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AUSTRIAN FINANCIAL REPORTING AND AUDITING COMMITTEE

Comment Letter

"Discussion Paper: Preliminary Views on an improved Conceptual Framework for Financial Reporting"

AFRAC

AUSTRIAN FINANCIAL REPORTING AND AUDITING COMMITTEE

The Austrian Financial Reporting and Auditing Committee (AFRAC) is the privately organised standard-setting body for financial reporting and auditing standards in Austria, and is supported by the competent Austrian authorities. The members of the Austrian Financial Reporting and Auditing Association, AFRAC's parent organisation, are several Austrian Federal Ministries and a number of public institutions. The members of AFRAC represent preparers of financial statements, certified accountants, academics, investors, analysts, and oversight bodies of capital markets and regulated industries.

The AFRAC International Financial Reporting Standards Working Group prepares comment letters on recent IASB publications and on publications of other standard-setting bodies pertaining to IFRS for final approval by AFRAC. Principal authors of this comment letter were Peter Geyer, Roland Nessmann and Alfred Wagenhofer. More information about the Working Group and AFRAC is available under www.afrac.at.

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Outline

1. General comments

The Austrian Financial Reporting and Auditing Committee (AFRAC) welcomes the opportunity to comment on the Discussion Paper: Preliminary Views on an improved Conceptual Framework for Financial Reporting issued by IASB and FASB in July 2006.

We support the two Boards' efforts to develop a modern framework. In general, we believe the Discussion Paper (DP) addresses the main issues, given the scope of the present part of the project. However, as we discuss below, we do not agree with several standpoints expressed in the DP.

A general comment concerns the appropriateness of a single framework for all actual and potential users of IFRSs. The DP clearly focuses on capital market uses of financial reports. This is similar to the current frameworks used by IASB and FASB. However, this focus is inappropriate for most SMEs. The European Union requires financial reporting by (at least) all limited liability companies and allows member states to require IFRS for their financial reports. We believe that the DP does not address the financial reporting needs of SMEs. Given IASB's SME project, we wonder whether IASB envisages that the framework in the DP will also be appropriate for SMEs. We understand that this issue was discussed in the SME project and the IASB considers it as appropriate, with which we do not agree. A similar problem arises with respect to financial reporting for non-profit entities. Different purposes may require different information that best serves the purposes. There is nothing like a "true" or "correct" way of accounting for transactions and events – accounting is a construct based on imposed rules and standards.

2. Specific comments on Chapter 1

2.1. Users of financial reports

We support the entity perspective adopted in the DP, i.e., the focus on a broad range of users of financial reports. OB1 establishes the objective of "general purpose external financial reporting" by business entities in the private sector. From that, we would expect that the requirements of all parties interested in an entity should be covered appropriately, taking into consideration the different risk exposures of interested groups in respect of the capability to generate future net cash inflows.

The difficulty with catering for different groups of users is that their typical interests usually differ. Therefore, the usefulness of particular financial information is likely to differ across groups of users, too. For example, many users, including creditors, suppliers, customers, and employees, due to their claims against the reporting entity, are more interested in downside than in upside risks. As another example, BC1.27 discusses whether financial reports should be useful to assess solvency and answers it in the affirmative. However, the boards do not want to consider particular groups of users and decided against addressing this sort of use of financial reports. As long as there are no limits to the provision of information, serving different users is not a major problem, because supplementary information can be provided to cater to the different information requirements. However, there are such limits, and they are determined by the understandability requirement. As a consequence financial reports contain condensed and aggregated information. Selection among different needs or trade-offs between different pieces of information are not addressed in the DP. Thus, the primary focus on the needs of present and potential investors and creditors (OB13) undermines the "general purpose" aspect of OB1.

The DP extends the focus from investors only, but only to creditors in addition. However, investors and creditors have different claims on the entity and therefore their information needs are not necessarily equal. The assumption that the needs of investors and creditors encompass the needs of a wide range of users does not really reflect the "general purpose" intention but rather favours investor (stakeholder) oriented financial reporting.

