IAASB International Auditing and Assurance Standards Board

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January 14, 2014

Mr. Hans Hoogervorst
Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Hans,

Re: Comments on IASB's Discussion Paper, *A Review of the Conceptual Framework for Financial Reporting*

I am pleased to provide comments on the International Accounting Standards Board (IASB)'s Discussion Paper (DP), *A Review of the Conceptual Framework for Financial Reporting*, published in June 2013. These comments have been developed by the International Auditing and Assurance Standards Board (IAASB)'s IASB Liaison Working Group (the Working Group), with a particular focus on auditability or verifiability, and reviewed by the IAASB Steering Committee.

The Working Group appreciates the IASB's decision to review the Conceptual Framework for Financial Reporting (Conceptual Framework) in responding to the comments received on its *Agenda Consultation 2011*. The Working Group is of the view that this review will contribute greatly to the improved quality of financial reporting because the Conceptual Framework is the cornerstone of the financial reporting standards setting process.

Of various topics in the DP, issues of particular interest to the Working Group are:

(a) Role of the concept of "verifiability" for information contained in financial statements (see our overall comments);

(b) Ensuring that information recognized in financial statements is capable of being verified (see our comments to Question 8);

(c) Drawing an appropriate boundary for disclosures that should be included in notes to financial statements (see our comments to Question 16); and

(d) Encouraging management and auditors to exercise sound judgment in determining the nature and extent of disclosures and the manner in which disclosures should be provided. This includes consideration of what measures to take for promoting a common understanding of the concept of materiality (see our comments to Questions 16 - 18).

Furthermore, although not explicitly discussed in the DP, the Working Group encourages the IASB to consider whether and to what extent financial reporting standards should prescribe the nature and extent of evidence that would support significant judgments of management (including the nature and extent of documentation requirements for management) as part of the Conceptual Framework project (see our other comments.)

Detailed comments in response to specific questions are provided in the Appendix to this letter.

I hope that you will find the comments helpful. If you require any clarification or would like to discuss this letter further, please do not hesitate to contact me or Mr. Tomokazu Sekiguchi, the Chair of the Working Group (t.sekiguchi@asb.or.jp).

Yours sincerely,

Prof. Arnold Schilder
Chairman, IAASB

Cc. Ms. Mary Tokar, Member and Liaison Representative, IASB

Appendix

IASB DISCUSSION PAPER -

A REVIEW OF THE CONCEPTUAL FRAMEWORK FOR FINANCIAL REPORTING

Comments of the IAASB's Working Group

OVERALL COMMENTS

Chapter 3 of the Conceptual Framework explains that "verifiability" is one of the enhancing qualitative characteristics of financial information. The Working Group agrees that "verifiability" could be placed as an 'enhancing' qualitative characteristic for useful financial information as a whole, because financial information includes not only financial statements, but also other information such as that presented in the management commentary section. Management commentary often includes explanations and forward-looking information that may not be verified until a future period.[1] However, the Working Group believes that the Conceptual Framework should clarify that "verifiability" is an 'essential' qualitative characteristic (that supports the concept of "faithful representation") for *information contained in financial statements*.

In the Working Group's view, this would be an important clarification because it would strengthen the rationale underlying the discussion of recognition, measurement and disclosure in the Conceptual Framework (see our comments to Questions 8 and 16). This clarification would also be helpful in maintaining and improving the ability for auditors to carry out audits of financial statements. Unless information contained in financial statements is verifiable, it would be very difficult (if not impossible) for auditors to provide an audit opinion on financial statements.

QUESTION 8: RECOGNITION OF ASSETS AND LIABILITIES

The IASB's preliminary view, as stated in paragraph 4.24 of the DP, is that an entity should recognize all its assets and liabilities, except as discussed otherwise. In addition, paragraph 4.25 of the DP states that the IASB *might* [emphasis added] decide that an entity need not, or should not, recognize an asset or a liability: (a) if recognizing the asset (or the liability) would provide users of financial statements with information that is not relevant, or not sufficiently relevant to justify the cost, or (b) if no measure of the asset (or the liability) would result in a faithful representation of the asset (or the liability), even if all necessary descriptions are disclosed. The Working Group understands that this would effectively eliminate both the "probability" and "reliability" filters from the Conceptual Framework, while leaving discretion for the IASB in its standard setting process.

