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January 14, 2013

Mr. Russell Golden
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IASB's REVIEW OF THE CONCEPTUAL FRAMEWORK FOR FINANCIAL REPORTING

Dear Mr. Golden:

The International Federation of Accountants (IFAC) recently commented on the International Accounting Standards Board (IASB)'s Discussion Paper, *A Review of the Conceptual Framework for Financial Reporting* (the DP). We have attached a copy of our response to the IASB and would like to draw your attention to the section on the "importance of global convergence."

IFAC is the global organization for the accountancy profession dedicated to serving the public interest by strengthening the profession and contributing to the development of strong international economies. IFAC is comprised of 179 members and associates in 130 countries and jurisdictions, representing approximately 2.5 million accountants in public practice, education, government service, industry, and commerce.

IFAC believes that there is tremendous value in the FASB and the IASB aligning their conceptual frameworks because convergence efforts going forward will depend, to a large measure, on accounting standards being developed from a common set of principles.

We note the FASB's commitment to convergence and the solid work relationship your board has enjoyed with the IASB. IFAC encourages the FASB to continue to explore ways in which it can work with the IASB, and the globally standard-setting community more generally, to move towards a common conceptual framework for financial reporting.

Please do not hesitate to contact me should you wish to discuss any of the matters raised in this letter.

Yours sincerely,

Fayezul Choudhury
Chief Executive Officer

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ATTACHMENT

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DISCUSSION PAPER: A REVIEW OF THE CONCEPTUAL FRAMEWORK FOR FINANCIAL REPORTING

Dear Sir/Madam:

The International Federation of Accountants (IFAC) values the opportunity to comment on the International Accounting Standards Board (IASB)'s Discussion Paper, *A Review of the Conceptual Framework for Financial Reporting* (the DP). We commend the IASB on reactivating the Conceptual Framework project and moving rapidly to the first stage of its due process. At this early stage of the IASB's due process, rather than answering the questions detailed in the DP, we have confined our comments to IFAC's views about the purpose and development of the Conceptual Framework and to highlighting some critical issues we believe should be considered during the project.

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This response has been prepared following consultation across our broad constituent base, recognizing that some of IFAC's stakeholders may have different views on the issues presented below.

Purpose of the Conceptual Framework

We strongly support the development of the Conceptual Framework to extend and clarify the principles that underpin International Financial Reporting Standards (IFRSs), as it is central to strengthening the credibility and understandability of general purpose financial reporting. As noted in the DP, the Conceptual Framework is critical to ensuring the IASB has a robust and enduring set of concepts to draw on in developing IFRSs. It also helps those in the accounting profession to make professional judgments to consistently apply IFRSs and select accounting policies for transactions and other events not addressed in the standards. IFAC considers it important to align existing and forthcoming standards currently under development with the revised Conceptual Framework. It would, therefore, be useful for the IASB to provide an indication of how it will go about achieving that alignment. While we note that it is indicated in the DP that any decisions to revise standards will need to be considered as part of the agenda-setting process, it would be helpful to understand how the IASB intends to resolve potential conflicts between existing IFRSs and the revised Conceptual Framework. Otherwise, it may not be clear how the Conceptual Framework contributes to improving financial reporting given that many aspects of financial reporting are already covered by existing or soon-to-be issued IFRSs.

The IASB notes in the DP that there may be rare cases when applying the Conceptual Framework does not result in an improvement in financial reporting. When this occurs, it is proposed that the IASB will note the departure in the Basis for Conclusions to that standard. IFAC's view is that it will be important for the IASB to explain, at all stages of its due process (discussion paper, exposure draft, and standard), why it has elected to depart from the Conceptual Framework and specifically invite constituents to provide comments on that aspect of the proposals. It would also be helpful for the related effects analysis to highlight the evidence the IASB has relied on to reach its conclusion that following the Conceptual Framework is expected to lead to a sub-optimal outcome. It is more likely that the IASB will not be departing from the Conceptual Framework but will, in developing standards, need to exercise judgment—particularly about the weight given to certain qualitative characteristics. In our view, explaining those decisions (using the mechanism noted above) will be useful in providing evidence about the effectiveness of the Conceptual Framework and may signal areas that need further development.

