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Sir David Tweedie
Chairman
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30 Cannon Street
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Berlin, 26 September 2008

Dear David,

Exposure Draft of 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

We appreciate the opportunity to respond to the International Accounting Standards Board's Exposure Draft (ED) of 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 represents the view of the German Accounting Standards Board (GASB).

We believe that the development of an improved Framework is of fundamental importance to high quality International Financial Reporting Standards. The principles contained in an improved Framework will further understanding and applying those standards. In addition, from the point of view of the standard setter, the principles in a Framework will assist the IASB in developing a consistent set of high quality accounting standards. We, therefore, highly appreciate the IASB's and FASB's joint Framework project.

In the GASB's view the versions of chapter 1 and chapter 2 of a revised Conceptual Framework for Financial Reporting proposed in the current Exposure Draft represent an improvement in comparison with the earlier Discussion Paper.

However, we are still concerned about certain aspects of the ED and the announced process.

This ED represents a first step in improving the Framework. As the ED covers only part of what will be included in the final Framework we believe that conclusions or decisions need to be revisited when Discussion Papers or Exposure Drafts on other phases become available. We, therefore, deem it absolutely necessary to review the output of all phases after finalising the last phase of the Conceptual Framework project and if needed change parts approved earlier to achieve consistency across the entire framework.

Furthermore, we see both, practical and conceptual problems when paragraphs of the current Framework are superseded by chapters 1 and 2 currently proposed before work on the later phases of the Framework is completed. To proceed in this way could not only mean that decisions reached now with regard to the objective and, in particular, the qualitative characteristics might have to be revisited, but, from our perspective, also lead to a mixture of the old and the new Framework. That mixture would conflict with the requirement that the framework should give a consistent basis for accounting standards and filling accounting gaps. To enable commentators to conclusively assess the implications of the proposed proceeding, ideally all consequential amendments need to be exposed.

We are aware that identifying all consequential amendments resulting from chapter 1 and 2 before amending parts of the current Framework by these chapters requires a lot of time and work which would decelerate the progress of the Framework project. In order to prevent creating unintended inconsistencies on the other hand, we urge the IASB at least to clarify how standard setters and preparers should deal with the mixture of the old and the new Framework. Consider the following example which is meant to demonstrate how confusing a lack of clarity could be: Should the term *reliability* be replaced by the term faithful representation and therefore disappear as a qualitative characteristic from the framework, preparers will wonder how to deal with standards referring to reliability such as IAS 38 para. 21b which states: ‘An intangible asset shall be recognised if … the cost of the asset can be measured *reliably*’.

To avoid confusion on the one hand and to progress with the framework project on the other, we suggest that the new parts of the Framework should be the basis for the standard setter in developing new standards; the application and interpretation of already existing standards should be based on the current version of the Framework, because they were produced on that basis. Once the new Framework has been finalised the standardsetter would revisit existing pronouncements and bring them into line with the new basis.

Regarding the authoritative status of the Framework, we believe that the status of the Framework has important implications for the level of detail in the standards. We prefer a high authoritative status of the Framework for both, standard setters and preparers, combined with the Framework being focused on high level principles. That means, on the one hand, the Framework should assist the standard setter in new projects and standards, and the standard setter should be required to publish new standards that are consistent with the Framework. Only in very rare circumstances the Board should issue a new or amended standard deviating from the Framework; i.e. the Board should issue proposed consequential amendments to the Framework concurrently with the exposure draft of the standard and conclude its deliberations on the initiating proposals and the consequential amendments at the same time. This procedure would lead to only very temporary differences due to the sequence of issuing new texts.. On the other hand, it means that preparers are required to consider the Framework when there is no standard or interpretation that specifically applies to a transaction or that deals with a similar or related issue. In this respect, we think that the current authoritative status in the IFRS hierarchy is appropriate.

For detailed comments concerning the objectives (chapter 1 of the ED) and the qualitative characteristics (chapter 2 of the ED) we refer to appendices A and B to this comment letter.

If you want to discuss any aspects of this letter in more detail, please do not hesitate to contact me.

Yours sincerely,

Liesel Knorr
President

Appendix A: 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?*

We welcome that the IASB expanded the description of its understanding of the entity perspective and the proprietary perspective and of its reasons for choosing the former as the basic perspective underlying financial reports in the Basis for Conclusions.

However, we believe that these explanations do not provide a sufficient basis to comment on the question whether the adoption of the entity perspective is superior to the proprietary perspective. In particular, the relation of determining a primary user group and adopting a reporting perspective remains unclear to us. Apart from that aspect we have concerns about adopting the entity perspective without discussing and deliberating the potential implications of that decision for decisions to be made in later project phases and in other projects.

