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DRAFT COMMENT LETTER

Comments should be sent to Commentletter@efrag.org by 31 October 2006

Dear Li Li

Re: 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"

On behalf of the European Financial Reporting Advisory Group (EFRAG) I am writing to comment on the 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* (the paper).

We would first of all like to say how pleased we are that the IASB has chosen to issue this material in the form of a discussion paper. The content of the IASB's Framework is of fundamental importance to the future development of IFRS and therefore of Europe's financial reporting system, so it is essential that Europe is given the opportunity to fully debate the Framework's content. That is particularly so bearing in mind that this is the first real opportunity that many European commentators have had to debate the principles involved.

We wish to start our comments by raising a general concern that we have about the paper and in particular about chapter 1. The analysis in that chapter starts by concluding that financial statements have a very wide range of users. It then, in OB6, provides an analysis of those users' information needs that is, in our view, rather superficial. OB11 then states that the objective of financial reporting stems from the information needs of external users who must rely on general purpose financial reporting. Then, with virtually no further analysis, we are told that:

- the objective of financial reporting is "to provide information that is useful to present and potential investors and creditors and others in making investment, credit, and similar resource allocation decisions" (OB2), and

- the primary focus of financial reporting is “the ability of an entity to generate net cash inflows” (OB13).

These statements are fundamental to the Framework and are expected to bear almost all the weight of the concepts and principles that follow (see appendix 2, paragraph 17), yet they appear to be unjustified assertions. We recognise that a similar comment can be made about the existing Framework; however, global standards are now being based on the IASB’s Framework and it is essential as a result that key statements of this kind are fully supported by reliable evidence.

Our detailed comments on the paper are set out in the three appendices to this letter. However, to summarise the main concerns raised in those appendices:

- We understand that the IASB believes it acceptable to issue new standards that are based on concepts that differ significantly from the Framework. That concerns us because we think it will have a major impact on the Framework’s usefulness. It also increases the risk of concepts being changed without being thoroughly debated in their proper context. In our view, it ought not to be acceptable to issue a new standard that is inconsistent with the Framework unless the inconsistency is relatively minor and temporary and certain other criteria are met. (See appendix 1, paragraph 3)

- An implication of the proposed Framework as currently worded is that its scope will be extended from general purpose financial statements to include other types of general purpose financial reports. Although we are very much in favour of having a Framework that applies to at least some types of financial report other than financial statements, we think the proposal has a number of important implications that appear not to have been fully addressed in the draft. (See appendix 2, paragraph 2)

- We are concerned about the proposed Framework’s treatment of stewardship and accountability. Although it would appear to be generally accepted that an objective of general purpose financial statements is to provide information that enables users of the statements to assess the stewardship of management, we think the proposed new Framework—like the existing Framework—is wrong to treat that stewardship objective as a sub-objective of the resource allocation decision usefulness objective. (See appendix 2, paragraph 3)

- Although we are pleased to see the ‘entity perspective v shareholder perspective’ issue addressed in the Framework (see OB10), we believe the issue should have been more thoroughly discussed in the paper. In the absence of such a discussion, we are not persuaded that an entity perspective should be adopted. (See appendix 2, paragraph 9)

- The paper proposes to clarify what is currently the qualitative characteristic of reliability. We agree that such a clarification is needed, but are concerned with the particular clarification proposed (which involves replacing ‘reliability’ with ‘faithful representation’). We think there is a lack of understanding—and some misunderstanding—as to what the notion of faithful representation entails, and we think further thought needs to be given to the possible need for a qualitative characteristic that encompasses the uncertainty (ie ‘softness’) of measures more broadly than the verifiability notion. (See appendix 3, paragraphs 3 - 6)

- We do not believe it is appropriate at the current time to omit the notion of 'substance over form' as a sub-characteristic of good financial information. The IASB is arguing that it can be omitted because it is encompassed by other qualitative characteristics and therefore adds nothing, but many commentators—including us—are not persuaded that is right. Indeed, we fear that the IASB's notion of economic substance might be different from ours. The notion has been very useful in the past and, we believe, will be very useful in the future as well if it is retained. (See appendix 3, paragraph 7)

Finally, we want to make a couple of general points about the style of document the revised Framework seems likely to be.

- First of all, judging by these first two chapters it will be a lengthy document; much longer than the existing IASB Framework. The longer the document is, the less likely it is to be read widely and the more likely those that read it are to disagree with at least some aspects of it. We wonder therefore whether it might be worth considering whether all of the material is needed or perhaps whether it might be possible to move a substantial part of it to a 'Development of the Framework' section.