The Working Group acknowledges the rationale stated in paragraphs 4.14 and 4.16 of the DP, but it does not agree with the proposal. This is because the Working Group believes that the term "might" used in paragraph 4.25 of the DP may provide too much discretion for the IASB, such that it leaves room for situations where financial information may not meet the fundamental characteristics of relevance and faithful representation, and thus may not be useful. Accordingly, rather than stating that the IASB *might* decide to do so, the Working Group believes that it should be amended to read that the IASB *must* decide that an entity should not recognize an asset or a liability, when no measure of the asset or the liability would achieve faithful representation.[2]

Furthermore, paragraph 4.22 (b) of the DP explains the role played by the concept of "verifiability." The Working Group notes that paragraph QC16 of the Conceptual Framework states that if the level of

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[1] Paragraph QC 28 of the Conceptual Framework

[2] This includes a situation where information is not verifiable.

uncertainty in an estimate is sufficiently large, that estimate will not be particularly useful (because the relevance of the asset being faithfully represented is questionable). The Working Group believes that this effectively refers to the situation where different knowledgeable and independent observers could not reach consensus, therefore the information is not verifiable.[3] For example, this might be the case for an entity's know-how and its brands (other than those acquired from third parties). In such a situation, assets and liabilities should not be recognized, because a relevant measurement basis that is capable of being verified would not be available (such that faithful representation is not possible.) The Working Group encourages the IASB to consider explaining the role of the concept of "verifiability" for recognition criteria of assets and liabilities in relation to that paragraph when it develops the Exposure Draft.

QUESTION 16: PRESENTATION AND DISCLOSURE GUIDANCE

Scope of Disclosure in Notes to Financial Statements

As stated in the covering letter, the Working Group believes that determining an appropriate scope for notes to financial statements is very important. The nature and extent of information that users call for have become increasingly large and varied, and the manner in which disclosure can be provided has become diversified with the increased use of electronic formats. Against this background, although the IASB may have to decide otherwise exceptionally in an individual standard setting process, the Working Group generally supports paragraph 7.37 of the DP. This paragraph states that information about management's view of the entity's performance, position and progress in the context of its stated plans and its strategies for achieving those plans belongs outside the financial statements. In the Working Group's view, it would be almost impossible for different knowledgeable and independent observers to reach consensus on certain of this information,[4] and therefore such information would not be capable of being verified.

Similarly, the Working Group generally agrees with paragraphs 7.38 and 7.39 of the DP. These paragraphs state that the notes to the financial statements do not usually include information about plans or future assets and future liabilities, and that the IASB should not require forward-looking information to be included in the notes to the financial statements unless such information is relevant to assets and liabilities that existed at the end of the reporting period or during the reporting period.

Disclosure Objectives

Paragraph 7.48 of the DP states that each standard that proposes disclosure and presentation requirements should have a clear objective to help enable an entity to determine whether the specified information would be material in the context of an entity's financial statements. It also states that the IASB should provide guidance to help enable an entity to determine whether the specified information would be material in the context of an entity's financial statements.

The Working Group agrees with the paragraph because it believes that providing a clear objective and sufficient guidance is critical for management to determine, and for auditors to assess, whether additional disclosure may be needed beyond what is specifically required by the disclosure requirements. The concepts noted in that paragraph will be especially important when the IASB establishes the "objective-based disclosure requirements" that would result in the need for management and auditors to exercise significant professional judgment when deciding what should be disclosed in the notes to financial statements. In the Working Group's view, setting out a clear objective and sufficient guidance would be

[3] Paragraph QC26 of the Conceptual Framework

[4] Paragraph QC26 of the Conceptual Framework

key in promoting effective communication between reporting entities and users of financial information, which is one of the primary objectives of the IASB's disclosure initiative.

Other Matters

Paragraph 7.10 of the DP proposes to use the term "presentation" as meaning the disclosure of financial information on the face of an entity's primary financial statements. The Working Group is not convinced that this proposal is appropriate. The term "presentation" is often applicable to some other information (such as segment information) even though it is not presented on the face of an entity's primary financial statements.