It is noted in the DP that some parts of the Conceptual Framework will be reserved for use by the IASB only. We are not convinced that this is necessary and it may just add an element of complexity that is not needed. The hierarchy in IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors,* makes clear the status of the Conceptual Framework. Even where there are no choices because an issue, such as presentation in the income statement, has been dealt with in the standards, the Conceptual Framework still serves as an important reference point to understand the first principles from which it was derived.

IFAC believes that the Conceptual Framework project provides the IASB with an important opportunity to address some fundamental issues that it has been unable to address within the context of developing individual IFRSs. We note that in the DP the IASB indicates that its objective is to update, improve, and fill gaps in the existing Conceptual Framework rather than undertake a fundamental re-think. In our view, it is perhaps too early in the life of the project to arrive at that conclusion. IFAC observes that in the IASB's 2011 Agenda Consultation there was very strong support from constituents for the IASB to reactivate its work on developing its Conceptual Framework. It is fair to say that many constituents see this project as a means of addressing longstanding issues (such as the distinction between debt and equity or measurement) that have been deferred pending the development of the Conceptual Framework.

It will be important for the IASB to manage expectations in this regard and for it to be able to demonstrate the strength of the principles that underpin financial reporting. For this reason robust debate of the proposals is needed. We see particular value in the recent initiatives to stimulate discussion and debate on aspects of the Conceptual Framework, such as the issues papers published by the Australian Accounting Standards Board and the European Financial Reporting Advisory Group. Discussion and debate of this nature are likely to be helpful to ensuring the long-term success of the IASB's efforts to develop the Conceptual Framework.

We agree with the IASB that the Conceptual Framework will continue to evolve over time as it is used in setting IFRSs and through its application by those preparing financial statements. However, it is important that the concepts developed continue to improve financial reporting for some time to come. With that in mind, although there is merit in the IASB attempting to complete this project by 2015, we question whether that will provide sufficient time for the board to develop an appropriate set of concepts that have been thoroughly considered and debated across the IFRS community. Some of the issues being considered have been points of contention for decades and deserve careful and detailed consideration to arrive at concepts that have global acceptance. It will also be important to establish that the concepts developed are effective across the varied reporting environments in which IFRSs are applied. For example, the proposals in the DP with respect to presentation in the income statement do not appear to identify principles for the presentation of financial performance. Instead, the discussion centers on the presentation of profit and loss and other comprehensive income (OCI) which is more in the nature of requirements to be found at a standards level.

The Development of the Conceptual Framework

Importance of Global Convergence

The Conceptual Framework has the potential to significantly influence global convergence of financial reporting principles. For that reason, we are disappointed that the IASB and the United States Financial Accounting Standards Board (FASB) do not appear to have formal plan in place to ensure that common conceptual frameworks result from the IASB project. The G20, along with others involved in reforming the global financial infrastructure, continues to call for greater convergence of financial reporting requirements. As noted in IFAC's Policy Position Paper 6: *Global Convergence and the Accountancy Profession*, convergence is an essential element of the globalization of capital and debt markets. The efficient pricing and flow of capital demands high-quality internationally accepted financial reporting, auditing, assurance, and auditor independence standards. The prospect of achieving convergence is more likely when standard setters work from the same set of first principles in developing standards. Therefore, it would seem appropriate for the IASB and FASB to consider how they might best align these sets of principles so that they arrive at a single set of globally-accepted concepts. While we understand that the IASB's Accounting Standards Advisory Forum (ASAF) is being consulted in the development of this project (and the FASB is a member of ASAF) it is not clear that it will to lead to converged conceptual frameworks between the IASB and FASB. For the new components of the conceptual frameworks being developed, such as financial statement disclosures, it is imperative that the boards strive to avoid any substantive differences in concepts (notwithstanding that there may be valid reasons for differences to exist at the standards level).

At a minimum, IFAC considers it important for the IASB (and the FASB) to explain the similarities and differences between their respective conceptual frameworks. Where differences exist they should be identified and explained.

