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AB/PhS

N°790

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July 2006 Discussion Paper–Conceptual Framework for Financial Reporting

Dear Li Li,

I am writing on behalf of the Conseil National de la Comptabilité to give you our comments on the above-mentioned Discussion Paper ("DP"). Our detailed comments are set out in the Appendix.

The CNC's main comments are as follows:

1 – The scope and authoritative status of the framework require clarification before proceeding with the subsequent stages of the project.

- The definition of the user target group and their financial information needs is imprecise.
- The objective of financial reporting is defined in very general terms so that it is not possible to determine exactly which needs of which users will be satisfied by it.
- The types of financial reporting within the scope of the framework have not been determined .As a first step it may be advisable to concentrate on defining the objectives, characteristics and content of financial statements.
- The purpose and authoritative status (mandatory or "guide"?) should be defined at an early stage in the project because they have consequences on the form and content of the framework.

2 – Certain fundamental orientations are adopted without sufficient discussion or justification.

- The main objective of financial reporting is described as helping current and potential investors in their decisions to buy, sell or hold the shares of the company (resources allocation). The objective of "accountability", as described in the current framework, has been downgraded as a subset of this main objective. We do not subscribe to this decision. The management of a company acts as an agent of the shareholders and therefore has to report to the current shareholders. This reporting constitutes a separate objective of the financial statements.
- The "entity approach" to financial reporting is adopted without sufficient justification and in apparent contradiction with the focus on investors' and creditors' information needs, as primary users .The full implications of adopting the "entity approach" are not discussed.
- • The extension of the scope from financial statements to financial reporting is proposed without analysing the possible implications of such a change e.g. the objectives and qualitative characteristics of certain types of financial reporting may be different to those of financial statements.
- • The DP focuses on "information about an entity's economic resources and claims." The reasons for which this approach is preferred to other possible solutions are not given. Moreover, it is not clear exactly which user needs are satisfied by the resources and claims approach.

3 –The step by step validation of the framework

At this stage, because of the above-mentioned imprecision in scope definition, it does not appear to be possible to form an opinion on the validity of the objectives and qualitative characteristics of financial reporting set out in the discussion paper.

In particular, it is not possible to determine whether the different types of financial reporting which may be within the scope of the framework can be treated by a single framework.

Furthermore we have reservations about the project validation process which is phase by phase. Without having an overall view of the coherency of the project as a whole it appears impossible to validate the first phase definitively. We therefore believe it may be necessary to reconsider the objectives and qualitative characteristics at a later stage.

On the whole, we recommend that the due process which has been defined at the beginning of the project be strictly followed: proceed step by step with each identified phase, allow time for comment and more research between phases, allow time for reconsideration when all phases have been completed.

We trust you have found our comments helpful and would be pleased to give you any further information or explanations you require.

Yours sincerely,

Antoine BRACCHI

APPENDIX

JULY 2006 DISCUSSION PAPER–CONCEPTUAL FRAMEWORK FOR FINANCIAL REPORTING

1. PURPOSE AND STATUS OF FRAMEWORK

1.1.Introduction

Although the purpose and status of the framework are to be dealt with in phase F of the project, at a date to be determined, the boards appear to be taking a position on this subject in the current discussion paper.

The main issue dealt with is the authoritative status of the framework for standard setting and/or for the preparation of financial reporting:

1.2. Is the framework mandatory for standard setting and/or for the preparation of financial reporting?

IASB/FASB position in DP

For standard setting

The position which the boards appear to take in the discussion paper is that the framework is a non-mandatory guide for standard setters.

The boards indicate that the main purpose of the framework is to be a conceptual guide (see IN2, IN3, and IN4) and a long-term goal for standard setters (OB 15).

IN5 goes on to say that IFRSs are developed in response to changes in business practices and the economic environment, which may in turn contribute to a change in the framework

For the preparation of financial reporting

In P2 the DP highlights the differences between the authoritative status of the boards' existing frameworks.

