esma European Securities and Markets Authority

The Chair

Date: 17 November 2015
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Mr Hans Hoogervorst
International Accounting Standards Board
30 Cannon Street
London
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United Kingdom

Ref: The IASB's Exposure Drafts *Conceptual Framework for Financial Reporting* and *Updating References to the Conceptual Framework*: Proposed amendments to IFRS 2, IFRS 3, IFRS 4, IFRS 6, IAS 1, IAS 8, IAS 34, SIC-27 and SIC-32

Dear ~~Mr Hoogervorst~~, Dear Hans,

The European Securities and Markets Authority (ESMA) thanks you for the opportunity to contribute to the IASB's due process regarding the Exposure Drafts (EDs) Conceptual Framework for Financial Reporting and Updating References to the Conceptual Framework. We are pleased to provide you with the following comments with the aim of improving the enforceability of IFRSs and the transparency and decision usefulness of financial statements.

ESMA strongly supports the aim of the IASB's Conceptual Framework project to improve financial reporting by providing a clear and comprehensive set of updated concepts. ESMA welcomes the ED as it provides a number of updated concepts underpinning IFRS financial reporting. In particular, we are of view that the ED provides welcomed changes and clarifications to the existing Conceptual Framework in areas such as elements of financial statements and their recognition. Furthermore, ESMA welcomes the proposed guidance on reporting entity, derecognition and the role of business activities in financial reporting.

However, considering the objective of the comprehensive revision of the Conceptual Framework, ESMA regrets that the ED does not provide guidance on some essential issues in financial reporting which leaves the Conceptual Framework incomplete. ESMA is of the view that these remaining gaps in the Conceptual Framework need to be filled on a timely basis. In particular,

- ESMA notes that the ED does not include sufficient guidance on distinguishing between liability and equity. In this respect, ESMA agrees with the Alternative View of Suzanne Lloyd and Patrick Finnegan in paragraphs AV8 - AV14 of the ED. ESMA agrees with the view of the IASB that the definition of a liability should be used to distinguish between liability and equity, but is concerned that the IASB has not sufficiently considered the issue yet. While ESMA understands that this issue is treated in the separate project, from a timing perspective, we are concerned that this project might lead to subsequent changes to the definition of a liability.

- ESMA is concerned that the ED does not attempt to define performance as highlighted in the Alternative View of Stephen Cooper and Patrick Finnegan. It implies that the Conceptual Framework will include neither a clear basis for distinguishing between items that should be recognised in profit or loss and items that should be recognised in other comprehensive income (OCI), nor a principle establishing whether and when recycling is appropriate.

ESMA broadly agrees with the proposed definitions of elements in the ED but points out that the new definition of assets and liabilities, together with the new recognition and derecognition criteria might have an impact on the assets and liabilities to be recognised in the statement of financial position. Therefore, we call on the IASB to analyse the possible consequences of the proposed changes in their entirety on a broad set of potential rights and obligations that are currently not recognised in the financial statements.

While ESMA agrees with the proposed description of a 'present obligation' at the conceptual level, we highlight the need for additional guidance at the level of individual standards that would make it operational. Furthermore, ESMA urges the IASB to further explore consequences of the proposed definition of present obligation on a broad set of liabilities, such as different types of levies, restructuring plans and obligations stemming from the accounting for repairs and maintenance.

While ESMA agrees with the basis of most of the proposed concepts, additional clarifications are required before finalising the Conceptual Framework. These clarifications are required in particular on factors to consider when selecting a measurement basis and possible consequences of the proposed changes in the recognition criteria. Furthermore, we are of the view that a more comprehensive effects analysis is required. Moreover, in case of conflict between the [revised] Conceptual Framework and an existing standard, ESMA suggests the IASB to assess whether it needs to add that standard to its active [research] agenda and to identify ways to address this conflict.

Finally, ESMA agrees with the proposed transition requirements and effective date of the proposed consequential amendments updating references to the Conceptual Framework.

Our detailed comments on the respective EDs are set out in the Appendix I and Appendix II to this letter. Please do not hesitate to contact us should you wish to discuss all or any of the issues we have raised.

Yours sincerely,

Steven Maijoor

Appendix I – ESMA's detailed answers to the questions in the ED/2015/3 – *Conceptual Framework for Financial Reporting*

Question 1 – Proposed changes to Chapters 1 and 2

Do you support the proposals:

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

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

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

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

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

Why or why not?

<u>Stewardship</u>

1. ESMA agrees with giving greater prominence to the assessment of management's stewardship of the entity's resources ('stewardship') in the description of the objective of financial reporting in the ED. ESMA welcomes that, unlike in the existing Conceptual Framework, the concept of stewardship is explained and exemplified in the paragraphs 1.22 - 1.23 of the ED.

2. ESMA agrees that the assessment of stewardship of the entity's resources is an element of making expectations about future cash flows in order to make decisions about providing resources to the entity. However, we believe that the assessment of stewardship often goes above and over the focus on the generation of future cash flows and is relevant also in other situations to users of financials statements (including users other than primary users), for example to evaluate the effectiveness and efficiency of management in using the resources available. Consequently, while we do not believe that the assessment of stewardship should be a separate objective of financial statements, as it could, in some circumstances, conflict with the existing primary objective of financial reporting, the assessment of stewardship should be further highlighted as an enhancing objective of the financial reporting.

3. ESMA encourages the IASB to further clarify the meaning and definition of stewardship so that the term stewardship can be properly understood and translated to different languages enabling the assessment and evaluation of its interaction with different corporate law/corporate governance frameworks. If appropriate the IASB should consider clarifying that the concept of stewardship is called 'accountability' in some jurisdictions.

