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THE CHAIRPERSON

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Discussion Paper: A Review of the Conceptual Framework for Financial Reporting

Dear Mr Hoogervorst

The European Banking Authority (EBA) welcomes the opportunity to comment on the IASB's Discussion Paper DP/2013/1: *A Review of the Conceptual Framework for Financial Reporting* (DP). The EBA has a strong interest in promoting sound and high quality accounting and disclosure standards for the banking and financial industry, as well as transparent and comparable financial statements that would strengthen market discipline.

The EBA welcomes the high priority that the IASB has given to the project of updating the Conceptual Framework (CF) in line with the views received to the IASB Agenda Consultation and the IASB's efforts to restart the project of revision of the CF, which will influence the shaping of the accounting standards in the future. The revision of the CF could increase the relevance and usefulness of the fundamental principles for the IASB to consider during the standard-setting process and for the users of financial statements, during the application of standards and the interpretation of financial information. We agree with the scope of the issues being addressed in the DP. However, the EBA believes that certain aspects of the DP could be further developed or deserve further consideration.

The revised 2010 Conceptual Framework removed the reference to the concept of prudence. However the EBA believes that prudence should be reintroduced in the CF and defined in line with the pre-2010 Conceptual Framework, as the inclusion of a degree of caution in the exercise of judgements and estimates required under conditions of uncertainty. In our view, this concept is already embedded in the individual standards (for example IAS 37) and it is not inconsistent with neutrality.

Additionally, we have also some concerns about the implications of the removal of the probability threshold both from the definition of assets/liabilities and the recognition criteria. If the IASB decides to remove the probability threshold, the EBA believes that further clarification is needed on the role of uncertainty in the recognition and measurement of assets and liabilities.

The EBA is concerned that some of the proposals of the DP conflict with some of the requirements in the current standards that EBA generally agrees with and which may lead to significant unintended consequences in financial reporting of banks, such as the distinction between equity and liability and in respect of the derecognition of repurchase agreements resulting from the decision taken on `control´ versus `risk-and-rewards´ approaches. For that reason, the interaction of the revised CF with the existing standards needs further justification as we are concerned about the appropriateness of the inclusion of these proposed principles within the CF, which could limit the flexibility to develop specific treatment in the individual standards.

Finally, the EBA believes that the purpose of Profit and Loss and Other Comprehensive Income and the conditions under which recycling should occur deserve further conceptual analysis in order to ensure consistency in the presentation and the disclosures of financial statements.

The Annex to this letter provides more detailed comments on the above areas. We have not explicitly responded to all the questions raised in the DP.

If you have any questions regarding our comments, please feel free to contact Mr. Colinet (+32.2.220.5247) in his capacity as Chairman of the technical group that coordinated this comment letter.

Yours sincerely

(signed)

Andrea Enria

Cc : Michel Colinet, Chairman of the technical group

Annex

<u>Section 1 DP—Introduction: purpose and status of the Conceptual Framework</u>

The EBA agrees that the primary purpose of the revised CF is to assist the IASB by identifying concepts that will be used consistently when developing and revising IFRSs, thereby strengthening the coherence and consistency in the development and application of the individual standards. However, we accept that in some cases, when a new or a revised standard is developed, a divergence from the CF might be justified. However, we believe that it is important that any departure from the CF and the reasons for that departure should be well-explained in the Basis for Conclusions of that standard.

Additionally, in our view, the identification of inconsistencies between an individual standard and the CF alone should not be a sufficient reason to revisit an existing standard. As such, we would be concerned if standards which are currently in place, almost completed or have recently been finalised are to be revised or reopened solely to address inconsistencies with the revised CF. Nevertheless, when an existing standard is being reviewed for other reasons, the possibility of eliminating inconsistencies between that standard and the CF should be considered.

Having said that, we would encourage the IASB to identify the main inconsistencies between existing standards and the revised CF. However, this assessment should not be a reason to delay further the finalisation of the revised CF.

