THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND & WALES

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Dear Li Li

CONCEPTUAL FRAMEWORK

I enclose the comments of the Institute of Chartered Accountants in England and Wales on the discussion paper, *Conceptual Framework.*

I would be grateful for confirmation of receipt in due course.

Kind regards

Yours sincerely

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ICAEW representation

ICAEW REP 64/06

IMPROVED CONCEPTUAL FRAMEWORK FOR FINANCIAL REPORTING

Memorandum of comment submitted in November 2006 by the Institute of Chartered Accountants in England and Wales, in response to 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', published for comment by the International Accounting Standards Board in July 2006.

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INVESTOR IN PEOPLE

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INTRODUCTION

1. The Institute of Chartered Accountants in England and Wales (‘the Institute’) welcomes the opportunity 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*, published by the International Accounting Standards Board in July 2006.

WHO WE ARE

2. The Institute operates under a Royal Charter, working in the public interest. It is regulated by the UK Department of Trade & Industry (DTI) through the Financial Reporting Council. As a world leading professional accountancy body, the Institute provides leadership and practical support to over 128,000 members in more than 140 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. The Institute is a founding member of the Global Accounting Alliance with over 700,000 members worldwide.

3. Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. The Institute ensures these skills are constantly developed, recognised and valued.

MAJOR POINTS

4. Our major points on the discussion paper are as follows.

    - The framework should be set at a high level (see paragraph 9 below).
    - The important decisions about the framework's authoritative status and the scope of its application need to be decided at an earlier stage for this and future consultations to make any real sense (paragraphs 15-19).
    - There should be a distinct objective of accountability and the discussion paper’s ‘resource allocation’ objective should be changed into an ‘economic decisions’ objective (paragraphs 21-26).
    - Consideration should be given to differentiating between the objectives of financial reporting for publicly listed companies and for owner-managed companies (paragraphs 29-30).
    - The importance of substance over form as a qualitative characteristic should be recognised (paragraphs 32-34).
    - Reliability should be a characteristic in its own right, although carefully defined. Verifiability should not be treated as a component of faithful representation (paragraphs 35-38).

THE PROJECT AS A WHOLE

General comments

5. The project of the IASB and the US Financial Accounting Standards Board ('the two boards') to establish a common conceptual framework is of fundamental importance. We do not believe that the framework should establish a set of rigid rules by which the two boards will be bound, but it is essential that the new framework should at least set out agreed principles that will provide a sound basis for the two boards' future work in setting common standards. We also believe that the process of establishing a joint framework will be a useful one for the two boards, as it will help them to recognise – and to address - differences in their thinking that might otherwise remain hidden.

6. We welcome the two boards' decision to proceed initially by issuing discussion papers setting out preliminary views. The issues to be tackled in the course of the project will require much consideration and debate, and it would be a mistake for the boards to rush into forming firm views on them. We also welcome the discussion provided in this initial discussion paper and its analysis of the issues addressed, and we would urge the boards to continue to devote the time and resources necessary to maintain the high standards set by this first paper throughout the project.

7. The various issues to be tackled in the different phases of the conceptual framework project are interdependent, and views on the issues raised at one stage will therefore affect views on the issues raised at a later stage and vice versa. We also note that decisions that are on the face of it essential preliminaries to developing a framework – such as its scope and authoritative status (see below) – have in fact been deferred. For this reason, we may wish to revisit our response to this discussion paper in the light of later proposals in the framework project. No doubt other commentators, and the two boards, will be in the same position.

8. At some points the discussion paper could be interpreted as paving the way for fair value and to be hostile to historical cost measurements (e.g., at QC 12,18 and 22). We do not draw any conclusions on this issue, but note that it would be inappropriate for any bias towards one form of measurement rather than another to affect the boards' discussion of objectives and qualitative characteristics. In due course, as the project reaches the question of measurement, what the boards see as the connections between conclusions on objectives and qualitative characteristics and conclusions on measurement - and whether they match our expectations - may become clearer. We may then of course wish to reconsider our response to this discussion paper.

