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Discussion Paper on Preliminary Views– Improved Conceptual Framework for Financial Reporting: The Objective of Financial Reporting and Qualitative Characteristics of Decision-Useful Financial Reporting Information

Dear Ms. Lian:

We are pleased to comment on the *Discussion Paper Preliminary Views on an improved Conceptual Framework for Financial Reporting: Objective of Financial Reporting and Qualitative Characteristics of Decision-Useful Financial Reporting Information* (the "DP" or the "proposed framework").

As we have indicated in previous letters, we support global convergence around high quality accounting standards. As such, we commend the Boards on their efforts to develop a high-quality conceptual framework that will be applied globally.

Although we agree with many of the provisions set forth in the proposed framework, we have concerns relating to certain provisions included in the DP. In this regard we have provided recommendations concerning specific provisions proposed for the conceptual framework. In addition, we have noted that the DP includes certain statements or assertions for items for which the debate has not yet taken place. As a result, as other phases of this project progress, our views for these two chapters may continue to evolve.

We encourage the Boards to develop a graphical illustration of the qualitative characteristics described in the proposed framework to assist users in understanding the different aspects of the framework. This illustration could be similar to that provided in Figure 1 of FASB Concepts Statement No. 2. The Boards also should provide a graphical depiction of the GAAP Hierarchy that clearly indicates the authoritative status of the Conceptual Framework relative to other authoritative standards and interpretations.

The Objective of Financial Reporting

Stewardship

The DP suggests that stewardship solely relates to providing information to assist in an assessment of the competence and integrity of 'stewards' (i.e. management, directors). This does not reflect the meaning of stewardship suggested in the current IFRS framework, which highlights the fact that management, in addition to having the responsibility for allocation of the assets entrusted to it for the benefit of shareholders, also has an obligation to provide its shareholders with an account of what it has done with those assets. This account has to be a faithful and complete historic description of the entity's assets and liabilities at the beginning and end of the accounting period, coupled with management's explanation of how those balances changed during the period. Recognizing this broader meaning of 'stewardship' as one of the primary objectives of financial reporting both supports all of the qualitative characteristics of financial reporting information proposed in the DP, and helps to align management's behaviour with the objectives of all of the entity's stakeholders. Such a stewardship objective will emphasize the role of financial reporting as a dialogue between management and the owners of the business. To satisfy this aspect of a stewardship objective of financial reporting, management, as preparers of financial reporting information, will provide a summary in the financial statements of past transactions and their economic impact on the entity, and, in doing so, will appropriately carry out its role not only as overseers of the business but also as the communicators of the entity's performance to existing and potential owners of the entity, investors and stakeholders.

Paragraph 14 of the current IFRS Framework highlights that one purpose of financial reporting is to provide existing shareholders with the information they need to make decisions as owners of the business. These decisions may go beyond a simple question of whether to buy or sell an interest in the entity and may include whether to exercise a right, as an owner of the entity, to change the direction of the business, or its management. De-emphasis of the stewardship objective in favour of a focus on the ability of an entity to generate net cash inflows, as currently contemplated in the DP, may result in an entity's owners having insufficient information to make these types of decisions. Nowhere does the proposed framework clearly identify the reporting of information about past transactions as a central feature of financial statements which seems inconsistent with the historical nature of financial statements. Elevating stewardship to the same level as decision-usefulness will ensure that sufficient information about an entity's past activity over a specified reporting period is provided to stakeholders to serve as a foundation for such decision-making. Accordingly, to satisfy the information needs of an entity's stakeholders, we recommend that stewardship and decision-usefulness be defined as separate objectives.

Cash Flow Focus

Paragraph OB13 contends that providing information about the ability of an entity to generate net cash inflows should be the primary focus of financial reporting because such information helps satisfy the needs of investors and creditors. Present and potential investors and creditors view cash flow information as essential data for their decision-making. They also value other information not specifically tied to cash flows. For example, many non-cash transactions such as asset write-downs and share-based payments lend insight into management's stewardship and the impact of current economic factors on the entity's assets and liabilities. Other information such as sensitivity or trend analyses might prove equally useful. For this reason, we believe the focus of the conceptual framework should transcend providing information about an entity's ability to generate net cash inflows. Additionally, the final conceptual framework should focus on both past and future cash flows because past cash flows can be useful in predicting future cash flows.

The DP's focus on cash flows raises a question for some as to whether the Objective of Financial Reporting phase of the conceptual framework leads to an ultimate endorsement of fair value accounting. The Boards could address this concern by reminding readers that they have yet to deliberate the measurement phase of the conceptual framework project and that a focus on cash flows does not preordain a measurement outcome.

