UNICE
THE VOICE OF BUSINESS IN EUROPE

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22.7/8/1

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Dear Sir,

RE: DISCUSSION PAPER ON FINANCIAL REPORTING OBJECTIVES AND QUALITATIVE CHARACTERISTICS

In response to your consultation on the above referenced discussion paper, UNICE is pleased to offer the following comments.

We are presenting our comments in the following order:
1- Overall comments on the form and content of the discussion paper
2- Discussion on the objectives of financial reporting
3- Discussion on the qualitative characteristics.

1- Overall comments on the form and content of the discussion paper

a. *The framework should be mandatory*

The IASB existing framework clearly stated that standard-setting would, from the issuance of the framework, progressively eliminate inconsistencies between IAS standards and the framework. It hence set forth that future standard-setting had to comply with the content of the framework. It also indicated that the framework would undergo revisions if and when necessary.

We strongly believe that the framework should not describe "the goal or ideal towards which standard-setters and preparers of financial reports should strive" as is presented in the discussion paper (OB15). It should include basic and robust concepts defined well enough to form the basement of consistent standard setting, in conformity with the description included in P3 and IN2-3. The discussion of the conceptual framework has value in such a context only.

Moreover the IASB should have in mind that it now serves as the standard-setter for many jurisdictions in the world. Having set a fully debated conceptual framework should form for the IASB the necessary shared understanding with its constituents of the accounting model that future IFRS are to build or safeguard. In our view the conceptual framework should have a role in the IASB's accountability. There should not be any free ride in standard setting.

b. *There is no room for assertions where concepts are being debated*

In the past few years, we have constantly requested that the conceptual framework be debated before any fundamental change to the IFRS accounting model is made. Our request was justified for the following reasons:

- exposure draft after exposure draft, we discovered that we did not share the Board's assumptions on several significant issues: whether the entity's perspective should prevail, whether fair value was the most relevant measurement attribute, why entity-specific inputs would not lead to more relevant forecasts of net in-flows, what an entity's performance should encompass...
- the IASB entered into the habit of justifying decisions in projects because of the necessary compliance with the framework, while promoting, in other projects, departures from the framework because the framework would have grown obsolete...

Now that the debate is starting, we regret that the IASB leaves no room for debate on the most fundamental issues. The discussion paper includes too many assertions which are repeated in the basis for conclusions instead of being fully explored and debated. If the IASB wishes to have a constructive debate with its constituents, it needs to take the adequate steps of explaining the directions which are chosen – more especially when those directions deviate from the existing accounting model.

c. *The document lacks in conciseness*

We understand that the two first chapters have been originally intended to be issued as exposure drafts. Hence their form and content are fairly representative of what the Boards intend their conceptual framework look like.

We deeply regret that the conciseness of the existing IFRS framework is being abandoned. We believe it gave the framework more strength and robustness. We therefore recommend the Boards to rethink the style of document they intend to issue.

In our view, many of the explanations given in the document would be better located in the basis for conclusions. Others are purely and simply repetitions likely to generate various interpretations and discussions in the future. And always as repetitions and rewording take place, contradictions appear.

2- Discussion on the objectives of financial reporting

a. *For the time being the scope of the framework should remain limited to financial statements*

We understand that the Boards' intent is to broaden the scope of the framework in order to encompass financial reporting. At this stage however the Boards have not yet defined exactly what financial reporting would include. They make the assumption that what is relevant for financial statements is likely to be broadly relevant for financial reporting.

Although we fully understand that a project as the conceptual framework project is best developed in successive stages, we are of the view that consultation with constituents should be carried out on the basis of fully defined scope, concepts and principles. It is impossible for us to provide relevant comments on a scope which is not yet defined. For example, the Boards indicate that financial reporting might include environmental reports. Such reports may have only a very remote link with an entity's ability to generate future net cash in-flows. We therefore question whether they are appropriate candidates for financial reporting.