- When we studied the draft text in the Discussion Paper, we thought that some of the language used was quite subtle and nuanced. While that might work well in countries in which English is the first language, it might mean that some of the meaning of the text is lost on translation. We think a Framework that is meant to be used worldwide needs to be capable of translation without loss or distortion of meaning.

We hope that you find our comments helpful. If you wish to discuss them further, please do not hesitate to contact Paul Ebling or me.

Yours sincerely

Stig Enevoldsen
EFRAG, Chairman

Appendix 1—EFRAG's detailed comments on the

Introduction to the [draft] Framework

1 The Introduction section explains the objective of the IASB's Framework, which is described as being to establish the concepts that underlie financial reporting. We support this objective. As the Introduction itself says, establishing the concepts that underlie financial reporting provides discipline about whether one solution to a financial reporting issue is better than other potential solutions.

2 The section then goes on to explain that the purpose of the Framework is to provide direction and structure to the standard-setting process. Although not mentioned in the Introduction, the Framework also currently has a more direct role in the preparation of financial statements by virtue of IAS 1.17 and IAS 8.11:

(a) IAS 1.17 requires that, where compliance with an IFRS requirement would be so misleading that it would conflict with the objective of financial statements as set out in the Framework, the entity shall depart (if the relevant regulatory framework requires or otherwise does not prohibit such a departure) from that requirement in accordance with IAS 1.18.

(b) IAS 8 requires that, in the absence of an IFRS that specifically applies to a transaction, other event or condition, management shall use its judgment in developing and applying an accounting policy that results in relevant and reliable information. IAS 8.11 requires that, in making that judgement, management shall refer to and consider the applicability of a hierarchy of sources and one item in that hierarchy is "the definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses" in the Framework.

We are comfortable with this purpose. We note that it is not the same as the purpose of FASB's Framework (because that Framework plays no direct role in the preparation of financial statements), but that difference does not concern us because a later phase of the project will seek to achieve convergence.

3 Finally, the Introduction makes clear that the status of the IASB Framework is that of a non-mandatory document.

(a) We support the view that the Framework does not set out *requirements* that preparers of financial statements are required to comply with.

(b) We have raised before with the IASB the question of whether it is appropriate for the IASB to issue new standards that are not consistent with the Framework (ie whether the Framework should be mandatory for standard-setting). Our view is that generally new standards should be consistent with the Framework. In the past the IASB has taken a different view and we have concluded

(i) (from the reference in paragraph IN2 to the Framework being "a guide",

(ii) the reference in IN5 to "financial reporting standards developed in response to changes in business practices and the economic environment may help in continuing the development of the [proposed] Framework";

(iii) the reference in OB15 and in QC47 to the concepts in the Framework being a goal or ideal toward which standard-setters should strive)

that the IASB's view remains that the Framework should not be mandatory.

In our view, the reason why Frameworks are such a valuable tool for standard-setting is because they provide a coherent frame of reference for standard-setting, thus enabling those standards to be developed on a consistent and coherent basis—the discipline referred to in paragraph 1 above. However, the moment it becomes acceptable to depart from the Framework, that coherent frame of reference is lost and, every time a new standard is developed, one possibility that will need to be considered is whether the standard should depart from the Framework. The result is a devalued Framework.

For that reason, our view is that it ought not to be acceptable to issue a new standard that is inconsistent with the Framework unless:

(i) the reasons and consequences of the decision to depart from the Framework, together with the plan for eliminating the inconsistency, are explained fully in the standard;

(ii) the change to or deviation from the concepts set out in the Framework has been considered in the context of the Framework as a whole and not merely in the context of the issues addressed in the particular standard;

(iii) the intention is that the inconsistency will be temporary and that the Framework and standard will be conformed as soon as practicable; and

(iv) the inconsistency is relatively minor.

end

Appendix 2—EFRAG's detailed comments on
Chapter 1: The objective of financial reporting

Scope

1 We note that the scope of the proposed Framework is wider than that of the existing Framework because, whilst the existing Framework applies just to 'general purpose *financial statements'* (henceforth just 'financial statements'), the proposed Framework applies to 'general purpose *financial reports'* (henceforth just 'financial reports'). As a matter of principle we support the IASB's decision to extend the scope of its Framework to cover some or all financial reports that are not financial statements because we believe that at least some of those financial reports (for example, the Management Commentary) are an integral part of the financial reporting package.

2 However, the manner in which the IASB is proposing to extend its Framework's scope to financial reports other than financial statements is causing us a number of concerns.

