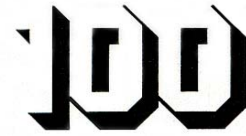

The Hundred Group
of Finance Directors

Financial Reporting Committee

Li Li Lian
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International Accounting Standards Board
30 Cannon Street
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EC3M 6XH

3 November 2006

Dear Ms Lian

Discussion Paper "Preliminary Views on an Improved Conceptual Framework for Financial Reporting: The Objective of Financial Reporting and Qualitative Characteristics of Decision-useful Financial Reporting Information"

I am pleased to submit The Hundred Group's comments on the above proposals. Our summary comments are set out below. Our detailed comments are set out in the Appendix.

The Hundred Group of Finance Directors represents the views of the finance directors of the UK's largest companies drawn largely, but not entirely, from the constituents of the FTSE100 Index. Our members are the finance directors of companies whose market capitalisation collectively represents over 80% of companies listed on the London Stock Exchange.

A. BACKGROUND TO OUR COMMENTS

Financial statements are in danger of losing their audience

We view financial reporting as a practical exercise in communication, not as a theoretical or academic construct. Communication is built upon characteristics of understandability, transparency, relevance and reliability and these should be central to the conceptual framework.

Over recent years we have seen financial reporting become increasingly theoretical. Although financial statements are now overloaded with disclosures they have actually become less, not more, transparent. As a result, in our view, financial statements are in danger of losing their audience.

We view the development of the conceptual framework as a vital step that, if we get it right, will help to arrest this trend. Get it wrong and, in our view, the credibility of accounting will be at risk.

We do not welcome the phased approach

We do not believe that it should be necessary to develop the conceptual framework in phases. We regard the boards as thought leaders and we expect that they have a vision of the future direction of financial reporting that will eventually be embodied in future phases of

the proposals. Rather than stand accused of having a hidden agenda, we urge the boards to share their vision with their constituents at an early stage so that there can be an informed debate. As things stand, Phase A has the feel of a "Trojan Horse" about it.

Ten years is too long

We are concerned that the Boards have not committed to a timetable for the development of the conceptual framework. We understand that the boards view the conceptual framework as a ten-year project. We acknowledge that the development of a common conceptual framework is not an easy task, but we would expect that, if they give the project sufficient priority, with their combined resources the boards should be able to complete the project within, say, three years.

The framework should be a clear, concise statement of principles

The Phase A proposals alone run to 41 pages (excluding the Basis for Conclusions and Alternative Views) which is almost twice as long as the IASB's entire existing framework which runs to 23 pages. We believe that the framework should be a clear, concise statement of principles and we would urge the boards pay particular attention to these qualities as the framework develops.

B. PREFACE

The framework should be developed before new standards, not made to fit them

We believe that the conceptual framework should be what it purports to be, i.e. it should be the framework around which future accounting standards are built.

We accept that it would be impractical to defer the development of new standards while the common conceptual framework is being developed. However, our problem is with the idea that the project should take ten years, not with the principle that no new accounting standards should be developed during that time.

Development of new accounting standards should continue, but draft standards should take account of the developing conceptual framework. If the boards were to accelerate the conceptual framework project, it should be possible for the first jointly developed standards to be implemented in 2010 (which is only one year later than is currently envisaged by the boards).

Status of the framework should have been considered

We disagree with the boards' decision to defer consideration of the authoritative status of the framework. We believe that this is an important issue because the authoritative status of the boards' existing frameworks is so different. We believe that the authoritative status of the common conceptual framework should be consistent with that of the IASB's existing framework.

C. OBJECTIVES OF FINANCIAL REPORTING

The framework should serve the real needs of the users

We fully support the notion that financial reporting is one basis for understanding future value creation. User groups tell us they want information to try to achieve the following:

- To forecast future cash flows to value the business or securities;
- To understand the business drivers behind the cashflows;
- To understand the risks inherent in the business and those measures adopted by management which aim to decrease (or increase) risk;

- To assess the historic performance of management against their stated aims and targets.

The proposed framework addresses the first objective but fails to address the remaining objectives.

We do not, therefore, believe that the proposed framework would provide the basis for accounting standards that meet the real needs of users.

The framework should stress transaction driven changes in value

We contend that historical transactions and cash flows are essential to assess financial (and management) performance and build up a picture of an entity that will enable users to take resource allocation decisions.

BC1.30 states (emphasis added) "The boards concluded that none of the terms…[comprehensive income, net profit or profit or loss]…communicate ***the critical idea*** that in measuring financial performance, an entity first identifies and measures its economic resources and the claims on them".

We believe that this is a fundamental misconception. In reality, entities measure performance based on transactions and cash flows, not on the difference between two balance sheets. A balance sheet is a residual and has relatively little predictive value.