Primary Users of Financial Reports

The DP identifies primary users of financial reports as potential and present investors, creditors, and their advisors ("investors"). The approach adopted in the DP may not appropriately consider that financial statement users within each of these groups could have different information needs. For example, the needs of present investors having a long-term investment horizon may differ from those with a short-term horizon. A long-term investor may desire information about the long-term cash flow prospects of the entity and the stewardship of management; whereas short-term investors may be more focused on short-term cash flows and liquidity.

The DP indicates that the Boards chose to identify a primary group of users to "provide an important focus" for the conceptual framework, and prevent it from becoming "unduly abstract or vague." We believe the Boards still can achieve this focus and avoid the pitfall of having to assume that all users within a broadly-defined category share the same information needs by developing a hierarchy of users based on their specific information needs. This hierarchy can be used as a tool to assist the Boards in developing standards. For example, present investors with long term investment horizons could be identified as being at the top of the hierarchy, meaning that the top priority of financial reporting is to provide information to satisfy the needs of these users. Incorporating a user hierarchy into the conceptual framework would ensure that none of the user groups identified in paragraph OB6 are ignored by the framework, yet still allow the Boards to place greater priority on the needs of critical user groups.

The DP does not designate management as one of the primary groups of users of financial information based on the rationale that management is able to prescribe the form and content of the information it needs in satisfying its responsibility to owners. Although we agree that management is capable of satisfying its own information needs, we do not believe that the information management needs for its decision-making is completely divorced from the information needed by investors for their decision-making. We believe the conceptual framework should acknowledge that management is an important user of financial information, and that standard-setting could benefit from understanding how management uses financial information in its decision-making.

Focus on Financial Reporting Instead of Financial Statements

The DP proposes that the framework applies not only to financial statements, but also to financial reporting. It is assumed that the objectives and qualitative characteristics of all kinds of financial reporting are the same. Financial reporting is not defined and could cover a broad range of reports including management commentary, and press releases, amongst others. It may encompass not only present financial information, but also forecasts and non-financial information that may incorporate judgements on market trends.

Conceptually, the proposed framework should focus more broadly on financial reporting, and not be limited to financial statements and supplementary schedules ("financial statements"). For the foreseeable future, however, financial statements must remain the Boards' priority because of the pressing needs to resolve numerous accounting issues, such as revenue recognition, lease accounting, liabilities and equity, amongst others. Accordingly, issues related to the financial reporting objective and the qualitative characteristics should be deliberated with a primary focus on financial statements. Once the scope of financial reporting is better defined, the Boards will be able to revisit the objective and qualitative characteristics chapters and determine whether additional changes are needed.

We note that the Discussion Paper on Management Commentary published by the IASB in October 2005 includes different qualitative characteristics for the information to be reported. The final conceptual framework should reconcile any differences that remain after both projects are finalized.

Limitations on Financial Reporting

In discussing the limitations of financial reporting, paragraph OB15 states that the Framework's vision of ideal financial reporting is unlikely to be achieved in full, at least not in the short term. Since the framework will likely have some authoritative status in the GAAP hierarchy, the Boards need to clarify in the final Framework whether it is appropriate in any circumstance to depart from generally accepted accounting principles if a proposed accounting treatment is deemed to be closer to the ideal articulated in the framework than existing accounting requirements. This is particularly important for IFRS, since IAS 1 provides a basis for departing from existing IFRS if applying IFRS would conflict with the objective of financial statements set out in the Framework.

Qualitative Characteristics of Decision-Useful Financial Reporting Information

Faithful representation

Paragraph QC45 of the DP notes that the qualitative characteristics of relevance and representational faithfulness work in concert with one another and that “both relevance and faithful representation are necessary because a depiction is decision-useful only if it faithfully represents an economic phenomenon that is relevant to investment and credit decisions.” QC45 continues that “**either** irrelevance … or unfaithful representation… results in information that is not decision-useful.” We believe this point needs to be emphasized more prominently in the discussion of faithful representation. QC18 presents an example that lists several ways to depict in financial terms the economic phenomenon associated with a stamping machine, and concludes that “whether one of those methods would provide both a more relevant and more representationally faithful depiction of the machine is an issue for standard-setters to resolve.” We believe this discussion should be amplified to state that in situations in which an economic phenomenon can be depicted in different ways, the boards should take additional steps to determine what depiction is the most relevant to users of the financial information. A depiction that provides a faithful representation of an economic phenomenon is not useful for an investor if that depiction has no relevance to the investor’s decision.

Further, we believe that reliability is an essential attribute of financial information and is an additional and separate characteristic that should not be subsumed in the attributes of faithful representation and verifiability. We agree with the view expressed in AV2.2 that where indirect verification is used, the method used should be one that may be expected to yield an estimate of the economic phenomenon that is free from material error or bias, i.e., there should be a requirement for the information to be reliable. We believe it is inappropriate to conclude that an estimate should be included in the financial statements if there is significant concern that the methodology used to produce that estimate is inappropriate, which is the conclusion one would get to if the attribute of verifiability is applied alone without the attribute of reliability.

