STAFF PAPER

September 2016

IASB Meeting

Project	**Conceptual Framework**		
Paper topic	Asymmetry in treating gains and losses		

CONTACT(S)	Jelena Voilo	jvoilo@ifrs.org	+44 (0)20 7246 6914
	Anne McGeachin	amcgeachin@ifrs.org	+44 (0)20 7246 6486

Purpose of paper

1. In May 2016, the Board tentatively decided to confirm its proposal in the Exposure Draft *Conceptual Framework for Financial Reporting* (the Exposure Draft) that the revised *Conceptual Framework* should include a reference to prudence described as the exercise of caution when making judgements under conditions of uncertainty. At the same meeting the Board rejected the notion of 'asymmetric prudence' which would require more persuasive evidence to support the recognition of gains than losses (asymmetry) in all circumstances.

2. In addition, the Board directed the staff to explore further whether and how the revised *Conceptual Framework* should acknowledge that asymmetric treatment of gains (or assets) and losses (or liabilities) could be selected if such selection is intended to result in relevant information that faithfully represents what it purports to represent.

3. This paper discusses whether and if so how the revised *Conceptual Framework* should acknowledge that gains can be treated differently to losses and assets differently to liabilities.

Summary of staff recommendation

4. The staff recommend:

(a) expanding the description of neutrality in the revised *Conceptual Framework* to clarify that achieving neutrality does not imply that uniform financial reporting requirements must be set for all economic phenomena. For example, it does not necessarily imply setting the same requirements for recognition of income as for expenses; and

(b) expanding the description of prudence in the revised *Conceptual Framework* to clarify that the exercise of prudence does not imply that it is necessary to have different financial reporting requirements for income than for expenses and for assets than for liabilities.

Structure of paper

5. This paper is structured as follows:

(a) background (paragraphs 6–11);

(b) staff analysis (paragraphs 12–29):

(i) what was the approach to asymmetry in the Exposure Draft? (paragraphs 12–17);

(ii) addressing respondents' concerns:

(1) why do respondents call for an explicit acknowledgement? (paragraph 18);

(2) explaining the link with neutrality (paragraphs 19–25); and

(3) avoiding misinterpretation of asymmetry (paragraphs 26–29);

(c) appendix— the relevant extract from the Basis for Conclusions on Chapter 2—*Qualitative characteristics of useful financial information* of the Exposure Draft.

Background

6. In the Exposure Draft, the Board proposed to include in the revised *Conceptual Framework* an explicit reference to the notion of prudence. The notion of prudence

was linked to the discussion of neutrality (changes proposed in the Exposure Draft are shown in mark-up):

> 2.17. A neutral depiction is without bias in the selection or presentation of financial information. A neutral depiction is not slanted, weighted, emphasised, de-emphasised or otherwise manipulated to increase the probability that financial information will be received favourably or unfavourably by users. Neutral information does not mean information with no purpose or no influence on behaviour. On the contrary, relevant financial information is, by definition, capable of making a difference in users' decisions.
>
> <u>2.18. Neutrality is supported by the exercise of prudence. Prudence is the exercise of caution when making judgements under conditions of uncertainty. The exercise of prudence means that assets and income are not overstated and liabilities and expenses are not understated. Equally, the exercise of prudence does not allow for the understatement of assets and income or the overstatement of liabilities and expenses, because such mis-statements can lead to the overstatement of income or the understatement of expenses in future periods.</u>

7. In the Basis for Conclusions on the Exposure Draft, the Board described this notion of prudence as 'cautious prudence'. In the Basis for Conclusions the Board:

   (a) noted that 'cautious prudence' is different from 'asymmetric prudence'. Asymmetric prudence requires asymmetry in the treatment of gains and losses. There is a range of views on how to achieve such asymmetry, and to what extent it should be applied in accounting. Most commonly, asymmetry is associated with:

      (i) recognising losses earlier than gains; and

      (ii) selecting a measurement basis that allows for recognition of unrealised losses but does not allow for the recognition of unrealised gains (ie historical cost).

(b) noted that the Exposure Draft proposes the introduction of a reference to cautious prudence and explained why the Board considers that cautious prudence can help achieve neutrality in applying accounting policies.