4. ESMA notes that under some legal frameworks the understanding of terms describing concepts considered equivalent to stewardship is limited to the assessment of backward-looking information, whereas under other legal frameworks such concepts relate to a broader range of information including the forward-looking information. Indeed, in ESMA's view investors need to rely on the financial statements in order to be able to actively take part in the corporate governance and for that purpose the concept of stewardship needs to encompass a broad range of backward-looking as well as forward-looking information, such as information about management remuneration as mentioned in paragraph BC1.9 of the ED.

5. Finally, depending on the definition of stewardship adopted in the new Conceptual Framework, ESMA recommends the IASB to assess whether the introduction of the concept of stewardship will have any impact on its future standard-setting activities and whether additional clarifications are necessary in this respect. ESMA would also welcome a clarification from the IASB on which additional information is expected to be included in the financial statements by defining stewardship and highlighting its role when defining the objective of financial statements.

<u>*Prudence*</u>

6. ESMA agrees to reintroduce an explicit reference to the notion of 'prudence' in the Conceptual Framework, where prudence is defined as caution when making judgements under conditions of uncertainty. We believe that the concept of prudence is equally important in standard-setting activities as well as when affecting behaviour of preparers of the financial statements.

7. ESMA agrees with the IASB that in some circumstances, application of the concept of prudence results in asymmetry in recognition of assets and liabilities provided that assets or income are not overstated and liabilities or expenses are not understated. However, application of this asymmetric prudence in standard-setting activities should be limited to circumstances, in which the asymmetry would result in more relevant information. This should be determined by the IASB at the level of individual standards (such as in IAS 2 *Inventories* or IAS 37 *Liabilities, Contingent Liabilities* and *Contingent Assets*). In this context, ESMA agrees with the IASB that the Conceptual Framework should not identify asymmetric prudence as a necessary characteristic of useful financial information for the reasons mentioned in paragraphs BC2.14 and BC2.15 of the ED. However, some elements of the discussion of asymmetric prudence could be included directly in the Conceptual Framework rather than in the Basis for Conclusions.

8. ESMA continues to believe that neutrality of financial reporting is an essential feature of faithful representation and agrees with the IASB that application of the concept of

prudence is necessary for achieving neutrality of financial reporting notably to counterbalance the inherent optimistic assumptions of management, e.g. when making estimates in financial reporting.

9. Furthermore, ESMA reiterates that the application of the concept of prudence should not lead to the creation of hidden reserves by deliberately understating the assets or overstating the liabilities.

10. ESMA is of the view that application of the concept of prudence as defined by the IASB will not affect transparency or comparability of financial reporting.

<u>*Substance over legal form*</u>

11. ESMA welcomes the IASB's proposal to reintroduce 'substance over form' as a component of faithful representation, both in standard-setting activities and in applying the standards in the financial statements. If information is to represent faithfully the transactions and other events that it purports to represent, it is necessary that they are accounted for and presented in accordance with their substance and economic reality and not merely their form or appearance. Furthermore, while the legal form of an arrangement is important it might not always fully depict its economic substance. The accounting for reverse acquisitions according to IFRS 3 *Business Combinations* is a good example of the usefulness of the application of the 'substance over form' principle.

12. However, ESMA is of the view that the IASB should clarify the wording as it might be misunderstood by some as suggesting that the legal form could never reflect the substance of an economic arrangement.

<u>*Measurement uncertainty and reliability*</u>

13. ESMA agrees that relevance and faithful representation should be identified as the two fundamental qualitative characteristics of useful financial information. However, in order to further clarify these characteristics, ESMA suggests that the IASB includes the existing reference to the true and fair view[1] and fair presentation[2] in paragraph BC 3.44 of the Basis for Conclusions to the 2010 Conceptual Framework directly in the Conceptual Framework rather than only in the Basis for Conclusions. Furthermore, we suggest that the IASB explains the concepts of the true and fair view and fair presentation more thoroughly and further develops their relation to the qualitative characteristics of useful financial information.

14. ESMA welcomes the proposed clarifications stating that measurement uncertainty is a factor that can make financial information less relevant, and that there is a trade-off between the level of measurement uncertainty and other factors that make information relevant. Equally, ESMA agrees with the IASB that the concept of reliability should not be reintroduced as a specific qualitative characteristics of financial reporting as it is

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[1] Please note that ESMA makes the reference to the true and fair view in its general sense, rather than any specific legal meaning that is used in a particular jurisdiction.

[2] As referred to in paragraphs 15 and 20 of IAS 1 *Presentation of Financial Statements*

covered by the principle of faithful representation and the label 'reliability' could be confusing. However, the IASB could make it clearer that faithful representation includes the notion that the information can be depended upon by users. Finally, ESMA is of the view that the discussion on measurement uncertainty should be clearly linked to the measurement guidance in the Conceptual Framework.

Question 2 – Description and boundary of a reporting entity

Do you agree with:

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

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

Why or why not?

15. ESMA welcomes the discussion on the concept of 'reporting entity' and its boundaries as we believe those concepts are of fundamental importance and should be included in the Conceptual Framework.

16. ESMA agrees with the proposed description for 'reporting entity'. In our view, a reporting entity is not necessarily a legal entity and can comprise a portion of an entity or a combination of two or more legal entities. However, the IASB could refer more explicitly to the theoretical basis of its proposals (e.g. referring to the 'entity theory of accounting') as such explicit reference could help understand better the proposals. Furthermore, such reference would conceptually align paragraph 3.24 of the ED which focuses on the investors in the parent entity and the fact that minority interest is presented as part of equity in the consolidated financial statements.