The Need for a Roadmap

There is a weight of expectation from the IASB's constituents about what the Conceptual Framework will achieve once finalized. IFAC believes that it is important for the IASB to provide a roadmap for how it intends to proceed with this project. In particular, we think the IASB should consider:

- *Reinforcing the point that the Conceptual Framework is intended to be a 'living' document* that will continue to be developed to ensure it remains relevant and effective given changes in the business environment and the needs of users of financial reports. While it is noted in the DP that the Conceptual Framework will from time to time be reviewed by the IASB, it would be helpful to make it clearer that it will need to continue to evolve over time to remain useful. This would also suggest that something more proactive than infrequent reviews is necessary. As we noted above, IFAC believes that it is critical for the IASB to take the time necessary to engage its constituents and ensure the current project results in a robust and well-accepted set of concepts. Investing at this formative stage of the project is likely to result in a Conceptual Framework that remains relevant for some time to come. It would not be helpful to have the Conceptual Framework subject to a cycle of ongoing changes as that would undermine its value to the standard-setting process.
- *Providing a description of the components of Conceptual Framework and how they relate to one another*. This would also be useful in building understanding of how the concepts are intended to be applied. It would be useful for the IASB to identify other components of the Conceptual Framework that it believes will need to be developed in the future.
- *Explaining why some of the issues that were intended to be covered in the IASB's previous Conceptual Framework project are not being considered*, in particular the scope of financial reporting and the applicability of the Conceptual Framework to not-for-profit entities. IFAC notes that the IASB acknowledges the work the International Public Sector Accounting Standards Board in developing a Conceptual Framework for the public sector but it is not clear how that work is informing the IASB's project. In our view, there might be benefits in exploring a longer-term ambition to align the various global conceptual frameworks given that there is a degree of consensus about the core principles that underpin financial reporting. However, IFAC appreciates that those core principles may need to be applied differently to deal with different user needs and reporting environments.
- *Providing a bridge between existing and new or revised concepts*. The IASB's existing Conceptual Framework is modeled on that of the FASB, which was developed in the 1970s. Therefore, it seems appropriate to consider how best to modernize and present the Conceptual Framework. It is possible that some of the current debates around the qualitative characteristics stem from inadequate discussion and explanation of the rationale for changing existing concepts. The Conceptual Framework is not an accounting standard, so a more discursive approach may prove helpful in explaining the concepts. For example, it seems that many people remain unconvinced by the arguments put forward by the IASB for replacing the concept of "reliability" with "faithful representation" and it is possible that the strength of the concept has been diminished by the change in emphasis and the explanations that go with it.

Matters where more could be done to bridge existing concepts with changes previously made to the qualitative characteristics

IFAC appreciates the challenges of moving towards greater global convergence of accounting standards given the jurisdictional differences that exist. In our view, no two issues highlight these tensions better than the concepts of "stewardship" and "prudence". We recognize that there are strong views for and against the inclusion of these concepts in the Conceptual Framework and we encourage the IASB to facilitate an open discussion on them. Setting to one side the actual terms themselves, we strongly believe that (i) "holding management accountable for safeguarding resources"; and (ii) "exercising caution when making judgments in drawing up the financial statements so that they can be relied upon" are two core principles that lie at the heart of financial reporting. It follows that both of these concepts need to be refined, developed, and ultimately adopted, in some form, within the Conceptual Framework. Our detailed reasoning is set out below:

(a) The role and importance of Stewardship

IFAC notes the discussion on stewardship in the DP and the call from some constituents to make more explicit references to the concept in the objective of financial reporting. In our view, it would be helpful to reframe the debate. Accountability and transparency in how management has discharged its obligations to capital providers and others should be a primary consideration in preparing general purpose financial statements. We suggest that stewardship needs to be a much more pervasive concept that underpins the judgments made in preparing financial statements. Issues such as the perceived 'disclosure overload' are unlikely to be resolved without a re-think of how decisions are made across the financial reporting supply chain and without putting a stewardship perspective ahead of mere compliance with requirements. Accordingly, in IFAC's view it would be appropriate to go beyond mapping the notion of "stewardship" to the existing objective of financial reporting and to consider more generally how it could inform the preparation of the financial statements. It is not clear how stewardship can be subsumed under the general desire of users to understand the reporting entity's capacity to generate future cash flows. Notwithstanding the difficulties of translating the word "stewardship" into other languages, we think the notion reflects a well-accepted governance principle that can be found in financial regulation (which typically includes accounting standards) in many jurisdictions.