(c) rejected asymmetric prudence as a necessary characteristic of useful financial information but explained that in some cases, when it is intended to result in relevant information that faithfully represents what it purports to represent, accounting policies that treat gains and losses asymmetrically could be selected in accordance with the proposals in the Exposure Draft.

The relevant extract from the Basis for Conclusions is provided in the appendix.

8. The explanation referred to in paragraph 7(c) attracted comments from respondents to the Exposure Draft. Around a third of those who supported the reintroduction of prudence, including national standard setters, accountancy bodies, accounting firms, regulators and user groups, expressed a view that it is important for the revised *Conceptual Framework* to acknowledge the possibility of selecting accounting policies that treat gains and losses asymmetrically. They thought that in the Exposure Draft this acknowledgement was not visible enough and suggested moving some of the material from the Basis for Conclusions into the main text of the *Conceptual Framework.*

9. These respondents agreed that there is no need for asymmetric treatment of gains and losses in all cases. In fact, some of these respondents strongly objected to asymmetry being an overarching concept. However, they asked for the revised *Conceptual Framework* to acknowledge that accounting policies that treat gains and losses asymmetrically could be selected if such selection is intended to result in a faithful representation of relevant information.

10. In their comment letters these respondents argued that:

(a) asymmetry is inherent in many IFRS Standards and the revised *Conceptual Framework* should contain a concept justifying such asymmetry;

(b) acknowledging the possibility of asymmetry and explaining the constraints on selecting asymmetric accounting policies would contribute to consistent application of the notion in IFRS Standards; and

(c) the fact that asymmetric policies would only be selected in some cases should not lead to the omission of the discussion of possible asymmetry from the revised *Conceptual Framework*.

11. On the other hand, a few respondents found the discussion of asymmetric prudence and possible asymmetry in selecting accounting policies in the Basis for Conclusions confusing and said it would create uncertainty about the role of prudence in financial reporting. They argued that the acknowledgement of possible asymmetry could be misinterpreted as leading to a conservative bias in recognition or imply that historical cost would be the preferred measurement basis.

Staff analysis

What was the approach to asymmetry in the Exposure Draft?

12. The Board included the discussion of asymmetry in the Basis for Conclusions on Chapter 2 of the Exposure Draft to help distinguish cautious prudence and asymmetric prudence. Its purpose was to explain which notion of prudence is being introduced in the revised *Conceptual Framework*.

13. The rest of the Exposure Draft did not discuss symmetry or asymmetry in accounting treatments. Rather, it explained that decisions throughout the financial reporting process should be based on satisfying the fundamental qualitative characteristics of useful financial information—relevance and faithful representation—to achieve the objective of financial reporting.

14. For example, the Exposure Draft already makes it clear that recognition requirements and selection of a measurement basis depend upon facts and circumstances and may need to differ for different assets, liabilities, income and expenses (paragraphs 5.9–5.10 and 6.48–6.49 of the Exposure Draft respectively). Decisions on both recognition and measurement are based on the usefulness of the resulting information to users. As explained in the Basis for Conclusions (paragraphs BC5.45 and BC6.57),

the proposals in the Exposure Draft do not require either symmetry or asymmetry in the treatment of income compared to expenses or assets compared to liabilities.[1]

15. Accordingly, the proposals in the Exposure Draft already allow income to be treated differently to expenses, and assets to be treated differently to liabilities, as long as the decision to require such treatment is based on the usefulness of the resulting information.

16. However, these proposals did not seem to provide enough assurance to some respondents as they asked for a more visible acknowledgement that it will still be possible to develop financial reporting requirements that treat income and expenses (or assets and liabilities) differently when the revised *Conceptual Framework* is issued.

17. The Board could include in the main text of the revised *Conceptual Framework* an explicit statement that financial reporting requirements that treat gains and losses asymmetrically could be selected if such selection is intended to result in relevant information that faithfully represents what it purports to represent. However, including such a statement in the revised *Conceptual Framework* in isolation without the supporting explanation that is currently included in the Basis for Conclusions may not be easily understandable to future users of the *Conceptual Framework*. The staff suggest it would be more useful to explore and address the cause of respondents' concerns (see the next section).