Level

9. The framework should be kept at the very high level of central and fundamental concepts, and should avoid as far as possible descending into consideration of subsidiary issues. This would help achieve consensus on the framework. It would also allow the content of standards to evolve as thinking changes, while avoiding constant friction between a detailed framework and

the needs of standard-setters to reflect changing thinking and changing circumstances.

Length

10. Although we welcome the full discussion of issues at this stage, to judge from this first paper there is a risk that the final framework will be significantly longer than it needs to be. If our proposal on the appropriate level of detail for the framework is adopted, this would also help keep the final document short. The IASB's existing *Framework for the Preparation and Presentation of Financial Statements* is about the right length for the proposed framework.

11. Whatever the length and format of the final framework, it will be useful in due course to have a highly condensed statement of underlying principles – just one or two pages - so that people can grasp the key points quickly. We do not believe that there are so many different fundamental principles underlying financial reporting that any greater length is required.

Scope: entities

12. The proposed framework would apply only to business entities in the private sector (OB1), but the discussion paper indicates that 'once concepts for those entities are developed, the two boards will consider the applicability of those concepts to financial reporting by other entities' (P8). We support the exclusion of non-business entities and public sector entities at this stage. However, we note that the chairs and senior staff of the Australian, Canadian, New Zealand and UK standard-setters have issued a report on the proposals in the discussion paper, *Application to not-for-profit entities in the private and public sector*, setting out a number points where modifications would be required in applying the proposals to such entities.

13. There will be other pressures on the framework as to whether it can be applied to the reporting even of all business entities. In particular, while we support the development of a single framework that applies to all private sector business entities, it needs to be recognised that financial reporting serves different purposes for publicly listed companies and for owner-managed enterprises, and it will be necessary to develop the framework in a way that reflects this.

14. If, as we propose, the framework is kept at a high level of central and fundamental concepts, this should make it easier both to deal with all private sector business entities within a single framework and in due course to develop it further to apply to other entities.

Scope: financial reporting or financial statements

15. We support the proposal that the framework's scope should be financial reporting rather than financial statements (OB1). We note, however, that the two boards have deferred a decision on what exactly are the boundaries of financial reporting (BC1.4). In our view, this decision should be tackled now, as it cannot be logical to develop a framework without knowing what it will apply to, nor will commentators be able to give fully developed views when such a vital decision still has to be made. One point that will require further

consideration when the framework's scope is agreed is how far the qualitative characteristics and the trade-offs between them that are appropriate for financial statements are also appropriate for financial reporting outside the financial statements.

Status

16. We also disagree with the two boards' decision to defer consideration of the framework's authoritative status (P2). We do not understand how it will be possible to make decisions on all the points covered by the framework unless it is known why and for whom it is being prepared. In our view, as well as serving the purposes of standard-setters and those who wish to understand their approach, the framework should be regarded as an authoritative source of guidance for those involved in the preparation and auditing of financial reporting information, and should be written with that purpose in mind.

17. IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*, sets out a hierarchy of authoritative sources to be considered by those responsible for the choice of an accounting policy in the absence of an applicable standard. They are required to consider, in descending order:

- the requirements and guidance in IFRS standards and interpretations dealing with similar and related issues; and
- the definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses in the IASB's *Framework for the Preparation and Presentation of Financial Statements*.

They may also consider the most recent pronouncements of other standard-setting bodies that use a similar conceptual framework to develop accounting standards, other accounting literature, and accepted industry practices, to the extent that these do not conflict with the sources referred to earlier. In our view, this hierarchy should be preserved, and the conceptual framework developed by the two boards should replace the IASB's existing framework in it and, therefore, have the same status. If the new conceptual framework is to serve this purpose, this reinforces the need for it to set out clear fundamental principles which can be applied in practice.

18. The decision to defer a decision on the framework's authoritative status may reflect the different starting-points of the boards in existing practice as, in the US, the FASB's conceptual framework does not have authoritative status. We do not think this has been beneficial, as it has probably encouraged a tendency to believe that it is essential to have standards that provide for every conceivable situation. Such standards risk being perceived as rules and, while they may be described as principles-based standards, they do not encourage principles-based accounting outcomes.