The DP focuses in OB3–OB6 on the importance of information useful in assessing cash flow prospects. These cash flow prospects are considered to be the basis for the evaluation of assets and liabilities, and therefore the basis also of the information about an entity's resources, claims to those resources, and changes in resources and claims, as explained in OB18–OB26. It would therefore be more helpful to include OB3–OB6 in that section.

2.2. Stewardship use of financial reporting

The DP does not mention the stewardship use of financial reporting as an objective on its own, over and above its relevance to decision-making (OB27–OB28). It assumes that the usefulness of information is similar for decision-making (as explained there) and stewardship. We know from the existing literature that this is, generally, not the case. While it may be true that the basic information about transactions and events is similar, measurement and aggregation are likely to differ for the two uses. In addition, the timeliness of information is less crucial for stewardship purposes than for decision-making purposes.

BC1.37 argues that the separation of effects under the control of management from those not so controllable is not feasible in financial reporting. First, stewardship often does not aim at ignoring effects not under management's control – as long as that is informative about the management's activities in respect of those that are controllable. Secondly, separation is precisely what is being achieved with fair value measurement: it separates changes in fair values (market-based values) from other, idiosyncratic, gains and losses.

We therefore agree rather with the dissenting opinion that the stewardship use should be included more prominently in the purpose of financial reports. We suggest that stewardship is mentioned as one of the objectives of financial reporting (see also BC1.35). This would assure that the standard setters consider stewardship demands when developing new standards. After all, financial accounting developed out of stewardship requirements.

We note, moreover, that B1.39 contains a valid argument against the Boards' view: it says that those who can write individual contracts do not depend on general purpose financial reports, because they can specify the information that they want in the contract. A similar argument holds for most creditors, which makes it questionable why they should be considered to be among the most important users to focus on.

2.3. Boundaries of financial reporting

We do not agree with the Boards' conclusion that the boundaries are likely to be independent of the current DP (BC1.5). For example, changing the disclosure requirements may affect the contents of financial statements. A possible requirement to disclose more forecasts may make traditional financial statements uninteresting, or may change their function from forecasting future cash flows to ex post assessment of the precision of the forecasts (and management's forecasting ability). This may particularly affect the measurement of resources and claims and the presentation of information. Therefore, we believe it is important to specify whether, e.g., a management commentary is part of financial reporting or not. Similarly, OB26 talks about management's explanations, which we understand are included in the notes. What is the difference from a management commentary? We note that the recent Discussion Paper on management commentary struggles with exactly this question.

According to OB16, the financial statements are just one part ("central feature") of financial reporting as defined by the framework. It also mentions that "some types of both financial and non-financial information may best be communicated by means other than traditional financial statements". Although we agree with this statement, we are worried that IFRSs may in the future concern themselves with other forms of financial reporting , the functions of which will be less well defined than those of financial statements. As IFRSs are not restricted to financial statements, a more explicit positioning of the status of financial statements within the framework might be useful, in order to avoid issues and discussions as to where in the report particular information is to be disclosed. A practical consequence of this issue is what information falls within the scope of an audit and what does not.

3. Specific comments on Chapter 2

3.1. General observation

According to QC6, standard setters bear responsibilities to exercise due care in developing financial reporting standards. The qualitative characteristics however "pertain to the information that results from the process of establishing standards and implementing them – not to the characteristics of the standards themselves". We would find it useful if the proposed qualitative characteristics were analysed in terms of:

(i) Continuous (more or less) or binary (yes or no) characteristics, i.e., is the objective to rank alternatives with respect to that characteristic (e.g., comparability) or will it be enough to be considered as an alternative (e.g., neutrality). Questions arise, e.g., for relevance, which also implies the discussion in relation to materiality.

(ii) Who is concerned with the qualitative characteristic, the standard setter and/or entities and auditors, and/or the users? For example, benefits and costs mainly concern the standard setter, whereas materiality is less an issue of standard setters but of entities and auditors.

3.2. Relevance

The broad definition of relevance would seem to imply that almost everything can be relevant in a specific decision context and to a specific decision-maker. We suggest including references to typical decisions and decision-makers and examples. Otherwise, relevance may become an empty term, since almost anything may be relevant for a particular decision faced by a particular decision-maker.

