ISDA® Safe, Efficient Markets

International Accounting Standards Board
1st Floor
30 Cannon Street
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25 November 2015

Dear Sirs,

Ref.: IASB's Exposure Draft ED/2015/3 Conceptual Framework for Financial Reporting

The International Swaps and Derivatives Association ("ISDA")[1] is pleased for the opportunity to respond to the above referenced Exposure Draft ('ED') on the Conceptual Framework. Our responses focus on those aspects of the Conceptual Framework ('CF') that are most relevant to our members. In this letter we outline our key messages and in the Appendix we provide our more detailed responses to the specific questions.

- *Prudence*: Our members support the reintroduction of the concept of prudence. While they agree with EFRAG that reference might usefully be made to its use by the IASB itself and to the asymmetric prudence applied in some IFRSs, the majority of our members are concerned that the introduction of a more explicit notion of asymmetric prudence beyond this could be misinterpreted as a move towards standards that are more asymmetric than is currently the case, and so should be avoided.

- *Definition of liability*: Extending the definition of a liability, as proposed in the ED, might help address some situations where IAS 37 would not permit a provision to be recorded, such as for UK bank levies until the year end. But our members have concerns that, at least as worded, it could have unintended consequences. More research is needed on this proposal and any standard-level application would have to be very carefully considered. Our members also note that the discussion of the classification of instruments as debt or equity will need to be updated in due course

[1] Since 1985, the International Swaps and Derivatives Association has worked to make the global derivatives markets safer and more efficient. ISDA's pioneering work in developing the ISDA Master Agreement and a wide range of related documentation materials, and in ensuring the enforceability of their netting and collateral provisions, has helped to significantly reduce credit and legal risk. The Association has been a leader in promoting sound risk management practices and processes, and engages constructively with policymakers and legislators around the world to advance the understanding and treatment of derivatives as a risk management tool. Today, ISDA has over 850 member institutions from 68 countries. These members comprise of a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. ISDA's work in three key areas – reducing counterparty credit risk, increasing transparency, and improving the industry's operational infrastructure – show the strong commitment of the Association toward its primary goals; to build robust, stable financial markets and a strong financial regulatory framework. Information about ISDA and its activities is available on the Association's web site: www.isda.org.

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once the FICE project is complete, which might also require an amendment to the definition of a liability.

- *Performance and recycling*: Our members agree that profit or loss should be the primary measure of performance and that more work needs to be carried out to refine this concept. They also agree that there should be a more conceptual discussion of the use of OCI in the Framework and that the need to recycle all gains and losses to profit or loss should be more than a rebuttable presumption.

- *Dynamic risk management:* When the IASB published its Discussion Paper on Dynamic Risk Management, the concern was expressed that the idea of hedging changes in the fair value of an entity's equity would require modification of the Conceptual Framework. Our members agree that that the Conceptual Framework need not be modified at this time in this manner, but would not want future progress on the accounting for macro hedging activities to be constrained by what is written in the Framework. It would be helpful if the Conceptual Framework recognised that this issue needs further consideration, which should be undertaken when developing the future standard, in the same way as the ED deals with the classification of equity instruments.

Should you have any questions or would like clarification on any of the matters raised in this letter please do not hesitate to contact the undersigned.

Yours faithfully,

David Bradbery
Barclays Bank plc
Chair, European Accounting Committee

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Appendix – Responses to specific questions raised by the IASB

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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?

(a) While our members agree with the general concept of stewardship, as written it is not clear what it means or what it adds. There is no elaboration of the consequences of re-introducing the concept. This may be, in part, because of the focus of the ED on the needs of users for 'buying, selling or holding' equity and debt instruments, without explicit recognition that shareholders make decisions other than just whether to buy, hold or sell. They also engage in the appointment of directors and cast votes at general meetings and, through these powers, influence management's actions. To use these powers successfully, shareholders need information on stewardship, but our members recognise that the relevant information extends beyond that which is contained in financial information.

