

Discussion Paper: Conceptual Framework

This Comment Letter was sent by BDO Global Coordination B.V. on behalf of BDO International, to Li Li Lian, Assistant Project Manager at International Accounting Standards Board on 2 November 2006:

Dear Ms Lian,

Discussion Paper - *Preliminary views on an improved conceptual framework for financial reporting: the objective of financial reporting and qualitative characteristics of decision-useful financial reporting information*

We appreciate the opportunity to comment on the above discussion paper.

Overview

Before we discuss our comments on the two chapters covered by the discussion paper, we would like to raise some fundamental points about the overall project to develop a common framework. In summary, we do not believe that the project is being given the priority or focus that it requires.

We believe that the establishment of a common framework for financial reporting is of fundamental importance to the wider project on convergence between IFRS and US GAAP. Indeed one would logically assume that a common framework must be a prerequisite for other projects covered specifically in the Memorandum of Understanding between the IASB and the FASB ('MoU'). However, whilst the development of the common framework is acknowledged in the MoU it is not at the forefront where it belongs. This is indicative of our immediate concern over the common framework. We question whether it will be the real driving force (and also the controlling influence) behind the development of new standards or will it merely be seen as an academic exercise (in both senses of the word); that is a 'nice to have' for the standard setters but that has little practical relevance or authority for user groups?

A common framework must be practical, simple and clear. It must also be authoritative. Use of the word 'conceptual' in the title in itself questions the practicality and authoritativeness of the document. It gives the perception of an abstract and theoretical document. We would strongly prefer the removal of 'conceptual' from the title and replacing the use of 'concepts' throughout with 'principles'. This change is more than cosmetic. In our view it significantly improves the credibility of the framework and gets to the heart of what it should be: real and not abstract. Furthermore, we see no merit in adding a layer of concepts over principles and, as P6 confirms the board's desire to develop principles-based standards, it seems appropriate and consistent to establish the fundamental principles in the common framework.

The discussion paper concentrates heavily on the objectives of financial reporting but very little on the actual objectives of the common framework. IN2 gives us an impression that the common framework is merely serving as an internal document for standard setters. To retain credibility and relevance the common framework must have clearly stated objectives and must also define its user group. It is abundantly clear that both users and preparers of accounting standards must work from the same principles embodied in a common framework. The definition of the user group must explicitly include, and give greater weight to, users of accounting standards such as preparers of accounts and auditors.

This leads to perhaps our most fundamental concern with the common framework project. We believe that the input of constituents and user groups to the development of this common framework must receive far greater weight than it would do for discussion papers on specific accounting standards. This is because a natural objective (albeit unwritten) of the common framework must also be to exercise a constraint on standard setting activities. Standard setters can only predict what user groups may require of financial reporting; it is the user groups that actually know what they need, and more importantly what they do not need. Indeed some might consider it to be more appropriate if the 'objectives of financial reporting' section was actually written by user groups and not by standard setters. The principles that flow from those objectives must then be developed by consensus. Those principles must address directly the major issues around the convergence project, such as the scope of fair value accounting; open debate and decisions on these issues cannot be avoided or deferred for consideration in specific standards.

On a similar note, we are disappointed that the comments in P7 appear somewhat dismissive of the importance of what should be developed in the common framework, implying that only adjustments to existing frameworks are required. We believe this would be insufficient and that a common framework needs a comprehensive reconsideration in light of the convergence project, fully engaging user groups, before true convergence can be achieved.

We also take issue with the comments in IN5. Firstly it cannot be acceptable, other than for the very short term, that existing standards are in conflict with an agreed common framework. This would

undermine completely the objectives and authority of such a framework. It is quite improper for the boards to seek to develop and impose a framework to provide 'direction and structure' to their work and then comment only that existing conflicting standards 'may' rather than 'will' be reconsidered in future. Conflicting standards must take priority for amendment. Secondly, there is the comment that financial reporting evolves over time. That is true, but in recent times the evolution has consisted primarily of the promulgation of accounting standards (sometimes, but not always, to deal with specific changes in business practices) rather than changes in the underlying process of financial reporting. There is an implication here that a common framework will be subject to future revision. We contend that this should be unlikely, for the foreseeable future. It should be possible, and desirable, to derive a framework of principles at a level that will not require amendment for some considerable time. Most changes in business practices should be accommodated at a 'standard level' rather than 'framework level'. This is at the heart of how a true common framework should operate; the framework comes first followed by standards developed in accordance with the principles in that framework.

We note that only two sections of the proposed common framework are being considered in this discussion paper. Although it is quite possible that these sections will be the most esoteric it is difficult to gain a sense of the practicality of the common framework from these sections alone. There will clearly be interactions with other sections that will necessitate subsequent revisions to these sections and the Board acknowledges this in BC1.5 for example. It is vital that as part of the development process, constituents are given the opportunity to comment on the common framework in its entirety so the interactions and consistency of message can be clearly seen. It is also important that any new framework is introduced only at the conclusion of its development and in its entirety.

Finally, in our opening comments, we impress on the Board the need to recognise the wider limitations of any common framework. In many ways these are similar to the inherent limitations of the desirable objective of consistent global financial reporting. Absolute consistency of global financial reporting cannot be achieved by a common framework and accounting standards alone. No amount of effort in constructing a global set of accounting standards can eliminate the legal and cultural differences that affect the requirements for, or the form of, financial reporting in any given jurisdiction. A greater recognition of these limitations should act as a reality check on the Board's striving for global consistency. A mistaken belief that a framework and standards can achieve absolute consistency would inevitably lead to an undesirable shift to more complex and rules-based standards. Global application of accounting standards, and the framework, has to be principles-based.

