Centre for Financial Market Integrity
CFA INSTITUTE

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Chair, International Accounting Standards Board
30 Cannon Street
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United Kingdom

Mr. Robert Herz
Chair, Financial Accounting Standards Board
401 Merritt 7
Norwalk, CT 06856-5116
USA

Re: Preliminary Views – Conceptual Framework for Financial Reporting:
Objective of Financial Reporting and Qualitative Characteristics of Decision-Useful Financial Reporting Information

Dear Sir David and Mr. Herz:

The CFA Institute Centre for Financial Market Integrity (CFA Centre) of CFA Institute,[1] in consultation with its Corporate Disclosure Policy Council (CDPC)[2], appreciates the opportunity to comment on the International Accounting Standards Board's (IASB) and Financial Accounting Standards Board's (FASB) Preliminary Views – Conceptual Framework for Financial Reporting: *Objective of Financial Reporting and Qualitative Characteristics of Decision-Useful Financial Reporting Information (PV Document).* The CFA Centre develops, promulgates, and maintains the highest ethical standards for the investment community including the CFA Institute *Code of Ethics* and *Standards of Professional Conduct*. The CFA Centre represents the views of investment professionals to standard setters, regulatory authorities, and legislative bodies worldwide to promote investor protection and efficient global capital markets.

[1] The CFA Centre for Financial Market Integrity is part of CFA Institute®. With headquarters in Charlottesville, VA and regional offices in New York, Hong Kong and London, CFA Institute, formerly the Association for Investment Management and Research®, is a global, non-profit professional association of more than 89,000 financial analysts, portfolio managers, and other investment professionals located in 131 countries of which more than 74,600 are holders of the Chartered Financial Analyst® (CFA®) designation. CFA Institute has 134 affiliated Member Societies and Chapters in 55 countries and territories.

[2] The objective of the CDPC is to foster the integrity of financial markets through its efforts to address issues affecting the quality of financial reporting and disclosure worldwide. The Council comprises individuals, who are investment professionals with extensive expertise and experience in the global capital markets, as well as CFA Institute member volunteers. In this capacity, the Council provides the practitioners' perspective in the promotion of high-quality financial reporting and disclosures which meet the needs of investors.

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General Comments

We support the Boards' joint project to develop a common conceptual framework that is both complete and internally consistent, and has the primary objective to establish a sound foundation for developing financial reporting standards. Furthermore, this common framework should fulfill the Boards' goal to develop standards that are: (1) principles-based, (2) internally consistent, (3) internationally converged. Ultimately, the framework should form the basis for financial reporting that provides the information needed for making well-informed investment, credit, and similar decisions. Indeed, the concepts in the framework should serve as a benchmark by which the quality of financial reporting standards is assessed.

To achieve this goal, the Boards have decided to issue the common framework in phases through distinct chapters as they deliberate the key issues covered by a given chapter. Further, we understand that the Boards will discuss many of the issues concurrently and will strive to make the concepts in each chapter congruent with one another. We support and agree with the Boards' decision to proceed with the joint project in a phased-approach. The initial chapters covering the objective of financial reporting and its qualitative characteristics are building blocks to the other chapters yet to be deliberated fully, for example, elements and recognition; measurement; reporting entity; presentation and disclosure, including financial statement boundaries.

We acknowledge that achieving the goal of this joint project is a monumental undertaking. As such, substantial effort will be required to deal with a wide range of issues that build on the existing IASB and FASB frameworks as well as consider changes in business environments since the original frameworks were issued. Therefore, we commend the Boards and their staff for the issuance of a comprehensive and thoughtful document on the first two chapters of the conceptual framework.

Conceptual Framework's Purpose and Status in the GAAP Hierarchy

We believe that fundamental issues still remain open, in addition to those identified above, dealing with the Framework's purpose and status in the GAAP hierarchy. Although the Boards have identified these issues and plan to address them in Phase F of the project, there is no set time frame for the Boards' deliberation of these issues. In our view, these issues are overarching and directly affect the Boards' ultimate goal to develop standards that are principles-based; internally consistent and provide decision-useful information. Therefore, given the nature of these issues, we recommend that the Boards consider these issues with more urgency than is currently indicated on the project plan.

We believe that the Conceptual Framework should be placed at the top of the GAAP hierarchy. Otherwise, we question how effective the Boards will be in promulgating financial reporting standards that are consistent and principles-based if those standards are not viewed as direct "offsprings" of the Framework. Also, in the absence of an existing standard to address a particular business transaction and/or event, we believe that the Framework should be used to determine the appropriate accounting treatment before any analogy is made to other existing standards.