(a) We note that the IASB considers the term 'financial report' to have a very wide meaning. (For example, OB16 refers, inter alia, to news releases and descriptions of management's plans and expectations.) We note also that the IASB intends to address what it calls the 'boundary of financial reporting' (which we assume means a definition of what 'financial reporting' is for the purposes of the Framework) much later in the project. We think this is unhelpful because it means that, in responding to the paper, we are being asked to consider its applicability to all types of financial report. A preferable approach might have been to focus on financial statements in this phase of the project stage, then consider in a later phase how the scope could be extended to some or all other financial reports.

If it is of any help, we would have thought that it ought to be possible in the short- to medium-term to include within the scope of the Framework (subject to the point made in (b) below) those financial reports that are included in the annual and interim financial reporting packages alongside the financial statements, but that it is probably not realistic to attempt to include any other financial reports within the Framework's scope in that timescale.

(b) We do not believe that it can simply be assumed that the concepts that apply to financial statements apply equally—ie without amendment—to other financial reports. For example, the recent Discussion Paper on the Management Commentary suggested that the desirable qualitative characteristics of the information provided in a Management Commentary are slightly different from the desirable qualitative characteristics of the information included in financial statements. We share that view.

(c) Paragraph 12 of the existing Framework sets out the objective of the financial *statements*. However, OB2 of the proposed Framework—consistent with that Framework's broader scope—sets out the objective of financial *reports*. That creates a problem, because it is not clear whether the proposal is that every financial report should have the objective set out in OB2 or whether the proposal is that financial reports, when taken together, should seek to achieve that objective.

(i) This is important because, unless it is the former (ie that every financial report has the same objective), the proposed new Framework will not set out the objective of financial statements. We think that would reduce the usefulness of the Framework. It would also make it necessary to amend IAS 1.17.

(ii) We are however not convinced that the former is true, not even if the term 'financial report' is defined as referring only to those financial reports set out in the annual and interim financial reporting package.

Objective of financial statements

3 Putting the above issue aside and focusing on OB2 just from the perspective of the financial statements, we have two concerns about the objective as stated. The first concern relates to the treatment of stewardship.

(a) We share the view, expressed in the Alternative View section of the paper (see chapters AV1.1-1.7), that stewardship should be identified as a separate objective of financial statements. In many jurisdictions, stewardship and accountability (henceforth 'stewardship') were initially the primary reasons why financial statements were prepared. The subsequent development of capital markets has meant that there is now another reason for preparing financial statements, but the stewardship objective remains. We think those who suggest that the stewardship objective is nothing more than a subset of the resource allocation decision-usefulness objective might be taking too narrow a view of the information that can be needed to assess stewardship. An example of this is the way the Framework equates the resource allocation decision-usefulness objective with the need to provide information that helps in assessing the amount, timing and uncertainty of the entity's future cash flows (OB3 and OB13); in our view the stewardship objective cannot be met simply by providing information that helps in assessing future cash flows.

(b) We recognise that this aspect of the proposed new Framework is not significantly different from the existing Framework. However, that does not make it right; in our view the existing Framework also treated stewardship incorrectly.

We think that this issue has important implications for other aspects of the Framework. For example, as we have already suggested we think it would mean that the financial statements would need to do more than 'just' provide information that helps in assessing the amount, timing and uncertainty of the entity's future cash flows. We note also that some commentators have suggested that it would have implications for the qualitative characteristics (for example, to the importance attached to the reliability of measures under the existing Framework (and the verifiability of measures under the proposed new Framework)).

4 Our second concern about the objective as stated in OB2 is that it appears not to be consistent with the usage made of financial statements in practice, because evidence suggests that financial statements placed on the public record are used by a wide range of users for purposes other than resource allocation decisions. Again, this might have important implications for other aspects of the Framework.

Primary users of financial statements

5 OB12 argues that investors and creditors (potential and actual) and their advisers are the primary users of financial reports; the existing Framework states that the primary users of financial statements are investors. Putting aside the issue discussed in paragraphs 1 and 2 above concerning the extension of the scope of the Framework to financial reports, we agree that the main (and therefore primary) users of financial statements are investors and creditors, and that the Framework should be amended accordingly.

6 However, we have some difficulty with the actual logic in OB12. It argues that, because:

(a) investors and creditors are the most prominent external users of financial reports,

(b) their information needs are better understood than those of other external users, and

(c) information needed by investors and creditors is also likely to be useful to other users,

it follows that investors and creditors are the primary users of financial reports. We think (b) and (c) are irrelevant to an assessment of which users are the primary users of financial reports (unless the phrase 'primary user' is being used in some sort of specialised sense).

7 We note that, as is made clear in OB8, the proposed Framework is using the term 'creditors' in a specialised way and, as a result, does not include so-called 'trade creditors' (ie a supplier who supplies on credit). We are not currently persuaded that this differentiation is appropriate or even necessary, and in particular do not find OB8 convincing.