On the other hand, we would expect that the CF remains relatively stable over time. In this respect, it is important to strike the appropriate balance between a CF that provides a comprehensive set of high level accounting concepts and principles and individual standards that include more detailed and specific requirements.

The EBA notes that some of the proposals of the DP seem to address specific issues, which are already covered in particular current standards (for example the treatment of repurchase agreements, as explained further in Section 4 and the obligation to deliver variable number of own equity instruments, as explained further under Section 5). Therefore, the impact of the proposed changes needs thorough consideration, in order to avoid potential unanticipated consequences in financial reporting of banks. In that vein, the IASB should give appropriate consideration to the respective role of the CF (identification and definition of the concepts and overarching principles) and the standards, in order to avoid any overlaps and the risk of addressing in the CF a detailed technical issue.

<u>Section 2 DP—Elements of financial statements</u>

Definitions of an Asset and a Liability

In the proposed revised definitions of assets and liabilities, the references to the probability threshold and the “expected” inflows/ outflows are removed and the concepts of “capable of generating inflows/ outflows of economic benefits” are introduced. The revised definitions should result in more consistent application of the standards in practice. We understand the merits in removing the uncertainty element from the definitions of assets and liabilities to avoid exclusion of assets and liabilities with particular features (for example written and purchased options). However, it is not sufficiently clear in the proposals of the DP how the uncertainty element will be considered in the recognition/ derecognition and measurement of assets and liabilities. If the IASB decides to remove the uncertainty element from the definitions of assets and liabilities, a key role would need to be assigned to uncertainty in the recognition assessment.

The proposed definitions would increase the assets that will need to be assessed against the recognition criteria and could lead to an increase in the assets being recognised, which could raise concerns also from a prudential point of view, about the relevance and reliability of these newly recognised assets, together with their potential impact on the equity, especially if these assets are intangibles, as explained further in Section 4.

Section 3 DP—Additional guidance to support the asset and liability definitions

Constructive obligations and "present obligations" in the definition of liabilities

The EBA supports the intention of IASB to retain consideration of both legal and constructive obligations in the definition of liability. However, we would encourage the IASB to provide more principles and application guidance to help distinguishing between constructive obligations and economic compulsion, in order to ensure appropriate understanding and interpretation of the revised CF.

In addition, the DP suggests that economic compulsion be addressed in the individual standards (paragraph 3.108). However, we are concerned that in the absence of an appropriate articulation of the role of the economic compulsion in the CF, it may be interpreted and applied inconsistently in the development or revision of future standards. Therefore, we believe that the role of economic compulsion in the definition of a liability, including the conditions when economic compulsion exists need to be clarified in the CF. This would help to promote comparability, assist users and preparers of financial statements in the application of the definition of a liability and avoid possible divergence between the standards, but also between the standards and the principles of the CF.

The EBA supports the View 2 on the present obligation, when a present obligation must have arisen as a result of past events and is practically unconditional. This approach could reduce the risk of liabilities being understated and takes into consideration the substance and the economics of the transactions and the events. However, we are concerned that the term "practical ability" could be subject to different interpretations by users and preparers of financial statements. Thus, we would suggest that more guidance is provided in the revised CF with regards to the definition and the application of this term.

Section 4 DP—Recognition and derecognition

The removal of the probability threshold from the proposed recognition criteria for assets and liabilities is likely to increase the range of items to be recognised on the Statement of Financial Position. In this regard, we would suggest that the IASB provides further clarification on how the term "faithful representation" and "relevance" should be interpreted and applied in the recognition of both assets and liabilities, in order to ensure consistent application of the recognition criteria. In particular, the EBA believes that the role of uncertainty in the recognition and measurement of assets and liabilities could be further emphasized. The IASB should also assess the impact of the removal of the probability threshold to the type and amounts of assets and liabilities to be recognised compared to the current standards.

In relation to the above, the EBA supports the current approach of IAS 37, where liabilities are recognised when it is more likely than not to occur (when liabilities are "probable" to occur) and a lower degree of certainty is required compared to the recognition of assets (when assets are "virtually certain" to occur).