General Views on Chapters 1 and 2

Generally, we support most of the views expressed in the PV document. In particular, we agree that:

1) The objective of general purpose external financial reporting is to provide information that is useful to present and potential investors and/or creditors, as well as other investment professionals, making or advising on capital resource allocations and other related decisions. In other words, *decision-usefulness* should be the single overriding objective for financial reporting. We provide further elaboration of our views regarding stewardship on pages 5-7 of our letter.

2) Qualitative characteristics of decision-useful financial reporting information are relevance, faithful representation, understandability and comparability. We believe that it is appropriate to replace reliability with faithful representation. We also believe that neutrality is incompatible with conservatism or excessive prudence in presenting information. We provide further elaboration of our views on reliability and faithful representation later in this letter on pages 7-9.

However, we have particular concerns about two areas:

1) Although the definition of the reporting entity has not been addressed comprehensively in this PV document and is expected to be deliberated by the Boards during Phase D of the project, we are concerned with the views expressed in paragraph OB10 as follows:

    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… Accordingly, financial reports reflect the perspective of the entity rather than only the perspective of the entity's owners (existing common shareholders or common shareholders of the parent entity in consolidated financial statements) or any other single group of users. However, adopting the entity perspective as the basic perspective underlying financial reporting does not

> *preclude also including in financial reports information that is primarily directed to the entity's owners or to another group of users…*

Please refer to the section titled – **Establishing the Appropriate Perspective for the Reporting Entity –** for an elaboration of our views on the reporting entity**.**

2) We have concerns with how the constraint would be applied involving the costs and benefits associated with requiring a given accounting treatment and/or disclosure requirement. It has been our experience that the Boards' past decisions to not require certain accounting treatments and disclosures were based on incomplete information (or none at all) on the expected cost versus expected benefits. Conceptually, we agree with the Boards' view that the benefits of financial reporting should exceed the cost to produce it. However, as shareowners both receive the benefits and bear the costs associated with generating this information, the cost-benefit analysis should be done within the context of the Framework's objective to provide decision-useful information. We provide further elaboration of our view on page 8 of this letter.

The Importance of a Sound Conceptual Framework

As stated in the Centre's draft position paper – *A Comprehensive Business Reporting Model: Financial Reporting for Investors -*

> *Corporate financial statements and their related disclosures are critical to sound investment decision-making. The well-being of the world's financial markets, and of the millions of investors who entrust their financial present and future to those markets, depends directly on the quality of the information financial statements and disclosures provide. The quality, in turn, depends directly on the quality of the principles and standards by which managers recognize and measure the economic activities and events affecting their companies' operations.*

To achieve this quality, we believe that the conceptual framework for financial reporting must be viewed as the foundation or basis for the principles and standards applied for preparing financial statements and accompanying note disclosures used by the global capital markets. In other words, the Framework should be placed at the top of the GAAP hierarchy.

All financial reporting principles and standards should align with the objective to produce financial statements, including supplemental disclosures, which enable present and potential investors and creditors to make well-informed decisions regarding their allocation of capital. Also, these standards must be consistent and rooted in the framework's concepts for determining the financial reporting elements and their characteristics, as well as their recognition and measurement criteria. ***Exceptions and alternative methods for the recognition and***

measurement of economically or substantially similar transactions and events must be rare or, at best, unacceptable.

We understand that updating the Boards' existing frameworks, and establishing a common framework, does not in itself promulgate standards for particular financial reporting issues. As such, some existing standards may be inconsistent with the concepts set forth in the common framework. The Boards have stated that they *may* reconsider such standards in the future, depending on the extent to which the topics satisfy the criteria for adding a project to the respective Board's agenda. Although we acknowledge that the Boards cannot amend all of the inconsistent standards in one complete sweep, we nonetheless urge the Boards to set as a strategic goal to address these standards with the aim to make them consistent with the common framework. To leave those standards (for example, accounting for leases, financial instruments, and pension plans) as is, without amendments, will defeat the overall objective of financial reporting as stated in the PV document.

The Primary Objective for Financial Reporting

We agree with the Board's view that – *the objective of general purpose external financial reporting is to provide information that is useful to* [primary users] *present and potential investors and creditors and others in making investment, credit, and similar resource allocations.* Additionally, we concur with the Boards' view that to achieve this objective, financial reporting should provide information to help the primary users in assessing the amounts, timing and uncertainty of a company's future cash flows.