For entities reporting under IFRSs, management is expressly required to consider the framework if no standard or interpretation specifically applies or deals with a similar and related issue (see IAS8 §10and 11). Entities reporting under US GAAP are not required to consider the FASB's Concepts Statements.

The DP (IN5) indicates that the framework "does not establish standards for particular financial reporting issues" and therefore appears to be maintaining the status quo.

Position of the CNC

- The Purpose and authoritative status of the framework should be dealt with at an early stage in the project because they determine the content and the form of the framework. A framework for standard setters in a principle based system would set out general concepts and principles whereas it would be more detailed if it were for preparing financial reporting
- The CNC agrees that the framework is essentially for standard setting and that it should only be considered, as currently prescribed in IAS 8, for preparing financial reporting when no standard or interpretation is applicable. It is then also most useful for users of financial statements, as it guarantees the consistency of the information they will get through financial statements.
- However, in our view, a framework with mandatory status is the most useful for standard setters in that it provides a stable conceptual basis for developing standards and ensures the coherence and consistency of financial reporting standards.
- The position expressed by the boards in IN5 suggests that IFRSs might be developed from other sources and possibly on the basis of concepts different to those in the framework and that the framework might be changed subsequently.
- We disagree with this approach because it is in contradiction with the objective of the framework, as expressed by the boards in P3, which is to ensure the conceptual consistency of financial reporting standards.
- We believe that conceptual changes should be introduced into the framework after an appropriate public debate and that new standards should normally be based on the framework.
- When a standard departs from the framework in the very rare cases when the application of its concepts does not permit to correctly apprehend a specific economic phenomenon, it should clearly be stated so in the Basis for conclusions of the standard and the framework should be revised as soon as possible.

JULY 2006 DISCUSSION PAPER–CONCEPTUAL FRAMEWORK FOR FINANCIAL REPORTING

2. THE OBJECTIVE OF FINANCIAL REPORTING

2.1.The objective as set out in the DP

"The objective of general purpose external 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." (See OB2 of the discussion paper)

"To help achieve its objective, financial reporting should provide information to help present and potential investors and creditors and others to assess the amounts, timing, and uncertainty of the entity's future cash inflows and outflows (the entity's future cash flows)."(See OB 3)

2.2.The scope as set out in the DP

Business entities in the private sector (OB 1)

The objective pertains to all types of financial reporting not just financial statements. (OB 16)

2.3. The underlying issues

The following issues underlie the above definitions:

- Who are the users of financial reporting?
- What are the needs of the users of financial reporting?
- Are the needs of users of financial reporting the same for different kinds of entity?
- Are the objectives the same for financial statements and all other types of financial reporting?
- Is stewardship or accountability an objective of financial reporting?

2.4.Who are the users of financial reporting?

IASB/FASB position in DP

According to OB6 the potential users of financial reports include Equity Investors, Creditors (« lenders ») Suppliers, Employees, Customers, Governments and their agencies and regulatory bodies, Members of the public.

The information provided by general purpose external financial reporting is directed to the needs of a wide range of users rather than only to the needs of a single group (OB 10).

The external users concerned are those that "lack the ability to prescribe all the financial information they need from an entity." Hence management is excluded.

"Accordingly, financial reports reflect the perspective of the entity" (OB 10).

Investors and creditors are designated as primary users because they are the most prominent group whose needs are understood and because information that satisfies their requirements is likely to be useful to other user groups (OB 12).

Position of the CNC

- **Are investors and creditors a valid primary user group?**

As stated in OB 12 the DP identifies investors and creditors as primary users but without demonstrating that they constitute a homogeneous group with common reporting needs.

Investors would appear to include different profiles such as long term investors and market traders with rather different goals and information needs.

Creditors would also appear to include different categories such as debenture holders and bankers.

It is therefore suggested that further research is required to validate the primary user group.