Addressing respondents' concerns

Why do respondents call for an explicit acknowledgement?

18. The staff think that the calls for an explicit acknowledgement of asymmetry stem largely from the fact that the notion of prudence is introduced as supporting the notion of neutrality. Some respondents seemed to imply that the absence of such an acknowledgement means that, to be neutral, gains should be treated in the same way as losses and assets as liabilities. They argued that there is a tension between the notions of neutrality and prudence because they associate neutrality with:

[1] In July 2016 the Board confirmed the Exposure Draft proposals on recognition. The proposals for the measurement chapter will be discussed at the next Board meeting.

(a) symmetry in recognition of gains and losses;

(b) a need to recognise all assets and liabilities; and/ or

(c) a preference for fair value measurement.

Explaining the link with neutrality

19. In the Basis for Conclusions on the Exposure Draft the Board explained its understanding of the link between asymmetry, prudence and neutrality. It explained that neutral accounting policies should not attempt to bias users' views and that the selection of neutral accounting policies:

(a) does not require an entity to recognise the value of the entire entity in the statement of financial position;

(b) does not require the measurement of all assets and liabilities at a current value;

(c) does not prohibit impairment tests on assets measured at historical cost; and

(d) does not require the recognition of all assets and liabilities (see full text in paragraphs BC2.12–BC2.13 in the appendix).

20. This explanation in the Basis for Conclusions seems to have been overlooked or misunderstood. Some respondents continue to associate neutrality with the requirement for symmetry in treating gains and losses.

21. The general definition of neutrality in the Oxford Dictionaries Online is:

> 1. the state of not supporting or helping either side in a conflict, disagreement, etc.; impartiality;
>
> 2. absence of decided views, expression, or strong feeling.

Impartiality, lack of bias, lack of prejudice and objectivity are suggested as synonyms for the word.[2]

22. Similarly, the definition of a neutral depiction in the Exposure Draft (which has been carried forward from the existing *Conceptual Framework*) is based on impartiality,

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[2] See http://www.oxforddictionaries.com/definition/english/neutrality.

lack of bias or manipulation and objectivity. In 2010 in the Basis for Conclusions on the existing *Conceptual Framework* the Board explained:

> BC3.29 […] The Board does not attempt to encourage or predict specific actions of users. If financial information is biased in a way that encourages users to take or avoid predetermined actions, that information is not neutral.

23. When applying the description of neutrality as set out in the existing *Conceptual Framework*, achieving neutrality does not require a uniform, or symmetrical, treatment of all economic phenomena. The staff suggest it would be helpful to emphasise this in the revised *Conceptual Framework*. While it would mean a change to the wording of Chapter 2 that was issued jointly with the Financial Accounting Standards Board[3], we believe that such clarification would be helpful in achieving a consistent understanding of the notion of neutrality and its relationship with prudence. We think it would be more helpful than including an explicit acknowledgement of possible asymmetry in selecting financial reporting requirements.

24. Accordingly, the staff recommend including the following clarification in paragraph 2.17 of the revised *Conceptual Framework* (proposed changes are underlined):

> A neutral depiction is without bias in the selection or presentation of financial information. A neutral depiction is not slanted, weighted, emphasised, de-emphasised or otherwise manipulated to increase the probability that financial information will be received favourably or unfavourably by users. <u>Achieving neutrality does not imply that uniform financial reporting requirements must be set for all economic phenomena. For example, it does not necessarily imply setting the same requirements for recognition of income as for expenses.</u> Neutral information does not mean information with no purpose or no influence on behaviour. On the contrary, relevant financial information is, by definition, capable of making a difference in users' decisions.

25. The proposed clarification in the main text of the revised *Conceptual Framework* will be supported by an explanation in the Basis for Conclusions. It will:

[3] See the FASB's Concept Statement No 8 *Conceptual Framework for Financial Reporting—Chapter 3,* Qualitative Characteristics of Useful Financial Information.