17. However, ESMA is concerned that the reference to the terms 'direct' and 'indirect' control could be misunderstood as it is used in the ED in a different way from its customary use. In its ordinary meaning, the term '*direct control*' refers to relationship between a subsidiary and its immediate parent and the term 'indirect control' refers to a relationship when a subsidiary is controlled by other entities. However, in the ED the terms 'direct control' and 'indirect control' are used to refer, respectively, to reporting of economic resources in the unconsolidated financial statements and consolidated financial statements. Consequently, the IASB should use different terminology when explaining this issue.

18. ESMA proposes that the IASB redrafts the explanation of consolidated and unconsolidated financial statements. While we agree that the concept of 'control' is used for defining the reporting entity, we suggest that the interaction between the definition of a reporting entity and different levels of involvement between entities (e.g. joint control) is explained and explored in the Conceptual Framework.

19. While ESMA highlights the importance of the consolidated financial statements for investors, we point that unconsolidated financial statements can also provide relevant

information and are useful for the users relevant at that level. Consequently, we suggest that the IASB explains that there are two possible set of accounts with different purposes, being the consolidated and the unconsolidated financial statements. The IASB could consider adding additional discussion on unconsolidated financial statements to the Conceptual Framework.

20. ESMA also suggests that the IASB carefully considers the wording, as two different notions referring to unconsolidated financial statements in the Conceptual Framework and Separate Financial Statements in IAS 27 *Separate Financial Statements* might be confusing without adequate explanation.

21. ESMA agrees that a portion of an entity or combination of different portions could qualify as a reporting entity. However, we are of the view that the economic activities of these portions must be objectively distinguishable from the rest of the entity (i.e. supported by evidence) and financial information about these portions of the entity must have the potential to be useful in making decisions about providing resources to these portions of the entity. In this context, we would welcome further clarification related to the use of combined financial statements directly in the Conceptual Framework. For example, we suggest including the acknowledgement mentioned in paragraph BC3.17 that combined financial statements can provide useful information in some circumstances and explain the principle describing situations when combined financial statements provide more useful information that consolidated financial statements.

22. Finally, while ESMA agrees with the content of the paragraph 3.25 of the ED, we question whether this level of guidance is appropriate for the Conceptual Framework and should not be placed in an individual standard (e.g. IAS 27).

Question 3 – Definitions of elements

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

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

(b) a liability;

(c) equity;

(d) income; and

(e) expenses?

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

Definition of elements

23. In general ESMA agrees with the proposed definitions of elements in the ED. We agree that the probability of the inflow and outflow should be reflected in the recognition criteria rather than in the definitions of the elements and believe that the proposed simplified criteria could contribute to a greater clarity.

24. However, ESMA suggests that the IASB further explores the implications of the proposed changes in the definitions (notably the change in the definition of a liability) and explains them in the Basis for Conclusions.

25. As already stated in ESMA response[3] to the Discussion Paper *('DP')*,[4] the new definition of elements, together with the new recognition and derecognition criteria might have an impact on the assets and liabilities to be recognised in the statement of financial position. ESMA understands that in many cases, additional items will meet the definition of an element but their measurement in the financial statements might be nil. While it is the IASB's intention not to either increase or decrease the amounts of assets and/or liabilities recognised, ESMA calls on the IASB to analyse the possible consequences of the proposed changes in their entirety on a broad set of potential rights and obligations that are currently not recognised in the financial statements.

26. As regards the definition of an asset, ESMA suggests that the notion in paragraph BC4.16(a) related to economic benefits arising from some feature that already exists within the economic resource should be incorporated directly in the Conceptual Framework and it would make the section 'potential to produce economic benefits' clearer. In this context, ESMA welcomes the fact that the discussion in paragraph BC4.16(b), on existence of at least one circumstance in which the economic resource will generate economic benefits, is included in paragraph 4.13 of the ED.

27. ESMA believes that the description of revenue could have been retained for completeness purposes. ESMA agrees that the statement of financial position and statement of financial performance are both important to provide relevant information to users.

28. In particular, ESMA notes that description of revenue in the existing Conceptual Framework refers specifically to the 'ordinary activities of an entity' and this definition is currently used in paragraph 6 of IFRS 15 *Revenue from Contracts with Customers.* Consequently, ESMA suggests that this interaction between the new Conceptual Framework and IFRS 15 is further clarified.

29. Finally, while we agree with the IASB that the recognition of assets and liabilities arising from transactions or other events sometimes results in the simultaneous recognition of both income and expense ('matching principle'), we highlight that the recognition of expense and/or income cannot justify the recognition of assets and

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[3] ESMA letter, IASB's Discussion Paper: *A Review of the Conceptual Framework for Financial Reporting*, 18 December 2013, ESMA/2013/1951

[4] IASB's Discussion Paper: A Review of the Conceptual Framework for Financial Reporting, July 2013, DP/2013/1

liabilities that do not meet the definition of an asset or a liability. In this respect we suggest that the IASB makes the wording of paragraph 5.8. of the ED more explicit.

Financial statements

30. While the ED does not define primary financial statements, paragraph 3.6 of the ED states that financial statements consist of statements, including a statement of financial position and statement(s) of financial performance, and notes to the financial statements. ESMA questions why the IASB does not make any reference to the statement of cash flows an the statement of changes in equity.

31. ESMA is of the view that information on cash flows and analysis of cash position is indispensable for users of financial statements and therefore the role of the information on cash flows should not be de-emphasised by not referring to the statement of cash flows in the Conceptual Framework.

32. Equally, we note that the information on transactions with owners in their capacity as owners (such as additional investments, dividends or other distributions to equity investors) as well as the effects of retrospective changes in accounting policies and corrections of material errors recognised in the period, provide useful insight to users of financial statements on the residual interest in the net assets of the entity.