19. We have already stated that we do not believe that the framework should establish a set of rigid rules by which the two boards will be bound in setting standards. Accounting principles evolve with changes in:

- thinking on accounting issues,

- business activities, and
- user needs.

We note that existing standards are sometimes out of line with existing frameworks. In itself this is perhaps unfortunate, but it is a corollary of allowing standard-setters to regard frameworks as valuable guidance rather than binding rules, and we consider this to be the best approach. We would, however, expect the framework to be flexible and to evolve to fit standard-setters' changing thinking, rather than be left to become increasingly remote from standard-setters' actual decisions.

Context

20. Financial reporting forms only a part of communication between business and outsiders. In developing the framework it therefore needs to be borne in mind that the content of other forms of information – such as narrative reporting – is also relevant in considering what businesses should be required to provide by way of external financial reporting. Standard-setters need to be careful not to try to make financial reporting meet *all* of its users' information needs. Such an attempt would in our view be doomed to failure and might well prejudice the successful achievement of the tasks for which financial reporting *is* fitted.

COMMENTS ON DRAFT CHAPTER 1

Objectives: economic decisions and accountability

21. The discussion paper proposes a single 'resource allocation' objective for financial reporting: '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). We believe that this objective is drawn too narrowly and that an additional 'accountability' objective is required.

22. The discussion paper notes that the existing frameworks of both the IASB and FASB refer to 'economic decisions' rather than 'resource allocation decisions', and comments that the new term is 'consistent with, although more specific than, the term used in those frameworks' (BC1.32). Resource allocation decisions are, in our view, distinctly narrower than economic decisions. Resource allocation decisions are about providing (or withdrawing) finance. Providers of finance also use financial reporting information to assist them in making other important economic decisions, such as decisions about intervening in the management of the business and about appointing and rewarding managers. The objective in the discussion paper therefore needs to be extended so as to refer to economic decisions rather than resource allocation decisions.

23. We also consider that financial reporting has an accountability objective. Indeed, we find it difficult to see how (except in the circumstances identified at paragraph 29 below) it can be argued that accountability is *not* an objective of accounting. The discussion paper does not address this point. Information to meet the accountability objective may well be useful to providers of finance in making economic decisions and in that respect the accountability and

economic decisions objectives may overlap. But accountability information also has another use in constraining the conduct of those who are accountable – for example, making it more difficult for managers to misappropriate the resources they control.

24. Although there may be overlaps in the information needed to meet the accountability and economic decisions objectives, the accountability objective is likely to lead to different information in certain respects. It typically leads to:

- a focus on reporting actual past transactions;
- an emphasis on what can be checked by third parties; and
- a lower level of materiality for reporting on transactions involving directors.

25. A key aspect of accountability is its role in helping to reduce agency problems. In this respect, and in others, it serves a corporate governance function. We note the discussion paper's comment, in its discussion of stewardship, that 'those who consider providing information useful in assessing management's stewardship to be a broader objective than decision-usefulness [for users in allocating their own resources] may be mixing financial reporting and corporate governance issues' (BC1.38). This is a fundamental point. In much of the world, and certainly in the UK, financial reporting forms a key role in corporate governance, i.e. it is an inherent part of it. It is inappropriate in such a context to refer to 'mixing financial reporting and corporate governance issues' as though to do so is to commit a logical error.

26. Those who continue to press the importance of 'stewardship' (or accountability under our formulation) have been challenged to suggest how accounting standards might differ if it were retained as a separate objective compared to if it were not. In our view, there are possible differences that might arise. For example:

- discontinued operations might be disclosed differently if accountability was included as a separate objective (because management is accountable for its past performance in relation to the discontinued operations, even though – because they are discontinued – they are irrelevant to forecasting future cash flows);
- disclosures on related party transactions might well be different (again because, though they are relevant to managers' accountability, their disclosure may not help to forecast future cash flows. We believe that existing standards on related party transactions, quite rightly, reflect an accountability objective); and
- the treatment of acquisition costs (where management is accountable for the total cost of the investment including acquisition costs, even though these may not affect future cash flows) might also be different.

