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Sir David Tweedie
Chairman
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30 Cannon Street
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Berlin, 10. November 2006

Dear Sir David,

On behalf of the German Accounting Standards Board (GASB) I am writing to comment on the IASB Discussion Paper "Preliminary Views on an improved Conceptual Framework for Financial Reporting: The Objective of Financial Reporting and Qualitative Characteristics of Decision-useful Financial Reporting Information". We believe that the development of an improved Framework is of fundamental importance to high quality of the International Financial Reporting Standards. The principles contained in a new Framework will help in understanding and applying those standards. In addition, from the point of view of the standard setter, the principles in a Framework will assist the IASB in developing a consistent set of high quality accounting standards. We appreciate that the IASB is conducting this project together with the FASB. We welcome the opportunity to comment on the Discussion Paper.

We understand that the IASB has chosen to divide the project into different phases and to publish preliminary views on each phase of the project in form of a Discussion Paper first. We acknowledge that, given the complexity of the project, conducting the project in smaller phases is appropriate. Furthermore, we appreciate the decision to publish a Discussion Paper on each phase. This allows constituents to participate in the standard stetting process at an early stage.

However, since this Discussion Paper covers only part of what will be included in the final Framework, we think it is imperative that final conclusions may only be reached after all phases have been completed. Preliminary conclusions or tentative decisions may have to be revised when Discussion Papers on other phases become available. Therefore, we would like to stress that our comments – just as the proposals contained in the Discussion Paper – are of a preliminary nature and that they may be revisited once all draft chapters have been published.

Furthermore, we are not convinced by the sequence in which certain topics are considered throughout the whole project. For example, the term (the scope) of "financial reporting" will be discussed as late as phase E. Nevertheless, one, as a first step, has to define the term "financial reporting" before discussing the objectives of financial reporting, as previously defined.

In addition, we think a discussion about the status of the Framework should take place at the beginning of the Framework project. As the content and structure of the Framework will be influenced by its status, the status has to be discussed and decided as a first step within the Framework project. The status of the framework has important implications for the level of detail. In our view, the framework should assist the standard setter in new projects and standards, and the standard setter should be required to publish new standards that are consistent with the framework. Only in very rare circumstances, the Board should issue a new or amended standard deviating from the framework; in such event it should consider a revision of the Framework. In such event, the Board should, after due deliberation, change the Framework as well.

With respect to the status of the framework for the preparer, i.e. as a source in the absence of a Standard or Interpretation, we think that the current status in the IFRS hierarchy is appropriate. However, this asks for precise principles in order to allow the preparer to deduce an accounting policy in the absence of an IFRS, IAS or an Interpretation.

As explained above, the status of the Framework for the standard setter and the preparer may ask for different structures of the Framework and the IASB will need to find a balance. However, this issue requires a comprehensive discussion at the beginning of the Framework project, not in a later phase.

With respect to the structure of the proposals and the style in which the proposals are written, we would prefer the text to concentrate on principles with more explanations being given in the Basis for Conclusions. A more condensed style of the Framework could better assist the user in applying the Framework and could enhance the understanding of the principles. In our view, this would support the aim of the Framework as stated in IN 5: "Knowledge of the framework should also help interested parties to understand the content and limitations of information provided by financial reporting, thereby furthering their ability to use that information effectively."

Regarding the content of the Discussion Paper the GASB has concerns about a number of proposals. In particular, we

- are concerned that the <u>stewardship function</u> of financial statements is not given sufficient prominence, as we are convinced that it is not simply a critical attribute of providing useful information
- prefer investors being defined as the <u>primary users</u> of financial statements (not investors *and* creditors), as different information needs might arise and meeting the needs of providers of risk capital would meet most of the needs of other users such as creditors. Generally, we suggest a wording along the lines of par. 10 of the current Framework
- take the view that the <u>entity perspective</u> has to be (1) defined and (2) discussed in a broader context before promulgating this perspective in the

Framework. This perspective will have implications for a number of issues and we deem it important to discuss those implications

- are generally in agreement with <u>widening the scope</u> of the Framework ("financial reporting" instead of "financial statements"); this includes the management commentary in particular. However, widening the scope in this stage is inappropriate, because it requires "financial reporting" to be defined. We note that the current principles and concepts may not be applied to a different, i.e. wider scope (financial reporting) without carefully analysing the consequences
- disagree with the proposal to <u>replace the term "reliability"</u> by the term "representational faithfulness". We take the view that the term "reliability" is better understood than "representational faithfulness" and better conveys the intended meaning
- are concerned that, despite the Discussion Paper explicitly stating that the <u>balance between the qualitative characteristics</u> remains unchanged, the proposed complementary concept may be misinterpreted. Furthermore we have doubts if this complementary concept is appropriate. We take the view that the current Framework better illustrates that the qualitative characteristics, especially relevance and reliability, are of equal importance and that the preparer has to strike a balance between those two qualitative characteristics.