The comments we provide in the following sections of this letter therefore apply only to the objectives and qualitative characteristics of financial statements. When the Boards have defined financial reporting, another discussion will be necessary to determine what, if any, adjustments are necessary.

b. *The going concern assumption should be reinstated*

We have been surprised to see no reference made to the going concern assumption. Since the issue is debated neither in the main text nor in the basis for conclusions, we question whether removal of such an assumption is voluntary or the result of an omission. We are of the view that the going concern assumption should be reinstated and that it would be best placed in the first chapters of the framework. We believe it is not a measurement issue only.

c. *Users and their needs should be more thoroughly analysed and explained.*

The analysis in that chapter starts by asserting that financial statements have a very wide range of users. 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, it claims 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),
- the primary focus of financial reporting is "the ability of an entity to generate net cashinflows" (OB13), and

- "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" (OB13).

Although they do not bring anything new in the accounting debate, these assertions need more thorough research for credibility. The conclusions which are derived from them form indeed the basis for developing appropriate concepts for financial reporting. We believe that the very light description of users and their needs which is provided in OB6 would be valuably replaced by an analysis and description of what all these users have in common and where their needs differ or vary. From then on, the Boards would have the ability to decide and explain why they identify primary categories and users and how they expect other users needs to be fulfilled.

For the same reasons, we are not convinced by assertions made in BC1.23-25 that the same objectives would prevail for any type of entity.

d. ***Net cash in-flows that financial reporting should help to predict should be defined***

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

e. ***Consistency between internal and external reporting should be reaffirmed***

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

We believe that the proposed chapters should have retained such evidence, or at least have explained why the Boards believe it would no longer be relevant.

If the Boards have good reasons to believe that management and investors and creditors have different perspectives, describing and analysing the differences would probably be very useful to future developments of financial reporting.

*f. **Performance should be defined***

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

As the various and successive projects on reporting financial performance have shown, the definition of an entity's performance needs to be debated and understood.

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

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

*g. **The choice of the entity's perspective ought to be fully debated***

The Boards very rapidly opt for the entity's perspective because it would be the only perspective consistent with the objective of serving a wide range of users' needs.

We believe such a choice needs a more in-depth analysis and justification. The analysis we have recommended of differences in various users' needs would be useful for analysing this issue as well. As it stands we have no basis for agreeing or rejecting the choice made by the Boards. We note however that this decision embodies quite a fundamental change from the existing accounting model (even if already partly reflected in IAS 27) and hence requires a full and constructive debate.

*h. **Stewardship and accountability should remain as a separate objective***

We fully support the alternative views expressed in AV1.1-1.7 and will not attempt at reformulating them.

In addition to what is already said, we are concerned by the statement made in OB9 that "management is able to prescribe the form and content of the information it needs in satisfying its responsibility to owners", implying that stewardship and accountability would not be objective of general purpose of financial statements… at all!
We recommend that:

- stewardship and accountability remain as a separate objective from decision usefulness,
- the Boards in standard-setting have the duty of identifying any information which would be relevant for such a purpose,
- stewardship and accountability as a separate objective are dropped at the next revision of the framework if bases for conclusions of future standards make it clear that no specific consideration needs to be given to the information needs they generate.

3- Discussion on the qualitative characteristics

a. Users should be regarded as knowledgeable and competent enough to be able to evaluate whether financial information is likely to make a difference in their decision process

We agree with the definition of relevance which is provided in QC8. We however fully disagree with the end of QC9 which states that "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". We believe that the Boards should more heavily rely on views by their constituents. Users know their jobs and are able of identifying what information is *capable* of making a difference in their decision process. The Boards have shown in BC1.30 how little they understand how analysts for example prepare their net cash-inflows forecasts. As is stated in OB6,"financial reporting should not be an end in itself", should not be the opportunity for the Boards to develop a theoretical model that would make sense to them only. We strongly object to any statement that implies that standard-setters would know better than practitioners how financial reporting is effective or can be effective. Standard-setters have the responsibility for developing financial reporting requirements which fit users' needs. Standard- setters have not been entrusted the responsibility for making users adjust their practice to the reporting model standard setters believe is the best.