- **Does financial reporting that meets investors requirements satisfy the needs of other users?**

The assertion made to this effect in OB12 (see above) does not appear to be supported by analysis in the DP.

- **What justification is provided in the DP for adopting the entity perspective to financial reporting?**

The main argument, provided in OB 10, is that since financial reporting is directed to a wide range of users ("stakeholders"), it follows that the entity perspective of financial reporting should be adopted.

Given that investors and creditors (who are presumed to have the same reporting needs as investors) are identified as the primary users of financial reporting it is not clear why that would lead to the adoption of the entity (stakeholder) perspective as opposed to the proprietary (shareholder) perspective.

Before adopting one or other approach a full discussion of the reasons for and the consequences of the choice are necessary.

Also, to avoid further debates in standard setting, a clear choice between the two approaches should be made from the beginning and the choice should be followed consistently throughout the project. This does not appear to be the case in the current DP.

2.5. What are the needs of the users of financial reporting?

IASB/FASB position in DP

- The objective of financial reporting set out in OB2 and OB3 refers to information useful in:

-resource allocation decisions

-assessing future cash inflows of an entity.

Because of these two main objectives the focus is then put on "economic resources" and claims. Performance is the result of changes in the resources and claims.

- The description of "Potential users of financial reporting and their information needs" set out in OB6 is of a general nature and gives little further analysis e.g. for investors and creditors the needs correspond to information about an entity's capacity to generate cash flows.

Position of the CNC

- Is financial reporting used only for resource allocation decisions?

Financial reporting may be used for other decisions e.g. to replace or keep the management, to approve the annual accounts, vote dividends. These are separate objectives and relate more specifically to the financial statements.

- There is little or no analysis of user needs in the DP. It is therefore difficult to judge whether investors, creditors and other users have common needs.
- User needs are described at a very general level. Information about an entity's capacity to generate cash flows could take on quite different forms and relate to different objectives .It might well take the form of cash forecasts with different objectives and horizons to the financial statements e.g. information used for appraising liquidity would have a different focus to information about long term growth.
- It is not clear which user needs for cash flow information the DP is targeting . Is it information derived from the financial statements ,forecasts or both ? For which user requirement e.g. assessing liquidity , growth or some other objective ? There is no direct link made between the precise needs of a user group and the objective of financial reporting.
- The focus is put all throughout the DP on economic resources and claims, which are central in the conceptual framework. However, the DP gives only a very general justification for this focus i.e. information on resources and claims will be useful in assessing cash flow prospects .No other approaches e.g. revenue approaches are considered .The choice of the "balance sheet" approach is therefore a basic assumption of the DP .Moreover , there is no definition in the DP of what "economic resources" are. It is therefore difficult to assess at this stage whether they are the most useful information for investors. Such a focus on economic resources is therefore not acceptable at this stage of the project.

2.6.Are the needs of users of financial reporting the same for different kinds of entity?

IASB/FASB position in DP

- The focus of the DP is on business entities in the private sector

"P8 The boards decided to focus initially on business entities in the private sector. Once concepts for those entities are developed, the boards will consider the applicability of those concepts to financial reporting by other entities, such as not-for-profit entities in the private sector and, in some jurisdictions, business entities in the public sector."

- The objectives of general purpose external financial reporting are the same for small, large, listed and unlisted entities that issue such reports(BC1.23)

Some entities, such as small or "closed companies "may have little need to issue general purpose external financial reports. However, for entities that do have external users of their financial reports, the objective of the reports issued to them is the same because the information needs of investors, creditors, and others who need to make resource allocation decisions about the entity generally are the same (BC1.24)

- Cost-benefit considerations may lead standard setters to reduce reporting requirements for certain types of entity(BC1.25)

Position of the CNC

- Is the focus of the framework on business entities justified?

The focus on profit-oriented entities as a first step, as proposed by the current IASB Discussion Paper, is consistent with the objective set out in the IASCF constitution of helping participants in the world's capital markets in their decision making and reflects the priority given to profit-oriented entities in the IASB's standard setting activity.