Financial reporting should provide updated information regarding the fair values of a company's net assets that reflect current market and other related conditions, changes in those values, and the company's ability to meet and pay obligations and claims against those net assets. Indeed, decisions about whether to purchase, sell, or hold investments are based on fair market values of the investments and expectations about future changes in these values. Financial statements based on outdated historical costs are less useful for making these assessments.

"Decision-Useful" versus "Stewardship"

We believe that the stated objective to provide decision-useful information is sufficiently broad to address stewardship, and that the Boards have addressed the need for providing information about stewardship in paragraphs OB27-28 as follows:

THE OBJECTIVE OF FINANCIAL REPORTING AND ASSESSING MANAGEMENT'S STEWARDSHIP

OB27. Management of an entity is accountable to owners (shareholders) for the custody and safekeeping of the entity's economic resources and for their efficient and profitable use. Management's stewardship responsibilities include protecting the entity's economic resources, to the extent possible, from unfavorable economic effects of factors in the economy such as inflation or deflation and technological and social changes. Management is also accountable for ensuring that the entity complies with applicable laws, regulations, and contractual provisions. Because management's performance in discharging its stewardship responsibilities significantly affects an entity's ability to generate net cash inflows, management's stewardship is of significant interest to users of financial reports who are interested in making resource allocation decisions.

OB28. Users of financial reports who wish to assess how well management has discharged its stewardship responsibilities generally are interested in making resource allocation decisions, which include, but are not limited to, whether to buy, sell, or hold the entity's securities or whether to lend money to the entity. Decisions about whether to replace or reappoint management, how to compensate management, and how to vote on shareholder proposals about management's policies and other matters are also potential considerations in making resource allocation decisions in the broad sense in which that term is used in the framework. Thus, the objective of financial reporting stated in paragraph OB2 encompasses providing information useful in assessing management's stewardship. In addition, the information discussed in paragraphs OB18–OB26 is useful in assessing how well management has discharged its stewardship responsibilities because management is responsible for the entity's resources and related claims and changes in resources and claims.

As primary users of financial reports, we believe that "decision-useful" information embodies the notion that there will be a ***complete*** and ***fair presentation*** of a company's financial performance for the reported period, and its financial position as of a certain date. We define "stewardship" to mean how agents (or a company's executives) manage the company's resources on behalf of their principals (or a company's shareowners) to maximize the principals' return subject to a given level of risk. **Therefore, we believe that the concept of stewardship is embodied in and is an essential part of decision-useful information.** Simply put, information about how well managers or agents have discharged their stewardship responsibilities is in itself decision-useful information.

Those that argue that decision-useful information would exclude information about managers' stewardship are defining what is considered decision-useful too narrowly. We disagree with the suggestion that a *decision-useful objective* would exclude certain types of information that a *stewardship objective* would require. Moreover, we believe that making a distinction between the two objectives would risk separating the company's performance from that of the company's managers when they are inseparable. By elevating stewardship to a secondary objective, it could lead to a de-emphasis on information regarding the entity's performance which would be unacceptable in our view.

For example, it has been suggested that information regarding related party transactions would not be provided under the objective of decision usefulness. On the contrary, we believe that many, if not most users, find such information helpful in making investment decisions as they recognize that transactions with related parties are inherently different in character from those with unrelated parties. Similarly, we believe that information regarding managers' (including board) compensation and share compensation plans also have a high degree of decision usefulness.

In this context, we note that there is no single model used by all financial statement users to make investment and investment-related decisions. The opposite is so; different users apply a variety of models using an assortment of inputs, which may vary over time as business conditions change. Some users may decide to sell or not purchase common shares of a company if they believe that the company's corporate governance, or the stewardship of management, is lacking or deficient.

Establishing the Appropriate Perspective for the Reporting Entity

The Framework needs to have a clearly defined approach for determining the scope of the entity and the reporting perspective of the entity. Indeed, one of the primary weaknesses of the current conceptual framework is the lack of such a clearly and sharply defined perspective. In such a circumstance, the definition of the entity becomes confused, and even circular: the entity is what in a particular circumstance it defines itself to be, and this definition can change from one reporting decision to another. Unfortunately, the resulting ambiguity frequently results in the omission from the primary financial statements of information essential to the principal users, for example, significant obligations or claims treated as off-balance-sheet items,. In other words, reporting from the entity's perspective will not meet the primary objective of financial reporting: to provide decision-useful information to the primary users of financial statements – investors and creditors.

