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Paul Ebling
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2 October 2008]

Dear Paul

EFRAG's draft comment letter on the IASB Exposure draft '*An improved Conceptual Framework for Financial Reporting – Chapter 1 The Objective of Financial Reporting, and Chapter 2 Qualitative Characteristics and Constraints of Decision-useful Financial Reporting Information*'

This letter sets out the UK Accounting Standards Board's (ASB's) comments on EFRAG's draft comment letter on the IASB Exposure Draft mentioned above (ED).

The ASB shares the main concerns raised by EFRAG in relation to the proposals in the IASB ED that:

- no part of the Framework should be finalised until the whole Framework is ready to be issued in its final form;
- a comprehensive and in-depth debate is needed on the perspective from which financial statements should be prepared. We believe that the ED currently does not provide sufficient information on the choice of perspective and its implications for the rest of the Framework for such a debate to take place; and
- replacing the notion of "reliability" with "faithful representation" does not deal with the original problem identified by the IASB i.e. that "reliability" is misunderstood by constituents. In fact, as you correctly identify "faithful representation" as explained in the ED is not a notion commonly used outside of the US and is very likely to lead to further misunderstanding.

The ASB has some suggested changes to the draft comment letter for EFRAG to consider as follows:

- the order of priority of the issues raised in the letter and Appendix 1 to the letter need to be reviewed. The ASB agrees that finalisation of the Framework is the most important issue. However, we believe that the choice of entity perspective is far more important issue than the comments on the relationship between internal and external reporting and users' interest in gross flows. We would encourage EFRAG to consider prioritising the discussion on the choice by IASB of the entity perspective above the other two issues mentioned above;

- we do not find the discussion in paragraph 6 of Appendix 1 (page 4) useful in the context of discussion on what should be addressed in the Framework. We would expect standard-setters to explain when it asks for information in the financial reports that go beyond what management would generally consider relevant. However, we feel that the correct place for such protocol to be included (if it has to be included) is in the due process handbook. The discussion in paragraph 6 fails to convey why this should be noted it the Framework, which is part of the hierarchy of IFRS. The ASB would suggest that the discussion in paragraph 6 and the suggestions in paragraph 7 should be removed from the final response to IASB;

- we found the example in paragraph 17 (a) of Appendix 2 (page 10) confusing and feel it does not add to the arguments EFRAG puts forward. The example deals with measurement and therefore is open to interpretation. For example the last line in paragraph 17 (a) concludes that whether to measure the asset (explored in the example) at 100 (cost) or 500 (market based exit-value) is not addressed when looking at the qualitative characteristics of relevance and faithful representation. However, one interpretation from the example can be that the answer to the particular question of the measurement value depends less on the qualitative characteristics and more on the measurement model (historic cost or exit value-fair value) you have adopted. The ASB would recommend that EFRAG removes this example in its entirety; and

- Paragraph 18 of Appendix 2 (page 11) notes in the second sentence that "…in our view 'reliability' is a broader notion than 'faithful representation…'" but then goes on to note in the last sentence that "…reliability is and should be used in a context and for a specific purpose, whereas faithful representation is a broader and not so specific notion…". We would suggest that you amend the second reference as follows:

"…~~reliability~~ faithful representation is and should be used in a context and for a specific purpose, whereas ~~faithful representation~~ reliability is a broader and not so specific notion…"

We also enclose our response to the IASB for your information. If you would like to discuss any of the comments made above then please contact Seema Jamil-O'Neill on 020 7492 2422 or myself on 020 7492 2434.

Yours sincerely

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Enclosed: ASB response to the IASB Exposure draft '*An improved Conceptual Framework for Financial Reporting – Chapter 1 The Objective of Financial Reporting, and Chapter 2 Qualitative Characteristics and Constraints of Decision-useful Financial Reporting Information*'

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International Accounting Standards Board
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2 October 2008

Dear Li Li

IASB Exposure draft '*An improved Conceptual Framework for Financial Reporting – Chapter 1 The Objective of Financial Reporting, and Chapter 2 Qualitative Characteristics and Constraints of Decision-useful Financial Reporting Information*'

This letter contains the views of the UK Accounting Standards Board (ASB) on the above IASB Exposure Draft (the ED). The ASB welcomes the opportunity to comment on this IASB ED.

