeff, 2007)[5] so that compensating disclosures are needed to help users understand the important contextual factors within which the accounting numbers have been produced.

2. The role of 'deprival value'

Nevertheless, some conceptual improvement in the measurement area could be achieved. As argued in our *ABR* 2011 paper,[6] a principles based approach to asset and liability valuation needs to start from rigorous micro-economic analysis of how markets behave. Now that the constraint of ensuring agreement with FASB's proposals has been lifted, IASB can abandon fair value (FV) *in the terms in which it has previously been narrowly defined by FASB/IASB*. The Board now needs to go back to the drawing-board (alongside the other related projects mentioned above) to give proper consideration to the broader concept of 'deprival value' (= 'relief value' for liabilities), which both FASB and IASB have so far failed

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[4] FASB/IASB (2005), *Revisiting the Concepts* (May 2005), http://www.fasb.org/project/communications_paper.pdf (accessed 2014.1.10).

[5] Zeff, S.A. (2007). Some obstacles to global financial reporting comparability and convergence at a high level of quality. *The British Accounting Review, 39(4)*, 290-302.

[6] Horton, J., Macve, R.H. and Serafeim, G. (2011), ' "Deprival value" vs "fair value" measurement for contract liabilities: how to resolve the "revenue recognition" conundrum?'. *Accounting & Business Research*, Vol. 41 (December) Issue 5, p491-514.

adequately to address. This would enable removal of a lot of the confusing 'conceptual' argument paraded in the various Exposure Drafts and other papers on related projects.

The brief, dismissive discussion of deprival value (at 6.42-43) in the *Discussion Paper* remains at a very low level of analysis, and ignores liability measurement.[7] Paradoxically this same DP (e.g. *Snapshot* p. 6) argues that selection of an appropriate measurement basis should require consideration of 'how the asset contributes to future cash flows or how the entity will fulfil or settle the liability', and that here 'business model' type arguments may be relevant (DP 9.33).[8] For this purpose deprival value/relief value must surely be the closest fit. While many difficult issues remain, it would also provide a sound conceptual basis, which is currently lacking, for continuing with much of present GAAP and in particular with much of the current format of income statement presentation across industries (Horton *et al*., 2011).

3. OCI

The *Discussion Paper* could have usefully take one step forward by raising the question of whether some of the items currently presented in OCI are indeed 'income' of any kind at all at the stage that they are currently recognised. For example, mismatches resulting from just one side of a hedge being remeasured are really just being 'parked' until the items can be fully matched and the overall results meaningfully included in profit and loss: the OCI is here basically just a 'suspense' account so it is surely misleading to call these items 'other comprehensive income' alongside others which more clearly are. Using a 'suspense account' would be a break with the 'clean surplus' approach that IASB has so far taken and would require admitting more balance sheet elements than just 'assets', 'liabilities, and 'equity' but—given that it is recognised that accounts cannot themselves measure the value of a business and therefore that they can never fully measure its 'comprehensive income'[9]—labelling such items as 'suspense account' items would be a more straightforward and 'plain-speaking' approach than continuing to include them in OCI. And provided all elements are clearly displayed and explained users would remain free to reclassify them for their own purposes.

[7] Following Baxter, deprival value may properly be defined as 'the adverse consequence of deprival on the present value of all future cash flows, given the optimal response decision' (e.g. Macve, R. (2010), 'The case for deprival value'. In 'Wanted: foundations of accounting measurement', EAA Symposium, Tampere 2009. *Abacus*, 46(1): 111-119).

[8] It is important that the reporting of performance also enables investors (and others), and internally managers themselves, to evaluate the success of the management's current 'business model' and where necessary challenge it.

[9] Except for 'open end' investment funds such as OEICs in the UK http://www.investopedia.com/terms/o/oeic.asp (accessed 2014.1.10). Cf. Bromwich, M., Macve, R. and Sunder, S. (2010). 'Hicksian income in the conceptual framework'. *Abacus*, *46(3)*, 348-376.