(b) Our members agree with the reintroduction of prudence and the way in which it is described, since it helps to define the term in a manner consistent with how it has been traditionally applied in the development of accounting standards. However, they also believe that the concept applies to how standards are set as well as how financial statements are prepared, and the way it is described does not seem to reflect how the concept is applied in many existing standards. For instance, IAS 37 contains different recognition thresholds for assets and liabilities and IFRS 5 requires use of the lower of the carrying amount and fair value less costs to sell. The majority of our members are concerned that the introduction of a more explicit notion of asymmetric prudence beyond this could be misinterpreted as a move towards standards that are more asymmetric than is currently the case, and so should be avoided.

(c) Our members agree that faithful representation represents the substance of an economic phenomenon instead of merely representing its legal form, but the Framework could be misunderstood, as drafted, since it could be read to imply that legal form is unimportant. The legal form/structure of an economic phenomenon has to be considered, as that determines the rights and obligations of an entity (for instance, the liability/equity classification of financial instruments or the classification of joint arrangements structured through a separate vehicle). We therefore suggest that para 2.14 includes that the legal form of an economic arrangement will affect the rights and obligations of the parties to the arrangement and therefore it cannot be ignored when determining its substance.

(d) Our members agree. They believe that it is sometimes appropriate to use fair values even if there is measurement uncertainty, as is required for many financial instruments under IAS 39 and IFRS 9. The disclosures required by IFRS 7 in respect of 'level 3' valuations are an effective way to communicate measurement uncertainty for these instruments.

(e) The majority of our members agree that measurement uncertainty is most usefully regarded as an element of relevance and that faithful representation is a wider concept than 'reliable', as set out in BC 2.24 to the ED. The minority would prefer to use 'reliable' rather than 'faithful representation', as it would give greater emphasis as to the importance of measurement certainty.

(f) A majority of our members agree with the way that the ED describes 'users' of general purpose financial information. However our members are concerned that it is often not operationally feasible to manage a business using language and financial information that differs significantly from that reported to shareholders. Otherwise, there is the potential for a disconnect between management activities and how they are reported, with the potential for stakeholder confusion and a need to use non-GAAP measures in the financial report. As result, a minority of our members also view management as a 'user' of general purpose financial information. Also, in this context, our members believe that EFRAG's proposal, that where preparers tend to converge and oppose the IASB's proposals because, in their view, the outcome would not be a meaningful depiction of the entities' financial position and/or performance, the IASB should explain how and why meaningful information will be provided, would be helpful.

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 what not?

Our members agree with the description and discussion, but would disagree with the statement in paragraph 3.25 that consolidated financial statements are, in general, more likely to provide useful information than unconsolidated financial information. While consolidated financial statements are of considerable value, a lender will always wish to understand the financial position of the actual obligor (or guarantor) to whom he will be exposed. As it says in paragraph 3.22, the returns to investors, lenders and other creditors depend only 'partly' on the future net cash flows to the parent from subsidiaries. Hence both consolidated and unconsolidated information are necessary.

Our members believe that the Conceptual Framework should contain a better explanation of why control is the underlying principle used to define a reporting entity but that there is no urgency to make this adjustment.

Question 3 – Definitions of elements

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

c) An asset, and the related definition of an economic resource;

d) A liability;

e) Equity;

f) Income; and

g) Expenses?

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

Some of our members believe that a new definition of financial asset should not have been proposed without, first, an analysis of how this might affect current usage. They are not convinced that a new definition is needed.

Our members have concerns as to the revised definition of a liability and the guidance on present obligation - refer to our response to Q4. They also note that the discussion of the classification of instruments as debt or equity will need to be updated in due course once the FICE project is complete, which might also require an amendment to the definition of a liability.

Our members disagree with the point made in paragraph 4.25, that a liability of one party is necessarily an asset of another, since this doesn't seem to work for certain liabilities such as decommissioning costs. Also, they believe that revenue is a sufficiently important KPI that it should be an element of financial information.

Our members are also concerned that an asset/liability approach is, on its own, the best way to achieve robust and consistent financial information. They have always regarded matching as an important principle. For instance, based only on an asset/liability approach there would be no conceptual basis for cash flow hedge accounting; however, it is generally accepted that cash flow hedge accounting is helpful in order to represent faithfully an entity's results, primarily based on a matching principle.

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?