8 We are also confused about the role that the primary user notion is intended to play in the proposed Framework.

(a) OB12 and 13 argue that, because investors and creditors are the primary users of financial reports and they have a common interest in the reporting entity's ability to generate net cash inflows, information about that ability to generate net cash inflows should be the primary focus of financial reporting. Those paragraphs therefore seem to be suggesting in effect that the information content of financial reporting should be determined largely by the information needs of investors and creditors.

(b) On the other hand, OB2 and OB10 make it clear that the financial reports should be designed to meet the needs of a wide range of users, and not just investors and creditors. In other words, it is not particularly important who the primary users of financial reports are, because financial reports should be designed to meet the needs of all users.

(c) Yet the remainder of the proposed Framework seems to focus on what OB13 describes as the common interest of investors and creditors: the reporting entity's ability to generate net cash inflows. Other information needs are ignored.

This seems confusing and makes it difficult to know how to decide what information should be included in the financial statements and what information need not. Perhaps either:

(d) financial reports should focus exclusively on the information needs of investors and creditors (and thereby probably meet many of the information needs of other users). According to the proposed Framework this would mean focusing on the reporting entity's ability to generate net cash inflows (although as explained above we disagree with this focus because we think it ignores the separate stewardship objective that exists); or

(e) financial reports should focus on the information needs of all users, which would mean not focusing just on the reporting entity's ability to generate net cash inflows.

Entity perspective v shareholder perspective

9 OB10 argues that, because the information provided by financial reports is directed to the needs of a wide range of users, it follows that financial reports should adopt an entity perspective rather than a shareholder perspective.

(a) Last summer we expressed concerns in our comment letter on the proposed amendments to IAS 27 about the proposal to adopt an entity perspective (rather than a shareholder perspective) without there having been a proper conceptual debate. We argued then that the issue ought to be addressed in the context of the Framework. For that reason we are pleased to see the matter is now being addressed in the proposed Framework.

(b) We had hoped that, when the IASB addressed the issue in its Framework, it would debate the issue thoroughly before reaching a conclusion, especially as this is such an important issue. However, the Discussion paper merely asserts (in OB10) that there is a link between who the users are and the perspective from which the financial statements should be prepared, then concludes that because financial reports are prepared for a wide range of users (rather than just investors), it follows that an entity perspective (rather than a shareholder perspective) should be adopted.

(i) We know that some commentators think the paper is right to say there is a link between who the users are and the perspective from which the financial statements should be prepared. However, some others do not agree and we would have expected the issue to have been discussed in the paper.

(ii) The paper does not explain in any detail what the two perspectives entail, nor why one may result in more useful information than the other. Again, we would have expected this to have been discussed in the paper.

Assertions

10 There are a number of important statements in the proposed Framework (and probably in the existing Framework and even other standard-setters' Frameworks) that appear currently to be unjustified assertions. A number of these unjustified assertions play a fundamentally important role in the Framework. Although this might have been

acceptable when the various Framework documents were first developed, we question whether it is acceptable 20 or 30 years later. We think therefore that it is time that research was carried out to provide support for the various assertions made.

In this context perhaps our biggest concern is in the material on users, users' needs, and how those needs are reflected in the concepts set out in the Framework. For example, we have not been persuaded from the evidence we have seen and the material in the Discussion Paper that enough is known about users and user needs to make statements such as the one at the end of OB13 that "by focusing primarily on the needs of present and potential investors and creditors, the objective of financial reporting encompasses the needs of a wide range of users". This statement is very important in the context of the Framework, but is as far as we can tell simply an assertion.

Limitations of general purpose financial reporting

11 According to the heading above the paragraphs, OB14 and OB15 describe inter alia the limitations of general purpose external financial reporting. We think this is a potentially important section, at least in the context of financial statements, because it is as important to understand what financial statements cannot achieve as to understand what they can achieve. We were as a result disappointed by the section's proposed content. We think the proposed Framework could be improved by, for example, including some of the material on limitations contained in paragraphs 1.8 and 1.9 of the UK ASB's Framework (the Statement of Principles). Those paragraphs read as follows:

> "1.8 Financial statements do not seek to meet all the information needs of users: users will usually have to supplement the information they obtain from financial statements with information from other sources. Furthermore, financial statements have various inherent limitations that make them an imperfect vehicle for reflecting the full effects of transactions and other events on a reporting entity's financial performance and financial position. For example:
>
> (a) they are a conventionalised representation of transactions and other events that involves a substantial degree of classification and aggregation and the allocation of the effects of continuous operations to discrete reporting periods.
>
> (b) they focus on the financial effects of transactions and other events and do not focus to any significant extent on their nonfinancial effects or on non-financial information in general.
>
> (c) they provide information that is largely historical and therefore do not reflect future events or transactions that may enhance or impair the entity's operations, nor do they anticipate the impact of potential changes in the economic environment.
>
> 1.9 These inherent limitations mean that some information on the financial performance and financial position of the reporting entity can be provided only by general purpose financial reports other than financial statements—or in some cases is better provided by such reports. For example, although a description of the business environment and markets in which a reporting entity operates and the strategies it has adopted is usually needed to put into context the numerical information provided by the financial statements, it is generally better to provide such information in the material accompanying the financial statements than in the financial statements themselves."

We recognise that the UK Framework is discussing the limitations of financial statements and the proposed Framework is focusing on financial reports in general, but we nevertheless believe that a discussion along these lines is helpful in managing the expectations of those involved in the standard-setting and financial reporting process.

Performance reporting

12 In the existing Framework, each primary financial statement has a separate objective and the objective of the income statement is described as being to show financial performance. However, in the Discussion paper OB18 sets out a high-level summary of the things that financial reports should focus on: resources (ie assets), claims to resources (liabilities and equity), and “information about the effects of transactions and other events and circumstances that change resources and claims to resources”. This focus on the changes to resources and claims to resources is repeated in, for example, OB23 which refers to “information about an entity’s financial performance during a period measured by changes in its resources and claims to them other than claims resulting from transactions with owners as owners.” In other words, ‘financial performance’ should be measured in terms of non-owner changes in equity. To date, financial performance and non-owner changes in equity have been seen by many commentators as different things and we think that the view expressed in the proposed Framework needs to be debated properly before a change is made. Our understanding is that the IASB’s current intention is that that debate will take place in the context of Segment B of its project on Financial Statement Presentation—the renamed (and re-scoped) Performance Reporting project. Wherever that debate takes place, it is important that it is allowed to run its course and reach conclusions. Until then, it is premature to include the references highlighted above in a revised Framework.

More detailed points

13 OB1 has some words in italics (‘entities’, ‘entity’, and ‘business entities in the private sector’) which are presumably intended to be defined terms but are not, as far as we can tell, defined in the Discussion Paper or in IFRS generally. We do not think it particularly important to define ‘entity’ at this stage (because the reporting entity will be the focus of a later stage in the project) but we think it might be useful to define ‘business entities in the private sector’ so that it is clear whether the Framework is intended to apply to certain non-profit oriented entities and mutual arrangements that operate in the private sector.

14 The third sentence of OB23 states that information about financial performance as measured by changes in resources and claims to resources “indicates the extent to which the entity has increased its available economic resources, and thus its capacity for generating net cash inflows, *through its operations*…” (emphasis added) We think this is arguable because:

(a) some of the changes in resources could have been the result of value changes that had nothing to do with the entity’s operations; and

(b) as long as internally generated goodwill and other intangibles are not recognised as assets on the balance sheet, information about financial performance as measured by changes in resources and claims to resources will not indicates the *full* extent to which the entity has increased its available economic.

15 Finally, we thought we should mention that we found the order in which issues are discussed in the chapter rather confusing. For example:

(a) The description of objective of general purpose financial reports (in OB2) comes before the discussion that establishes what general purpose financial reports are and what the information needs of users of those reports are. This is odd, and makes it unclear whether the objective has been deduced from that later discussion or is some form of indisputable truth.

(b) It means it can sometimes be unclear exactly what the terminology being used means at any point in the text. For example, OB6 discusses the potential users of financial reports but it is not at first glance clear whether the paper is talking about all financial reports or just general purpose financial reports.

We think it might be more logical to structure the discussion as follows:

(c) start by identifying the users of all financial reports and their information needs,

(d) introduce the notion of special purpose financial reports and general purpose financial reports, thereby identifying the users of general purpose financial reports and their information needs, then

(e) set out the objective of general purpose financial statements and explain the extent to which they meet the needs of users of those reports. (This is where both the primary user notion could be developed, and the limitations of financial reports could be explained.)

