The Corporate Reporting Users' Forum

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Corporate Reporting Users' Forum response on Conceptual Framework

Dear Ms Lian

The Corporate Reporting Users' Forum welcomes the opportunity to comment on the joint consultation by the IASB and FASB on *Preliminary Views on an improved Conceptual Framework for Financial Reporting*. Our response is set out below.

About the Corporate Reporting Users' Forum (CRUF)

The CRUF came together in 2005 as a discussion forum to help its participants in their approach to the debate on current and future corporate reporting requirements. In particular, participants are keen to have a fuller input into the deliberations of accounting standard setters such as the IASB. CRUF participants come from across the City of London and around the world, including individuals from both buy- and sell-side institutions, and from both equity and fixed income markets.

The CRUF is a discussion forum. The chairmanship of the CRUF rotates at each meeting and different individuals take leadership in discussions on different topics and in the initial drafting of representations. It does not seek to achieve consensus views, though at times some or all of its participants will agree to make joint representations to standard setters or to the media. It would not be correct to assume that those individuals who do not participate in a given initiative disagree with that initiative.

CRUF participants take part in discussions and joint representations as individuals, not as representatives of their employer organisations. The participants in the Forum that have specifically endorsed this response are listed at the end of this letter.

Value of a Conceptual Framework

We welcome the opportunity to respond to the draft conceptual framework. For us, the conceptual framework is key to ensuring higher quality financial reporting standards going forwards.

We are responding to the consultation in the light of our own Guiding Principles, which are attached to this response. These articulate briefly what we believe are the key roles of financial reporting standards from the user's perspective. We developed these Principles some 18 months ago as our first action after coming together as a group. Our aim was to reach consensus among a diverse group of users on our overarching desires from accounts and therefore our views on the appropriate nature of accounting standards.

We support the updating of the Conceptual Framework. In particular, we would welcome both the IASB and FASB giving the document authoritative status, and are disappointed that it is not yet clear that the Framework will have such status in US GAAP (P2). We regard this as a vital ingredient in developing shorter, more principles-based financial reporting standards, which we think would be in the interests of both preparers and users. We welcome convergence towards short, principles-based standards and away from lengthy rules-based standards.

As stated in our Guiding Principles, "Accounting standards … should be principles-based and comprehensible to the financially literate", and they "should avoid unnecessarily detailed prescription". We regard a Conceptual Framework with proper authoritative status as a vital mechanism to ensure that these key aims are fulfilled.

We therefore welcome the move to revise the Conceptual Framework. We believe that it needs to have authoritative status for both IFRS and US GAAP. We furthermore believe that the proposed schedule for the Framework should be accelerated such that it can form the basis for future, shorter and principles-based financial reporting standards.

The user and the entity concept (OB10-12)

In a previous letter to the IASB, we have indicated that members of the CRUF favour the proprietary approach to the entity approach to financial reporting. As we said in relation to the Business Combinations consultation in October 2005: "we cannot see sufficient flaws or problems with the current parent company approach to warrant this change" to the entity approach. We continue to be of the view that a switch to the entity approach risks giving theory precedence over commercial reality and user needs.

The reason why the proprietary approach has been the prime framework for international accounting is precisely this point of user need. Current shareholders are more economically exposed to all aspects of company performance than any other party. In contrast, creditors, employees, suppliers and so on, are all protected by contractual or other rights. Because current shareholders do not share the same protections by contractual or other rights, their reporting requirements extend well beyond the needs of any of these other individual parties. Thus, reporting which serves the purposes of current shareholders by taking their perspective also serves the needs of other stakeholders. We believe that the clarity and simplicity which would come from designating the perspective of current shareholders alone as primary would be extremely valuable.

Furthermore, our view is that *potential* investors do not need to be named separately as primary users. They will not have interests in reporting which differ from current investors, and their inclusion in the definition of primary users risks adding apparent additional obligations for directors and auditors which are not appropriate in all legal jurisdictions.

We therefore believe that the perspective of current shareholders alone should be designated as primary in financial reporting and that the parent company approach should be used rather than the entity approach.