It would be helpful if the conceptual framework provided additional clarification about how uncertainty about financial information should be dealt with in the financial statements and what effects, if any, it has on the qualitative characteristics. The discussion in QC20-QC22 appears to focus on whether financial information should be limited to precise information. Information may be very imprecise, but relevant and verifiable (in the sense that methodologies can be developed to produce an amount, even if the measurement is very uncertain). If current deliberations cannot resolve this debate, the Boards should discuss this issue in later phases of the project (e.g., the elements and recognition phases.)

Substance over Form

The proposed conceptual framework does not explicitly identify the concept of “substance over form” as being one of the components of faithful representation. QC17 notes that “to include what has often been termed *substance over form* as a separate qualitative characteristic is unnecessary because faithful representation is incompatible with information that subordinates substance to form.” If the Boards believe that depicting the economic substance of accounting information is an inherent aspect of providing a faithful representation of such information, it is unclear why “substance over form” is not identified by the proposed framework as being one of the components of faithful representation.

Verifiability

The DP's discussion of verifiability does not express a preference for direct verification, nor does it limit the use of indirect verification only to those situations for which direct verification is not available or the costs of direct verification exceed the related benefits. As noted by the DP in QC26, indirect verification does not guarantee the appropriateness of the method used. The final framework should discuss the possible applications of direct and indirect verification including a general preference for direct methods since those methods typically provide more persuasive support.

The framework's identification of verifiability as a component of faithful representation may establish an expectation for users of financial information that all reported information is auditable. The final framework should discuss this expectation and indicate that auditability concerns should be considered in standard-setting, perhaps as a constraint on financial reporting, along with materiality and cost-benefit considerations.

Neutrality

We agree with the Boards' conclusions that neutrality is an important aspect of faithful representation. In light of the Boards' discussions regarding fair value accounting, however, the Boards should consider clarifying how neutrality concepts should be applied to those narrow circumstances in which an entity is trying to determine the appropriate fair value measurement for a security that does not have a readily determinable fair value. In such situations would it ever be appropriate to inject conservatism into the assumptions or models used to determine the fair value measurement?

Other comments

We have noted one instance where the DP makes an assertion that has not been justified or debated.

OB10 states *"The information provided by general purpose external financial reporting is directed to the needs of a wide range of users rather than only to the needs of a single group. Accordingly, financial reports reflect the perspective of the entity rather than only the perspective of the entity's owners …"* Our understanding is that the debate on whether the financial reports

should reflect an entity's perspective or provide a proprietary view will occur in a later phase of the project, therefore this comment may change as a result of subsequent deliberations.

Vision From the CEOs of the International Audit Networks

This November, the Chief Executive Officers of the international audit networks released a vision statement calling for a robust dialogue among stakeholders in the global capital markets about how financial reporting and public company auditing procedures must adapt to better serve capital markets around the world. Well defined investor needs that are met and "a new business reporting model" that delivers reliable and relevant information in a timely way are both among the key attributes the vision statement identifies for stabile, efficient and growing capital markets.

Repeatedly, the vision statement emphasizes the need for global convergence – pertaining to accounting, auditing and regulation. The fact that the IASB and the FASB are jointly developing an improved conceptual framework demonstrates that both boards recognize the importance of convergence and harmonization. In many other ways, the DP aligns well with the visions of the CEOs. For example, the vision statement indicates that investors and other stakeholders of public companies want and need information that is relevant, reliable, timely, simply presented and comparable across jurisdictions. It also emphasizes the importance to users of forward looking information. These align well with the overall objectives and qualitative characteristics identified in the DP.

However, the vision statement finds the current financial reporting model deficient in a number of fundamental respects and, in the long run, calls for the development of a new business reporting model – perhaps one driven by web technology and that is suitable for individuals to tailor to their individual needs. According to the vision statement:

> "A new company reporting model will require a global conversation of a broad range of investors (individual and institutional), other users, company preparers, regulators and standard-setters. We believe our networks can help facilitate that conversation and indeed help start the conversation. We stand ready to host conversations among all the key stakeholders in business information about what a new reporting model should look like. The process should be one from the "bottom up," rather than one imposed from the "top down" by a single global standard-setter or regulator."

As the IASB and the FASB make progress on a joint and improved conceptual framework, we urge them to participate in and take advantage of initiatives such as this and other efforts undertaken by the CEOs of the International Audit Networks and other key participants in these debates.

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We appreciate the opportunity to provide our comments. If you have any questions concerning our comments, please contact Ken Wild in London at +44 (0) 207 007 0907.

Yours truly,

Sincerely,

Ken Wild
Global IFRS Leader