In our view, the best indicator of future performance are past transactions and cash flows adjusted by users to take into account changing economic conditions and specific business developments.

The framework should have as a specific objective the assessment of management performance

Reporting on management performance is **absolutely fundamental** where there is division of ownership and management. Owners need to know whether management has made effective use of the resources that they have entrusted to them. Reporting on management performance has historically been termed "stewardship".

We sense that stewardship has become an emotive term and there is strong opposition to its use among members of the boards. We therefore suggest that "stewardship" might be better termed "management accountability".

We believe financial statements are, and will continue to be, used to assess management performance, regardless of whether events or circumstances are directly controlled by management. Management run a business in light of the events and circumstances that occur and their ability to manage under such conditions is a powerful indicator of their ability in the future to generate net cash inflows.

Users use financial statements to assess management performance. We therefore find it difficult to understand why the boards object so strongly to including stewardship (or management accountability) as a specific objective of financial reporting.

The framework should emphasise the need to align financial reporting with internal performance measurement

Whilst we accept that management information is often prepared using different bases than statutory reporting – for example, budget rates of exchange, standard costs etc – the information is still underpinned to a significant extent by reporting standards.

We can conceive of few instances where users require information that management does not use to run the business. We contend that if there is further deviation between financial reporting and internal performance measurement, there is the danger that financial reporting will lose credibility among both non-financial management and users.

D. QUALITATIVE CHARACTERISTICS

The framework should be practical, not theoretical

We support the view expressed in QC4 that "Financial reporting is a means of communicating information…."

We therefore believe that it is incumbent on standard setters to write standards that are comprehensible and reflect transactions and other events in a way that users can relate to as well as being capable of implementation by preparers without undue effort.

The elevation of faithful representation (and, in particular, verifiability) as a qualitative characteristic is unjustified and represents a dilution of standard setting principles

We view the elevation of faithful representation and the replacement of reliability with verifiability as misguided. The relegation of substance over form as a concept is particularly regrettable. In the United Kingdom, we have a strong test of whether or not financial reporting portrays a "true and fair" view. We do not believe faithful representation will always meet this test – faithful representation will, we believe, show a true position but not necessarily a fair one.

The framework must explicitly support the idea that standard-setters should be obliged to compare costs to prepare against the benefits to the users and be transparent in that process

It is often forgotten that the single biggest users of standards are the preparers and whilst we welcome the cost-benefit aspect elements of the framework, there is insufficient emphasis within the framework on the governance that is required on the part of the standard setters to ensure this is truly addressed.

E. FUTURE DEVELOPMENT OF THE FRAMEWORK

Phase C - Measurement

Phase A seems to be setting the scene for performance measurement to be based on the difference between two balance sheets measured at fair value.

We are not necessarily opposed to the use of fair value provided it is both relevant and reliable. However, we are strongly of the view that the wholesale proliferation of fair value should be avoided. Excessive use of fair value would result in an abundance of fair value changes that, in our view, would obscure the measures on which users base their assessment of past and future performance.

We reiterate our view that the best indicator of future performance are past transactions and cash flows adjusted by users to take into account changing economic conditions and specific business developments.

Phase E – Presentation and disclosure

We regard the current joint project on financial statement presentation as absolutely critical for the credibility of financial reporting. If, as we fear, financial statements are to become more theoretical and more focussed on fair value, it is essential that users are presented with performance statements which clearly differentiate between the underlying trading performance and the background noise of changes in fair values and other theoretical constructs.

We hope that sufficient users and preparers are consulted before any firm proposals are made public. We have to say that we are not encouraged by what we have seen so far. It

seems that not content with making the income statement less transparent, the boards now wish to do the same with the balance sheet.

Since the adoption of IFRS, there has been a marked increase in the use of pro-forma information and non-GAAP measures. We expect that we will see more of this unless the performance statements are presented in a way that highlights the information that is required by users.

As we suggested at the outset, financial statements are in danger of losing their audience.

Disclaimer

We reserve the right to revisit our comments on Phase A as subsequent phases of the framework emerge and the whole picture unfolds.

Please feel free to contact me if you wish to discuss our comments on the Board's proposals.

Yours sincerely

Ken Lever
Chairman
The Hundred Group - Financial Reporting Committee

APPENDIX

A. BACKGROUND TO OUR COMMENTS

Financial statements are in danger of losing their audience

We view financial reporting as a practical exercise in communication, not as a theoretical or academic construct. Communication is built upon characteristics of understandability, transparency, relevance and reliability and these should be central to the conceptual framework.

Over recent years we have seen financial reporting become increasingly theoretical. Although financial statements are now overloaded with disclosures they have actually become less, not more, transparent. We have found that users are requesting that pro-forma information is provided outside the financial statements in order that they can assess trading performance. We have also found that our own non-financial management are losing confidence in the published financial statements because the information contained within them is increasingly different from that which they use to run the business. In summary, in our view, financial statements are in danger of losing their audience.