With regards to derecognition of an asset or a liability, the EBA believes that the interaction between the control and the risk-and-rewards approaches is not clear. The EBA believes that the control and risk and rewards approaches should be complementary and not exclusive to each other. Each of the proposed approaches has merits and could be appropriate depending on the substance and the economics of the particular transactions and events. Prescribing a control approach or a risk-and-reward approach only could have in some cases (such as in the treatment of repurchase agreements) unintended adverse consequences in financial reporting by banks.

Thus, the EBA suggests that detailed and specific considerations on the approach to be used be addressed in the particular standards, while the CF should set out the appropriate high level principles.

Section 5 DP—Definition of equity and distinction between liabilities and equity instruments

The EBA supports retaining the existing definition of equity as the residual interest in the assets of the entity after deducting all its liabilities. However, we are concerned that the revised definition and recognition criteria of liabilities will have a significant impact on banks – as it may result in certain instruments currently classified as liability being classified as equity and vice versa. For example, under the new definition of liabilities, the issuer's obligation to deliver a variable number of the issuer's own equity instruments, which is currently classified as a financial liability under IAS 32, will be reclassified as equity, since the obligation of the issuer to deliver own shares is not a transfer of economic resources, even though these instruments involve the element of obligation of the entity (as explained in current IAS 32). These are complex issues and we believe that the IASB should perform a thorough analysis, in particular regarding the definition of 'economic resource' which is important when distinguishing equity and liabilities in the above-mentioned example. Nevertheless, we welcome the new disclosure requirements with regard to wealth transfers, which could provide useful information in the distinction between liability and equity.

Measuring equity claims

Additionally, if the IASB decided to introduce a requirement to measure equity claims, the EBA considers that the proposals for the requirement to update the measurement of each class of equity claims should be addressed in individual standards. We would welcome more specific presentation and disclosure requirements at the individual standard's level.

Section 8 DP—Presentation in the statement of comprehensive income—profit or loss and other comprehensive income

The EBA supports the proposals of maintaining presentation of Profit or Loss as a total or subtotal, which should be separately reported from other comprehensive income.

While recognising that there are merits to some of the approaches currently followed by existing standards for the presentation in OCI, the EBA believes that the proposed CF should include further conceptual analysis with regards to the definition and the purposes of Profit or Loss and Other Comprehensive Income (OCI) and the conditions under which recycling should occur. This is necessary to understand how the proposed narrow and broad approaches and the corresponding recycling criteria would give a faithful representation of the financial performance of an entity and in the future to ensure coherence of requirements between standards and also between standards and the CF. As they stand, the proposals of the DP seem to fit the definition of OCI to its current use in existing standards rather than addressing the key question of what should be presented in OCI and what in Profit or Loss.

Section 9 DP—Other issues

Prudence

The EBA encourages the IASB to reinstate the pre-2010 concept of prudence in the revised CF. Prudence would need to be clearly defined in the CF not as bias towards conservatism (which may compromise neutrality), but as exercise of caution when making estimates and judgments under conditions with significant uncertainty; this is already embedded in particular standards (for example IAS 37 and other standards). Including such a notion in the CF should ensure that it continues to be applied in the development, application and interpretation of current and future standards.

Stewardship

Stewardship should be reintroduced in the CF as an objective of financial reporting. We understand the possible practical difficulties in interpreting the term of stewardship in other languages, but the objective of stewardship is as important as information for assessing future cash flow prospects when deciding whether to provide resources to the entity (paragraph BC 1.27 of Chapter 1 of the CF).

Business Model

Lastly, we welcome the approach of the DP proposals that takes into account the business model, being the way assets and liabilities are used to generate cash flows, in order to define the appropriate measurement method (Section 6 of the proposals). Transactions should be accounted for and measured consistently with their economic substance, the entity's business model, while also considering the characteristics of the instruments.