> 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?*

We think that different user groups have different information needs, as the decisions these groups have to make are often dissimilar. Consequently, the most favourable information for one user group is not necessarily the most favourable for other user groups as well. Nevertheless, information given to satisfy one specific user group's most important information needs is likely to also satisfy the information needs of other user groups to a certain extent. The current Framework acknowledges this by referring to a wide range of users and by focusing on primary users.

We support the ED's approach to also identify a primary user group. From our point of view, having a primary user group is essential for determining the kind of information that is decision-useful for this particular user or group of users and that should, therefore, be provided by financial reporting. Without identifying, or knowing, respectively, the primary user group of financial reporting the principles in any conceptual Framework would be more abstract and potentially vague.

In its ED the IASB has identified 'present and potential equity investors, lenders and other creditors' as the primary users of financial reports, i.e. present and potential capital providers. This represents a widening of the range of primary users as the current Framework solely focuses on investors. In broadening this range the IASB assumes common information needs for all capital providers. We do not share this view. We agree that equity investors, lenders and creditors all provide capital (in the broader sense) to an entity and, therefore, all these users are more or less interested in the entity's ability to generate cash flows to meet their claims. However, this view oversimplifies the relationship between an entity and the individual user groups. To us, there seems to be a big difference between equity investors providing risk capital and, therefore, having both up- and downside risks, and lenders/other creditors. This difference results in differences in information needs. We, therefore, believe that equity investors and lenders/creditors are too heterogeneous to be combined into the primary user group, since the primary user group concept only works if there is sufficient homogeneity in the information needs within this user group.

We believe it would be better to retain the current narrower approach of defining investors of risk capital as the primary user group, because meeting the equity investors' needs will in many cases implicitly meet the needs of lenders and other creditors. Generally, we suggest a wording along the lines of para. 10 of the current Framework.

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.*

We agree with the broader objective of general purpose financial reporting as set out in the ED. We deem explicitly addressing the capital providers' decisions on whether and how to protect and enhance their investments in addition to resource allocation decisions a major improvement in comparison to the DP. As capital providers' decisions on whether and how to protect and enhance their investments are directly linked to management's ability to protect and enhance capital providers' investments, we are now more comfortable with the description of financial reporting's objective. We think that the objective of financial reporting set out in the ED takes better into account *past* and *future* aspects of entities' economic activities, which are both relevant for capital providers' decisions.

4. *Additional comments on Chapter 1: **Financial Statements versus Financial Reporting***

We generally take the view that a Framework should be the conceptual foundation not only for financial statements, but also for other means of financial reporting, e.g. the management commentary. However, we deem it necessary to define the term 'financial reporting' before widening the scope. As 'financial reporting' will be discussed and defined in a later phase of the project, we feel unable to conclusively assess at this stage whether the Framework's scope should be set as 'financial reporting' or 'financial statements'. This is because current principles and concepts may not be applied to a different, i.e. wider, scope (financial reporting) without carefully analysing the consequences. One would (possibly) need to take into account different characteristics, e.g. qualitative and quantitative information, forward-looking information and information concerning the (past) reporting period; for example, financial reporting may encompass explicit forecasts by management.

Appendix B: Chapter 2 / Qualitative Characteristics and Constraints of Decision-useful Financial Reporting Information

*Chapter 2 describes the qualitative characteristics that make financial information useful. The qualitative characteristics are complementary concepts but can be distinguished as fundamental and enhancing based on how they affect the usefulness of information. Providing financial reporting information is also subject to two pervasive constraints—materiality and cost. Are the distinctions—fundamental and enhancing qualitative characteristics and pervasive constraints of financial reporting—helpful in understanding **how the qualitative characteristics interact** and how they are **applied** in obtaining useful financial reporting information? If not, why?*

We welcome the IASB's intention to clarify the relationship between the different qualitative characteristics. However, we doubt that evaluating the different characteristics in a particular order is the appropriate approach. We are concerned that one could interpret this order in a way that 'relevance', being the first characteristic to be evaluated, is of higher importance for the decision usefulness of information than, say, 'faithful representation'/'reliability'.

Furthermore, we are not convinced that evaluating every qualitative characteristic on its own in a particular order is suitable. The qualitative characteristics are interactive. A rational user would not consider unreliable information and does not necessarily prefer a more relevant but less reliable piece of information over a more reliable but less relevant piece of information as academic research suggests[1]. We, therefore, think that information that is not reliable cannot be relevant to the users of financial reporting. Interactivity exists not only between relevance and reliability, even though this is the most prominent relationship between the qualitative characteristics. For instance, information that is not understandable has no value either, since information is not capable of making a difference in the decisions of users if information is not understandable.