We view the development of the conceptual framework as a vital step that, if we get it right, will help to arrest this trend. Get it wrong and, in our view, the credibility of accounting will be at risk.

When asked in a recent survey what they thought should be the priorities for the IASB in setting its work programme, Hundred Group members thought that the highest priority project should be given to the review of the conceptual framework.

We do not welcome the phased approach

We do not believe that it should be necessary to develop the conceptual framework in phases. We regard the boards as thought leaders and would expect that they have a vision of the future direction of financial reporting that will eventually be embodied in future phases of the proposals. Rather than stand accused of having a hidden agenda, we urge the boards to share their vision with their constituents at an early stage so that there can be an informed debate. As things stand, Phase A has the feel of a "Trojan Horse" about it.

Furthermore, we do not believe that it is reasonable to expect the boards' constituents to comment on each phase in isolation. As commentators, we reserve the right to revisit earlier phases as the whole picture unfolds. We expect that the boards will do likewise. We believe that this will prolong what already promises to be a long drawn-out process.

Ten years is too long

We are concerned that the boards have not committed to a timetable for the development of the conceptual framework. Based on the IASB's published work plan, discussion papers on five of the eight phases will not appear until some time in 2008 and there is no mention of when the project is expected to be completed. We understand that the boards view the conceptual framework as a ten-year project.

We acknowledge that the development of a common conceptual framework is not an easy task, but we would expect that, if they give the project sufficient priority, with their combined resources the boards should be able to complete the project within, say, three years.

The framework should be a clear, concise statement of principles

The IASB's existing conceptual framework runs to 23 pages. The Phase A proposals run to 78 pages. We recognise that 37 pages are taken up by the Basis for Conclusions and Alternative Views, but the Phase A proposals alone are still almost twice as long as the entire existing framework.

We believe that the framework should be a clear, concise statement of principles and we would urge the boards pay particular attention to these qualities as the framework develops.

B. PREFACE

The framework should be developed before new standards, not be made to fit them

We believe that the conceptual framework should be what it purports to be, i.e. it should be the framework around which future accounting standards are built. In our view, the authority and content of the boards' existing conceptual frameworks are so different that we cannot see how they can jointly develop accounting standards without having first established a common conceptual framework. Yet, the boards seem content to pursue this course. In our view, this is rather like two people setting out on a journey without a map. If they don't know where they are going, there is a strong likelihood that they will eventually disagree strongly about their choice of direction.

We envisage that the lack of a common conceptual framework may jeopardise the entire convergence project.

We accept that it would be impractical to defer the development of new standards while the common conceptual framework is being developed. However, our problem is with the idea that the project should take ten years, not with the principle that no new accounting standards should be developed during that time.

Development of new accounting standards should continue, but draft standards should take account of the developing conceptual framework. If the boards were to accelerate the conceptual framework project, it should be possible for the first jointly developed standards to be implemented in 2010 (which is only one year later than is currently envisaged by the boards).

We suspect that the reality will be that the framework will be designed to fit the standards and will not be, as we believe that it should, the framework around which the standards are built.

We do not believe that, once established, the conceptual framework should never change. We recognise that it may need to be modified to reflect changing business activities, user needs and developing thought on accounting issues.

Status of the framework should have been considered

We disagree with the boards' decision to defer consideration of the authoritative status of the framework.

We believe that this is an important issue because the authoritative status of the boards' existing frameworks is so different. While the FASB's framework has little or no authoritative status, the IASB's framework is included in the hierarchy of GAAP to be considered by preparers when setting an accounting policy in the absence of an applicable standard. In our opinion, the authoritative status of the common conceptual framework should be consistent with that of the IASB's existing framework. In other words, the framework should be a guide

(not rigid rules) for standard-setters in setting standards and for preparers in the absence of an applicable standard.

C. CHAPTER 1 - THE OBJECTIVE OF FINANCIAL REPORTING

<u>The framework should serve the real needs of the users</u>

The objective of financial reporting—providing information useful in making investment and credit decisions

We do not regard "true and fair" view as being a qualitative characteristic (BC 2.72) but rather the main objective of any form of financial reporting. We further believe that a true and fair view allows less ambiguity in interpretation than faithful representation as the latter in our view extends to a more legalistic framework.

OB2 is focussed on information for investment, credit and similar resource allocation decisions, all forward-looking concepts. One of the most important aspects of financial reporting is to assess management performance and stewardship of the assets of the business which we believe should be clearly stated.

The framework as currently written is unduly weighted to the prediction of future cash flows in OB 3-5. The discussion in OB 3-5 is certainly related to financial reporting but does not automatically follow from OB2. For instance, historical performance is absolutely key in considering the future and is very relevant information for users.