(a) explain that the clarification is made to achieve a common understanding of the notion of neutrality;

(b) explain that neutrality does not preclude financial reporting requirements that treat income and expenses or assets and liabilities differently if their selection is intended to result in relevant information that faithfully represents what it purports to represent;

(c) retain the explanation referred to in paragraph 19 above.

Question 1—clarifying the notion of neutrality
Do you agree that the description of neutrality in the revised *Conceptual Framework* should be expanded to clarify that achieving neutrality does not imply that uniform financial reporting requirements must be set for all economic phenomena? For example, it does not necessarily imply setting the same requirements for recognition of income as for expenses.

Avoiding misinterpretation of asymmetry

26. As noted in paragraph 11, some respondents expressed a concern that including an explicit statement on asymmetry in the revised *Conceptual Framework* could be misinterpreted as leading to a conservative bias. These respondents argued that such inclusion in the *Conceptual Framework* of a statement that gains and losses can be treated differently may be misinterpreted by some as an introduction of the version of prudence that was referred to as 'asymmetric prudence' in the Basis for Conclusions on the Exposure Draft.

27. The staff propose that the most effective way to address this concern would be to state explicitly in the revised *Conceptual Framework* that exercising prudence does not imply that it is necessary to have different financial reporting requirements for income than for expenses and for assets than for liabilities.

28. Such clarification would emphasise that while sometimes financial reporting requirements that treat gains and losses differently may be selected, this will not always be the case.

29. Consequently, the staff recommend adding the following wording to the description of prudence proposed in the Exposure Draft (recommended changes are underlined):

2.18. Neutrality is supported by the exercise of prudence. Prudence is the exercise of caution when making judgements under conditions of uncertainty. The exercise of prudence means that assets and income are not overstated and liabilities and expenses are not understated. Equally, the exercise of prudence does not allow for the understatement of assets and income or the overstatement of liabilities and expenses, because such mis-statements can lead to the overstatement of income or the understatement of expenses in future periods. <u>Moreover, the exercise of prudence does not imply that it is necessary to have different financial reporting requirements for income than for expenses and for assets than for liabilities.</u>

Question 2—avoiding misinterpretation as conservative bias

Do you agree that the description of prudence in the revised *Conceptual Framework* should be expanded to clarify that the exercise of prudence does not imply that it is necessary to have different financial reporting requirements for income than for expenses and for assets than for liabilities?

Appendix—Extract from the Basis for Conclusions on the Exposure Draft

BC2.6 Having considered how interested parties have interpreted the removal of the term 'prudence' in 2010, and the responses to the Discussion Paper, the IASB noted that prudence is a term used by different people to mean different things. In particular:

(a) some use it to refer to a need to be cautious when making judgements under conditions of uncertainty, but without needing to be more cautious in judgements relating to gains and assets than for those relating to losses and liabilities ('cautious prudence'—see paragraphs BC2.9–BC2.10).

(b) others use it to refer to a need for asymmetry: losses are recognised at an earlier stage than gains are ('asymmetric prudence'—see paragraphs BC2.11–BC2.15). There is a range of views on how to achieve such asymmetry, and to what extent. For example, some advocate a concept of prudence that would:

   (i) require more persuasive evidence to support the recognition of gains (or assets) than of losses (or liabilities); or

   (ii) require the selection of measurement bases that include losses at an earlier stage than gains.

BC2.7 An understanding of prudence and its different interpretations is linked to an understanding of the term 'neutrality'. The IASB has identified two aspects of neutrality:

(a) selection of neutral accounting policies: selecting accounting policies in order to provide relevant information that faithfully represents the items that it purports to depict. A faithful representation requires, among other things, that the depiction is neutral, ie not 'slanted, weighted, emphasised, de-emphasised or otherwise manipulated to increase the probability that financial information will be received favourably or unfavourably by users';[4] and

(b) neutral application of accounting policies: applying the selected accounting policies in a neutral (unbiased) manner.

BC2.8 The IASB continues to believe that both of these aspects of neutrality make financial information more useful. The relationship between cautious prudence and the neutral application of accounting policies is discussed in paragraphs BC2.9–BC2.10. The relationship between asymmetric prudence and the selection of neutral accounting policies is discussed in paragraphs BC2.11–BC2.15.