A final remark

16 The conclusions that are reached about the users of financial statements, the information needs of those users, the extent to which those needs can be met by a single set of financial statements, and, therefore, the objective of those financial statements are of fundamental importance to accounting and therefore to the Framework. We would expect to see virtually all other aspects of the Framework justified in terms of those conclusions. For example, the choice, purpose and elements of primary financial statements should be deduced directly from those conclusions, because if that is not done, we cannot be confident that the concepts involved contribute to the usefulness of the financial statements. We think this needs to be borne in mind when developing future Framework Discussion Papers and Exposure Drafts.

end

Appendix 3—EFRAG’s detailed comments on

Chapter 2: Qualitative characteristics of decision-useful financial reporting information

The need for a neutral discussion

1 As you are probably aware, we are waiting somewhat impatiently for the promised debate about measurement to commence. We are particularly keen to ensure that, when the debate does take place, it is a full and proper debate and that the conclusions are not prejudged in any way. As a result, we are concerned that there are a number of instances in this chapter where the drafting and use of example seems to show a bias in favour of current market-based values (such as fair value) and against cost-based measures. For example:

(a) The example in QC12 that is used to illustrate how financial information can be highly predictable without being relevant picks a cost versus current value example and concludes that cost-based depreciation may not be relevant. Incidentally, the final sentence seems to imply that information about the decline in value of an asset-in-use and information about its “current condition in financial terms” is clearly highly relevant to an assessment of an entity’s ability to generate net cash inflows. We think that is a so-far unjustified assertion. Perhaps the measurement debate will provide the justification, but until then such assertions should be avoided.

(b) The example in QC18 seems to imply that current value-based amounts are more faithfully representational than cost-based amounts. In addition, we note that, although historical cost, replacement cost, and fair value are referred to in this example, there is no reference to value-in-use even though the discussion is about information that is very useful to those wishing to make assessments about future cash inflows. This seems an odd omission unless the authors have already reached some conclusions on measurement.

(c) Similarly, the example in QC22 also criticises the use of cost. It would have been very easy to have used a current value example here, yet again an example is used that, in our view somewhat unfairly, criticises cost at the expense of current value.

We recognise that the actual wording used in the examples referred to above allows room for other conclusions (because words like ‘might’ be more relevant and ‘might’ be more faithfully representational are used) but if there had been any doubt in the IASB’s mind as to whether current value is more relevant and representationally faithful than cost we would have expected to see some examples in which cost is described as being perhaps more relevant or more faithfully representational than current value. There are no such examples.

We cannot emphasise enough that, if the measurement debate is to be a success, it is very important that there is no suggestion whatsoever that the conclusion has been decided before the debate has started. The examples we have highlighted above do not help in this respect.

Relevance

2 The Paper proposes that relevant information should be defined as information that is *capable of* making a difference in the decisions of users (rather than information that *does* make a difference). We understand that the primary reason for this change is that it has been argued in the past that if information is not made available it cannot make a difference and would therefore under a strict application of the old definition not be deemed to be relevant. That is clearly an absurd situation and we would support an amendment that prevents such an argument being applied. However, the revised wording (particularly the final sentence of QC9, which says "standard-setters cannot rely entirely on users to request or identify all of the information that is capable of making a difference in a decision") could conceivably be used by the IASB to justify it insisting on the provision of information that users do not consider relevant. As we assume that is not the intention, we suggest amending the wording so that it refers to "information that is provided and makes a difference and information that is not provided but were it to be provided would make a difference."

Faithful representation v Reliability

3 The Paper proposes that the qualitative characteristic of 'reliability' (which has as sub-characteristics faithful representation, substance over form, neutrality, prudence and completeness) should be replaced by the characteristic of 'faithful representation' (which should have as sub-characteristics verifiability, neutrality and completeness). The Paper argues that this change is not a change of substance, but is needed to resolve long-standing problems over the meaning of reliability.

4 We agree that there are problems over the meaning of reliability and that this is a good opportunity to try to address them. For example, it is common, when people talk about reliability, for them to talk about it as if as it focuses solely on the uncertainty (ie ''softness') involved in a piece of information. (Under this usage, a measure based on an observed price on a market that is not highly active will always be less reliable than cost.) That is not however how the notion is described in the Framework. Furthermore, even under that usage, there seems little agreement on what the term means:

(a) It has been suggested that information prepared using a "through the eyes of management" approach is inherently less reliable than information based on a more independent view of the reporting entity.

(b) The recent Canadian Discussion Paper appeared to suggest that the use of allocation techniques reduces the reliability of information.

(c) Some commentators believe that reliability is actually a characteristic of relevant information—or, put another way, that information that is not reliable cannot be relevant.

There is therefore clearly some confusion as to what the notion means and how it should be applied.

5 However, although we agree that there are problems over the meaning of reliability that need to be fixed, we have some concerns about the fix proposed in the Discussion Paper. In particular, although faithful representation has been a sub-characteristic for

many years, we do not think it is a well-understood notion and some of the things we think we do understand about the notion make us uncomfortable.