Distinction between liability and equity

33. ESMA notes that the ED does not include sufficient guidance on distinguishing between liability and equity. In this respect, ESMA agrees with the Alternative View of Suzanne Lloyd and Patrick Finnegan in paragraphs AV8 - AV14 of the ED. ESMA agrees with the IASB that the definition of a liability should be used to distinguish between liability and equity, but is concerned that the IASB has not sufficiently considered the issue yet.

34. ESMA is of the view that the Conceptual Framework should provide the Financial Instruments with Characteristics of Equity (FICE) project with the conceptual starting point, rather than the FICE research project subsequently leading to changes in the Conceptual Framework. While ESMA understands that this issue is treated in the separate FICE project, from a timing perspective, we are concerned that this project might lead to subsequent changes in the proposed definition of liability as the proposed definition might not provide the suitable basis for the distinction between liability and equity (i.e. that FICE will replace rather than complement the proposed definition).

35. Furthermore, ESMA is concerned that despite the urgent need to reduce complexity of IAS 32 *Financial Instruments: Presentation* in the short term, the IASB has been unable to progress in the FICE project. In particular, ESMA points out that in the past the IASB argued that it needs to wait for finalising of the Conceptual Framework before being able to make progress in the FICE project.[5] In light of this situation, the issues of

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[5] After FICE project was suspended because of other priorities in October 2010, the IASB consulted on the project in the 2011 Agenda Consultation. While the FICE project was identified as a priority area, in the Feedbacks Statement on the Agenda consultation the IASB stated that any consideration of the distinction between liabilities and equity needs to be undertaken in

classification as financial liabilities or equity that are significant notably in the current economic environment will not be addressed in the foreseeable future.

36. Consequently, ESMA agrees with Alternative View that distinction between liability and equity is a fundamental issue in the financial reporting that should be included in the Conceptual Framework which leaves the Conceptual Framework incomplete and might not assist the IASB in developing standards in this area.

Question 4 – Present obligation

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

37. ESMA agrees with the proposed description of a present obligation and a constructive obligation. However, we suggest particular clarifications to the guidance in order to make the implications of the changed definition clearer.

38. In our view, particular clarification is required in the wording of paragraph 4.32 of the ED where no practical ability to avoid the transfer is exemplified as '*...any action necessary to avoid transfer would cause <u>significant</u> business disruption or would have economic consequences <u>significantly</u> more adverse that the transfer itself*' (emphasis added). Accordingly, the IASB should clarify what the qualifier 'significant' means in this set of circumstances.

39. While the level of description of the present obligation is appropriate for the Conceptual Framework, we highlight the need for additional guidance on the level of individual standards. Furthermore, ESMA urges the IASB to further explore consequences of the proposed definition of present obligation on a broad set of liabilities, such as levies in scope of IFRIC 21 *Levies and* the application of the acquisition method under IFRS 3. Furthermore, the IASB should explore the possible consequences of the proposed requirements in paragraph 4.31(b) on the accounting for the restructuring plans currently accounted for under IAS 37 *Liabilities, Contingent Liabilities and Contingent Assets* and the definition of '*no practical ability to avoid transfer*' in paragraph 4.32 of the ED on the accounting for repairs and maintenance.

40. In particular, the IASB should further explore the implications of the proposed definition of the present obligation on accounting for levies in a number of industries and jurisdictions. ESMA acknowledges the analysis already made by the IASB and the conclusion in paragraph BC4.65 of the ED concluding that the proposed definition of a liability would conflict with current guidance in IAS 37 as interpreted by IFRIC 21.

41. In light of the proposed changes to the definition of a present obligation and the controversial nature of IFRIC 21, as in many cases it could be argued the accounting outcome does not fully reflect the underlying economic substance, notably in interim

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conjunction with the *Conceptual Framework* work on elements. IASB Feedback Statements; Agenda Consultation 2011, December 2012.

financial statements, ESMA requests the IASB to address the inconsistency between the Conceptual Framework and IAS 37/IFRIC 21 in a timely manner, either by changes in IAS 37 and IFRIC 21 or by stating that no changes to IAS 37 and IFRIC 21 are expected and justifying this departure from the new principles in the Conceptual Framework.

42. ESMA is of the view that while the new definition of liability might clarify the existence of an obligating event for some type of levies as states in paragraph BC4.65 of the ED, for other type of levies this might not be so clear. For example, this would be the case if a levy related to a calendar year 20x6 is to be paid by 15 January 20x6 based on an entity being active in the market on 1 January 20x6 but is calculated related to average assets or average liabilities (deposits, unsecured liabilities) over last 5 years (20x0-20x4). ESMA encourages the IASB to analyse when liability needs to be recognised in this set of circumstances and whether application of the principles in the ED would not lead to entities starting recognised liabilities at the beginning of the calculation period (in this case in 20x0). In this context, ESMA notes that the existing Conceptual Framework focuses on commercial transactions, which entail reciprocal exchanges of benefits. ESMA is of the view that the IASB should consider adding a specific discussion on the non-reciprocal transactions (e.g. transactions with the government) both in the Conceptual Framework and as a separate research project to its active agenda following the Agenda Consultation.

Question 5 – Other guidance on the elements

Do you have any comments on the proposed guidance?

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

Executory contracts

43. ESMA welcomes and agrees with the basis of the proposed guidance on executory contracts. However, we are of the view that the explanation included in the Basis for Conclusions (specifically in paragraphs BC4.87-4.88 and BC4.92) is much more clear and understandable than the current wording in the ED of the Conceptual Framework.

44. Furthermore, ESMA considers important to highlight that the proposed guidance does not have an impact on executory contracts[6] only in when the existing measurement requirements. Consequently, ESMA suggests that the interaction between the guidance for executory contracts (i.e. contracts that are equally unperformed) and the revised general guidance on recognition and measurement in the Conceptual Framework is further explained.