Extending the definition of a liability as proposed in the ED might help address some situations where IAS 37 would not permit a provision to be recorded, such as for UK bank levies until the year end. But we have concerns that, at least as worded, it could have unintended consequences, and any standard-level application would have to be very carefully considered. For instance, a levy might be calculated based on a multi-year basis, in which case it is not clear as to the date at which the liability would need to be recorded. A present obligation approach would need to be very carefully thought through in any future project to replace IAS 37. The problem of bank levies might be better addressed by adjusting IAS 34, to allow levies to be accrued over the year in a manner similar to staff bonuses.

Question 5 – Other guidance on elements

Do you have any comments on the proposed guidance? Do you believe that additional guidance is needed? If so, please specify what the guidance should include.

According to paragraph 4.54, reporting the substance of contractual rights and contractual obligations must take into account terms implied by statute. We note that this is consistent with the approach taken in IFRIC 2 but not, for instance, the treatment of write down bonds in example E in B4.1.13 of IFRS 9. It is also not consistent with how ordinary shares are classified in jurisdictions which imposes a minimum dividend rate by statute. This paragraph highlights that there is an inconsistency that needs to be resolved.

Our members agree that the Framework should incorporate the principle of IAS 39 IGC B6, to consider a group of contracts as a whole, as set out in paragraph 4.56. They believe that this should have been included in IFRS 9.

Our members also agree with the inclusion of the reverse notion in the same paragraph, i.e., that a single contract may need to be accounted for as more than one unit of account when it creates two or more sets of rights and obligations that would have been identical if each set had been created through separate contracts. However, they question how consistent this is with the classification of financial assets in IFRS 9, where the unit of account is always the whole financial asset. Use of more than one unit of account could, in some situations, be equivalent to the separation of an embedded derivative.

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?

Our members agree with the proposed approach.

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?

Our members agree with the point made in paragraph 5.30 (b) that derecognition of an asset may misrepresent an entity’s financial position if at the same time as transferring an asset the entity enters into a forward contract, a written put or a purchased call option. This would be consistent with the risks and rewards-based approach set out in IAS 39, according to which repurchase contracts (‘repos’) are accounted for as collateralized loans. Our members believe that a risks and rewards based approach to derecognition is superior to one based on control.

However we disagree with the logic set out in that paragraph, that derecognition may misrepresent the extent of change in the entity's financial position "because the component that has been transferred must or may be reacquired". We note that it is possible for an entity to be obliged to reacquire an asset without being exposed to the risks and rewards of ownership (for instance if the repurchase must be at fair value) while, conversely, it is possible for an entity to retain exposure to the risks and rewards of an asset without being required to reacquire it (for instance if it enters into a total return swap). The Framework should be adjusted to reflect this, by explicitly introducing a principle of risks and rewards alongside that of control. It should recognize the potential conflict between the two principles, but that resolution of this conflict is best addressed at the standard level.

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?

Our members agree with the identification of the measurement bases and the way that they are described, except that the binary distinction between historical cost and current value does not fully reflect the manner in which assets are measured under IFRS. First, although it is not clear whether equity accounting is a method of measurement (as opposed to partial consolidation), if it is viewed as the former then it lies somewhere between historical cost and current value. Similarly, the requirement in IAS39 and IFRS 9 to base the effective interest rate on estimations of expected future cash flows and the revision of the amortised cost to reflect changes in those estimates, plus the introduction in IFRS 9 of an expected credit loss model, mean that amortised cost also now lies somewhere between a historical cost and a current value measurement basis. The Board may wish to adjust the revised Conceptual Framework to describe better the possible methods of measurement.

Nevertheless, as they have stated before, our members believe that a mixed measurement model is the appropriate way to account for financial instruments.

Our members do not agree with the treatment of transaction costs as set out in paragraph 6.26. They have on various occasions sought to explain to the Board that bid-ask spreads that would be charged if an asset is sold or transferred to a market participant are just one form of transaction costs and that IFRS 13 is inconsistent in requiring bid-ask spreads to be reflected in the fair value of financial instruments but not any other costs that would need to be incurred to sell or transfer them. Whether an entity is charged a bid-ask spread or a commission, or a mixture of the two, varies with the conventions of a particular market and the practice of the dealer. There would appear to be no conceptual basis for the distinction in accounting treatment or for not including transaction costs to sell in determining an exit price.

