COMMENTS

6 October 2008

CONCEPTUAL FRAMEWORK: OBJECTIVE OF FINANCIAL REPORTING AND QUALITATIVE CHARACTERISTICS

Main comments

1- As set out in BUSINESSEUROPE's response to the Discussion Paper, we remain opposed to the revision of the conceptual framework on a piecemeal basis. While we believe that running the conceptual framework project in parallel with other active projects has demonstrated its efficiency, we do not believe appropriate to finalise any chapter (and hence consider a partial completion of the framework valid conceptual guidance to standard-setting) before the subsequent steps have either confirmed – or triggered necessary changes to – the first tentative conclusions.

2- While BUSINESSEUROPE, amongst others, has raised substantive comments, we observe that the bases for conclusions reflect only very few of the concerns we had formulated. As a result we have inserted in the appendix extracts of our answer to the Discussion Paper which reflect concerns which remain valid and that have been ignored in the Board discussion. Those concerns include:

   a. Net cash inflows that financial reporting help to predict should be defined (or described);

   b. The necessary broad consistency between the needs for financial reporting of capital providers and of management in its stewardship capacity of the capital provided, and the conclusions to be drawn there from;

   c. The need to define performance;

   d. Faithful representation being no justified valid substitute for reliability;

   e. Materiality to remain a distinct characteristic of relevance.

Considering, and providing views on, IASB's proposals, is a time consuming and expensive process that we wish as useful an exercise as possible. The basis for conclusions of an exposure-draft that follows a discussion paper should include a feedback statement on all comments received.

3- BUSINESSEUROPE also has also strong reservations about changes brought into the ED:

a. The issue at stake, i.e. the choice between two possible views of the entity theory, the **entity's perspective** and the parent company's perspective, is misrepresented in a discussion between the entity theory and the proprietary perspective; as a result no progress is made in the debate; furthermore we observe that the Board affirms the choice between the entity's perspective and the parent company's perspective in the DP on the reporting entity, without developing a proper argumentation on the issue. We therefore call again for the necessary debate to be initiated by the IASB before any decision is made;

b. The Board has introduced a distinction between **fundamental and enhancing characteristics** which we welcome. However we believe that understandability is a fundamental characteristic of financial reporting. Financial information which would be both relevant and reliable, but would be not understandable by users, would remain useless;

c. We have concerns on how **understandability** is characterised. We disagree with two aspects: first, the Board implies that complexity in financial reporting increases with the complexity of transactions only. We believe and could cite numerous examples where the complexity of financial statements grows because of Board's decisions. Secondly, as characterised by the Board, understandability will always be met, since the knowledge and expertise of users is expected to grow with the complexity of financial reporting, or users are expected to call for external advice. We believe that there should be a limit to growing sophistication, growing needs of users for always more powerful analysis tools. Limiting reasonably easy access to financial reporting to a few experts could have far-reaching and damaging consequences for the efficiency of financial markets as investors would no longer be able to make investment decisions without relying heavily on the services of advisors. Well informed investment decisions should not become the luxury of a happy few, while the ability to provide advice concentrates in a very small number of firms;

d. While we are now comfortable with the description of **verifiability**, we do not think it is well labelled as "verifiability". The notion seems to carry in English and in other languages the notion of "test against the truth". We would suggest substituting "supportability" to "verifiability";

e. Although we fully concur with BC 2.20-2.21, we believe that the description of **neutrality** would be valuably supplemented by something similar to the following: "in conditions of uncertainty where nonetheless an estimate can still faithfully depict an economic phenomenon, a degree of caution is needed in the exercise of judgement, so as to avoid any overstatement or understatement of both assets and liabilities". Such an addition does not suggest any form of conservatism, but clearly indicates that dealing with uncertainty requires caution and judgement;

f. We have concerns with how the fundamental characteristic of **reliability** (i.e. faithful representation in the proposed new IASB jargon) is described in paragraph QC11. We believe that financial reporting is reliable if the amounts shown in the primary financial statements can be relied upon without having to analyse supplementary information included as disclosures. Disclosures are useful in our view to provide further detailed information or enhance the predictive value of the information presented. *Disclosures cannot be seen as necessary to make the information presented reliable*. Disclosures can supplement financial statements when uncertainty is such that an amount would not be reliable enough to be recognised as an asset or liability.