Unit of account

45. ESMA agrees with the guidance on the unit of account, and welcomes the discussion in the Conceptual Framework. ESMA believes that the guidance on the unit of account

[6] Their recognition, measurement an when applicable the test for onerous contracts

at the level of the Conceptual Framework should be kept at the high level (e.g. limited to paragraphs 4.57-4.59 and 4.61) as the choice of the unit of account should be a decision at standard level. In this context the need of explicit discussion of the unit of account when developing individual standards in order to avoid confusion needs to be sufficiently highlighted.

46. ESMA also believes that when the unit of account is defined at a different level for recognition and measurement decisions within a standard, the IASB should include its rationale and justification of this decision in the Basis for Conclusions.

Question 6 – Recognition criteria

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

47. ESMA agrees with the guidance on recognition. We agree that an entity should recognise an asset or liability if such recognition provides users with (i) relevant information and (ii) a faithful representation of the asset or liability. ESMA is also of the view that the recognition decision should be kept at the standards level.

48. However, ESMA calls on the IASB to explore the possible consequences of the changed recognition criteria for issuers developing accounting policy in accordance with paragraphs 10 - 11 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. While based on the experience of European enforces, circumstances when an accounting policy is developed solely with the reference to the Conceptual Framework are currently infrequent,[7] ESMA notes that the change in the recognition criteria might lead issuers to make more frequent references to the Conceptual Framework when developing an accounting policy. This could, in some circumstances, lead to recognition of a broad range of assets and/or liabilities that are not covered by individual standards.

49. While ESMA agrees with the removal of the general recognition criteria, we believe that the link to the measurement of recognised assets and liabilities should be better explained in order to avoid unintended consequences for future standard developments (such as recognition of a greater number of assets in the financial statements, e.g. research costs).

50. Furthermore, the IASB should provide additional guidance on when recognising an asset where there is uncertainty or a low probability of an inflow or an outflow would not result in relevant information and highlight more prominently that items that fails the recognition criteria still might need to be disclosed where information about these items provide relevant information to users.

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[7] See also our response to Q2 in appendix 2

51. Finally, ESMA questions why the IASB included a cost-constraint as a separate element of the recognition criteria as the cost constraint is pervasive to all areas of financial reporting as explained in paragraphs 2.38 – 2.42 of the ED.

Question 7 – Derecognition

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

52. While theoretically derecognition criteria should mirror the recognition criteria, from a practical and operational perspective separate derecognition guidance is necessary. Therefore, ESMA agrees with the guidance in the section and believes that a separate aim for the development of derecognition criteria in the Conceptual Framework has its merits. We equally suggest that similar discussion on the aim of the recognition criteria is included in the section on recognition.

53. ESMA agrees with the ED that the aim of the derecognition is both to depict faithfully an entity's financial position resulting from the transaction or an event and income or expense resulting from that transaction or event. As acknowledged in the ED, achieving this aim might be difficult and alternative ways to achieve it might exist. Consequently, ESMA agrees that these alternative aims might need to be explored at the level of individual standards and the level of guidance in the Conceptual Framework is sufficient.

54. Finally, ESMA welcomes the discussion on modification of contracts in paragraphs 5.33 - 5.36 of the ED. Nonetheless, we highlight that in order to address existing diversity in practice a more comprehensive guidance would need to be provided at the level of individual standards.

Question 8 – Measurement bases

Has the IASB:

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

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

55. ESMA welcomes the description of the measurement bases and description of the information provided by each of the measurement basis in the ED. However, while we agree that the distinction between historical cost and current value is a useful one, it does not provide guidance in some common circumstances, such as for composite measurement bases (e.g. lower of cost and net realisable value) or when discussing 'current cost' measurement base. Consequently, we suggest that the IASB further analyses whether additional guidance on measurement bases is required.

56. We agree that several measurement bases could be implemented by cash-flow based measurement techniques (e.g. fair value, current cost). Therefore, the cash-flow based measurement techniques should not be considered as a separate measurement basis.

57. ESMA notes that the IASB has made the decision to deal with the equity method of accounting in a separate research project. This project should clarify whether the equity method of accounting represents a measurement base or a consolidation technique. However, we would like to add the discussion on the equity method to the Conceptual Framework. Without prejudice to the future decision whether the equity method of accounting is considered a measurement base or a consolidation technique, the IASB could explain in the Conceptual Framework whether, before any fundamental clarification, the equity method is to be categorised as a current value measurement base or as a historical cost measurement base.

58. ESMA welcomes the IASB efforts to summarise in a concise manner the information provided by various measurement bases in Table 6.1 in the ED. However, in our view, the table should be clarified so that readers understand easily what information is given in each of the boxes of the table. For example, the description of the historical cost measure on the asset side of the statement of financial position is confusing, since it refers to the "recoverable" cost. This gives the impression that the measure refers to the amount that can be recovered from the asset, which might be understood as a current value measure. Furthermore, the table could clarify more prominently that the cash-flow based measuring techniques (present value) could be used for both types of current value measures.

Question 9 – Factors to consider when selecting a measurement basis

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

59. Whereas ESMA does not disagree with the identified factors to be considered when selecting a measurement basis, we are concerned that the guidance provided for the IASB is at a very high level and thus is unlikely to be useful for future standard-setting activities. While the IASB should have full flexibility for selection of a measurement basis at the level of individual standards, the guidance in the Conceptual Framework should provide a robust theoretical underpinning of the considerations that the IASB will evaluate as part of the standard-setting process.