b. Reliability should remain a defined qualitative characteristic

We can see no valid justification why the term "reliability" has been dropped. The Boards indicate that the term was not well understood. If this is the case, the term should be clarified, not dropped and replaced. We cannot see how adopting "representational faithfulness" makes the qualitative characteristic clearer. QC19 suggests that confusion arose because "purport to represent" was not well understood. We believe that the lack of common understanding was not in the words themselves, but

as already explained above because there is no shared understanding of what future cash-flows should embody or what performance means.
Moreover we are aware that the change of wording is likely to raise translation issues and hence confusion.

c. ***Substance over form should remain one of the distinctive characteristics of reliability***
We also fully disagree that substance over form is so necessary that it would not need to be enunciated as a distinctive characteristic of reliability. We believe that qualitative characteristics and their components are necessarily all fairly basic and that substance over form absolutely needs to be fully explained.
This is all the more necessary that there have been heavy discussions in the recent past between the IASB, the IFRIC and their constituents to determine whether economic compulsion should be assessed as part of the substance of a transaction. It seems that the IASB has already made the choice that only the *legal substance* of a transaction was to be taken into account, as if rational economic behaviour was not a reasonable assumption for parties when they sign contracts, as if it didn't belong to *the real-world economy.*

d. ***Only real world phenomena should be depicted, and this should be the overarching principle not only in recognition but also in measurement***
We agree with the focus the Boards have chosen to make on *real-world economic phenomena*. We also agree with QC20-21 describing the interrelationship between certainty, precision and reliability.
We however do not believe that market to model can valuably depict a real-world phenomenon where no market exists, where no transaction is at any time observable. Only models that can be verified from time to time, even on the basis of very infrequent transactions, can be deemed reliable enough for financial reporting requirements.
We therefore believe that reliability should include a supplementary feature, one that would impose *some real-world basis* for all estimates and estimating techniques.

e. ***Verifiability as defined is likely to lead to endless disclosures and lack of understandability***
QC23 refers to "knowledgeable and independent observers" who, it is implied, will be able to corroborate (verify) the information contained in financial statements. The impression the reader might be left with is that a set of financial statements will contain errors and/or fraudulent misstatements unless users (the independent and knowledgeable ones) are able to verify them. We believe there is no room in a conceptual framework to suggest malpractice.
We also observe more and more requirements for disclosures of models and inputs used for valuation purposes as standard-setting develops requirements to market to model more and more assets and liabilities. This indeed suggests that although valuation methods used are

supposed to offer the most objective measurement bases, users need to re-compute values assigned to assets and liabilities in order to assess their own predictions.

We believe that such a direction is counter-productive:

- detailed disclosures tend to obscure rather than clarify financial reporting, thus impairing the overall understandability of financial reporting,
- valuation requirements are not well selected if they end up with a need of re-computation by users,
- such re-computations are necessarily costly,
- more and more users may be left out of financial reporting as the condition of being *reasonably* knowledgeable may represent a higher and higher hurdle.

For the reasons explained above, we believe that the whole paragraphs dealing with verifiability need at least redrafting and clarification on what this qualitative characteristic is meant to achieve.

Beyond our above comments, we wish to raise an additional concern. We acknowledge that financial statements need to be "capable of being audited by reference to underlying accounting records". However, we do not think that this necessary capability can be regarded as one qualitative characteristic of financial statements. We therefore believe the framework should make clearly indicate that "verifiability" is not meant to designate this capability.

f. Materiality should remain a distinctive characteristic of relevance

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

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

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

g. ***The framework should make clear that costs involved in financial reporting are costs for shareholders, and hence costs to primary users***

In the IASB's recent discussions on cost/benefits issues, we have noted that a distinction was being made between costs to preparers and costs to users of financial statements. As existing shareholders remain in our view the primary users of financial reporting, those to whom financial reporting is due, we cannot see any merit in such a distinction. When management expresses the view that some reporting requirements are likely to be too costly and hence to exceed benefits, management acts in its stewardship capacity and in view of reducing costs to shareholders. We therefore believe that costs to preparers and costs to users should not be opposed. We therefore recommend that mention that reporting costs are borne by existing and future shareholders is included in the framework.

Yours sincerely,

(original signed by)
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