

STAFF PAPER

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Project	Conceptual Framework		
Paper topic	Asymmetry in treating gains and losses		
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Purpose of paper

1. In September 2016 the Board tentatively decided that the main body of the revised *Conceptual Framework* should acknowledge that, in some cases, income may need to be treated differently from expenses and assets differently from liabilities. The Board directed the staff to develop the wording for such an acknowledgement for discussion at a future Board meeting. This paper proposes the wording for the acknowledgement.

Structure of paper

2. This paper is structured as follows:
 - (a) background (paragraphs 3–11);
 - (b) staff analysis:
 - (i) acknowledgement in Chapter 2 (paragraphs 13–15);
 - (ii) acknowledgement in the recognition and/or measurement chapters (paragraphs 16–23);
 - (c) staff recommendation and question for the Board (paragraphs 24–25); and

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

Background

3. In the Exposure Draft *Conceptual Framework for Financial Reporting* (the Exposure Draft), the Board proposed to include in the revised *Conceptual Framework* an explicit reference to the notion of prudence:

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.

4. In the Basis for Conclusions on the Exposure Draft, the Board described this notion of prudence as ‘cautious prudence’ and:

- (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.

5. In May 2016, the Board tentatively decided to confirm its proposal in 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’.
6. In September 2016, the Board discussed whether the revised *Conceptual Framework* should acknowledge the possibility of selecting accounting policies that treat gains and losses asymmetrically¹. This suggestion was made by some respondents, many of them from Europe, who 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*.
7. A few respondents suggested that the possibility of selecting asymmetric accounting policies could be discussed in other relevant chapters of the *Conceptual Framework* (Chapter 5—*Recognition and derecognition* and/or Chapter 6—*Measurement*) instead of in Chapter 2.
8. The respondents who asked for the acknowledgement 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.

¹ See September 2016 [Agenda Paper 10D Asymmetry in treating gains and losses](#).

9. 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*.
10. 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.
11. In September 2016 the Board tentatively decided that the main body of the revised *Conceptual Framework* should acknowledge that, in some cases, income may be treated differently from expenses and assets differently from liabilities. This paper proposes the wording for such an acknowledgement.

Staff analysis

12. The staff have identified two options for including the acknowledgement of possible asymmetry into the main body of the revised *Conceptual Framework*, ie including it:
 - (a) in Chapter 2 (paragraphs 13–15); and/or
 - (b) in the recognition and/or measurement chapters (paragraphs 16–23).

Acknowledgement in Chapter 2

13. Most of those who asked for an explicit acknowledgement of possible asymmetry suggested that it should be based on the explanation in the Basis for Conclusions on

Chapter 2 of the Exposure Draft with some of the material being moved from the Basis to the main body of the revised *Conceptual Framework*.

14. Although this would mean a further change to the wording in Chapter 2 that was issued jointly with the Financial Accounting Standards Board², the benefits of including such an acknowledgement in Chapter 2 are:
 - (a) it would help clarify the distinction between prudence and asymmetry and emphasise that asymmetric treatment of assets and liabilities (or income and expenses) can be selected only when it is necessary to provide a faithful representation of relevant information;
 - (b) it could include a high-level description of the term asymmetry that will be further supported by an explanation similar to that included in the Basis for Conclusions on Chapter 2 of the Exposure Draft (see the appendix);
 - (c) as Chapter 2 applies to financial reporting in general, including the acknowledgement there would explain that in some cases assets and liabilities (or income and expenses) may be treated asymmetrically at different stages of the financial reporting process. For example, respondents to the Exposure Draft and academic papers refer to asymmetry in recognition, measurement and presentation and disclosure. Chapter 2 can set out the discussion of asymmetry that, if necessary, can be referred back to in later chapters of the revised *Conceptual Framework*, or when developing Standards.
15. The acknowledgement could be included in Chapter 2 after paragraph 2.18 on prudence as follows:

2.18A The exercise of prudence does not imply a need for asymmetry, eg more persuasive evidence to support the recognition of assets than of liabilities or of income than of expenses. Nevertheless, such asymmetry may sometimes arise as a consequence of providing relevant information that faithfully represents what it purports to represent.

² See the FASB's Concept Statement No 8 *Conceptual Framework for Financial Reporting—Chapter 3, Qualitative Characteristics of Useful Financial Information*.

Acknowledgement in the recognition and/or measurement chapters

16. As noted in September 2016 Agenda Paper 10D *Asymmetry in treating gains and losses* the discussion of asymmetry in the Basis for Conclusions on Chapter 2 of the Exposure Draft was included to help distinguish cautious prudence and asymmetric prudence. The rest of the Exposure Draft did not directly 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.
17. Paragraphs 5.9–5.10, 6.3 and 6.48–6.49 of the Exposure Draft already make 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. However, the guidance on recognition and measurement in the Exposure Draft does not refer specifically to asymmetry.
18. A few respondents to the Exposure Draft suggested that the possibility of selecting asymmetric accounting policies could be discussed in the recognition and/or measurement chapters.