60. The ED proposes that the qualitative characteristics of useful financial information are the main factors to consider when determining a measurement basis. While we agree that the qualitative characteristics of financial information are the starting point of the consideration how to select a measurement basis, the lack of specific description of the linkage between the measurement bases and the factors to be considered when selecting a measurement basis, and lack of guidance on the relative importance of each of the factors means that the general description included in the ED is unlikely to be sufficient to ensure consistency in the selection of a measurement basis in the standard-setting process.

61. ESMA agrees with paragraph 6.53 of the ED that when selecting a measurement basis, it is important to consider what information the selected measurement basis will provide in both the statement of financial position and the statement(s) of financial performance. However, the ED does not further analyse what information meets the qualitative characteristics from the perspectives of the statement of financial position and the statement(s) financial performance.

62. ESMA also agrees with paragraph 6.54 of the ED that both the characteristics of the asset or the liability and the way that the asset or liability contributes to future cash flows (i.e. nature of business activities) need to be assessed in order to evaluate whether a measurement basis will provide relevant information.

63. The section describing measurement bases and the information they provide (paragraphs 6.4 – 6.47 of the ED) might better facilitate consistency in the IASB's future standard-setting activities than the guidance proposed for factors to consider when selecting a measurement basis (paragraphs 6.48 – 6.63 of the ED). Furthermore, some elements of the proposed guidance in paragraphs 6.48 – 6.63 of the ED are repetitive from the general guidance on qualitative characteristics of the financial information. Accordingly, ESMA suggests to better structure the guidance by incorporating some of the former guidance in the factors to consider when selecting a measurement basis and further streamlining the guidance.

64. ESMA welcomes the discussion on specific cases in paragraphs 6.64 - 6.71 of the ED as it provides more guidance on the selection of the appropriate measurement basis. We are of the view that the discussion on selection of a measurement basis in paragraphs 6.58 – 6.109 of the IASB's Discussion Paper DP/2013/1 would have been more useful for the future standard-setting process. Indeed, detail and precision of the proposed guidance on selection of the measurement basis in the DP could have been, in our view, more suitable for inclusion in the Conceptual Framework.

Question 10 – More than one relevant measurement basis

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

65. ESMA agrees that sometimes more than one measurement basis is needed to provide relevant information about an asset, liability, income or expense and that in many of these cases the relevance of the information provided in the statement of financial position and the statement of profit or loss is enhanced by using different measurement bases for the statement of financial position and the statement of profit or loss.

66. The way in which an asset or a liability contributes to future cash flows (which depends in part on the nature of the business activities conducted by the entity) or specific characteristics of the asset or the liability could justify the use of different measurement bases for the statement of financial position and the statement of profit or loss. However, ESMA is of the view that the IASB should provide additional guidance on when it would be relevant to use different measurement bases.

67. Furthermore, the use of different measurement bases for the statement of financial position and the statement of profit or loss requires that the purpose of the statement of profit or loss and statement of OCI is clearly defined. In our view, such purpose is not sufficiently defined in the ED (please see also our response to Question 13 below).

Question 11 – Objective and scope of financial statements and communication

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

68. ESMA agrees with the proposed objective and scope of the financial statements. We welcome that the IASB proposes that the notes to the financial statements may provide information about items that meet a definition of an element but that have not been recognised as well as information about the nature of both recognised and unrecognised elements and about the risks arising from them.

69. The ED is not sufficiently clear about the intended meaning of the terms 'presentation' and 'disclosure' as these are often used interchangeably in the IFRS literature. Therefore, ESMA suggests that the IASB defines the terms 'presentation' and 'disclosure' and distinguishes the references to presentation and disclosure at the level of the Conceptual Framework.

70. ESMA notes that the IASB is also working on the *Disclosure Initiative*, a collection of implementation and research projects aimed at improving disclosure in IFRS financial statements. It is unclear at this stage how Chapter 7 of the proposed Conceptual Framework on Presentation and Disclosure will interact with some elements of the Disclosure Initiative, such as the Principles of Disclosure project.

71. Finally, ESMA is of the view that paragraph 7.18 of the ED is confusing as it discusses at the same time the relationship between entity specific information and boilerplate language as well as information that is readily available outside the financial statements. As these are two different elements, these two relationships should be dealt with separately. ESMA is of the view that 'boilerplate' language is not useful and therefore we suggest the IASB to redraft the wording that might suggest that in some circumstances boilerplate language can be useful (even though entity 'specific information is more useful'). Furthermore, we believe the financial statements are a self-standing document that should provide a complete picture about the financial position and performance of the entity.

Question 12 – Description of the statement of profit or loss

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

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

72. ESMA is of the view that the statement of comprehensive income is a starting point for the analysis of the performance of an entity.[8] Furthermore, we agree with the IASB's position that income and expenses included in the statement of profit or loss are the primary source of information about an entity's performance for the period.

73. ESMA agrees with the proposed description of the purpose of the statement of profit or loss, stating that the purpose is to (i) depict the return that an entity has made on its economic resources during the period; and (ii) provide information that is helpful in assessing prospects for future cash flows and in assessing management's stewardship of the entity's resources.

74. While ESMA agrees that the statement of profit or loss is the primary information about an entity's financial performance in the period, ESMA supports the main arguments used in the alternative view of Stephen Cooper and Patrick Finnegan in paragraph AV 3 of the ED. The AV states that identifying the statement of profit or loss as the primary source of information about financial performance, without actually defining financial performance or specifying the characteristics of income and expenses that require their presentation in OCI, will leave the IASB in effectively the same position that it is now and thus represents a missed opportunity to identify a conceptual basis for reporting of performance and the use of OCI.

75. ESMA urges the IASB to better articulate the notion of performance, from the perspective of equity investors. While ESMA understands that this issue is treated in a separate research project related to Performance Reporting, ESMA is concerned that such project will modify what the current proposals in the ED on Questions 12 - 14.