We therefore would wish to see accountability retained as a separate objective, at least at this stage of the project. It may be that in the end it is not necessary to retain it, but we would like that decision taken at the end of the analysis, not at the beginning, in order the keep its importance in view.

Objectives: creditors

27. We agree that the objectives of financial reporting should refer to both creditors and investors. We believe that it is right that the information needs of both groups should be met, but we note that their needs may not be the same in all cases.

28. It is made clear at OB6 that ‘creditors’ do not include ‘trade creditors’, who are categorised instead as ‘suppliers’. There are two issues here. First, if the two types of creditors are to be separated in this way, we suggest that what the discussion paper terms ‘creditors’ should be called ‘lenders’; this would be clearer. More fundamentally, for many businesses trade creditors provide greater finance resources than equity investors or lenders. We do not see that those who make these cumulatively important decisions on the allocation of resources should be treated by the framework as occupying a secondary position. It would be better to include trade creditors and lenders within the scope of the objective, although again the two groups’ information needs may not be the same. Further consideration may also need to be given to the situation of pension schemes as, where deficits exist, the sponsoring company can be said to be obtaining finance from the fund (and ultimately the employees). To the extent that the company does not make up the deficit immediately, is the pension fund not also a creditor in that it is lending to the company?

Different types of entity

29. We believe that the two objectives we have proposed will be appropriate for publicly listed companies, but that further thought needs to be given to the case of owner-managed companies, for which financial reporting serves different purposes. The concept of accountability is not obviously applicable where those doing the accounting and those to whom accountability is owed are identical. Nor is it clear for all owner-managed businesses that their financial reporting is used in making economic decisions (although in some cases it will be – by creditors, for example).

30. We recommend that the two boards should explore this point further. We note, though, that only publicly listed companies are required to comply with FASB’s standards and that such entities inevitably provide the focus of its work. It may therefore be difficult, and perhaps even impossible, for the two boards acting jointly to deal with issues affecting owner-managed companies where these require different treatment.

Users’ needs

31. We accept the need for a focus on one group of users and support the group identified in the paper - present and potential investors and creditors - so far as publicly listed companies are concerned (OB12-13), and subject to the point noted at paragraph 28 above.

COMMENTS ON DRAFT CHAPTER 2

Substance over form

32. In our view, substance over form (properly defined) should be identified as a component of faithful representation – in fact as the primary component, as it is in our view more important than verifiability, neutrality or completeness. Substance over form is essential to the achievement of principles-based accounting. Unless there is recognition of the overriding importance of substance over form, there is a growing risk - as standards become more numerous and more detailed - of falling into a rule-bound and blinkered approach to accounting.

33. The discussion paper states that ‘the quality of faithful representation is incompatible with representations that subordinate substance to form. Accordingly, the proposed framework does not identify *substance over form* as a component of faithful representation because to do so would be redundant’ (BC2.18). This fails to reflect the importance of the substance over form principle. According to the discussion paper, the quality of faithful representation is also incompatible with the absence of the qualities of verifiability, neutrality and completeness. But this has not prevented the two boards identifying them as components of faithful representation.

34. We should emphasise - as there is apparently a view that ‘substance’ in this context can mean *legal* substance – that by ‘substance’ we mean the economic substance of a transaction. Importantly, the principle requires that (1) all aspects and implications of a transaction must be identified, (2) consideration of substance involves using judgement to determine which aspects and implications of a transaction are more likely to have a commercial effect in practice, and (3) a group or series of transactions that achieves or is designed to achieve an overall economic effect should be viewed as a whole. This approach is a strong behavioural control over preparers, but it also provides helpful rigour to the decisions of standard-setters in that it helps to avoid standards producing counter-intuitive solutions that may bear no relation to the economic reality of the transactions that are purported to be represented.

Reliability

35. We disagree with the removal of reliability as a qualitative characteristic, especially in view of the way that the discussion paper deals with verifiability (see paragraph 38 below). At present, there is a trade-off between reliability and relevance in setting financial reporting standards. On some issues the effect of the trade-off will be that it is appropriate to require unreliable information to be disclosed because it is highly relevant, at any rate where it supports an economic decision objective. However, the reliability of financial reporting information *is* nonetheless an issue for its users, who want to be able to understand the solidity of the information on which they are basing their decisions.