The ASB notes that the version of chapters 1 and 2 of the Framework proposed in the ED has been significantly improved compared to those proposed at the DP stage. In this respect, the ASB would commend the IASB in the efforts made to rewrite certain sections including those concerning the references to stewardship in the objective of financial reporting, the reduced emphasis on cashflow forecasting and the inclusion of references to decisions taken by investors that are not buy, sell or hold.

Despite the efforts made by the IASB and FASB in improving the proposals in the ED the ASB continues to have a number of key areas of concern. These are listed below and discussed in more detail in the Appendix to this letter.

Key concerns regarding Chapter 1

Piecemeal finalisation of the Framework

1) The ASB remains concerned at the IASB's proposals to finalise each chapter of the Framework independently of the others so that some of the earlier chapters will be completed a long time in advance of the rest of the Framework. For example, chapters 1 and 2 as proposed in the ED could be finalised within the year (in 2009) whilst we are aware that some of the later phases of the conceptual framework project have yet to be started. So conceivably there could be a number of years between the finalisation of the earlier chapters and some of the later parts of the even being discussed.

2) Although the IASB intends to address the apparent inconsistencies with the rest of the Framework as the project progresses, the ASB believes that not all of them can be eliminated by adopting this approach. This letter provides some examples of areas where inconsistencies will continue to exist partly because the impact of earlier changes on the rest of the Framework has not been fully discussed yet. For example, the impact of adopting the entity approach has not been fully considered (see below for further discussion on this).

3) The ASB can understand the pressures on the IASB to have some aspects of the Framework in place. However, we fail to understand how an internally inconsistent Framework will be useful in either one of its purposes – as a backdrop to the standard-setting process or as part of the hierarchy of IFRS. The ASB believes that the IASB, by adopting this chapter-by-chapter finalisation approach, is putting undue pressure on itself and the constituents and that it will lead to the undesirable outcome of an internally inconsistent Framework over a long period of time.

4) The ASB therefore recommends that the IASB does not finalise any section of the Framework until all parts are ready to be finalised.

Stewardship

5) As noted above, while the ASB acknowledges that the ED now contains an expanded objective of financial reporting to encompass stewardship, it takes the view that the spirit of a number of the concerns raised in the ASB's response of 2 November 2006 to the IASB's Preliminary Views Discussion Paper (see paragraphs 6-16 of the appendix to that letter) remain to be addressed.

Adoption of the entity perspective

6) The ASB is concerned that the ED proposes the adoption of the entity perspective in the Framework but fails to provide adequate justification for this or discuss the potential impact on other parts of the Framework. The ASB is concerned that without an in depth discussion of the issues arising from adopting the entity perspective, as opposed to any of the other possible perspectives (including the proprietary perspective, the parent shareholder perspective and other hybrid models), the detailed implications of this proposals to the remainder of the Framework and IFRS in general will be difficult to ascertain.

7) The ASB recommends that a full debate on the issues arising from adopting the entity perspective needs to take place before a decision can be made on its adoption and its consequences on the remainder of the Framework. (see Appendix paragraphs 1-10)

Boundaries of financial reporting

8) The ASB is concerned that the ED makes no reference to what constitutes general purpose financial reports. The consideration of specific issues concerning the boundaries of financial reporting and distinctions between financial statements and other parts of financial reporting have been deferred to a later phase (Phase E) of the Framework project. In our view, there is a need for the IASB to

first define what is covered by financial reporting. A widening of the application of the Framework (currently applied only to financial statements) to all financial reporting will give rise to problems as it will be attempting to outline the concepts that underpin two fundamentally different things: financial statements and financial reports (which can comprise of corporate annual reports, prospectuses, news releases, managements forecasts, etc). In our view, users have very different expectations from financial statements and financial reporting. The latter are more explicitly forward looking and accordingly users recognise the differences in the qualitative characteristics of these two types of reports.

Key concerns regarding Chapter 2

9) Many of the concerns raised in the ASB's response to the IASB DP in the letter dated 2 November 2006 still remain. The ASB believes that the term "faithful representation" as defined in the ED is not well understood outside of the United States. The ASB is not in favour of this change and would recommend that the IASB instead spend time improving the definition of reliability so that it conveys the meaning as understood by the IASB. However, if the IASB were to continue with the proposals in the ED the ASB would encourage greater rigour in the language of the definition. (See Appendix paragraphs 19-24)

10) The differentiation between fundamental and enhancing QCs proposed in the ED is artificial. The ASB believes that which QCs are more important depends on the circumstances and the information being conveyed. The ASB would recommend that this differentiation is removed and instead a general reference is made to the QCs the IASB would expect to be considered first in the vast majority of the cases. (See Appendix paragraphs 14-18)

11) The ASB also continues to have concerns with the qualitative characteristic of verifiability which were also raised in the letter dated 2 November 2006. The ED notes that verifiability is a quality of information that is arrived at as a result of consensus between different knowledgeable and independent observers. When reviewed in light of the statements in OB14 that equate financial models to judgements it concerns the ASB that the results from the models may be verifiable and objective but not always a good approximation of the underlying economics.