Our comments on the two chapters are set out below. We feel these comments are important but they must be considered in the context of what we feel are the more fundamental points raised above.

The objective of financial reporting

- There is a difference between those who general purpose external financial reporting is prepared for (often a legal requirement) and those who it might be used by (potentially anyone with an interest in the entity). It should be recognised more prominently that general purpose financial reporting cannot (an perhaps should not) be prepared with the specific requirements of all users in mind.
- In many jurisdictions the legal requirement is for financial statements to be prepared for the members (shareholders / investors). We believe that extending the primary user group to investors and 'creditors' creates potential for confusion. On the one hand, creditors, as defined in the discussion paper, have interests similar to investors. On the other hand they are liabilities of the entity rather than equity (and this is a clear difference of principle as set out in IAS 32) and have a similar status to other liabilities of the entity. In addition, the term 'creditors' is a long standing, well understood term that encompasses all parties to whom the entity owes money. Furthermore, we believe that extending the primary user group to creditors' advisors is wholly unnecessary. Whether creditors choose to use the information themselves or appoint advisors should be of no concern to the entity preparing the financial reporting. Our view is that the primary users of financial reporting should therefore be investors. We believe that this is consistent with the legal position in many jurisdictions and in any event, meeting the needs of investors will almost certainly satisfy the requirements of other providers of finance.
- We are concerned about the strong emphasis on the need for financial reporting to provide information to enable an assessment of the future cash flows of the entity. We believe this focus is currently unrealistic. For example typical annual financial statements do provide historic information about performance from which a user can make assumptions about future cash flows, but the financial statements are not geared to providing the best information that a user would need to make those assumptions. If it is believed that financial reporting really should focus on information to assess future cash flows, this perhaps represents a radical shift in emphasis that will require an equally radical approach to future accounting standards. The

current reality is that financial reporting is generally designed to present how the entity has performed over a given past period in terms of profitability and cash flows and its financial position at the period end. This information can certainly be used to assess future cash flows but it also serves other key purposes such as an assessment of stewardship.

- Continuing the previous point, we believe clarification is needed. Is the board seeking to improve the presentation of fundamentally historic information to enable users to better assess future cash flows or is there intended to be a more radical shift in the nature of financial reporting to current /fair values and even prospective financial information? This issue will be fundamental to the development of future standards and the board should make this clear.
- On the matter of stewardship, we do not believe that subsuming stewardship under the one objective of general purpose external financial reporting is appropriate and believe this should stand on its own as a separate and equally important objective. We believe there are naturally two objectives of financial reporting, based on at least two discrete decisions taken by investors. On receiving any form of financial reporting, for example annual financial statements, an investor would be likely first to assess how the entity has performed in the given period, and secondly to make a judgement about how it is likely to perform in the future (so the investor can make resource allocation decisions). We believe that the first assessment an investor makes, that is on past performance, is essentially a view on stewardship and as such this should have equal prominence with the resource allocation decisions.
- The importance of stewardship is further reinforced in many jurisdictions where, investors, based on their assessment of past financial performance are required in law to make decisions on the performance of the directors of the entity (by approval of their re-election and / or remuneration)
- It is in this area where the Chapter is in danger of becoming too theoretical. The present reality is that the vast majority of financial reporting comprises reporting on past performance. We are again unclear as to whether an absence of an acknowledgement of this is indicative of a potential radical change of emphasis in financial reporting

Qualitative characteristics of decision–useful financial reporting information

- Paragraphs QC3 to QC6 in our view sit quite uncomfortably with the rest of the document. This goes back to our earlier point that standard setters are not necessarily best placed to understand the needs of users of financial statements. It reads both like an edict and a caveat which is unhelpful to the flavour of consensus that should permeate this document. Indeed QC6 is quite alarming. We agree that the qualitative characteristics and the framework pertain to the information produced by financial reporting but cannot accept that they do not necessarily pertain to accounting standards themselves. This is an admission that individual accounting standards could, for example, be irrelevant and incomprehensible. We believe this whole section requires redrafting - the framework is to guide standard setters, in the same way it is to guide preparers and users of financial reporting.
- We are uncomfortable with the use of the qualitative characteristic 'faithful representation' in place of reliability. We believe that 'reliable' is a simpler and more widely accepted concept and reject the board's arguments that replacement by faithful representation (previously, and validly in our view a subset of reliability) brings greater clarity to the framework. Indeed we consider the sections on verifiability are difficult to understand and largely theoretical.
- We acknowledge the board's debate over reference to substance over form (BC2.17). We strongly disagree with the proposal that substance over form is not identified separately in the proposed framework. We believe this aspect is of fundamental importance and that explicit reference should be reintroduced. This is vital to ensuring accounting standards remain principles based rather than rules based. As a minimum QC17, that at present argues why there is no need for a separate characteristic of substance over form, should be turned into an overt statement that substance over form is a key component of faithful representation (or, in our preference, reliability).

We would be pleased to discuss our comments and observations with you further if this would be helpful. Please contact Helen Thomson of BDO Global Coordination B.V. on +32 2 778 01 30.

Yours faithfully,

BDO Global Coordination B.V.