If the objective of financial reporting is focussed solely on predicting future cash flows which is how the framework is currently being drafted, we would question whether the objective can ever be realised. Future cash flow performance is a function of many different variables of which only some can be reflected in financial reporting.

We fundamentally believe that financial reporting is more than just a tool for users to predict cash flows but also allows users to assess other factors that they expect from the entity (eg corporate ethics).

We would suggest that OB 2 is amended to reflect the assessment of management performance:

"The objective of general purpose financial reporting is to show management's performance in managing the resources entrusted to it and to provide other information that is useful to present and potential investors and creditors and others in making investment, credit, and similar resource allocation decisions""

Limitations of general purpose financial reporting

We concur with the sentiments of OB14: "Financial reporting is but one source of information needed by those who make investment, credit and other resource allocation decisions. Users of financial reports also need to consider pertinent information from other sources, for example, information about general economic conditions or expectations, political events and political climate, or industry outlook." We believe that this is an important point of principle and somewhat at odds with the increasing move by both boards towards trying to provide information in the primary financial statements which for most users are not wanted or could be better presented as disclosures.

We further concur with OB20 which clarifies that "…information is also likely to help those who wish to estimate the value of the entity, but financial reports are not designed to show the value of an entity….". We believe any move towards fair valuing all assets and liabilities on the balance sheet is fundamentally flawed and would hope that the boards recognise the

limitations of financial reporting as set out in OB20 before imposing any further fair value requirements. This is especially true in the light of the fact that our user base informs us they do not generally want this information (except in some instances where disclosures in the notes to the accounts only would be helpful).

The framework should stress transaction driven changes in value.

Changes in economic resources and claims to them

We agree with the basis in OB 22 that the effects of transactions are key to understanding financial performance. We are very concerned that the basis of conclusion in BC 1.30 and BC1.31 seems to reduce the importance of transaction reporting and thereby undermine the very basis on how financial reporting has developed over a long period of time to genuinely meet users' needs.

We fundamentally object to the boards' view that financial performance is simply the net change in economic resources and claims. We are greatly concerned that the basis for conclusions is paving the way for a single financial performance statement based on the difference between two 'balance sheets' before adequate consultation on users needs has taken place. We believe such an approach is conceptually unsound.

Our own evidence suggests that most users do not regard the difference between two 'balance sheets' as representing any sensible basis of measurement for financial performance. It is clear that users do regard the historical transactions performance as being more representative of the financial performance of an entity. Further, we would point out that management do not run their business on the basis of balance sheet information and are unlikely to start doing so.

And we take issue with the suggestion in BC 1.30 that an entity first identifies and measures resources, which is at odds with the reality of transaction based bookkeeping.

The framework should have as a specific objective the assessment of management performance

Stewardship

Reporting on management performance is **absolutely fundamental** where there is division of ownership and management. Owners need to know whether management has made effective use of the resources that they have entrusted to them. Reporting on management performance has historically been termed "stewardship".

We sense that stewardship has become an emotive term and there is strong opposition to its use among members of the boards. We therefore suggest that "stewardship" might be better termed "management accountability".

We strongly believe that the attributes associated with the term "stewardship" should be embodied within a financial reporting objective at least equivalent to the objective that has been identified by the boards. These attributes include:

- An emphasis on historic performance and transactions which underpin the financial performance of the business which helps balance the forward looking intent of OB3-5;
- The capture of completeness of information where management conceal non-quantitative information from shareholders (which does not correlate as strongly with faithful representation as currently defined);
- A preservation of management perspective;

- Accountability of management to the owners of a business (AV1.3) especially for smaller entities;
- Providing information that enables management performance to be assessed in the light of actual events and circumstances whilst recognising that this is only one part of any assessment (AV1.6). The ability for users to assess management performance is a fundamental part of the use of financial reporting by users (eg it may lead to the dismissal of management!);
- Disaggregation of information to highlight management related party transactions which may be to the detriment of a business but which may be immaterial to the business as a whole (AV1.7). Often such activities are not isolated and act as important signals to users.

We believe that the importance of the statement in OB23 (emphasis added) "Investors and creditors ***usually*** find information about an entity's past financial performance helpful in predicting the entity's future returns on its resources, which will be its future financial performance" is understated and not adequately reflected in the discussion paper.

The past financial performance is absolutely key to most users and management in assessing financial performance and is the best practical measure of whether cash inflows previously forecast by users have been realised which we believe is highly indicative of whether or not future net cash inflow projections are realistic and likely to be achieved.

Whilst we acknowledge the need for economic resources and claims on those resources, these provide ***additional*** evidence of future net cash inflows rather than evidence in isolation.