Cautious prudence

BC2.9 The IASB considers that prudence (defined as the exercise of caution when making judgements under conditions of uncertainty) can help achieve neutrality in applying accounting policies (the aspect of neutrality described in paragraph BC2.7(b)). Thus, cautious prudence is a factor in giving a faithful representation of assets, liabilities, equity, income and expenses. Setting out that message clearly in the *Conceptual Framework* can be expected to:

(a) help preparers, auditors and regulators counter a natural bias that management may have towards optimism; for example, it would point to the need to exercise care in selecting the inputs used in estimating a measure that cannot be observed directly; and

(b) help the IASB to develop rigorous Standards that could counteract any bias by management in applying the reporting entity's accounting policies.

BC2.10 Therefore the IASB, in paragraph 2.18 of the Exposure Draft, proposes to reintroduce the term prudence, defined as cautious prudence, in the *Conceptual Framework*. It notes that the removal of the term prudence in the 2010 revisions led to confusion and perhaps has exacerbated the diversity in usage of this term. People continue to use the term, but do not always say clearly what they mean. In addition, some have claimed that, because the term was removed, financial information prepared using IFRS is not neutral but is in fact imprudent. The IASB thinks that reintroducing the term with a clear

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4 See Paragraph 2.17 of the Exposure Draft (paragraph QC14 of the existing *Conceptual Framework*).

explanation that caution works both ways (so that assets and liabilities are neither overstated nor understated) will reduce the confusion.

Asymmetric prudence

BC2.11 Some argue that asymmetric prudence is a necessary characteristic of useful financial information and that prudence cannot be consistent with neutrality. The IASB disagrees with this view. However, the IASB also thinks that not all asymmetry is inconsistent with neutrality.

BC2.12 The selection of neutral accounting policies means selecting accounting policies in a manner that is not intended to increase the probability that financial information will be received favourably or unfavourably by users.

BC2.13 The selection of neutral accounting policies, contrary to fears sometimes expressed:

(a) does not require an entity to recognise the value of the entire entity in the statement of financial position. Paragraph 1.7 of the Exposure Draft states that general purpose financial reports are not designed to show the value of a reporting entity.[5]

(b) does not require the measurement of all assets and liabilities at a current value. Indeed, the proposals in Chapter 6 of the Exposure Draft would not lead to such a requirement.

(c) does not prohibit impairment tests on assets measured at historical cost. Measurement at historical cost (including an impairment test) is consistent with neutrality if that measurement basis is selected without bias; in other words, without slanting, weighting, emphasising, de-emphasising or otherwise manipulating information to increase the probability that it will be received favourably or unfavourably by users.

(d) does not require the recognition of all assets and liabilities. Chapter 5 of the Exposure Draft discusses recognition criteria for assets and liabilities.

BC2.14 Hence, accounting policies that treat gains and losses asymmetrically could be selected in accordance with the proposals in the Exposure Draft if their selection is intended to result in relevant information that faithfully represents what it purports to represent. Such an approach is reflected in many existing Standards, for example IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* requires different recognition thresholds for contingent liabilities and contingent assets. However, the IASB thinks that the *Conceptual Framework* should not identify asymmetric prudence as a necessary characteristic of useful financial information. In particular, the IASB rejects the following approaches that some argue would follow from a requirement to apply asymmetric prudence in all circumstances:

(a) prohibiting the recognition of all unrealised gains. In some circumstances, for example, the measurement of many financial instruments, the recognition of unrealised gains is necessary to provide relevant information to users of financial reports.

(b) prohibiting the recognition of unrealised gains not supported by observable market prices. In some circumstances, measuring an asset or a liability at a current value (which may require the recognition of unrealised gains) provides relevant information to users of financial reports even if the current value must be estimated.

(c) permitting an entity to measure an asset at an amount that is less than an unbiased estimate using the measurement basis selected for that asset or to measure a liability at more than such an amount. Such an approach cannot result in relevant information and cannot provide a faithful representation.

BC2.15 In addition, the IASB notes that if it were to introduce asymmetric prudence, it would need to consider how much bias is appropriate.

[5] Paragraph OB7 of the existing *Conceptual Framework* makes the same statement.