76. Moreover, we encourage the IASB to analyse possible approaches to defining performance, among others, approaches described in the alternative view of Stephen Cooper and Patrick Finnegan. As suggested in the alternative view, the conceptual foundation for performance reporting could be based on principles of separate presentation of income and expenses with different characteristics (including, for example, different degrees of persistence and different predictive values) and principles of disaggregation or splitting of items of income and expenses to highlight components that have different characteristics (within profit or loss, either on the face of the statement or in the notes). In this context, ESMA suggests that the IASB also evaluates whether the financial statements should provide information disaggregating the gains and losses between realised and unrealised.

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[8] As stated in paragraph 31 of this comment letter, ESMA highlights the importance of the statement of cash flows, inter alia, for assessing performance of an entity

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

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

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

77. ESMA agrees with the requirement to present a total or subtotal for profit or loss should be maintained. However, the ED does not provide a sufficient basis for the use of OCI in the IASB's standard-setting activities. ESMA believes that a definition of performance is the first building block for development of robust and clear basis for distinguishing between items that should be recognised in profit or loss and items that should be recognised in OCI.

78. ESMA would have preferred that guidance defining performance and distinguishing between items that should be recognised in profit or loss and items that should be recognised in OCI were developed as part of the Conceptual Framework. If the IASB concludes that it is unable to develop such guidance in a reasonable timeframe, the research project on performance reporting should be advanced and prioritised in terms of resources as this would remain a significant gap in the Conceptual Framework on an issue of essential importance for the standard-setting process.

79. In this context, the IASB should further develop the guidance to describe the circumstances when the relevance of the information in the statement of profit or loss is enhanced. However, the ED is lacking a concept to provide useful guidance when current value adjustments related to assets measured at current value should be included in the OCI. Therefore, ESMA agrees with the alternative view of Stephan Cooper and Patrick Finnegan that the IASB should define the use of OCI on a conceptual basis. One of the areas to explore is the suggestion in the AV explaining that the component of income or expenses should result in an amount recognised outside profit or loss, if doing so enhances the relevance of the information in the statement of profit or loss in each of the reporting periods and over the life of the transaction (or where relevant economically linked transactions).

80. Another area to explore and take into account, consistently with our response to the DP,[9] is the element discussed in the alternative view that the use of OCI should be restricted to a limited number of cases in which either (1) a different measurement basis is judged appropriate for measuring income and expenses in profit or loss, compared with that best suited to the measurement of the asset or the liability in the statement of financial position; or (2) there is a mismatch in the recognition basis for different but economically related transactions. Consequently, these two elements could be used by the IASB to further develop any principles in this respect.

[9] Paragraph 87 of the ESMA comment letter to the DP (Ibid 1, paragraph 87)

81. ESMA is of the view that the nature of business activities is one of the factors to be considered for distinguishing between items that should be recognised in profit or loss and items that should be recognised in OCI, however, it should not be the only determining factor.

82. Finally, ESMA agrees with the proposals in the ED that (a) income or expenses related to assets and liabilities measured at historical cost; and (b) components of income or expenses related to assets and liabilities measured at current values if the components are separately identified and are of the type that would arise if the related assets and liabilities were measured at historical cost should be always included in profit or loss.

Question 14 – Recycling

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

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

83. ESMA considers that without a clear definition of performance (i.e. clarification whether OCI is considered another equivalent measure of performance) and principle for distinguishing between items that should be recognised in profit or loss and items that should be recognised in OCI, it is difficult to provide a conclusive view on whether and when recycling is appropriate.

84. However, when assessing the proposal in the ED in light of the existing proposals, we are of the view that it is not sufficiently clear when the proposed presumption can be rebutted as the reference to enhancing the relevance of the information in the statement of profit or loss is too vague and general for being operationalised in the standard-setting process.

85. Furthermore, the IASB should further explore and clarify implications of the principles for the use of OCI and recycling on current standards. This would for example require the assessment of how the use of OCI and the (lack of) recycling for re-measurement of plan assets and defined benefit obligations in IAS 19 *Employee Benefits* and gains or losses on an investment in equity instruments classified at fair value through comprehensive income, as allowed by IFRS 9 *Financial Instruments,* interacts with the proposals.

Question 15 – Effects of the proposed changes to the Conceptual Framework

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

86. ESMA agrees with the existing status of the Conceptual Framework and believes that the proposed changed to the Conceptual Framework that conflict with existing standards should not automatically result in any changes to Standards. However, in case of conflict between the Conceptual Framework and an existing standard, ESMA

urges the IASB to assess whether it needs to add that standard to its active agenda and to address this conflict on a timely basis.

87. In particular, as stated in our response to Question 4, ESMA suggests that the IASB addressed any inconsistency between the definitions of present obligation in a timely manner, either by changing IAS 37 or by stating that no changes to IAS 37 (and consequently IFRIC 21) are expected and justifying this departure from the new principles in the Conceptual Framework.

88. Furthermore, ESMA notes that not all the expense recognised arising from share-based payment transactions in accordance with IFRS 2 *Share-based Payment* fulfils the proposed definition of expense in paragraph 4.49 of the ED, as this expense does not necessarily represent '*decreases in assets or increases in liabilities*'.

89. ESMA welcomes that the IASB has provided an effects analysis of the proposed changes to the Conceptual Framework. While ESMA agrees with the results of the proposed effects analysis, ESMA notes that the list of inconsistencies in paragraphs BCE.1-BCE.31 is incomplete (e.g. it lacks the assessment of the existence of the category of equity instruments measured at fair value through other comprehensive income in IFRS 9 *Financial Instruments* and lack of the recycling of the related gains and losses as well as assessment of the accounting under the revaluation model in IAS 16 *Property, Plant and Equipment*). Consequently, ESMA suggests that the IASB develops an exhaustive list of all inconsistencies between current standards and interpretations and the revised Conceptual Framework.