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?

While the ED usefully sets out the various types of measurement and the factors to be taken into account in selecting them, it provides little in the way of guidance on the subject. The Conceptual Framework should provide a better linkage between the various measurement bases and the identified factors and what priority to give the various factors in different situations, especially when they give conflicting indications.

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?

The majority of our members disagree with the approach set out in paragraphs 6.74 to 6.77 of the ED. They accepted reintroduction by the IASB in IFRS 9 of fair value through OCI for debt instruments as a compromise solution, because it provides more useful information than fair value through profit or loss for those instruments. However, for financial assets that are both held to receive contractual cash flows and for sale (and so are not primarily held to realise fair value gains and losses) they would have preferred the use of amortised cost on the face of the statement of financial position as well as the profit or loss account. It is misleading to report fair value gains and losses, even in OCI, which are unlikely to be realised through sale, while the continued use of fair value through OCI for debt instruments was a missed opportunity to simplify their accounting. Our members agree that fair value information is useful for financial instruments that are not held for trading or managed on a fair value basis, but it is best given through the notes to the financial statements.

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?

Our members agree with the proposals in the ED. However, they believe the Framework should contain a high level discussion of factors to consider when deciding what information to present on the face of the financial statements as opposed to be disclosed in the notes.

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.

Our members agree with the description of profit or loss and that profit or loss is the primary source of information about financial performance.

They believe that most items of income and expenses should be included in profit or loss, but not that this should be a rebuttable presumption. Instead, the Board should seek to find a conceptual basis for what is reported in profit or loss and what is reported in OCI. This inevitably means seeking to define 'performance' more clearly than is set out in the ED. The Board is encouraged to seek to make use of the thinking of the FASB on this topic.

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?

Our members believe that the Board should seek a conceptual basis for the use of OCI.

Our members do not agree with the view of Messrs Cooper and Finnegan, that a better approach would be to replace the use of OCI with disaggregation within the profit or loss account. As already set out earlier, the majority of our members believe that debt financial assets which are required by IFRS 9 to be recorded at fair value through OCI would better be recorded at amortised cost. They also believe that other uses of OCI, such as for cash flow hedge accounting or to capture foreign currency revaluations of net investments, would be better served by keeping the current accounting approach rather than by disaggregation within the profit or loss account.

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?

Our members agree that profit or loss is the primary measure of performance and, to the extent that gains and losses are recorded in OCI, they should eventually be recycled to profit or loss. This should be more than a rebuttable presumption. While the Board may decide to choose not to follow the Framework when developing a standard, this should be viewed as a departure from the Framework rather than the rebuttal of a presumption.

Our members disagree with the requirement in IFRS 9 that gains and losses due to changes in own credit risk on liabilities recorded at fair value using the fair value option should never be recycled to profit or loss, if the liabilities are transferred or settled at fair value and the gains or losses are actually realised. Moreover, the Conceptual Framework should not attempt to justify the non-recycling of gains and losses on equity securities, as set out in in IFRS 9, which was arrived at for pragmatic rather than conceptual reasons.

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?

Our members agree that changes to the framework should not automatically result in any changes in standards.

Question 16 – Business activities

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

While our members agree that the business model has a role to play in helping to define performance, they do not agree with how it was applied in IFRS 9 and note that different parties have different views as to what 'the business model' actually means and how it should be used. They have no desire to reopen IFRS 9, but note that the idea of the business model would need more analysis and debate if it were to play a more central conceptual role. It is therefore premature to include this notion in the Conceptual Framework.

Question 17 - Long term investment

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

Our members believe that the ED provides sufficient guidance on how to reflect long-term investment business models and contains sufficient and appropriate discussion of primary users and their information needs. The accounting should reflect the 'performance' of the entity but, once this is achieved, there should be no need to give any further special significance to long term investment.

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.

When the IASB published its Discussion Paper on Dynamic Risk Management, the concern was expressed that the idea of hedging changes in the fair value of an entity's equity would require modification of the Conceptual Framework. Our members agree that that the Conceptual Framework need not be modified at this time in this manner, but would not want future progress on the accounting for macro hedging activities to be constrained by what is written in the Framework.