Accounting Standards Board

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3 August 2005

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Dear Ian

FASB/IASB conceptual framework project

Your e-mail of 12 July invites general comments on the above project, and I enclose a memorandum that David Loweth (ASB Secretary) and I have prepared which sets out our principal thoughts at this time.

You will understand that the views expressed are not necessarily those of the ASB. We have not attempted to comment on every tentative decision that has been made to date in the project, so silence should not be taken as consent. We have, however, attempted to address the points made in "Revisiting the Concepts" on which we have strong views.

Inevitably, much of this memorandum discusses areas where we would suggest the emphasis of the project might be changed. Agreement can be expressed briefly—alternative ideas require more explanation. I would therefore emphasise our strong support for the project and for many of the directions that it is taking. Of course we acknowledge that some of the issues we suggest the project should address are difficult, and are aware that we do not have ready solutions to all of these.

ASB are committed to working with IASB, FASB and others to contribute to a framework that will provide a sound basis for high quality accounting standards. You will note that in the last section of the memorandum we describe some of the ways in which we propose our work might be arranged to be as helpful as possible. I would welcome in particular your comments on these.

Yours sincerely

Andrew Lennard
Technical Director

cc: ASB Members & Observers

FASB/IASB Conceptual Framework Project

Comments by Andrew Lennard and David Loweth (UK ASB)

1 Context

1.1 We very much welcome the commitment of the IASB and FASB to undertake a review of their conceptual frameworks, and to devote significant resource to it. We agree that there are significant differences between the two frameworks; that they are incomplete and, in certain respects, out of date. We also welcome the Boards' willingness to consider the conceptual frameworks developed by other accounting standard-setters.

1.2 We support the strategy of building on the existing frameworks, rather than a 'clean sheet of paper' attempt to develop a new, possibly radically different framework. The current plan envisages completion of the Framework in 2010: whilst that may seem leisurely to some, we think it is realistic given the number, complexity and importance of the issues to be addressed. Undue haste would result in only minor tinkering to the existing frameworks and would incur the risk of failing to consider all relevant points of view. It is important that there is sufficient and genuine consultation on each of the main phases. As the conclusion to "Revisiting the Concepts" makes clear, many of the issues are controversial and difficult. Constituents will need an adequate opportunity to debate and articulate their views, and if these are not accepted, the reasons for this must be clearly explained.

1.3 Subject to this, we agree that the new framework should be completed as rapidly as possible and hope that some parts will be finished relatively quickly. It is important that work on the framework and on new accounting standards take place in parallel, with insights gained in one area informing another.

1.4 In our view, the role of the framework is to set out a vision of what are the ideal qualities of financial statements. It therefore provides an important tool for standard setting—perhaps the most important tool in the standard-setter's kit. We agree that it is not the only tool: standard-setters have to take into account many other factors besides conceptual purity in developing sound accounting standards, such as cost vs. benefit, the impact of radical change etc. But it is important to resist the temptation to develop the framework into an all-purpose manual of standard-setting: an adjustable spanner is not as useful a tool as a set of individual spanners. The relationship of standards to the framework should be transparent and departures from it on pragmatic grounds should be clear: this is less likely to be the case if the framework is itself to address pragmatic concerns.

1.5 It would, however be useful to explore in some depth the relationship between the framework and accounting standards, including what are the legitimate grounds for difference. This might be published to aid understanding of how the framework should be used—perhaps as a preface or appendix—but, for the reasons explained above, should not be part of the framework itself.

"Principles based standards"

1.6 Whilst we share both the aim of "principles-based" standards and work on the conceptual framework, we believe the relationship between them is not always direct. "Revisiting the Concepts" notes, for example, that both IASB and FASB classify some obligations as liabilities, notwithstanding that their current frameworks' definitions of liabilities are not met: but this does not in itself imply that those standards are not "principles-based" in our understanding. A standard may be fairly judged to be "principles-based" provided its underlying aim and objective is clear enough to be implemented without the need for lengthy and detailed supporting requirements, irrespective of whether or not its principles can be reconciled to the framework.

2 Scope

2.1 IASB and FASB have decided that the frameworks should be revised initially only for private sector business entities. A later stage will address private sector not-for-profit entities, and the prospect of work on the application of the framework to public sector entities is even more remote. This seems to be a serious omission.

2.2 The not-for-profit and public sector accounts for a very large proportion of global economic activity and we believe its considerable financial reporting needs should be built on the same framework as that used by business entities. Issues arise outside the business sector that will inform the development of the framework and their consideration will improve its usefulness.