We concur wholeheartedly with OB27: "Because management's performance in discharging its stewardship responsibilities significantly affects an entity's ability to generate net cash inflows, management's stewardship is of significant interest to users of financial reports who are interested in making resource allocation decisions."

BC1.33 seems to conveniently blur the issue of whether stewardship should be a separate objective when it states: "Views about the meaning and implications of a stewardship objective differ, and supporters of such an objective do not necessarily view the implications of a separate objective focusing on stewardship in the same way that opponents do."

The discussion paper does not put forward these differing arguments so we find it difficult to understand how the boards have reached the conclusion they have. Whilst we accept that stewardship may be more difficult to define in one sentence, that is not a credible reason to effectively sideline it as an objective.

The statement in BC1.36 implies that the boards do think that stewardship is important (emphasis added): "On balance, the boards concluded that providing information useful in assessing how management has fulfilled its stewardship responsibility should remain as part of the overall objective of providing information useful in making resource allocation decisions. As noted in paragraph OB28, users of financial reports who wish to assess how well management has discharged its stewardship responsibilities generally are interested in making resource allocation decisions. The boards also concluded that eliminating any discussion of stewardship, even with an explanation of why such a discussion is unnecessary, ***could erroneously imply that the boards do not think that financial reports should provide information that is useful in assessing stewardship***".

OB 28 implies that resource allocation decisions and stewardship cannot always be viewed in the same way and hence, if indeed this is the case that users assessing management performance do not necessarily make resource allocation decisions (for instance, an owner

of a family business may want to assess whether management have respected the family business' values), then this surely supports the view that this should be a separate objective.

We believe that BC1.37 is misguided when it states "Financial reporting provides information about an entity during a period when it was under the direction of a particular management, but it does not directly provide information about that management's performance. To make stewardship a separate objective might exaggerate what is feasible for financial reporting to accomplish".

BC 1.37 contradicts the view set out in QC 4 that users are assumed to have a reasonable knowledge of business and economic activities. We find it hard to understand why anybody would argue that stewardship is about management's performance trying to ***ignore*** the effects and circumstances beyond the control of management; we would argue stewardship is about assessing management's performance ***in the light of*** actual events and circumstances.

Similarly, BC1.38 seems misguided. There are undoubtedly similarities between corporate governance requirements and stewardship in that both are addressing the agency issue. However, the context is entirely different; assessing financial performance as part of stewardship is entirely different to assessing management pay and conditions, albeit that performance (which may or may not be based on financial reporting measures) will impact on these factors as alluded to by BC1.39.

BC1.41 seems to be a very narrow interpretation. The ability of current management to use the resources of the entity to generate future cash flows is pretty fundamental to any business and whilst past performance is not necessarily a guide to future performance, it does represent the most tangible evidence of management's capability. Together with qualitative as well as quantitative true and fair reporting, users are able to assess the degree to which management have helped guide the business given the effects and circumstances that occur.

Why is the assessment of management performance so key?

The emphasis on the future detracts from events that have happened in the past which may be less relevant to future decision-making.

For example, a business disposal will not lead to future cash flows but is indicative of management's ability to extract value from the resources it manages. One could argue that the ability to extract value is decision useful information and helps resource allocation decisions although this is seems somewhat of a tenuous link. We believe assessment of management is so fundamental to the way in which management and owners interact and how businesses actually really operate, that it should be specifically included within the conceptual framework.

Similarly, discontinuing a particular hedging strategy during a year by using collars to fix in interest rates within a band, may not be decision useful going forward but is indicative of how management managed the business in the time period under review (perhaps when interest rates were more volatile). Non-owner users may be indifferent to this past strategy; owners of the business however have entrusted management with the business assets and therefore this is highly relevant when determining whether management have effectively used those assets.

Decision usefulness does not necessarily extend to management taking out an immaterial loan provided by the company which is then repaid within the financial year. Most users may be indifferent but the owners of the business would seek to have this highlighted as this

may not be something they agreed and may be indicative of inappropriate use of the company's resources.

The assessment of management is a tool in which one of the most important primary users of financial reporting - the owners of the business – can change cash flows. That is, the framework is directed at forecasting cash flows without apparently addressing that users can influence those very same cash flows.

Accordingly, we believe assessment of management should be a central objective of financial reporting which links to a recognition that financial reporting should reflect the way in which a business is run by management as set out below.

The framework should emphasise the need to align financial reporting with internal performance measurement

Financial reporting and management perspective

We have major concerns with the implication in BC1.42 that "general purpose external financial reporting is not explicitly directed to the information needs of management." Whilst we accept that management information is often prepared using different bases than statutory reporting – for example, budget rates of exchange, standard costs etc – the information is still underpinned to a significant extent by reporting standards. In addition, recent proposed developments in reporting (management commentary and segment information) recognise the close alignment of management and statutory reporting.