If you would like to discuss any of the comments made above then please contact Seema Jamil-O'Neill on 020 7492 2422 or myself on 020 7492 2434.

Yours sincerely

Ian Mackintosh

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Appendix

Chapter 1 ***The objective of financial reporting***

1 The boards decided that an entity's financial reporting should be prepared from the perspective of the entity (entity perspective) rather than the perspective of its owners or a particular class of owners (proprietary perspective). (See paragraphs OB5–OB8 and paragraphs BC1.11–BC1.17.) Do you agree with the boards' conclusion and the basis for it? If not why?

1) The ED introduces the notion of financial reporting being produced from the entity's perspective for the first time. The discussion in OB5 asserts the "financial reports reflect the perspective of the entity rather than the perspective of the entity's equity investors, particular group of its equity investors or any other group of capital providers. Adopting the entity perspective does not preclude the inclusion in financial reports of additional information that is primarily directed to the needs of an entity's equity investors or to another group of capital providers."

2) These assertions are left largely unsupported and little information is provided on why it is appropriate to choose the entity perspective rather than the proprietary perspective. BC 1.13-1.14 note that under the proprietary perspective "the reporting entity does not have substance of its own separately from that of its proprietors or owners" and that the proprietary perspective belongs in the times when "entities were owner-managed and owner-managers had unlimited liability for the debts incurred in the course of the business".

3) This appears to be a generalisation and has little basis in the contemporary corporate world. In the UK and certain other countries for example, the concept of the "veil of incorporation" and limitation of liability has been enshrined in company law since the case of Salomon v Salomon & Co. (1897). This important case sets out that a limited liability company is not an agent or trustee of its shareholders. Therefore, the comments in relation to the proprietary perspective in BC 1.13-1.14 have not applied to companies, whether publicly traded or privately held, in these countries for over a century. For example, All such limited companies in the UK are required to produce financial statements in accordance with GAAP (either UK GAAP or EU adopted IFRS).

4) An area where limitation of liability does not apply is in relation to certain partnerships and co-operatives. A number of these entities are set-up so that the owner-managers do have unlimited liability for the debts incurred in the course of business. A large number of these entities are currently complying with IFRS. The proprietary perspective, as explained in the ED, could be appropriate for such entities.

5) BC1.15 goes on to note that the two boards concluded that "the entity perspective is more consistent with the fact that the vast majority of today's business entities engaged in financial reporting have substance distinct from that of their capital providers. As such, the proprietary perspective generally does not reflect a

realistic view of financial reporting." The ED contains no further discussion of the issues arising from the adoption of the entity perspective for the remainder of the Framework or financial reporting as a whole. The ASB is concerned that without an in depth discussion of the issues arising from adopting the entity perspective, as opposed to any of the other possible perspectives (including the proprietary perspective, the parent shareholder perspective and other hybrid models), the detailed implications for this proposals to the remainder of the Framework and IFRS in general will be difficult to ascertain.

6) For example, one of the potential issues that the ASB has noted is that the stewardship objective relies on an element of the proprietary perspective – shareholders want financial reporting to contain information that would enable them to evaluate management's performance and whether it aligns with their objectives. Management does not have this responsibility towards any of the other primary users identified in the ED. This aspect of stewardship does not appear to be best served by adopting the entity perspective.

7) A potential implication of the entity perspective may be on the elements phase of the Framework project. Currently, that phase is considering the definitions of assets, liabilities and equity. The entity perspective is sometimes depicted with the following simple equation:

Assets = Liability + Equity

8) Therefore, one could deduce that from the entity's perspective any item on the balance sheet that is not an asset of the entity is a claim on those assets. This approach would not differentiate between liabilities and equity, both of which represent claims against the entity. This then begs the question as to why the differentiation between liabilities and equity is still maintained. This line of reasoning can be used to justify the claims approach and an elimination of the distinction between equity and liability.