2.3 It sometimes seems that there is little new in accounting standard-setting. Commenting on the objectives of financial statements as described in FASB Concepts Statement No. 1, David Solomons argued in 1986 that its narrow focus was:

> *"…especially regrettable because of the message transmitted to standard setters in other countries, especially in the less developed ones. In a country like India, for example, private investors play a much less important role than they do in the United States; government and other public agencies play a larger part. The financial reporting needs of the public sector are more important there, and the objectives of financial reporting in those countries should reflect those needs."*[1]

2.4 We understand that IASB and FASB are unlikely to reconsider this fundamental issue, and set out in section 6 below how ASB, working with other standard-setters, aims to bring a perspective from other sectors to the work on the framework as it goes forward.

3 Objectives

3.1 We agree that the overriding objective of financial statements is to provide information that is useful in making economic decisions. However, we are concerned that this proposition, especially when coupled with a focus on investors and potential investors as the primary users, gives rise to considerable misunderstanding. In particular, it fosters the naïve assumption that investors look to financial statements only to make decisions to buy, sell or hold securities—and that the quality of an accounting standard should be judged wholly by whether it provides information that informs such decisions. In our opinion, this mindset sometimes leads to inferior financial reporting.

3.2 In our view, financial statements should not aspire to provide information that is sufficient for a valuation of the company to be made, nor should that be their exclusive focus. Whilst the information in financial statements should be useful, relevant, and helpful (to cite some of the commonly used words) they will never provide all the information that is

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[1] The FASB's Conceptual Framework: An Evaluation. Reprinted from Journal of Accountancy June 1986 in 'Readings and Notes on Financial Accounting: Issues and Controversies', edited by Zeff and Dharan, Fourth edition 1994.

necessary to make informed investment decisions. (This point is acknowledged in the ASB's Statement of Principles at paragraph 1.8.)

3.3 Financial statements, by providing information on economic resources, claims on those resources and changes in them are useful in making a large number of assessments about the financial position and performance of a company. A few examples of the many questions that users might look to financial statements for assistance with are:

- What return is the company making on its investment in assets?
- What margins is the business achieving? How have these changed, and how do they compare with its competitors?
- How is the company placed to adapt to a fall in its sales or an increase in interest rates?
- Does the company have the need or ability to raise further finance? Could it finance a takeover of another company?

3.4 If the sole aim of financial statements were to be to influence decisions about buying, selling or holding the company's securities, it is arguable that the most useful form they could take is a summary of management's expectations for the future. We do not question that forward-looking financial information would be useful, but do not expect it to supplant the current form of financial statements.

3.5 An obvious fact about current financial statements is that they are historical—the information is nearly all about financial position at a past date and changes in that position over a past period. The framework needs to articulate clearly why this information is useful. In particular, transactions are of central importance to economic activity, and so the summary which is provided by financial statements of past transactions and their economic impact on the entity is useful in assessing the extent to which similar transactions might recur in the future and how they might affect the entity. If, for example, sales have grown strongly but margins are squeezed, this is important information for assessing both future sales and their profitability. We believe that the framework should clearly identify the reporting of information about past transactions as a central feature of financial statements.

3.6 We understand that the IASB and FASB have tentatively decided that the provision of information relevant for assessment of stewardship should not be regarded as an explicit objective of financial reporting: instead discussion would clarify that information provided to meet the primary objective would include some information that would be useful for assessing stewardship. There are, however, some matters that are very significant in the context of stewardship—such as major illegal acts, or directors' remuneration: it seems to us to be a mistake to imply that accounting standards can only require disclosure of such matters if their relevance for 'making economic decisions' can be demonstrated.

4 Elements of financial statements

Asset and liability approach

4.1 We noted in paragraph 1.2 above that we support the approach of building on the existing frameworks. For this reason—and for the reasons set out in "Revisiting the Concepts"—we agree that the framework should continue to have as its foundation the "asset and liability view" under which conceptual primacy is given to assets and liabilities.

4.2 It should, however, be borne in mind that the existing frameworks reflect their history. When they were developed, deferral and matching were much more prevalent in accounting practice than is, perhaps, the case today. Aside from a few insurance companies, no-one now believes that their financial statements should reflect one-twentieth of the cost of an earthquake every year irrespective of whether an earthquake has actually occurred. It may be wise therefore to recognise that, in the vast majority of cases, an asset and liability approach, properly applied, will not conflict with a legitimate matching approach. It is worthwhile considering those cases—such as deferral of revenue—where deferral and matching seem to be most ingrained to determine whether the perceived conflict with the asset and liability approach is, perhaps, reconcilable.

4.3 We would, however, envisage that there will continue to be cases where expenditure is recognised as an expense, even where it is expected (sometimes confidently) to result in future inflows, because it does not give rise to an asset.

One figure income measures

4.4 We agree that income and expenses[2] should be defined in terms of changes in assets and liabilities, but we do not find the argument for this, drawing on Hicks, persuasive (cited on page 7 of "Revisiting the Concepts"). We have already noted (paragraph 3.2 above) that, in our view, financial statements should not aspire to provide a valuation of the company. Consistently with that, we do not believe they should aspire to provide a comprehensive statement of the company's wealth. There is, therefore, no particular significance in the total net change in a company's reported assets and liabilities in a period.