(a) It is argued in the paper that the sub-characteristic of 'substance over form' is not needed in the revised Framework because it is encompassed within the faithful representation characteristic. (BC2.18 says that "to represent legal form that differs from the economic substance of the underlying economic phenomenon could not result in a faithful representation.") On the face of it that is good news, because we believe very strongly that financial statements need to faithfully represent the economic substance of transactions and other events. However, IFRIC has recently been considering the role of contractual and economic obligations in the classification of financial instruments under IAS 32 Financial Instruments: Presentation. In our view, if, for example, the terms and conditions of the instrument being classified are such that the entity will in the future be economically compelled to redeem the instrument, that instrument, depending on the exact facts of the case, could in substance be a liability not withstanding the absence of a contractual obligation to redeem. It is our understanding that some commentators, including some IASB and IFRIC members, argue that that is not however a faithful representation of the position. If that is the case, in our opinion the meaning of the faithful representation notion needs to be revised.

    We think part of the reason why the IASB might feel able to say that sub-characteristic of 'substance over form' is encompassed within the faithful representation characteristic is because the IASB has a notion of substance that is different from the notion that some other commentators have. We note in this context that US literature often refers to 'legal substance', a notion that we understand is in complex cases often closer to what many would view as legal form than to economic substance.

(b) It would also appear that some commentators believe that the application of the faithful representation characteristic as described in the Discussion Paper would inevitably result in the more widespread use of current value measures. If that is the case, the proposed amendment *does*, in our view, involve a change of substance; and if it is not the case it is further proof that the notion is not well-understood.

(c) We note (from BC2.49) that the IASB believes that the notion of faithful representation is "much the same" as the notion of presents fairly. We have looked back through the Discussion Paper's explanation of the faithful representation characteristic for evidence that it is the same sort of multifaceted dynamic notion as' true and fair view' and do not see any such evidence. In particular, one of the things that the true and fair view requires is that the information presented should make sense both at a micro transaction-level and at a macro level when one stands back and considers the financial statements as a whole. However, the discussion in paragraphs QC16 - QC19 seems to be fixed firmly on the micro level. As we have to date assumed that 'present fairly' and 'true and fair view' are essentially the same notion, it follows that either the explanation of the faithful representation notion is incomplete or that the notion is *not* "much the same" as the notion of presents fairly.

This suggests that further work should be done exploring and fleshing out the notion of 'faithful representation' before 'promoting' it as a qualitative characteristic of financial information.

6 There is a second issue that concerns us about the proposal that faithful representation should replace reliability as a qualitative characteristic of financial information, and that issue arises out of the way the existing characteristic of reliability has been widely applied by many practitioners over the years—to relate to the softness of the information. It seems to us that this application has not arisen by accident; it has arisen because practitioners believe that good financial information needs to strike an appropriate balance concerning its 'softness'. We recognise that some could argue that that is the function of the verifiability sub-characteristic—to ensure that soft information is not deemed to be a faithful representation. However, we think the verifiability notion as currently drafted fulfils a narrower role.

Put another way, it seems to us that one of the reasons there has been some many difficulties with the existing notion of reliability is that the way in which people wish to apply it and the way in which it is described in the existing Framework are different. We think that, rather than simply rename the characteristic, it would be better first to more fully explore the reasons why people want to use it in the way they do.

Substance over form

7 We have already mentioned some of our concerns about the way that the proposals treat the notion of 'substance over form'. We think it also important to state that our experience has been that the notion has been extremely useful to date—frankly more so than 'faithfully represent'—and we can imagine that, especially as it is difficult for the IASB to develop standards that fit well with all the different legal and cultural systems, that it will also be extremely useful in the future in helping to improve accounting worldwide and ensuring the appropriate application of IFRS. As the IASB's view is that the notion is encompassed within the faithfully represent characteristic, it is in effect saying that it can be omitted because it adds nothing—and that the change is not a change of substance. However, as explained in paragraph 5(a) of this appendix, many commentators (including EFRAG) do not share the IASB's view that the notion is encompassed within the faithfully represent characteristic. It follows that we (and those commentators) believe the notion adds something and that its omission *is* a change of substance. We therefore do not believe it is appropriate to omit 'substance over form' without doing further work.

Relevance v faithful representation/verifiability

8 As mentioned above, some commentators argue that information cannot be relevant if it is not reliable. We share that view. We also believe that information that is not a faithful representation cannot be relevant either. We think this is what QC44 means when it says "unfaithful depictions will be either useless for making decisions or misleading", but think the paper could be clearer.

Completeness

9 We mentioned in the previous appendix that we thought there were difficulties in taking the concepts that have to date applied to financial statements and simply extend their application to financial reporting generally. The qualitative characteristic of completeness provides a good illustration of the sort of problem that arises.