QUESTION 17: CONCEPT OF MATERIALITY

The Working Group believes that properly applying the concept of materiality is critical for financial information to be useful. Although the Working Group agrees with the discussion of the concept of materiality in the existing Conceptual Framework, the Working Group believes that development of educational material that supports the requirements of IAS 1 and IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors* would be helpful, to support consistent application of the concept in practice. In addition, based on the feedback received on its auditor reporting project, the IAASB continues to believe that the term "material uncertainties" stated in paragraph 25 of IAS 1 should be clarified.

Furthermore, it would be helpful if such guidance explains how the concept of materiality could be applied to qualitative disclosures (or non-quantitative disclosures.) In its project on auditing disclosures, the IAASB found that this aspect is important yet challenging. The IAASB has received strong feedback from stakeholders to work collaboratively with accounting standards setters to improve how the concept of materiality is applied in practice, therefore the IAASB believes it is important to continue working with the IASB in this regard.

QUESTION 18: COMMUNICATION PRINCIPLES

The Working Group is of the view that the proposed communication principles would promote effective communication of information. However, the Working Group provides the following comments.

(a) Qualitative characteristics of disclosures

Paragraph 7.50 (b) of the DP proposes that disclosure guidance should result in different disclosures that are *clear, balanced, and understandable* [emphasis added]. The Working Group understands that this indicates a point of reference for management to consider when it "stands back" in determining whether disclosures are appropriate.

The Working Group generally agrees with the proposal, but notes that the paragraph is inconsistent with paragraph 17 (b) of IAS 1, *Presentation of Financial Statements*, which states that a fair presentation requires an entity to present information in a manner that provides *relevant*, *reliable*, *comparable* and *understandable* information [emphasis added]. The Working Group understands that these qualitative characteristics are drawn from the *Framework for the Preparation and Presentation of Financial Statements* (pre-2010 Framework), and questions whether the IASB intends to revise the paragraph.

This clarification is important because the International Standards on Auditing (ISAs) embody a requirement for auditors to evaluate whether the information presented in the financial statements is *relevant, reliable, comparable, and understandable*[5] [emphasis added], which is consistent with the

5 ISA 700, *Forming an Opinion and Reporting on Financial Statements*, paragraph 13 (a)

paragraph of IAS 1. Depending on the IASB's future amendments, the IAASB might consider whether changes to its requirement is desirable as part of its Disclosure project.

(b) Use of cross-references

Paragraph 7.50 (d) and (e) of the DP propose to create better linkages between disclosures and the use of cross-referencing. The Working Group agrees that avoiding duplication of information in financial reports, and providing better links between related information, would promote users' understanding of financial information. However, in the view of the Working Group, it is essential that the IASB clearly articulate the criteria for determining when the use of cross-references is appropriate. A key issue is that when an entity's financial statements refer to information outside those statements, the responsibilities of both management and auditors are likely to become blurred, unless the scope of information incorporated by reference is made clear. Also, the nature of information sources to which financial statements are cross-referenced should be carefully considered. For example, it would not be appropriate for an entity to make reference to a hyperlink to an audio-cast or web-cast (e.g., those at press conferences) that is incorporated in other information, even if it might enhance the users' understanding of financial information.

Related to this matter, the IAASB is proposing to clarify the auditors' responsibilities for such information in its Exposure *Draft* of ISA 720 (Revised), *The Auditor's Responsibilities Relating to Other Information in Documents Containing or Accompanying Audited Financial Statements and the Auditor's Report Thereon.*

OTHER COMMENTS

As stated in its previous comment letters, the Working Group believes that financial reporting standards should prescribe the nature and extent of evidence that would support significant judgments of management in preparing the financial statements. In the Working Group's view, such documentation would be an effective measure for management to substantiate its significant judgments. In addition, in the Working Group's view, this is increasingly important because financial reporting standards have come to require increased use of estimates in measuring assets and liabilities, leading to more significant judgments by management.

Although the DP does not discuss what role financial reporting standards should play to help substantiate these management judgments, the Working Group believes that the Conceptual Framework should clarify the nature and extent of evidence that a financial reporting standard should prescribe when setting out accounting requirements involving significant judgements. The Working Group believes that this would significantly help management and auditors to share a common understanding of how significant judgments are exercised, thereby contributing to high quality financial reporting.