- Do the users of financial reporting of small, large, listed and unlisted entities have similar needs?

The users of the financial reporting of listed entities are not the same as for small or "closed" companies. Financial market participants will be the users of the financial reporting of listed companies whereas the financial reporting of small-unlisted companies may have few external users other than bankers. However, the basic reporting models (statements of financial position and performance) are fundamentally the same. The differences come from the greater sophistication of the information requirements of the financial markets, which include reporting by business segment, interim reporting etc.

Further research is required on this subject in order to focus on a specific category of entities (e.g. listed entities?). This would prevent diluting reporting requirements.

2.7. Are the objectives the same for financial statements and all other types of financial reporting?

Position of the FASB/IASB Discussion Paper

The scope of the Discussion Paper is extended to financial reporting. However, the DP acknowledges that Financial Statements still play a major role. It considers that the framework applicable to financial reporting would be applicable to financial statements.

Position of the CNC

- There is no definition of financial reporting within the scope of the framework, nor of financial statements. It assumes that the objectives and qualitative characteristics of all kind of financial reporting are the same.
- Financial reporting may include not only the financial statements, the information contained in the notes to the financial statements, information in the management commentary, but goes much further than that and may also include any type of information that a company may publish outside of its annual accounts (communiqués, press releases and so on, for example). It may include actual financial information but also forecasts, non-financial information including judgements on market trends etc.
- Financial reporting is therefore a potentially far-reaching concept and consequently it is legitimate to ask: Do all kinds of financial information correspond to the definition of financial reporting?
- It therefore appears that both definitions – financial statements and financial reporting - are needed before proceeding with the framework. It may then very well appear that there is a need for specific parts of the framework addressing separately financial statements.
- Notably, the objectives of the financial statements may be different than the one of other form of financial reporting. Also, characteristics such as verifiability or comparability may be used differently for financial statements and financial reporting.

2.8. Is stewardship or accountability an objective of financial reporting?

Position of the FASB/IASB Discussion Paper

In OB 27 the DP explains that management is accountable to shareholders for the custody and safekeeping of the entity's economic resources and their efficient and profitable use. Protection includes dealing with the effects of technological and social change, compliance with laws etc. Management's performance affects the cash flow generating capacity of an entity.

In OB 28 the DP says that decisions to replace or keep management is also a resource allocation decision "in a broad sense ". Therefore stewardship is included in the overall objective of resource allocation decisions set out in OB2.

Position of the CNC

- The conclusion set out in OB 28 that stewardship, as described in OB 27, is just a category of resource allocation decision would not seem to be correct. We believe that the fact that management has to report to the shareholders of the entity should be a distinct objective of financial statements. Financial statements should be designed in such a way that they help the management reporting to the shareholders of the entity.
- The management of the company is not mentioned in the list of users in scope of the framework, as management has access internally to all the information it may require. However, management are clearly users as part of their stewardship role. With regard to the management, we consider that the following issues should be addressed before proceeding: which information might be useful to the management and not to other users of financial statements, and vice versa.

3.QUALITATIVE CHARACTERISTICS (“QC”) OF DECISION-USEFUL FINANCIAL REPORTING INFORMATION

IASB/FASB position in DP

- The order of application of QCs is:

  1.Relevance (= pertinence to decision making) which includes predictive and confirmatory value, timeliness.

  2.Faithful representation (includes verifiability, neutrality, and completeness)

  3.Comparability

  4.Understandability

By order, relevance should be considered first “because relevance determines which economic phenomena should be depicted in financial reports.”

Once the economic phenomena are chosen, a representation faithful to the economic phenomena should be applied.

Comparability and understandability enhance the decision-usefulness of financial reporting information that is relevant and ensures faithful representation.

- Reliability is not a clear concept (BC2.13) and is often used with different meanings (BC2.26). The components of reliability are included in “faithful representation”(BC2.28).