Stewardship (paragraphs OB2; BC1.32-41, AV1.1-7)

We strongly believe that the stewardship concept should be retained as a separate objective of financial reporting – we note that we included the term stewardship in our Guiding Principles. We are therefore supportive of the Alternative View.

For many of us, we share this view because of the problems which arise through agency theory, as outlined in the Discussion Paper. We therefore also strongly support the specific application of the Alternative View to dealings with management: that the threshold for disclosure must be determined by reference to the individual rather than the entity. This is not driven by a prurient interest in excessive remuneration, as BC1.41 attempts to simplify it, but because such an analysis will assist users in taking a view as to whether management is driving full value at the entity, or whether personal motivations may be hindering changes which might otherwise generate additional value.

Others of us support the retention of stewardship as a separate objective – while acknowledging the agency argument – more because stewardship appears to be a key anchor for the retention of historic data in reporting. We are concerned that unless stewardship is retained as a separate objective, financial reporting risks becoming excessively focussed on forward-looking predictions and estimates of future cashflows. Accurate reporting of the capital invested in a business – highlighted in our Guiding Principles as the core role of the balance sheet – enables a more effective analysis of the dynamics of that business. History matters, because it allows users to gain a closer understanding of how an entity generates returns, and therefore provides users with key tools in assessing what future returns may be.

We do not believe that financial reporting should seek to disaggregate management performance from entity performance, as BC1.35-38 suggest is a necessary implication of an agency/stewardship approach. Any attempt to make such a disaggregation would be futile and would produce meaningless results. But neither should financial reporting obscure management performance, as we fear a model which impairs assets or restates them at so-called 'fair value' does. There is a risk that this ensures that every company seems to generate a cost of capital return, obscuring reality in many cases. To suggest that an entity has a performance independent of its management defies reality: a good management will generate greater cashflows from the same assets than a poor management.

We fear that a good deal of information which is useful to users will not be required if the objective of financial reporting is restricted in the way currently proposed in paragraph OB2. The overall objective should be, we believe, to provide information that helps decision-making by investors, rather than just that which helps in making investment decisions. We believe that this is most likely to be achieved if the concept of stewardship, or an equivalent, is retained as a separate objective of financial reporting.

Cash-flow focus (OB3-4)

We note the intent to focus on information useful in assessing cashflow prospects. We are concerned that this focus solely on a forward-looking measure may limit the value of financial reporting to users. As we note in our Guiding Principles, financial reporting is not solely about cashflows but about the capital invested in a business and the returns generated from that capital invested. We are sure that the IASB understands this, not least given its comments regarding the need for historic data and accrual accounting, in BC1.31 and elsewhere. However, we would welcome an explicit statement as part of the way the objective itself is framed. A further sentence in OB3 to the effect that "This will include data on capital invested historically and accruals accounting to allow users to understand the company's business model and so develop assessments of future performance" would, we believe, more fully articulate the IASB's intentions.

As the Framework itself states at QC10 "Without knowledge of the past, users generally will have no basis for a prediction." We believe that explicitly including disclosure of the past into the terms of the objective will help ensure that future accounting standards provide users with that necessary basis for their work.

Qualitative characteristics

We find these areas difficult to comment on in any detail. It is not clear to us as users of accounts what the various terms will mean in practical terms for the financial reporting standards which will be brought in under the Conceptual Framework or for accounts that we use. We similarly understand that the terminology is not clear to many preparers, and nor is it to auditors.

This appears to us a fundamental problem. The Conceptual Framework should be a framework of principles helping to minimise the need for detailed rule-making in financial reporting standards and providing a basis for preparers and auditors to reach judgements based on high-level principles. Where there is a lack of clarity in the meaning of the Conceptual Framework, it will fail to perform this function.

It should not be a surprise therefore that various parties, including preparers, auditors and users, are calling for the retention of terminology which is well understood by all parties, such as substance over form, because the use of such terms would ensure that the framework does provide a basis for judgements as intended.

We believe therefore that the IASB should be slow to abandon terms which are well-understood by all participants in the reporting process in favour of new terms which do not provide any relevant party with the clarity that they require. We would, however, accept that there is not always a common understanding of certain terms (perhaps notably reliability) across all interested parties.