36. Reliability needs to be carefully defined, to encompass the idea that it is possible and desirable to have information of varying reliability depending on its relevance. We regard reliability as a question of variability about an

estimate. That is, the reliability of information increases the more likely it is that different people would agree on its formulation. To meet users' needs we suggest that disclosures of inputs into the calculation of point estimates in the primary statements should be increased as information becomes subject to increasing variability and, therefore, measurement uncertainty. This should allow users to assess the reliability of the information in question and, where appropriate, to calculate alternative measurements.

37. The role of reliability as a qualitative characteristic is likely to be particularly relevant when the conceptual framework project addresses the issue of measurement. While, as we have noted above, we accept that unreliable measurement information may be appropriately required, this does not mean that reliability should be disregarded in making decisions on measurement.

Verifiability

38. We do not consider that verifiability as described in the discussion paper (QC23-26) is an essential component of faithful representation (QC16). Moreover it confuses the issue of reliability with auditability. Some information that provides a faithful representation is 'verifiable' and some is not. We also doubt whether 'indirect verification' as described in the paper would ensure that an item has been faithfully represented. In order to do this, it would be necessary to ensure that an appropriate method of measurement had been used. It may also be helpful for financial reporting to disclose how far different items of information are verifiable (along the lines discussed at paragraph 36 above for reliability).

Understandability

39. The discussion of understandability at QC39 seems to be tilted towards the inclusion of information that is complex and difficult to understand; it should place more emphasis on the need for understandability. The complexity of business activities and of the transactions dealt with by financial reporting often makes complexity in reporting inevitable. But even where this is the case, standard-setters should be under a duty to endeavour to ensure that the reporting is as clear as possible and that, where necessary, explanations are provided to make it comprehensible. In some cases, complex transactions may be capable of being portrayed in financial reports in a straightforward way if this is sufficient to portray their economic substance; unnecessary complexity should always be avoided.

40. Different users can cope with different levels of difficulty and complexity, and it may be appropriate to provide the generality of users with something relatively simple, but to make more difficult information available for those who want it.

Ranking of qualitative characteristics

41. We do not agree entirely with the discussion paper's ordering of qualitative characteristics (QC43-46). While we note that there is an argument for some kind of logical ranking, we suspect that in practice these issues will not be clear-cut. Information often has degrees of relevance, representational faithfulness, understandability and comparability, and decisions on what it is

appropriate to require will therefore require trade-offs between qualitative characteristics rather than the simple application of a hierarchy. We believe the framework should recognise that pragmatic interplay between the elements – which we believe has always existed in accounting – which will tend to benefit users by producing the best outcome depending on the circumstances.

Cost-benefit considerations

42. The discussion paper recognises that 'The benefits of financial reporting information should justify the costs of providing and using it' (QC53). We strongly support this approach to financial reporting and would stress that even for publicly listed companies the costs of financial reporting changes can only be justified if they are outweighed by the resulting benefits. It would also be helpful if the discussion on benefits and costs (QC53-58) recognised explicitly that cost-benefit considerations may lead to different requirements for different types of business entity. An acknowledgement is also required of the difficulties in assessing costs and particularly benefits and the subjective nature of their consideration. The boards may wish to refer to the existing literature on the principles of good regulation, such as the *OECD Guiding Principles for Regulatory Quality and Performance*.

Management perspective

43. The discussion paper states that 'general purpose external financial reporting is not explicitly directed to the information needs of management' (BC1.42). While management information and financial reporting information are often prepared on different bases for certain items, the two are inevitably closely related and share a common database. We believe that it is helpful if, as far as possible, financial reporting does not deviate too far from the underlying way in which businesses are run. If it does, it may lose credibility. Managers may be forced to explain numbers that do not reflect their perceptions of the business's performance or they may decide to provide pro forma information that better reflects their understanding of the business. It is important, therefore, that management's perspective is at least considered in an assessment of relevance, as otherwise the financial statements will be bypassed in the communication between management and investors/creditors.

BSG/20.11.06