In QC 12 to QC 14 the ED outlines a process for applying the fundamental qualitative characteristics. Under the first step of this process "Application of the qualitative characteristic of relevance will identify which economic phenomena should be depicted in financial reports". In a second step "faithful representation is applied to determine which depictions of those phenomena best correspond to the relevant phenomena". We disagree with this process outline as we believe that the fundamental qualitative characteristics should be applied as follows: In a first step the economic phenomena are identified that the financial reports should provide information on. We agree that relevance is the criterion to apply in this identification. The following step is about identifying those depictions of the economic phenomena identified in the first step that provide decision-useful information. In this second step the characteristics of relevance and representational faithfulness are applied equally with none of the two having more prominence or being applied before the other. Outlining the process like this could avoid the confusion that may result from the ED's

[1] Cf. Stiglitz, J.: Information, Screening, and Welfare, in: Boyer, M./Kihlstrom, R.E. (Eds.): Bayesian Models in Economic Theory, Amsterdam, New York and Oxford 1984, pp. 209-239.

current, rather unclear use of the term 'relevance' in the context of both, the underlying real-world transactions and the information provided with regard to these transactions. Additionally, our outline of the process would clarify that relevance is not applied ahead of representational faithfulness when it comes to identifying decision-useful information – which is what QC13 currently appears to indicate.

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?*

As set out in our response to the previous question, we are not of the opinion that a hierarchy of qualitative characteristic as set out in the ED by differentiating between fundamental and enhancing qualitative characteristics is appropriate. We refer to our comments above.

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?*

In the ED information is defined to be of 'relevance' if it is capable of making a difference in the decisions of users. We acknowledge that, under the current wording, it may be difficult to demonstrate that information actually *does* influence the decisions. Accordingly, we concur with the proposal to introduce some kind of probability notion to the definition. However, we are concerned that the proposed phrase '*capable* of making a difference' unduly broadens the definition of relevance. We, therefore, prefer a wording that refers to an influence on the decisions of users that can be "reasonably expected".

Generally, we welcome the intention to clarify the term 'reliability'. However, we disagree that changing the term into 'faithful representation' is the appropriate approach. Even if we accepted the IASB's intention that the change in terms did not imply any change in meaning, we are concerned that this change might be perceived as a change in meaning by those who interpret, apply, use and enforce IFRSs. We also believe the term 'faithful representation' is just as liable to differing understanding as the term 'reliability'. Especially, when seen in connection with the order in which the qualitative characteristics have to be evaluated, we are seriously concerned that the status of 'faithful representation'/'reliability' as a qualitative characteristic could be interpreted as being diminished compared to the current Framework.

In addition, we would like to mention a circular statement regarding the definition of 'faithful representation' that seems to us not being very helpful for a consistent understanding of what is really meant by 'faithful representation'. QC7 defines 'to be useful … information must be a faithful representation of the economic phenomena that it purports to represent' and goes on to state that 'faithful representation is attained when the depiction of an economic phenomenon is *complete*, neutral, and free from material error'. To explain what is meant by being *complete*' QC9 states: 'a depiction of an economic phenomenon is *complete* if it includes all information that is necessary for faithful representation of the economic phenomena that it purports to represent', so that statement leads back to the initial definition of 'faithful representation' in QC7. We recognise a similar circular statement regarding the definition of 'neutrality' in QC7 and QC10, sentence 2.

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?

In our view the qualitative characteristics of comparability and timeliness are appropriately identified and sufficiently defined for them to be consistently understood and useful.

However, we do not think that the proposed definition of verifiability is appropriate. We still share the concerns given in the alternative view of the earlier DP that reliable evidence is essential for verification and that the proposed definition does not sufficiently safeguard faithful representation.

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

After discussing the issue at length, we agree that the pervasive constraints are appropriately identified and sufficiently defined. It should be noted, though, that there are some arguments for materiality representing a component of relevance.

5. Additional comments on Chapter 2:

Substance over form

We do not agree with deleting the qualitative characteristic ‘substance over form’. Transactions and other events should be accounted for and presented in accordance with their economic substance and reality and not merely with their legal form. In situations in which the legal form and the economic substance of a transaction differ, it is the substance that should determine the accounting treatment. We would, therefore, prefer to see this notion being explicitly stated in the Framework, instead of incorporating it into the first paragraph of the explanation what faithful representation means.

Prudence

We think that the notion of prudence is an important attribute of decision-useful information. The Boards reasoning behind eliminating prudence might be due to a misapprehension. In our view the notion of prudence is important when making estimates, e.g. about uncertain future events, but not as a justification for understating assets or overstating liabilities. In cases in which making estimates and assumptions about uncertain future events and attributing probabilities to those future events is highly arbitrary, exercising a degree of caution seems appropriate. We disagree that the qualitative characteristic ‘neutrality’ serves the same purpose as ‘prudence’. Often a decision must be made between a more conservative and a more progressive alternative, without one being more neutral than the other. In such scenarios the notion of prudence helps to make a decision whilst the notion of neutrality would not. Therefore, we disagree with the prudence notion being eliminated and rather advocate keeping the notion of prudence in the framework accompanied by an appropriate definition of its meaning along the lines of our explanation above.