In this context, we focus our comments on this area in highlighting some relevant aspects of our Guiding Principles:

> Substance over form. We highlight the need to favour economic substance over accounting form in our Principles. We believe this is so fundamental an issue and so well understood a concept that it should be made an explicit stand-alone qualitative characteristic, not one implicitly included in another less well-understood term. Users see no value at all in accounts which do not prioritise economic substance over accounting and legal form.
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> Uncertainties. We welcome the statement in OB20 that "financial reports are not designed to show the value of an entity". This reflects the statement in our Principles that "The purpose [of the balance sheet] should not be to determine the entity's fair value". Our Principles go on to say that "Further information … (including assumptions and sensitivities), should be provided in the notes". We therefore welcome the various acknowledgements that there cannot always be certainty in financial reporting, and that there is a need for disclosure of judgements and their underlying assumptions and estimates. This occurs in QC23 and elsewhere.
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> This acknowledgement of uncertainties in models we believe goes to the heart of the Conceptual Framework's discussion of verifiability, neutrality and completeness. Where modelling is used to derive values reported to users, the verifiability of the process is often of secondary practical consideration to users: such information is only complete in the sense of practically useful if it includes the assumptions and sensitivities which form part of the model, so that users can gain greater insight through their own scenario analyses.
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> Materiality. We have already indicated that we support the Alternative View position that materiality in the area of related party transactions with and pay for management should be based on the materiality of the issue to the individual rather than to the company. This is a particular example of the sensible discussion in QC51 that the threshold for materiality depends on the nature of the item in question, as much as its specific amount.

We believe that the Conceptual Framework will serve most value if it is a framework of principles with authoritative status. For the principles to be of value to preparers, users and auditors, all groups will need a common understanding of the terms used. We believe that this *argues for the retention of some terms which are already well understood. In particular, substance over form is a concept which is well understood and tends to generate accounts which are of most value to users. We would welcome its retention as a qualitative characteristic in its own right, and as one with senior status.*

We would welcome the opportunity to discuss these comments with the IASB and its staff, and we look forward to being able to input fully into the Conceptual Framework as it develops. In particular, we will be pleased to participate in the future phases of the Framework project, including definitions and recognition of elements of financial statements, measurement, and definition and boundaries of a reporting entity.

Yours sincerely

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Accounting standards that govern the preparation of corporate reports should be principles-based and comprehensible to the financially literate. These standards should not result in outputs that are at odds with economic reality.

Such standards should be based on the presumption that the stated principles are faithfully applied. Therefore standards should avoid unnecessary detailed prescription and not unduly restrict companies in presenting meaningful results that are in accordance with those principles.

Corporate reports should report economic reality.

Accounting standards should require compliance with their spirit rather than their letter so that preparers are required to disclose the economic 'substance' rather than the accounting 'form'.

Users want transparent and comprehensive disclosures.

Corporate reports should be prepared with the objective of providing a fundamental source of information for investors and creditors on which to base their decisions.

Corporate reports should provide information that is clear, understandable, consistent and relevant.

No single primary statement should take precedence.

Not all information that is relevant for users of corporate reports has to be reflected in the primary financial statements. Some information, such as contextual and non-financial information may best be presented outside the primary financial statements.

Accounting standards should not discourage companies from presenting additional information that is useful to users.

The purpose of the cash flow statement should be to identify and explain cash inflows and outflows over the period. Further, the cash flow and accompanying notes should provide insights into the drivers of maintainable cash flows as well as the trends over time of these drivers.

The cashflow should be capable of comparison and reconciliation with the P&L and B/S. The impact of acquisitions and disposals on these cashflows should also be clear.

The purpose of the balance sheet should be to reflect the capital invested in the business along with capital adequacy, compliance with legal covenants and stewardship.

The purpose should not be to determine the entity's fair value. Further information regarding the values of individual assets and liabilities (including assumptions and sensitivities), should be provided in the notes.

The purpose of the profit and loss statement should be to identify the returns generated from the capital invested in the business.

The P&L and the accompanying notes should clearly differentiate and analyse relevant information, such as: operating performance from financing activities; recurring from non-recurring activities; value changes from trading activities.