We believe that the reporting entity should be viewed (for financial reporting purposes) from the perspective of the last residual claimant, frequently the common shareowner. We do not say this because we believe that the common shareholder is the only user, or the most important user. Rather, the common shareowners must perform the most comprehensive analysis because they bear the greatest risk. Their analyses generally encompass at a minimum the information required by other financial statement users, such as the ability of the entity to service the claims of secured and unsecured creditors in a timely fashion, and additional information as well, for example, the commitments made by managers to transfer equity interests to employees of the company in the future. That is because other claims are superior to those of common shareowners, the last residual risk-bearer, and as such, must be satisfied before the common shareowners may exercise their claims to the net assets of the company.

By reporting from the perspective of the last residual claimant, we believe that superior claimants will have the information that they need regarding the financial position and financial performance of the company. We also believe, as discussed in the section **"Decision-Useful" versus "Stewardship,"** that information that is decision-useful also satisfies the needs of those who want to evaluate management performance in a comprehensive way.

Qualitative Characteristics

Generally, we support the Boards' preliminary views on the qualitative characteristics that underpin decision-useful financial reporting information.

Cost-Benefit Constraint

We believe, and thus agree with the Boards' view, that the benefits of financial reporting should exceed the cost to produce it. Since shareowners both receive the benefits *and bear the costs associated with generating this information*, the cost-benefit analysis should be done within the context of the framework's objective to provide decision-useful information.

Frequently, the determination of the related costs and benefits is incomplete, and/or is virtually impossible to make, because the full benefits are rarely identified. Ideally, a complete assessment of the costs and benefits would require an extensive and global economic study to compare the potential effects of a particular accounting treatment or disclosure with the potential effects of taking no action. However, such a comprehensive approach would take considerable time and effort, both to gather the information required for estimating these effects and to conduct the follow-up to evaluate the actual impacts.

In lieu of a complete assessment, we believe that the primary users of financial reporting - investors and creditors - are best able to advise standard setters as to the proper balance of costs and benefits associated with providing decision-useful information. Therefore, we urge the Boards to act judicially in exercising this constraint in their standard setting process.

Faithful Representation and Reliability

We strongly agree with the Boards' views stated in paragraph QC 21 - "Economic activities take place under conditions of uncertainty, and most financial reporting measures involve estimates of various types, some of which incorporate management judgment. With the possible exception of the amount of cash that an entity controls, it rarely is possible to develop a measure of an economic phenomenon that does not involve some degree of uncertainty." The Boards go on to state – "Some financial reporting measures that are often thought to be precise, or at least more precise than the alternatives, prove to be not necessarily so precise upon closer inspection."

We believe that the above views of the Boards are consistent with ours, which is that reliability has been much misunderstood and misused in the financial markets. Indeed, reliability has in some quarters been taken to mean certainty of occurrence and measurement. We believe that such an interpretation was never intended by the standard setters. Rather, reliable information is that which faithfully represents the events that it "purports to represent or could reasonably be expected to represent."[3]

True and Fair Presentation

We concur with the Boards' conclusion that *true and fair view* or *present fairly* is not a qualitative characteristic. But instead, a true and fair view should result from applying the qualitative characteristics and that they are embedded in the characteristic – *faithfully represent*.

Moreover, we believe that there must be no "true-and-fair-view override." If managers or auditors disagree with a treatment, they must still provide the statement presentation required by GAAP then can discuss the items in the notes. Companies have routinely done this when amended standards affected their financial positions because of an "accounting" change.

[3] Framework for the Preparation and Presentation of Financial Statements, International Accounting Standards Committee, p.39.

Closing Remarks

The CFA Centre for Financial Market Integrity, together with its Corporate Disclosure Policy Council, appreciates the opportunity to provide comment to the IASB's and FASB's Preliminary Views – Conceptual Framework for Financial Reporting: *Objective of Financial Reporting and Qualitative Characteristics of Decision-Useful Financial Reporting Information* . If you or your staff have questions or seek further elaboration of our views, please contact Georgene B. Palacky, by phone at +1.434.951.5326 or by e-mail at georgene.palacky@cfainstitute.org.

Sincerely,

/s/ Gerald I. White

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