9) In view of the above, the ASB would recommend that the IASB considers this issue more thoroughly, taking into account all relevant issues, as well as engaging constituents in this debate before making any conclusions.

2 The boards decided to identify present and potential capital providers as the primary user group for general purpose financial reporting. (See paragraphs OB5–OB8 and paragraphs BC1.18–BC1.24.) Do you agree with the boards' conclusion and the basis for it? If not why?

10) The ASB is in general agreement with the IASB that the primary user group comprises the present and potential capital providers. However, there are a few inconsistencies in the way this has been expressed in the proposals in the ED.

11) In this respect, the ASB would like to ensure that it is clear from the Framework that management is primarily accountable to the equity investors. Currently, and

to our minds incorrectly, OB12 notes that "Management is accountable to the entity's capital providers for the custody and safekeeping of the entity's economic resources." We would prefer to see the reference to "capital providers" in that sentence and the last sentence in OB12 to be changed to "equity investors".

3 The boards decided that the objective should be broad enough to encompass all the decisions that equity investors lenders and other creditors make in their capacity as capital providers including resource allocation decisions as well as decisions made to protect and enhance their investments. (See paragraphs OB9–OB12 and paragraphs BC1.24–BC1.30.) Do you agree with that objective and the boards' basis for it? If not why? Please provide any alternative objective that you think the boards should consider.

12) The ASB agrees that the objective as identified in the ED is broad enough to encompass the decisions of capital providers. There are few minor adjustments, as noted in the answers above, which would ensure that it is relevant for all profit making entities.

13) However, our concern is in relation to the not-for-profit entities which we feel may not be as well served by the objective as identified. In this respect, we would recommend that the IASB refers to the July 2008 report produced by the chairs and senior staff of the Australian, Canadian, New Zealand and United Kingdom Accounting Standards Boards on the implications for the not-for profit sector of the Framework proposals (we enclose the report with our letter). This report considers how some of the differences in the not-for-profit sector affect the possible application of the concepts proposed by the IASB and FASB to entities in that sector. In this respect, the report raises particular concerns with the adequacy of the emphasis on accountability/stewardship and a need to broaden the identified users and establish an alternative primary user group.

Other

14) We are concerned that statements in paragraph OB14 equate financial models to judgements. We believe that models inform estimates and judgements and not equate to estimates and judgements, which must incorporate qualitative aspects as well.

Chapter 2 ***Qualitative characteristics and constraints of decision-useful financial reporting information***

1 Do you agree that: (a) *relevance* and *faithful representation* are fundamental qualitative characteristics? (See paragraphs QC2–QC15 and BC2.3–BC2.24.) If not, why? (b) *comparability*, *verifiability*, *timeliness* and *understandability* are enhancing qualitative characteristics? (See paragraphs QC17–QC35 and BC2.25–BC2.35.) If not, why? (c) *materiality* and *cost* are pervasive constraints? (See QC29–QC32 and BC2.60–2.66.) If not, why? Is the importance of the pervasive constraints relative to the qualitative characteristics appropriately represented in Chapter 2?

15) The ASB has a number of concerns with the proposals as set out in QC1-QC15 and the explanations provided in BC2.3-BC2.24. These include: the differentiation between fundamental and enhancing qualitative characteristics (QCs); the replacement of reliability with faithful representation; and the interaction between relevance and faithful representation. These are explored in more detail below and in the answer to question 2.

16) QC1 notes that the QCs of general purpose financial reporting can be "…distinguished as fundamental or enhancing characteristics, depending on how they affect the usefulness of the information." The ED then goes on to note that relevance and faithful representation are considered fundamental QCs whilst comparability, verifiability, timeliness and understandability are enhancing characteristics. BC2.54 notes that this distinction between the QCs was provided because there is some confusion among respondents to the DP about how the QCs relate to each other.

17) The ASB considers such a distinction between the QCs to be artificial. The ASB would suggest that the application of all the qualitative characteristics (not just the enhancing characteristics as noted in QC26) is an iterative process that does not follow a prescribed order. It agrees with the sentiment in paragraph 45 of the current IASB Framework which notes that, "In practice a balancing, or trade-off, between qualitative characteristics is often necessary… The relative importance of the characteristics in different cases is a matter of professional judgement."