In QC49 materiality is negatively defined, perhaps to distinguish it from relevance; this suggests that it can be seen as a sub-characteristic of relevance (as it is in the IASB's Framework). On the other hand, materiality is considered to play a role in connection with other qualitative characteristics, too, and is not a concern of the standard setter (BC2.67). This reinforces our earlier point that it is important to be clear for whom the characteristics are important. We suggest making the connection between materiality and other characteristics clearer.

We do not understand why timeliness is considered as part of relevance (see QC15 and BC2.9). We think timeliness is just like materiality – it affects several qualitative characteristics, including faithful representation and reliability (or, given the comments above, relevance may be linked to timeliness similarly to materiality). Moreover, given the existence of other sources of information, timeliness is just another characteristic that affects relevance of information.

3.3. Alternative accounting methods (QC38)

QC38 states that “Permitting alternative accounting methods for the same transactions or other events (real-world economic phenomena) is undesirable because to do so diminishes comparability and may diminish other desirable qualities as well.” From an information point of view this is not necessarily true, as the selection of the accounting method itself provides information, and can hence be useful over and above the numbers it produces. We suggest consideration of this argument.

3.4. Faithful representation and reliability

The DP introduces a new characteristic, faithful representation, which includes verifiability, neutrality, and completeness. The term replaces “reliability” (although this is included in both Boards’ current frameworks), on the grounds that it is used with different meanings in the literature.

We conceptually agree with this change but strongly recommend including reliability, in the sense of precision of information, as a separate qualitative characteristic. It falls into the same category as comparability and understandability, as a characteristic that standard setters and preparers should take into account. A major reason for including reliability as a qualitative characteristic is the fact that it has provided the main counterbalance to the other main qualitative characteristic, relevance of information.

Reliability as precision of the financial information is different from faithful representation; information can be highly imprecise but still be faithful (particularly if the underlying phenomenon is imprecise).

An alternative would be to consider treating reliability as part of relevance – as mentioned in BC2.24, this is also what empirical studies can and do measure.

3.5. Conservatism (prudence)

The DP does not include conservatism as a characteristic, despite the fact that conservatism is a significant empirical phenomenon in financial reports as they have been produced up till now. There are many good reasons why conservatism has been so predominant (e.g., contracting purposes, liability issues). These are not discussed in the DP. It simply states in BC2.22 that conservatism and neutrality tend to be conflicting characteristics. However, such conflicts are not peculiar to these two characteristics alone; they also occur with other qualitative characteristics. Hence, we do not believe this is a convincing reason for excluding conservatism from consideration.

BC2.22 states: "It almost goes without saying that accountants should be careful in the presence of uncertainty. In a particular situation, that care might include searching for additional information to reduce uncertainty, reflecting the uncertainty of a range of potential amounts in making an estimate, or selecting an amount from the midpoint of a range if a point estimate is required." Given that the DP does not include conservatism (see our comments above), we believe it would be most useful to put such thoughts into the text of the Framework – as it is done with many other themes (e.g., substance over form).

3.6. Relationship between qualitative characteristics (QC42–QC47)

We do not agree with the argument that the qualitative characteristics are usually complementary, and may only need to be constrained by considerations of cost-benefit or technical feasibility. The most common issue in financial reporting is the trade-off between relevance and reliability (see above). Obviously, different measurement bases imply differing mixes of relevance and reliability.

We would also like to see examples of technical feasibility issues.

3.7. Should other qualitative characteristics be added (BC2.41)?

We note that many national financial reporting regimes, including that current IFRSs (IAS 1), include an overriding principle. Given that IASB stands by the overriding principle, we think it important that it should be mentioned in the framework, as it is clearly fundamental to financial reporting. Alternatively, if IASB aims to abandon the overriding principle, it should explicitly discuss that in the DP, too.

We also suggest adding internal consistency as a qualitative characteristic (see also BC2.52–BC2.54). It highlights the need for standard setters to take internal consistency into account when developing new standards. Currently, internal consistency is lacking in both IFRS and U.S. GAAP, which causes uncertainty about the validity of the aggregation of quantitative numbers. We do not believe that including internal consistency will impede evolution of standards: standard setters need not follow it to the exclusion of other considerations.