For the sake of clarity “faithful representation” is used instead of reliability (BC2.29).

In Concepts Statement 2, the components of reliability are representational faithfulness, verifiability and neutrality, and its discussion of representational faithfulness also encompasses completeness and freedom from bias.

The IASB framework §31 indicates that reliable information is “free from material error and bias” and can be depended on by users as a faithful representation of transactions.

- “Faithful representation” embodies “substance over form” by definition (BC2.18).”The proposed framework does not identify substance over form as a component of faithful representation because to do so would be redundant.”
- “Prudence” conflicts with the neutrality characteristic of faithful representation. (BC2.22). Neutrality implies freedom from bias and “an admonition to be prudent is likely to lead to a bias in reported financial position and financial performance.”

POSITION OF THE CNC

3.1.Is the proposed classification of QC by order of application valid (QC42 –QC47)?

The sequence of application is logical .It is however difficult to dissociate relevance and verifiability since the relevance of unverifiable information to decision making is questionable.

3.2.Should reliability be maintained as a QC (QC16–QC34; BC2.13–BC2.29)? Can information be relevant without being reliable?

- Reliability is currently used as a threshold criterion to determine, for example, whether a liability or an intangible asset should be recognised. Where a transaction cannot be estimated with sufficient reliability it is not recognised under existing IFRSs (IAS 37,38) .The "reliability threshold" would appear to have disappeared in the draft framework.
- Verifiability does not equate to reliability. According to QC23 (b) the application of a chosen recognition or measurement method without material error or bias makes information "verifiable" .If the chosen method or underlying assumptions are subject to considerable uncertainty the information will be "verifiable" but not necessarily reliable.
- Although the discussion paper says that reliability is difficult to define, it appears to be a useful notion, which is of practical application .On balance, we disagree with eliminating reliability and its recognition threshold function.
- Reliability should be assessed at the same time as relevance since there is no relevance without reliability. Many commentators therefore consider that reliability is a qualitative characteristic of the same importance as relevance.

3.3.Should economic substance over legal form be maintained as a QC (BC2.17–BC2.18)?

- Some jurisdictions have a tradition of legal form over substance and it is therefore useful at international level to have a framework which corrects this tendency.
- The concept of substance over form requires to be clarified in order to develop a common understanding. Do we all agree that the economic substance should systematically be given priority over the legal form of the contract to faithfully represent a transaction? If not, we need to define when the economic substance has priority.
- The IASB has recently raised this issue in its treatment of the distinction between debt and equity by giving priority to the legal form of financial instruments with a "step up clause" over the economic substance. Where there is an "economic compulsion" to redeem an instrument at a fixed date should the instrument be considered as debt rather than equity?
- On balance we consider that the notion of substance over form should be clarified and maintained as an element of faithful representation.

3.4.Should prudence be maintained as a QC? Is prudence necessarily biased (BC2.19-BC2.22)?

- The DP states that prudence has often lead to excessive conservatism, which results in biased information. This is not consistent with the definition of prudence given in §37 of the current framework, which specifically excludes deliberate understatements of assets or income etc.
- A prudent approach to uncertainty would not necessarily give rise to biased information. Are systematic estimates in the middle of the possible range of uncertainty less biased than estimates at the upper (or lower) end?
- On balance the arguments for eliminating prudence are not convincing.
- The issue of how to treat the uncertainty of financial information arises in considering “reliability” and “prudence”. We consider that this issue should be addressed specifically in the framework in order to develop a conceptual basis for dealing with it.

3.5.Are the Qualitative Characteristics (QC) set out in the DP valid for financial reporting other than financial statements?

- Different types of financial reporting may have different QC :

- Financial statements are more standardised , neutral ,comparable
- Management commentary is more entity specific , less neutral , less comparable

It may well be difficult to establish the comparability, the neutrality of the verifiability of non-financial and judgmental information including forecasts.

It is therefore suggested that these types of reporting would have to be treated separately to financial statements and possibly not in the same framework.