90. Furthermore, ESMA is of the view that a more comprehensive analysis of possible consequences on the existing standards and future standard-setting activity would facilitate evaluation of the proposals. Such analysis could include assessment, to the extent possible, of the possible consequences of the change of the recognition and measurement requirements, the current use of OCI and the reclassification to the statement of profit or loss of income and expenses included in OCI in an earlier period.

91. Finally, we also agree that the IASB and the IFRS Interpretations Committee should start using the revised Conceptual Framework as soon as this has been published.

Question 16 – Business activities

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

92. ESMA agrees with the proposed approach. ESMA welcomes that the ED acknowledges that the way in which an entity conducts its business activities may affect the unit of account, selection of a measurement basis as well as presentation and disclosure.

93. Like the IASB, we are of the view that the Conceptual Framework should not include a general discussion on the role of the business activities as the nature of entity's business activities plays different roles in different aspects of financial reporting.

Furthermore, depending on the characteristics of the assets, liabilities, income and expenses, the nature of business activities should be only one of the considerations used for standard-setting activities.

94. Consequently, the discussion on the role of business activities should be kept at the level of individual standards (as was done for classification of financial assets in IFRS 9 *Financial Instruments* or consolidation exception for investment entities in IFRS 10 *Consolidated Financial Statements*).

Question 17 – Long-term investment

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

95. ESMA believes that if financial statements provide useful information to make decisions to buy, hold and sell and to assess stewardship of management, all investors' needs are fulfilled, without the need to differentiate them by their horizon of investment.

96. Hence, ESMA agrees that the proposals in the ED provide sufficient tools for the IASB to make appropriate standard-setting decisions if future projects to consider (i) how to measure the long-term investments (or liabilities) of entities whose business activities include long-term investment; or (ii) whether such entities should report changes in the carrying amount of those investments (or liabilities) in the statement of profit or loss or OCI. In this respect ESMA highlights the need for transparent information to about all types of assets and/or liabilities held by types of entities.

Question 18 – Other comments

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

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

97. ESMA suggests that the IASB clarifies at the conceptual level the relationship between the terms 'material' and 'significant'. ESMA notes that in the ED (and when setting individual standards), the IASB uses the often the words 'material' and 'significant'. However, it might not be always clear whether these terms are used interchangeably, or whether they depict different magnitude.

98. ESMA believes that some sections of the ED would benefit from editorial clarifications that would improve clarity and readability of the text. These include e.g. the section on stewardship (see paragraph 3 of this comment letter), section on selection of a measurement basis (see paragraph 64 of this comment letter) and the section on the objective and scope of the financial statements (see paragraph 73 of this comment letter).

Appendix II – ESMA's detailed answers to the questions in the ED/2015/4 – *Updating References to the Conceptual Framework*

Question 1 – Replacing references to the *Conceptual Framework*

The IASB proposes to amend IFRS 2, IFRS 3, IFRS 4, IFRS 6, IAS 1, IAS 8, IAS 34, SIC-27 and SIC-32 so that they will refer to the revised Conceptual Framework once it becomes effective.

Do you agree with the proposed amendments? Why or why not?

99. ESMA believes that the consistent application of IFRS requires the use of consistent terms and concepts in all the IFRS. Therefore we consider that all IFRS should refer to the same *Conceptual Framework*.

100. However, ESMA is concerned about possible unintended effects of the proposed update of references to the *Conceptual Framework*. While we agree that all IFRS should refer to the same *Conceptual Framework*, we are not sure that all proposed changes are of a purely linguistic nature (e.g. in case of IFRS 2 or IFRS 3). Therefore, ESMA suggests the IASB to analyse whether any material changes will result from replacing references to the *Conceptual Framework* and if so, how to address them.

Question 2 – Effective date and transition

The IASB proposes that:

(a) a transition period of approximately 18 months should be set for the proposed amendments. Early application should be permitted.

(b) the amendments should be applied retrospectively in accordance with IAS 8, except for the amendments to IFRS 3. Entities should apply the amendments to IFRS 3 prospectively, thereby avoiding the need to restate previous business combinations.

Do you agree with the proposed transition provisions and effective date? Why or why not?

101. ESMA agrees with the proposed transition requirements and effective date.

102. Based on ESMA's experience accounting policies are only seldom developed solely on the basis of the definitions, recognition criteria and measurement concepts for assets, liabilities, income and expense in the Conceptual Framework in accordance with paragraph 11(b) of IAS 8. In most of the cases, the development of the accounting policy is based on the existing IFRS requirements dealing with similar or related issues as required in paragraph 11(a) of IAS 8. As, when developing the accounting policy, entities must first rely existing IFRS requirements dealing with similar or related issues before developing the accounting policy solely with reliance on the concepts in the Framework, ESMA does not expect the proposed amendments to be onerous.

103. ESMA agrees that the proposed update of the reference to the Conceptual Framework in paragraph 11 of IFRS 3 might have indirect impact on the recognition of identifiable assets acquired and liabilities assumed in a business combination. Consistently with our response to Question 4 in Appendix I, ESMA calls on the IASB to further explore the implications of the proposed changes on the assets and liabilities recognised following a business combination. In light of the expected indirect impact, ESMA agrees that the consequential amendments to IFRS 3 should be applied prospectively.

Question 3 – Other comments

Do you have any other comments on the proposals?

104. ESMA suggests that the IASB considers using the term 'statement of performance' consistently across all standards.