4- While all the concerns described above are quite significant, we observe that the ED has improved over the DP, notably in style and conciseness. We are satisfied also with how the proposals deal with stewardship and how substance over form is re-affirmed.

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Appendix
Extracts of BUSINESSEUROPE comments on the DP which unfortunately remain relevant as no change has been introduced and no opposite argument is provided in the basis for conclusions.

a. ***Net cash in-flows that financial reporting should help to predict should be defined***
BUSINESSEUROPE notes that the Boards only refer to users' assessment of an entity's ability to generate future cash in-flows. We however believe that there is at present no common understanding of the information which is relevant for assessing such ability. Whether future cash-flow forecasts and hence the entity's performance should include and reflect a market benchmark instead of being consistent with an entity's business model and operations remain, in our view, to be thoroughly analysed, debated and explained.

b. ***Consistency between internal and external reporting should be reaffirmed***
The existing IFRS framework (paragraph 11) explains that management does not need to be considered as part of users of financial statements because they have the authority of requesting whatever information they need. It also states that external reporting is to be derived from internal reporting. In doing so, the existing framework acknowledges the necessary consistency between the two sets of reporting and the commonality of needs between management and users. What is relevant to users is also relevant to management and vice versa, although not at the same level of detail. Management as well as investors and creditors make resource allocation decisions on the basis of the entity's data.

BUSINESSEUROPE believes that the proposed chapters should have retained such evidence, or at least have explained why the Boards believe it would no longer be relevant.
If the Boards have good reasons to believe that management and investors and creditors have different perspectives, describing and analysing the differences would probably be very useful to future developments of financial reporting.

c. ***Performance should be defined***
As explained earlier, the conceptual framework should be the opportunity to discuss basic concepts, in particular concepts for which no shared understanding exists between the Boards and their constituents.

As the various and successive projects on reporting financial performance have shown, the definition of an entity's performance needs to be debated and understood.
We regret that no discussion at all is provided in the proposed chapter on financial reporting objective. Where the existing framework describes

the specific objective of each primary financial statement, (indicating that the objective of the income statement is to present an entity's performance), OB18-25 only discusses economic resources and claims to them, and changes in them, as if users were only interested in entities' financial positions (and how they have changed). The basis for conclusions provides no relevant justification as to why the Boards have decided to change the existing frameworks. The tentative justifications are not convincing as they remain based on the description of the accounting process rather than on the users' analytical process. No future net cash-inflows can be predicted starting with assets and liabilities at the closing date as primary inputs. We support paragraph 43 of FASB Concepts Statement 1 as quoted in BC1.28.

The Boards also indicate in BC1.30 that the notions of comprehensive income, net income, profit and loss do not convey the critical idea that in measuring performance an entity first starts to identify and measure economic resources and claims to them. We agree with the Boards; however we conclude that the "critical idea", although justified by how the accounting process works, should be dropped altogether as it does not relate in any way with how future cash in-flows can be predicted. It is therefore irrelevant to the objective as defined by the Boards.

d. Reliability should remain a defined qualitative characteristic

We can see no valid justification why the term "reliability" has been dropped. The Boards indicate that the term was not well understood. If this is the case, the term should be clarified, not dropped and replaced. We cannot see how adopting "representational faithfulness" makes the qualitative characteristic clearer. QC19 suggests that confusion arose because "purport to represent" was not well understood. We believe that the lack of common understanding was not in the words themselves, but as already explained above because there is no shared understanding of what future cash-flows should embody or what performance means.
Moreover we are aware that the change of wording is likely to raise translation issues and hence confusion.

e. Materiality should remain a distinctive characteristic of relevance

We disagree with the Boards' decision to re-characterise the concept materiality as a "pervasive constraint" (QC49-52). Materiality as a concept applies equally to relevance and reliability, but we believe that its application actually enhances the quality of financial reporting information rather than constraints it because:

- "Completeness" in the context of financial reporting does not mean "all information about every single transaction or event";
- Immaterial information has no impact on economic decisions and should therefore be excluded from financial reporting information that aims to provide relevant information;
- The aggregation of immaterial items (such as segments that are insignificant) enhances financial reporting information because it

makes it more understandable (and, therefore, more reliable). Conversely, the inclusion of immaterial information reduces understandability.

According to the DP assessing materiality is not a matter for standard-setters. However, for practical purposes, some practical and common-sense guidance on materiality is essential to ensure consistent application of standards and meaningful, useful financial reporting.

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