4. Capital maintenance concepts

It was recognised at the beginning of the then joint FASB/IASB attempt to revisit the CF that IASB and FASB differed over what capital maintenance concepts—'physical' or 'financial'—might be accepted (FASB/IASB, 2005, p.10).[10] But in the current *Discussion Paper* (at 9.45.4-98) IASB now sidesteps the issue by regarding it a problem that is only relevant under high inflation, whereas it is by definition the inseparable complement to *any* decision on what is or is not to be recognised as 'income' and is therefore essential for any conceptual progress on the major issues about OCI and recycling. This issue must be properly addressed in the CF now.

5. 'Core earnings'

The exclusion of certain items from P&L (and inclusion in OCI) also raises the issue of the significance to be attributed to the widespread practice of publication alongside IFRS earnings of what in the UK are known as 'core earnings', which both preparers and analysts often appear to find more useful than the IFRS numbers in trying to convey 'genuine' comparability of results. While there are dangers of opportunistic reporting (e.g. Zeff, 2007) these appear to be outweighed overall by the advantages of giving a closer insight into the management's own interpretation of the business's (and their) performance. Enforcement disciplines such as requiring consistency, full reconciliation to the IFRS net income, and audit scrutiny mitigate the dangers (e.g. Young, 2014).[11] But the fact that the practice is so widespread raises the question of why the adjustments that are commonly made to arrive at core earnings are not already incorporated into the reported IFRS earnings measure. The same issue arises with regard to the insurance project and the apparent usefulness of the practice of Embedded Value reporting, as discussed in my letter of 17 October 2013 (see Serafeim, 2011).[12]

This question brings out an underlying ambiguity at the heart of the IASB agenda: should standards reflect what investors and others actually say/show they find useful (as the CF's stated objective might be taken to imply) or what the 'experts' (the standard setters) believe to be 'the best accounting' for net asset and profit measurement (Zeff, 2013)?[13] The initial mandate from the SEC to the US accounting profession in the 1930s to 'narrow the

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[10] The list should be extended to distinctions between 'realised' and 'unrealised' and include Hicks's 'maintainable (real) income' (e.g. Bromwich *et al.* 2010).

[11] Young, S. (2014). The Drivers, Consequences and Policy Implications of Non-GAAP Earnings Reporting (presented at ICAEW Information for Better Markets Conference, London, UK, 16-17 December 2013), *Accounting and Business Research* (forthcoming).

[12] Serafeim, G. (2011). Consequences and institutional determinants of unregulated corporate financial statements: evidence from Embedded Value reporting. *Journal of Accounting Research, 49(2),* 529-571.

[13] Zeff, S.A. (2013). The objectives of financial reporting: a historical survey and analysis. *Accounting and Business Research, 43(4),* 262-327.

differences in accounting treatment' has continued to drive US and now international standard setting and this focus on finding the 'right' measure of profit and net assets has culminated in the FASB's and now the IASB's search for a comprehensive CF (Macve, 1997). And, as the recent consultation exercise has shown, this is apparently what your constituents still demand.

It is interesting to ask whether recent significant changes, such as the freedom to develop IFRS without the constraint of necessarily converging with FASB, and the change of IASB chairman, have now shifted the IASB's emphasis more from this second motivation to the first.[14] If so, the issue of who legitimately decides what is 'useful' (rather than 'what is good accounting') will become more pointed, especially as IASB's scope extends to more and more countries with different business and financial cultures, differing roles for accounting and auditing, and different regulatory systems and cultures, such as China. They will increasingly need due consideration in debates that have until now been in arenas largely dominated by the influence of the US and then the EU. The CF therefore needs to address and make transparent the policy for how IASB should accommodate different accounting traditions (which may themselves be rapidly changing) in promulgating standards that will be globally acceptable and assist investors (and others) in understanding how accounting results from these differing contexts around the world may properly be compared.

I will be happy to discuss any of these issues further.

Please acknowledge receipt.

Best regards

(signed electronically)
Richard Macve

ref:
cjas/IASB CF letter

http://www.ifrs.org/Current-Projects/IASB-Projects/Conceptual-Framework/Pages/Conceptual-Framework-Summary.aspx

[14] Cf. Bhimani, A., Bond, D. and Sivabalan, P. (2013). Righting the pendulum: Explaining IASB pursuits for user legitimacy. LSE/University of Technology, Sydney working paper.