The examples in BC1.43 are helpful as they appear to be indicative that the boards have become more attuned to asking for disclosure of real management information which we would contend is highly relevant for users.

We contend that if financial reporting deviates significantly from the underlying way in which businesses are run, it will lose a lot of credibility and management will be forced to either explain numbers they do not understand (which users do not want) or provide proforma information as requested by their users. We therefore support financial reporting being closely aligned to how the internal management of the business is undertaken.

D. CHAPTER 2: QUALITATIVE CHARACTERISTICS OF DECISION-USEFUL FINANCIAL REPORTING INFORMATION

The framework should be practical, not theoretical.

We support the view expressed in QC4 that "Financial reporting is a means of communicating information…."

Whilst we also concur with the sentiments in QC5, it is equally incumbent on standard setters as set out in QC6 to write standards that are comprehensible and reflect transactions and other events in a way that users can relate to as well as being capable of implementation by preparers without undue effort. We feel that QC5 and QC6 should be re-ordered as QC6 naturally comes before QC5.

We believe that the framework should stress the provision of true and fair information based on observable data rather than theoretical or academic constructs.

As an indicator that the framework is practical, not theoretical, we would suggest that the boards avoid using the terms like "real world economic phenomena" (in this case, we suggest that the boards substitute for it something with meaning in the real world such as "transactions and other events").

The elevation of faithful representation (and, in particular, verifiability) as a qualitative characteristic is unjustified and represents a dilution in standard setting principles

Faithful representation

QC17 states that representational faithfulness incorporates "substance over form". Whilst some may view this as semantics we believe substance over form belongs to a broader concept which incorporates representational faithfulness.

A transaction may be represented faithfully in a number of ways including legal form but nonetheless may not reflect the substance of an arrangement. Further, the conceptual framework does not highlight in whose eyes representational faithfulness should be seen. A lawyer will often view the legal form as representing the economic position faithfully regardless of whether that is the economic substance of the transaction. A third party may view a transaction as faithfully represented in a different manner to management who determine the economic intent of the transaction. Accordingly, we would contend that representational faithfulness can only be determined by management and hence, is not quite as simplistic as the boards contend.

The example in QC 18 highlights this point that representational faithfulness is in the eye of the beholder. The conceptual framework does not cover this point. For example, the use of replacement cost of a machine that is never going to be replaced is simply wrong both on an economic and conceptual basis; the fair value of the machine is conceptually flawed (short of fair valuing the entire assets and liability of an entity) and lacks reliability; some form of "use" measure or amortised historical cost again appears to be the most sensible basis of measurement and does faithfully represent the consumption of the asset over its life. The logic of the above can only really be applied by using management intent to determine the value, a notion that is sadly missing from this part of the conceptual framework.

In contrast, substance over form reflects not only the economic intent but also the rationale of management. If representational faithfulness is predicated upon management intent, then this should be stated.

A key step in determining the substance of any transaction is to identify whether it has given rise to new assets or liabilities for the entity and whether it has increased or decreased the entity's existing assets or liabilities. If representational faithfulness encompasses the principle of new asset and/or new liability identification or a change in an entity's existing assets or liabilities to determine the accounting, it should state this.

We agree with the emphasis on economic form but the example in QC 18 is exceedingly unhelpful. To summarise the example with the words "…Whether one of these methods would provide a more relevant and more representationally faithful description of the machine is an issue for standards setters to resolve" is flawed. In the hypothetical instance that some form of non-historic cost accounting is required for property plant & equipment, surely it is on the part of the preparer to decide what the most appropriate method should be used in line with the substance of the fixed assets use?

The purpose of QC 22 is unclear unless it is designed to pave the way for a weak excuse for alternative bases for measurement. Faithful representation should represent the substance of the asset or liability in question and we do not regard certainty or precision as relevant to that discussion.

We have concerns over the definition of verifiability especially the alternative in QC 23 part (b) which states "that the chosen recognition or measurement method has been applied without material error or bias." This would appear to allow any mathematical formula to be used in conjunction with an academic model to meet the definition of verifiable but does not

(as the definition is drafted) include any reference to being representative of economic phenomena! This is supported by QC 26 which appears to sanction its use despite the fact that "…independent verification does not guarantee the appropriateness of the method used…."

Whilst we agree that independent verification carries some assurance over the method used, we believe a definition of verifiability as it stands is not only flawed but is conceptually wrong if there is no relation to reflecting economic phenomena or if the method is not economically proven. Whilst the boards could argue that this would be covered by faithful representation, it is somewhat surprising that the boards felt the need in QC 23 part (a) to explicitly include a reference to economic phenomena.

We are also concerned in what context such methods could be used. We would have thought that unless there is a complete move to fair value accounting (which we would strongly oppose both conceptually and on practicality grounds), the number of times QC 23 part (b) would be used practically is so few that it is not relevant to include in the framework.