(b) "Prudence" as a concept

IFAC notes there is a significant debate in the IFRS community about whether "prudence" should be included in the Conceptual Framework. However, it is not clear that there is a common understanding of what is intended by the term "prudence". A notion based on exercising a degree of skepticism and challenging the robustness of the inputs and assumptions that underpin accounting estimates is perfectly reasonable, especially given the number of accounting estimates in the financial statements that are based on significantly uncertain outcomes. However, IFAC would not consider a notion of prudence that introduces bias in the financial statements by providing overly conservative estimates to be appropriate. Good disclosure, in our view, should result in understandable and transparent information about accounting estimates and it is then for users to apply their judgment to those estimates based on the nature of their decision making. It would be helpful for that distinction to be made within the discussion of the qualitative characteristics in the Conceptual Framework.

While some of that is implicit in the existing description of 'faithful representation,' IFAC suggests that consideration be given to further developing the notion and defining it in the Conceptual Framework. In developing a definition of the concept of prudence, IFAC believes that it would be helpful for the IASB to carry out research on how prudence should be defined so that it does not become a basis for supporting aggressive earnings management.

Critical Issues for Consideration

There are several issues that IFAC believes the IASB should consider in the development of the Conceptual Framework.

Concepts for SME Reporting

It is noted in the DP that concepts and basic principles in the *IFRS for SMEs* may be amended once the Conceptual Framework project is completed; it would be helpful for the IASB to explain how it will assess the impact of the revised Conceptual Framework on that standard. In IFAC's view, the *IFRS for SMEs* should be developed using the same concepts as other IFRSs, although those concepts may need to be applied differently to address the specific needs of users and other reporting considerations for SMEs. We also think the cost/benefit considerations are somewhat different for SMEs as they typically have fewer resources available to comply with complex financial reporting requirements. As the *IFRS for SMEs* is a standalone reporting framework, IFAC considers it important for the IASB to engage with the SME community to establish how it will evaluate and, if necessary, modify the concepts in the Conceptual Framework to address the needs of users and capacity and cost constraints for SMEs.

Measurement

IFAC considers measurement to be one of the key areas that needs to be progressed during the current phase of the Conceptual Framework project. There continues to be vigorous debates about the appropriate measurement basis to apply to satisfy relevance and achieve faithful representation—particularly (but not only) for financial instruments. In IFAC's opinion, it is difficult to understand how the measurement objective stated in the DP differs from the overall objective of financial reporting, making the discussion rather circular. This underscores the point we have made above: that it would be helpful for the IASB to explain how the Conceptual Framework is intended to be used. It would, therefore, be useful to explain that having made the decision to recognize an item, at the measurement stage it is necessary to establish what measurement basis will yield relevant faithful representation while having regard to the cost constraint. What is perhaps more useful is to consider establishing a measurement objective for a specific item or groups of items, because it is at that level where it is important to clarify what is being measured and why. For example, for an item of property, plant, and equipment that is to be used in an entity's production process, the measurement objective is, say, to measure the economic benefits that flow to the entity from intended use of the asset at the reporting date. Once the objective is established, it is then possible to consider the alternatives for how it can be satisfied.

In our view, there is benefit in working on identifying the characteristics that need to be applied in determining how judgments are made to select a measurement basis for assets and liabilities. In terms of applying the qualitative characteristics, IFAC believes that more attention might be given to the enhancing characteristics of timeliness, understandability, verifiability, and comparability. Although they are mentioned in the DP, more detailed discussion would assist in explaining how they impact the selection of a relevant measurement basis. However, we do not think that the application of the qualitative characteristics alone will yield sufficiently meaningful criteria for making judgments about measurement.

We suggest that additional considerations may be needed to establish high-level principles to guide when to apply a particular measurement basis. The proposal to select a measurement basis based on how an asset contributes to future cash flows (or a liability is intended to be settled) is intuitively appealing. However, without anchoring this to something specific, such as an entity's business model, it is not clear that it will assist in addressing or clarifying current difficulties experienced when assessing the intended use (for example, in IAS 12, *Income Taxes*) and situations where there are multiple intentions, or changes to those intentions. This is acknowledged in the DP and the conclusion drawn is that the IASB will deal with the uncertainty at the standards level. However, IFAC is of the view that this is an intrinsic part of making judgments about measurement and therefore needs to be addressed in the Conceptual Framework.