4.5 More fundamentally, we do not believe that financial statements should aspire to provide a single figure measure of income, or that the framework should suggest that they should. The income recognised in a period will typically comprise the results of a large number of transactions and events which are highly diverse. Financial reporting can aspire to report these as helpfully and transparently as possible, and to provide information about the amount and quality of earnings, but not to provide a single measure of income that is useful for a wide range of purposes. That is why progress on reporting financial performance is vital—and why reporting the amount of comprehensive income is unlikely, in itself, to improve financial reporting significantly.[3]

4.6 Because we doubt that single figure income measures are generally useful, we do not agree that it is necessary for the framework to explicitly adopt a concept of capital maintenance. In any event the physical capital maintenance concept seems of declining relevance given the economic mobility of companies in to day's economy. As described in "Revisiting the Concepts" the 'financial capital maintenance concept' seems to be simply a sophisticated rationale for not having a capital maintenance concept: although there are variants (set out, for example, in "Capital maintenance concepts: the

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2 We would prefer the terms 'gains' and 'losses' to 'income' and 'expenses', but that is irrelevant to the point being made here.

3 To avoid misunderstanding, we should make explicit that we agree that all and only income and expenses should be reported in a financial statement, and that it would probably be useful to total that statement so that its relationship to other parts of the financial statements was easily understood. But we do not find it helpful to argue for this on the basis that the total (ie comprehensive income) is generally a useful measure of financial performance.

choice": Tweedie and Whittington, ASC, 1985) under which financial capital is adjusted for the change in a general inflation index. But in many modern economies general price changes are relatively low, whilst specific price changes vary greatly, so we question whether exploration of financial capital maintenance is likely to be fruitful. Nor do we believe that a real-terms accounting system is likely to attract widespread support at the present time and would distract the debate from more fundamental issues.

5 Issues

Measurement

5.1 We agree that measurement issues are one of the most fundamental subjects to be addressed in the project, and welcome the emphasis accorded to in "Revisiting the Concepts". It is, in our experience, fruitless to pose the question (as it has so often been in the past) simply in terms of a stark choice between historical cost and fair value. (We note that "Revisiting the Concepts carefully refers to "historical-price" and "current-price" measures.[4]) We agree that the virtues and drawbacks of various measurement attributes require careful consideration: and those considered should include historical cost.

5.2 It would be useful to add a further cross-cutting issue to those listed[5] under measurement: "Should different entities report similar assets at the same amount, or should measurement reflect their economic constraints and opportunities?" Another way of framing the question is "Should the measurement of assets reflect the *best possible use (ie the best use that might be available to another entity)*, or the most profitable use that is available to the entity?"

[4] We guess that the use of the term of 'current price' has been crafted to avoid the connotations associated with the term 'fair value'. Our guesses feel more speculative, however, as to why the term 'historical-price' is used in place of the more familiar 'historical cost'.

[5] We appreciate that the list of cross-cutting issues set out in "Revisiting the Concepts" is not intended to be comprehensive.

Offset of assets and liabilities

5.3 In our view, the issue of when to offset balance sheet debits and credits is very important. We agree that it is essentially a unit of account issue—although IAS 32 seems to suggest that it is a matter of presentation. Agreement must be reached on the circumstances in which a number of rights and obligations represent separate assets and liabilities and those in which they should be reported together as a single asset or liability.

5.6 As noted in "Revisiting the Concepts", the issue of offset is central to resolving the accounting treatment for executory contracts. It is also important in resolving in a satisfactory manner the question of derecognition: robust derecognition criteria may require continued recognition of an asset and a liability, but will be of no practical effect if defective offset rules allows these to be offset.

Display and presentation

5.7 Whilst we would not suggest that issues of display and presentation should command resources at this early stage in the project, their importance should not be neglected. We strongly welcome their explicit inclusion in the project.

6 ASB involvement

6.1 The ASB has decided that it wishes to monitor closely the work on this project and we shall be presenting papers on it to the ASB at each of its meetings in order to inform the Board and develop views. When it appears appropriate or helpful we shall ensure that IASB and FASB are aware of the ASB's ideas and any concerns, as well those of ASB's constituents.

6.2 We shall also actively engage with other national standard-setters. In particular we shall seek to debate the issues with European standard-setters.

6.3 We noted in section 2 above that we disagreed with the limitation of scope of the project to private sector business entities. Together with other standard-setters we shall be considering the implications of the project for the public sector.

6.4 We would welcome direct participation in the project. We are uncertain to what extent this would be achieved by seconding staff to work on it directly. However, we would be very glad to develop papers on specific aspects of the framework, for consideration by the IASB and FASB and believe we are in a position to offer considerable assistance in this way.