Why does faithful representation not equate to substance over form?

In the United Kingdom, we have a strong test of whether or not financial reporting portrays a "true and fair" view. We do not believe faithful representation will always meet this test – faithful representation will we believe show a true position but not necessarily a fair one. The relegation of substance over form as a concept is regrettable. To illustrate, consider the following examples:

A business enters into a debt factoring agreement where the bank has full recourse to the business. The business expects the debtors to pay but has effectively accelerated its cash receipts. One could argue that the business has realised its debts and taken out a credit derivative – the debtors no longer exist and hence, why should one continue to recognise them when the business effectively only has credit risk exposure? This seems to faithfully represent the position.

The counter argument is that the business has taken out a loan secured on its debtors. The substance is that the risks and rewards of the debtor receipts are the same both before and after the event as the credit risk remains; therefore, why should one derecognise the debtors? Both positions are tenable but only one in our view constitutes the substance of the arrangement, not least as businesses do not as a general rule (knowingly) take out credit derivatives.

A similar argument exists for sale and repurchase agreements which may be structured whereby the buying party has a put option to return the goods in question. A faithful representation is that the goods have been sold and a financial instrument written (the put option). On this basis, revenue would be recognised for the sale and a cost for the potential obligation. We would contend the real question that should be asked is whether that was the substance of the transaction? Typically, accelerating revenue to achieve an accounting result would be the wrong answer.

Faithful representation may allow available for sale investments previously impaired to be valued upwards through the SORIE; substance over form would suggest that the amount being written up should be booked in the income statement (at least to the point of the original investment cost).

These examples also highlight the need for assessment of management performance; in our view, any sub-optimal activities (cash inflows accelerated or delayed between two time periods) undertaken to achieve financial targets is not necessarily decision useful if reflected

in the financial statements but is very important when setting standards to avoid economic misstatements and abuse to achieve internal measures.

In conclusion, we believe that the elevation of faithful representation to a qualitative characteristic is unjustified. We now look at why reliability should be retained as a qualitative characteristic.

We regard reliability as a better qualitative characteristic than verifiability

We do not understand why the discussion in BC2.23 "Can reliability be empirically measured?" is included given the fact that representational faithfulness is equally incapable of being empirically measured.

If empirical measurement is regarded as being important, we see no grounds for replacing reliability with faithful representation and wonder if this discussion is indicative of a political compromise between the boards on qualitative characteristic nomenclature.

Reliability is a qualitative characteristic which is contained in the existing IASB framework and we believe it is readily understood. Reliability allows preparers to measure assets and liabilities in a way that can be verified and that users can understand. We accept absolute precision in reliability is unlikely in most cases to be fully achievable but the arguments in the conceptual framework do not address adequately why reliability as a concept is flawed. Indeed, if one believes the yardstick by which the boards have assessed reliability, we do not understand why representational faithfulness should give an enhanced answer – it certainly will not give increased precision.

BC2.28 states (with emphasis added): "The boards concluded that at least some of the problems seem to be related to presenting *faithful representation* as only one component of reliability. Faithful representation—correspondence or agreement between the accounting measures or descriptions in financial reports and the economic phenomena they purport to represent—is essential if information is to be decision-useful. To faithfully represent real-world economic phenomena, accounting representations must be complete and neutral. In addition, verifiability is needed to assure that the measures or descriptions are free from material error and bias and can be depended on to represent what they purport to represent. Accordingly, the boards concluded that faithful representation encompasses all of the qualities that the previous frameworks included as aspects of reliability. In addition, elevating faithful representation helps to emphasise that ***the goal of financial reporting is to faithfully represent real-world economic phenomena and changes in them—whatever they may be. For example, representations of fair values should change when the values change, and the changes should reflect the degree of volatility in those changes. To depict a lack of volatility if the values are, in fact, volatile would not faithfully represent the economic phenomenon***."

We are concerned that this statement advocates the use of fair values ahead of the Basis of Measurement discussion paper to be issued as part of the Conceptual Framework and is without context. We agree that representations of fair values should change when the values of economic phenomena change, and the changes should reflect the degree of volatility in those changes. We do not agree that to depict volatility on the balance sheet faithfully represents the position of the entity and further, when taken with the other qualitative characteristics would suggest that fair value volatility can be disclosed in the notes to the accounts to give a far more relevant and understandable information set to users.

We are further concerned that QC23 part (b) seems to imply that a degree of unreliability or less precision is acceptable. Whilst this may be poor drafting there is insufficient argument

to support the need to change. We find it difficult that the boards wish to support a potentially unreliable qualitative characteristic over a reliable one.