A related issue is whether measurement should be based on an entity perspective or a market perspective. This is noted in the DP but not sufficiently explored. IFAC thinks that for the financial statements to have coherence it is essential that the perspective that underpins the measurement of assets and liabilities is clearly articulated. It is not clear that it is just a function of the availability of market information and the relevance of each perspective for specific assets and liabilities, as noted in the DP. It may not necessarily be a binary choice as suggested. It depends on (a) the measurement objective; (b) the weighting given to each of the qualitative characteristics and the application of the cost constraint; and (c) the availability of appropriate inputs required to satisfy (a) and (b). For example, in the Basis for Conclusions to IFRS 9, *Financial Instruments,* the IASB describes a mixed attribute approach where both amortized cost and fair value can provide useful information to users of the financial statements for particular types of financial assets in particular circumstances. It would helpful if the Conceptual Framework were to identify the conditions under which each perspective has particular utility for users. It is conceivable that there may be instances where users need to be provided with both perspectives. Again, consideration should be given to the role and appropriateness of an entity's business model or other factors in selecting a relevant perspective.

We agree that an important consideration in measurement is the application of the cost constraint. What does not seem to come through clearly enough in the DP is that the constraint requires consideration of both costs and benefits and that a net benefit needs to be demonstrated. While the discussion notes a number of cost-related issues it does not appear to adequately consider the need for the IASB to establish the specific benefits of a particular measurement basis for users of the financial statements. Accordingly, any criteria the IASB establishes in the Conceptual Framework for the selection of a measurement basis should aim to ensure that cost and benefit consideration are sufficiently granular to enable it to make those judgments in the context of a specific item and not be based on some generalized view of costs and benefits.

The role of the business model in financial reporting

Our comments above on measurement highlight some of the ways in which an entity's business model could have a bearing on the preparation of its financial statements. There may be other aspects of financial reporting that could be influenced by an entity's business model. For example, some business models, such as those employed by investment funds, challenge the logic of existing presentation and disclosure requirements because of the manner in which those entities create value. Accordingly, their business models have implications for how their financial statements should present and communicate financial information.

It is noted in the DP that the IASB has considered recent developments in Integrated Reporting but it is not apparent what impact that has had (or may have) on the Conceptual Framework. IFAC has been a strong supporter of the work of the International Integrated Reporting Council (IIRC) and we think there are important insights from that project for the development of the IASB's Conceptual Framework. For instance, the IIRC has been considering the meaning and role of the business model in understanding how an entity adds value. The IASB notes in the DP that some commentators have underscored the importance of an entity's business model driving how it reports.

It is suggested in the DP that financial statements can be made more relevant if, when setting standards, the IASB considers how an entity conducts its business activities. However, there is no discussion how this might work in practice and what implications it has for the development of the Conceptual Framework. IFAC agrees with the IASB assessment in the DP that the term "business model" is used to convey different aspects of an entity and how it operates. Given the term is already used in the IFRS literature, both explicitly in IFRS 9, *Financial Instruments,* and implicitly in other standards, such as IAS 12, *Income Taxes*, we think the Conceptual Framework project provides an opportunity for the IASB to test the relevance of the concept for financial reporting.

The IASB notes in the DP that opinions are divided on whether the business model has a useful role to play in financial reporting so it would be worthwhile to encourage that debate to better understand the arguments.

As we have noted above, an important consideration for the IASB is whether the current form and structure of the Conceptual Framework remains appropriate for the purpose it is intended to serve. In IFAC's view, there are number of general principles, such as stewardship, prudence, the business model, unit of account, and going concern, which we believe potentially lie somewhere between the "objective of financial reporting" and the "qualitative characteristics." For example, in satisfying the needs of users, it is important to have regard to discharging accountability obligations, developing robust estimates of uncertain conditions, and understanding the means by which an entity creates (or destroys) value; these are critical to ensuring that financial information is both relevant and faithfully represents economic phenomena. In our view, these general principles have been fundamental to drawing up decision-useful financial statements for some time, and therefore deserve greater prominence in the Conceptual Framework.

We do not necessarily agree with the tentative conclusion of the IASB that many of these issues are best tackled at a standards level. In our view, the principles need to be articulated in the Conceptual Framework, whereas the application of those principles should be set out in specific standards.

We stand ready to assist the IASB, in whatever way we can, in its endeavors to develop its Conceptual Framework, given the global importance of the project. Please do not hesitate to contact me should you wish to discuss any of the matters raised in this letter.

Yours sincerely,

Fayezul Choudhury
Chief Executive Officer