For the detailed comments concerning the objectives (chapter 1 of the Discussion Paper) and the qualitative characteristics (chapter 2 of the Discussion Paper), we refer to appendices A and B to this comment letter.

If you want to discuss any aspects of this letter in more detail, please do not hesitate to contact me.

Yours sincerely,

Harald Wiedmann

President

Appendix A: Chapter 1 / Purpose of Financial Reporting

Financial Statements versus Financial Reporting

Generally, we take the view that a Framework may be a suitable conceptual foundation not only for financial statements, but also for other financial reporting instruments, e.g. the management commentary.

However, we deem it inappropriate to widen the scope without defining the term “financial reporting” at the same time. As ”financial reporting” will be discussed and defined in a different (later) phase of the project, we feel unable to answer the question (or comment on the question) whether the Framework’s scope should be defined as ”financial reporting” or ”financial statements” at this stage.

OB 16 contains a very wide interpretation of the term ”financial reporting”, e.g. the term encompasses news releases. We disagree with this interpretation and/or widening the scope in this way.

Furthermore we note that the current principles and concepts may not be applied to a different, i.e. wider scope (financial reporting) without carefully analysing the consequences. One would need to take into account (possibly) different characteristics, e.g. qualitative vs. quantitative information, forward-looking information and information concerning the (past) reporting period; for example, financial reporting may encompass explicit forecasts by management.

Generally speaking, we think that the IASB needs to discuss these issues in more detail before considering widening the scope of the Framework. Although not disagreeing with a possible wider scope, we think that prior to this comprehensive discussion the Framework’s scope should remain to be defined as ‘financial statements’.

Potential Users of Financial Reporting and the Focus on Primary Users

We think that different user groups do have different information needs, as the decisions these different user groups have to make are dissimilar. Consequently, the most favourable information system for one user group will not be most favourable for another user group. Nevertheless, information given under one user group’s most favourable information systems contain also information meeting the information need of other user groups too. The current Framework acknowledges this by referring to a wide range of users and by focusing on primary users.

In its Discussion Paper the IASB has identified, as the primary users of financial reports, “present and potential investors and creditors.” That means a widening of the definition of the primary users as the current framework focuses on investors as primary users. Investors represent a homogeneous group and should have homogenous information needs. Homogenous information needs are of fundamental importance, since otherwise it is not possible to reach unambiguous conclusions, i.e. deduce appropriate accounting policies/standards. We therefore prefer investors being defined as the <u>primary users</u> of financial statements (not investors *and* creditors). Generally, we suggest a wording along the lines of par. 10 of the current Framework.

Entity's Perspective

Given the controversial discussions related to ED IFRS 3amend und ED 27amend, we appreciate the IASB considering this issue again in a more general context. As set out in our comment letters to ED IFRS 3amend and ED 27amend, we deem this more general context to be appropriate.

Those discussions showed that there is no common understanding of the parent view and the entity view and which accounting policies result from these views. Therefore, we would welcome if the IASB described in more detail its understanding of the entity perspective and the implications this perspective has. We think the Discussion Paper does not discuss this perspective and its implications in sufficient detail

Stewardship and accountability as a separate objective

Financial Statements, apart from providing decision-useful information, may also be aimed at assessing the management's performance. According to the principal-agency theory, information is distributed asymmetrically between the owners and the management, and, resulting from this distribution, problems commonly referred to as management's hidden actions and following from that, moral hazard, may be encountered. The so-called "stewardship function" may be defined as providing information on how well the management performed and acted in the owner's interest.

In our view, while it is important that information is provided to enable a user to assess how management has fulfilled its stewardship responsibilities, the information needed to make this assessment is included within the objective of providing information useful to making credit and investment decisions. We would consider it appropriate to consider stewardship also as a critical element of all decision useful financial information.