(a) We agree that the information provided in financial statements should be complete.

(b) However, the proposed new Framework does not say that. Instead it says that financial reporting shall be complete. That seems to suggest that, if an entity provides some of the information in the financial statements, some in the management commentary and some in a separate press release that would be satisfactory because the financial reporting is complete. Yet everyone would agree that such reporting would be unsatisfactory.

In our view any discussion of completeness needs to be accompanied by material that establishes where the boundaries should lie between the various types of financial report.

Comparability

10 We are uncomfortable with the discussion in QC38 about temporarily reducing the comparability of information in order to improve relevance or faithful representation because of its possible implications for the transitional arrangements incorporated into new or revised standards. In our view the IASB's general principle, when issuing new or revised standards, should be to require full retrospective application of the new requirements. Exceptions to that general principle should be rare, and usually the IASB should impose a longer lead-time rather than allow an exception to the general principle. We think this is important because, if prospective application is permitted or required for a particular standard, the reduction in comparability can often continue for many years And, if prospective application is permitted but not required for a lot of standards, there is likely to be very little comparability at all between companies–which would be an extremely bad thing. Our concern is that the wording in QC38 might make it easier for the IASB to depart from the retrospective application approach.

11 We think this wording also has potential implications for the inclusion of options in standards. As a general rule, we are not in favour of such options.

12 We are also concerned with the inference in this section that like items should be accounted for in the same way regardless of their function. That is not currently always the case and the paper does not explain why it is necessary for that current position to change.

More detailed points

13 Paragraphs QC3–QC6 set out a number of presumptions that the IASB makes and expectations that the IASB has about users and preparers. One of the statements is that financial reporting "cannot be of much direct help to those who are unable…to use it or who misuse it." We believe this part of the paper would be more balanced had it acknowledged that standard-setters have a responsibility in setting standards to do their best to make it possible for financial reports to be used properly.

14 We think the term 'relevant' might not be used in a consistent way in the paper. For example, in QC8 the Paper talks about relevance in terms of the information provided; yet in QC43 the paper seems to be talking about relevance in terms of determining which economic phenomena should be depicted in financial statements. This might appear to be a subtle difference, but it could be important.

15 We have already commented in paragraph 1 above about the example given in the discussion around predictive value in QC12 (straight-line depreciation of historical cost). We think there is an additional reason why the example is a poor one: it seems

to imply that depreciation is some sort of forecast of an asset-in-use's loss in value. In our view that is not its purpose. Predictive value is a more complex notion than it is presented as being in this paragraph.

16 We are a bit uncomfortable with the wording used to describe the faithfully represent characteristic. For example, in the reference to "a faithful representation of *the real-world economic phenomena that it purports to represent*" (emphasis added) is difficult. The exact meaning of 'real-world phenomena' is not clear. For example, we have heard concerns raised about how is it to be applied to an accounting measure that is never trued up or cannot be calibrated against a real world transaction.

17 We think it would be better if in QC30 an example that carries less 'baggage' were used to illustrate the point being made; we are not in favour of the Framework being used to comment on past very contentious standard-setting debates in this way. Similarly, we do not think it appropriate to include the discussion in QC31 about "political winds" and "politically motivated standards" in a document that is supposed to be setting out the concepts that should underpin good financial reporting. The discussion highlighted would be better placed in an essay about standard-setters and how they should behave. On the other hand, if the IASB believes such material is appropriate, we suggest that it expands the material and discusses the desirability of allowing the nature and content of standards to be based on anti-abuse concerns. Our view is that standards that are based on anti-abuse concerns can result in the provision of financial information that is not neutral.

18 As paragraphs BC2.21 and 2.22 explain, the existing Framework describes prudence as "the inclusion of a degree of caution in the exercise of the judgements needed in making the estimates required under conditions of uncertainty…". In the proposed new Framework, those words and the term 'prudence' is omitted.

(a) Bearing in mind all the baggage that the term 'prudence' seems to carry, we can accept the proposal that there should be no reference to it in the revised new Framework.

(b) On the other hand, we thought the explanation about the need to exercise caution in the face of uncertainty was quite useful and would prefer it to be retained (even if the word 'prudence' is omitted).

19 We think the discussion of understandability in QC39-QC41 could be improved by explaining that understandability needs to be considered both at the level of the individual item and at the aggregate level. We also question whether the discussion on hedging in QC41 is useful; we suggest retaining the last sentence but deleting the rest.

20 It seems a bit odd that having emphasised in the discussion on materiality that it is a qualitative as well as quantitative matter, much of the discussion tends to focus on the quantitative aspects. The discussion also seems to get into some auditing matters.

end