18) In general we would agree that any information to be potentially included in the financial reports would first be judged on its relevance. However, we can foresee cases where the so called "enhancing" characteristics are as important as the "fundamental" characteristics. For example, information that is relevant but so out-of-date (i.e. not timely) that its inclusion is likely to confuse the users thus impacting its understandability. In such a case, faithful representation is a secondary consideration.

19) The ASB's concerns with the replacement of the QC "reliability" with "faithful representation" are set out in the answer to question 2 below.

2 The boards have identified two fundamental qualitative characteristics—*relevance* and *faithful representation*: (a) Financial reporting information that has *predictive value* or *confirmatory value* is relevant. (b) Financial reporting information that is *complete*, *free from material error* and *neutral* is said to be a faithful representation of an economic phenomenon. (i) Are the fundamental qualitative characteristics appropriately identified and sufficiently defined for them to be consistently understood? If not, why? (ii) Are the components of the fundamental qualitative characteristics appropriately identified and sufficiently defined for them to be consistently understood? If not, why?

20) Although verifiability is no longer a component of faithful representation, the ASB still remains concerned that the IASB is persisting in its replacement of the QC "reliability" in its current Framework with "faithful representation". BC2.11 sets out the Board's thinking when it notes that "neither board's [IASB or FASB] existing framework conveys the meaning of reliability clearly enough to avoid misunderstandings." However, many of the concerns raised in the ASB's response to the IASB DP on 2 November 2006 still remain (see paragraphs 27-35 in Appendix to the letter).

21) The ASB believes that although the meaning of the two terms may overlap in some respects they mean very different things and that "reliability" may be seen as a broader notion than "faithful representation". The current IASB Framework when defining reliability notes in paragraph 31 that, "Information has the quality of reliability when it is *free from material error* and *bias* and *can be depended upon by users to represent faithfully* that which it either purports to represent or could reasonably be expected to represent." Paragraph 32 of the IASB's current Framework goes on to elaborate that, "Information may be relevant but so unreliable in *nature or representation* that its recognition may be potentially misleading."[italics added]

22) The proposed definition of faithful representation in the ED in QC7 notes that "Faithful representation is attained when the depiction of an economic phenomenon is complete, neutral, and free from material error. Financial information that faithfully represents an economic phenomenon depicts the economic substance of the underlying transaction, event or circumstances, which is not always the same as its legal form."

23) In the ASB's view, faithful representation and its components as defined cover some of the quantitative aspects of reliability, namely *free from material error* and *bias*. Although it goes on to require the depiction of the economic substance, the components appear not to address the qualitative aspect of reliability i.e. exclusion of information being so unreliable in *nature* that its recognition is potentially misleading

23) The ASB further believes that faithful representation as defined in the ED is not well understood outside the US. Furthermore, the definition and explanations provided in the ED add to the confusion. The illustration of how a single economic phenomenon may be represented in different way is included in paragraph QC8 which notes that, "…and estimate of the risk transferred in an insurance contract may be depicted qualitatively (eg a narrative description of the nature of the possible losses) or quantitatively (eg an expected loss)." The qualitative aspect noted above does not appear to us to be derived directly from the definition of faithful representation.

24) The ASB therefore feels that if the IASB were to continue with this replacement the ASB would encourage greater rigour in the language of the definition, in particular to reflect the concerns raised in paragraph 22 above.

3 Are the enhancing qualitative characteristics (*comparability, verifiability, timeliness* and *understandability*) appropriately identified and sufficiently defined for them to be consistently understood and useful? If not why?

25) The ASB is broadly happy with the proposals in this area of the ED.

4 Are the pervasive constraints (*materiality* and *cost*) appropriately identified and sufficiently defined for them to be consistently understood and useful? If not why?

26) We agree that materiality and cost are pervasive constraints. That said, the discussion of materiality in paragraph QC28 places the emphasis on the omission or misstatement of financial information. The ASB believes that it is also important to emphasise materiality in the context of excluding the provision of immaterial financial information. As noted in the ASB's 'Statement of Principles for Financial Reporting' (paragraph 3.29) "…when immaterial information is given in the financial statements, the resulting clutter can impair the understandability of the other information provided."

Other

27) The ASB also notes that the IASB is proposing to retain paragraph 23 in the current Framework, which relates to the going concern principle. We support the proposed retention, but note that the IASB has not provided any rationale as to why it considers going concern an important notion. As noted in the ASB's response of 2 November 2006 to the IASB's DP, we would urge the Boards to include a specific reference to, and rationale for, going concern in the converged framework.