In general, we share the alternative views of the two Board Members. The Stewardship function requires monitoring past transactions and events. In addition, we are concerned that eliminating the stewardship function may result in a reduction of the status of reliability as a qualitative characteristic.

Appendix B: Chapter 2 / Qualitative Characteristics

Relationship between the different qualitative characteristics

We welcome the IASB's intention to clarify the relationship between the different qualitative characteristics. However, we have some doubts as to whether evaluating the different characteristics in a particular order is the appropriate approach. We are concerned that one could interpret this order in a way that "relevance", being the first characteristic to be evaluated, is of higher importance for the decision usefulness of information than, say, "faithful representation"/"reliability".

Furthermore, we are not convinced that evaluating every qualitative characteristic on its own in a particular order is suitable. The qualitative characteristics are interactive. A rational user will not consider unreliable information. Academic research proves this fact. Therefore, we think that information that is not reliable can not be relevant to the user of financial statements. Interactivity exists not only between relevance and reliability, even though this is the most prominent relationship between the qualitative characteristics. For instance, also information that is not understandable cannot be relevant since information is not capable of making a difference in the decisions of users if information is not understandable.

Furthermore, we observed an inconsistency regarding the description of relevance. QC 8 refers to the relevance of the information *conveyed by* the financial statement. On the contrary, QC 43 refers to the relevance of the underlying real-world transactions, i.e. relevance in this sense acts as a filter as to which real-word transactions should be accounted for in the financial statements at all. However, under this definition, the characteristic as defined in QC8 would be a mere tautology: Every information contained in the financial statements must by definition in QC43 be relevant, since, if the information was irrelevant, it would not have been considered in the context of the financial statements in the first place.

We believe that the reference to the relevance of the information conveyed by the financial statement is appropriate and with this description of relevance, the relationship between relevance and the other qualitative characteristics is not as simple as described in the Discussion Paper.

Relevance

In the Discussion Paper, information is defined to be of "relevance" if it is capable of making a difference in the decisions of users. We acknowledge that, under the current wording, it may be difficult to demonstrate that information actually *does* influence the decisions. Accordingly, we concur with the proposal to introduce some kind of probability notion into the definition.

However, we are concerned that the proposed phrase "*capable* of making a difference" unduly broadens the definition of relevance. Our concerns especially pertain to the further explanations in the last sentence of QC 9 "[…] standard-setters cannot rely entirely on users to request […]".

Therefore, we prefer a wording that refers to an influence on the decisions of users that can be reasonably expected.

Faithful representation

Generally, we welcome the intention to clarify the term "reliability". However, we have doubts whether changing the term into "faithful representation" is the appropriate approach. Even if we accept the view that the change in terms does not imply any change in meaning, we are concerned that this change might be perceived as a change in meaning. We also believe that the meaning of the term „faithful representation" is just as unclear, if not even more unclear, than the term "reliability".

Especially when seen in connection with (1) the change in emphasis on the stewardship function and (2) the order in which the qualitative characteristics have to be evaluated, we have severe concerns that the status of "faithful representation"/"reliability" as a qualitative characteristic could be interpreted as being diminished compared to the current Framework.

Verifiability

We do not think that the proposed definition of verifiability is appropriate. We share the concerns given in the alternative view that reliable evidence is essential for verification and that the proposed definition does not sufficiently safeguard faithful representation.

Substance over form

We do not agree with deleting this qualitative characteristic. We think it is very important that transactions and other events are accounted for and presented in accordance with their economic substance and reality and not merely with their legal form. In situations in which the legal form and the economic substance of a transaction differ, it is the substance that should determine the accounting treatment. Therefore, we would prefer to see this notion being explicitly stated in the Framework.

Prudence

We think that the notion of prudence is an important attribute of decision useful information. The Boards reasoning behind eliminating prudence might be due to a misapprehension. In our view the notion of prudence is important when making estimations, e.g. about uncertain future events, but not as a justification for understating assets or overstating liabilities. In the cases in which making estimations and assumptions about uncertain future events and attributing probabilities to those future events is highly arbitrary, exercising a degree of caution is highly important. Therefore, we disagree with the prudence notion being eliminated and rather advocate keeping the notion of prudence in the framework accompanied by an appropriate definition of its meaning along the lines of our explanation above.