<u>We believe understandability should be given equal prominence to relevance and reliability (faithful representation)</u>

We concur with the importance of understandability as a qualitative characteristic and believe that it is an **equally important** qualitative characteristic to relevance and reliability. Indeed, ranking the qualitative characteristics is not a particularly useful departure for standard setting in our view.

Any event that is unlikely to be understood by users is irrelevant; we would particularly point out that developing accounting standards and measurements bases to try to value items that are not readily understandable through quantitative means is flawed and that it is far more appropriate to provide qualitative disclosures. Relegating understandability to a less prominent qualitative characteristic in our view increases the risk of inappropriate and irrelevant quantitative data being provided to the user groups.

We are somewhat surprised by the inclusion of BC2.36: "Despite those discussions of understandability and the descriptions of the users to whom financial reporting is directed, misunderstandings persist. For example, respondents other than users sometimes comment that a proposed financial reporting standard would result in information that users would not understand. Those respondents generally do not explain why they think users would not understand the information, nor is it apparent that they acknowledge the responsibility of users to study the information with reasonable diligence or of preparers to enhance its understandability. In some circumstances, constituents seem to consider understandability to be more important than relevance. They imply that a standard-setter should not require a new accounting method that would enhance the relevance of financial reports because some users might not understand it."

Anecdotal evidence suggests that users do not understand some of the more recent IFRS standards and to suggest otherwise is disingenuous. If the boards genuinely believe that the standards are understandable, they can look no further than the prevalence (and increasing prevalence) of non-GAAP measures and proforma financial information. Preparers should not and in our experience, do not produce such measures to be misleading or to tell a story different to the economic reality.

In our experience, non-GAAP measures and proforma financial information is a necessary requirement to (i) remove volatility that does not faithfully represent economic phenomena for instance because it arises from an accounting mismatch, (ii) to provide information that is understandable as a result of being misrepresented as a result of accounting standards, and (iii) to provide users information that they have requested and find useful.

We believe the increasing number of companies that concentrate on date having removed the volatility associated with IAS 39 fair value changes is illustrative of the fact that it lacks understandability given (i) users do not want this information given it does not represent a future economic indicator, and (ii) management do not use fair values in running their business in this way.

We feel understandibility is an important criteria to be considered in the context of relevance. If the requirements of a standard are not understood, even after study with reasonable diligence on the users' behalf and with preparers trying to enhance the understandability, then the requirements for most users will be irrelevant.

Should additional qualitative characteristics be added?

Transparency

We support transparency of financial reporting information as a qualitative characteristic. A framework that advocates transparent information is one which supports information that is able to be seen through and clear. Transparency and understandability are related characteristics but transparency focuses on simplicity and clarity whereas understandability focuses on whether something can be understood. An entity can produce an understandable information set in 10 pages or one; transparency seeks to emphasise the need to focus on the one page summary for clarity. Accordingly, transparency as a qualitative characteristic we believe helps focus messages to be concise and clear. We cannot think of a good reason why it should not be added as a separate characteristic rather than being indirectly obtained via other qualitative characteristics.

The framework must explicitly support the idea that standard-setters should be obliged to compare costs to prepare against the benefits to the users and be transparent in that process.

QC 53 states "…standard setters seek information from preparers, users, and other constituents about what they expect the nature and quantity of the benefits and costs of proposed standards to be and consider in their deliberations the information they obtain." We are supportive of this principle.

However, we are somewhat surprised by this statement given the real and anecdotal evidence we have obtained from our members and the users we interact with which does not indicate this information has been sought from a sufficiently broad constituency in the past.

The statement in BC2.6 that "…The boards also meet frequently with users and user organisations to discuss not only the potential benefits and costs of particular proposed standards but also potential agenda decisions and other matters" as somewhat disingenuous. On the basis this is occurring, we believe such meetings should be transparent so that all parties who are affected by standard setting activities can understand who is shaping the financial reporting agenda. We further note that there is no mention of preparers who are the only constituents who incur direct costs and as such, should be party to any such discussion.

QC 58 further states: "…Nevertheless, standard-setters should do what they can to assure that benefits and costs are appropriately balanced." We concur with the sentiment.

BC 2.72 states "the boards concluded that the improved framework should go further in the area of assessing benefits and costs than the existing frameworks do. But the draft framework stops short of committing standard-setters to demonstrate that the benefits of a proposed requirement would justify the related costs." We concur with the sentiment but in addition, for the purposes of providing transparency, we believe the cost-benefit decision should be supported by a rationale which should incorporate which user groups, preparers and other constituents have been consulted.

We do not believe any standard setting activity can be neutral if only certain users' views (which invariably, happen to align with the boards views) are represented. Further, the users' views are not verifiable for the purposes of proper governance if they are not identified and the remaining preparer, user groups and other constituents cannot have confidence that any standard faithfully represents a real user need.