Possible asymmetry in the recognition chapter

19. Asymmetry is most commonly associated with recognising losses earlier than gains (see paragraph 4(a)), so it could be useful to include a more prominent observation on the role of asymmetry in the recognition chapter of the revised *Conceptual Framework*. Discussing possible asymmetry in the context of the requirement to provide a faithful representation of relevant information would help ensure that the main aim is to provide useful—rather than symmetric or asymmetric—financial information.
20. An acknowledgement of possible asymmetry that could be included in the recognition chapter is as follows (changes from the Exposure Draft are marked-up):
 - 5.10 It is not possible to define precisely when recognition of an item that meets the definition of an element will provide useful information to the users of financial statements. What is useful to users depends on the item and the

specific facts and circumstances. Consequently, judgement is required when deciding whether to recognise an item and recognition requirements may ~~need to~~ vary between Standards, or for different items within a Standard. In particular, different recognition requirements may be selected for assets than for liabilities and for income than for expenses, if such selection is necessary to provide relevant information that faithfully represents what it purports to represent.

Possible asymmetry in the measurement chapter

21. As noted in paragraph BC2.6(b)(ii) of the Basis for Conclusions on the Exposure Draft, in terms of measurement, asymmetry is most commonly associated with the selection of measurement bases that include losses at an earlier stage than gains. It is clear from the responses to the Exposure Draft, as well as from academic literature, that many view historical cost as an example of asymmetry in financial reporting.
22. The main concern of respondents to the Exposure Draft who asked for an explicit acknowledgement of asymmetry was that without such an acknowledgement it would not be possible for the Board to select what those respondents consider to be an asymmetric measurement basis (ie historical cost) when developing Standards. On the other hand, there were those who were concerned that the introduction of prudence into the *Conceptual Framework* could be misinterpreted as a systematic preference for historical cost. Both sets of respondents wanted reassurance that when developing Standards it will still be necessary for the Board to select the most relevant measurement basis that can be faithfully represented.
23. The staff think that both the proposals in the Exposure Draft and staff proposals for the revised *Conceptual Framework*³ already make it clear that the Board has no preference for any measurement basis. They set out both historical cost and current value measurement bases on an equal footing, and state that the consideration of the objective of financial reporting, the qualitative characteristics of useful financial information and the cost constraint is likely to result in the selection of different measurement bases for different assets and liabilities.

³ See September 2016 [Agenda Paper 10H Measurement: suggested redraft of parts of Chapter 6](#) which was discussed at the Education Session.

Staff recommendation and question for the Board

24. The staff recommend including the acknowledgement of possible asymmetry both in Chapter 2 and the recognition chapter:
- (a) The acknowledgement in Chapter 2 would reassure constituents that the introduction of prudence in the revised *Conceptual Framework* will not lead to systematic asymmetry in treating assets and liabilities (or income and expenses). It would also respond to those who want the revised *Conceptual Framework* to acknowledge that asymmetry can arise in Standards but only as a consequence of providing the most useful information to users. Such an acknowledgement in Chapter 2 would also provide a useful reference point for discussion in later chapters and in the Basis for Conclusions, or when developing Standards in future.
 - (b) The acknowledgement in the recognition chapter would address the issue of asymmetry in the area where it most often arises. It would help reassure constituents that the Board will be able to develop asymmetric recognition requirements for assets and liabilities (or income and expenses) if it is necessary to provide a faithful representation of relevant information.
25. The staff suggest that no changes are needed to the measurement chapter in relation to the issue of asymmetry because the measurement chapter is already clear that there is no preference for any measurement basis. If the Board decides to include the acknowledgement of possible asymmetry as suggested in paragraph 24(a), that could further reassure constituents that there will be no systematic preference for a particular measurement basis when developing Standards.

Question to the Board

Do you agree with the staff recommendation to acknowledge:

(a) in Chapter 2 of the revised *Conceptual Framework*—that the exercise of prudence does not imply a need for asymmetry, eg more persuasive evidence to support the recognition of assets than of liabilities or of income than of expenses. Nevertheless, such asymmetry may sometimes arise as a consequence of providing relevant information that faithfully represents what it purports to represent; and

(b) in the recognition chapter—that different recognition requirements may be selected for assets than for liabilities and for income than for expenses, if such selection is necessary to provide relevant information that faithfully represents what it purports to represent?

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

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.