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Professor David Boymal
The Chairman
Australian Accounting Standards Board
PO Box 204
Collins Street West VIC 8007

9 October 2008

Dear David

Exposure Draft ED 164 and Invitation to Comment ITC 17

I am enclosing a copy of the PricewaterhouseCoopers responses to the following two documents issued by the International Accounting Standards Board:

- Exposure Draft of *An improved Conceptual Framework for Financial Reporting: The Objective of Financial Reporting and Qualitative Characteristics and Constraints of Decision-useful Financial Reporting Information*
- Discussion Paper *Preliminary Views on an improved Conceptual Framework for Financial Reporting: The Reporting Entity.*

The letters reflect the views of the PricewaterhouseCoopers network of firms and as such include our own comments on the matters raised in the Exposure Draft and the Discussion Paper.

We would welcome the opportunity to discuss our views at your convenience. Please contact me on (02) 8266 2549 or Meina Rose on 0432 320 540 if you would like to discuss this further.

Yours sincerely

S. Horlin

Susan Horlin
Partner
Assurance

PricewaterhouseCoopers is committed to providing our clients with the very best service. We would appreciate your feedback or suggestions for improvement. You can provide this feedback by talking to your engagement partner, calling us within Australia on 1800 792 111 or visiting our website http://www.pwcfeedback.com.au/

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29 September 2008

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RE: File Reference No. 1570-100: Exposure Draft - Conceptual Framework for Financial Reporting: ***The Objective of Financial Reporting and Qualitative Characteristics and Constraints of Decision-Useful Financial Reporting Information***

We are responding to your invitation to comment on the above referenced Exposure Draft on behalf of PricewaterhouseCoopers. "PricewaterhouseCoopers" refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

We agree with the Boards' view that to consistently achieve useful financial reporting, the body of standards taken as a whole, and the application of those standards, should be based on a framework that is sound, comprehensive and internally consistent. Until such time as IFRS is adopted in the United States, we agree that a single framework shared by both Boards is more likely to lead to convergence on a set of high-quality solutions.

We agree with the Boards that the conceptual frameworks underpin the development of financial reporting standards. This leads, however, to a need to further clarify for whom the framework is intended. We believe that some preparers may be of the view that the framework is principally written for standard setters. While the GAAP hierarchy will be addressed in a later Phase of the project, it is important that it is understood that the Framework may have wider consequences for financial reporting. In the description of our views in the Appendix to this letter, we identify several areas that appear to address the specific needs of either the Boards, or preparers, but not both. We acknowledge that it may be appropriate for certain sections of the guidance to apply either to the Boards or to preparers, but recommend that the Boards clearly identify when this might be the case in order to avoid confusion.

If the conceptual framework is to underpin the development of financial reporting standards, we believe that more focus is needed on the qualities of the standards themselves, and not just the information they seek to regulate. In other words, the conceptual framework should also consider what makes a good accounting standard. At the Global Public Policy Symposium in January 2008, the CEOs of the larger international audit networks issued a paper on *Principles-Based Accounting Standards* that explores what they believe to be six characteristics of a high quality accounting standard. Some of these are reflected in the Boards' deliberations on the conceptual framework. Indeed we support the emphasis that the Boards have placed on "faithful representation of economic reality" and "responsiveness to users' needs for clarity and transparency", which the international audit networks consider to be critical to the success of a principles-based system of standards. But we believe that the Boards should go further to ensure, for example, that both standards and the conceptual framework are written in clear, concise and plain language. This is particularly the case when considering how the words may be translated into languages other than English.

We have enclosed a copy of *Principles-Based Accounting Standards* for your reference.

We note the Boards' intent, described in paragraph P15, to finalize the common framework as sections are completed. Given the long-term nature of the conceptual framework project and the expected value each completed phase can provide independently, we understand why the Board has taken this approach. We believe, however, that the Boards should not underestimate the importance of the 'look back' contemplated in Phase H to consider whether issues addressed in earlier phases of this project require revision in the light of subsequent work and discussion, and from the perspective of viewing the framework as a whole. We believe that this is an essential element of the development of a coherent framework.

We also foresee the potential for internal contradictions if sections of the existing conceptual framework are superseded before the entire framework is competed. We believe that the Boards' have an obligation to evaluate whether such contradictions exist and provide guidance for preparers to navigate such conflict as sections are completed.

As the Boards' current exposure draft is the first of a series of perhaps as many as eight Conceptual Framework publications for consideration, our comments in this letter are subject to revision in light of the content of subsequent discussion papers, exposure drafts and standards issued by the Boards. In this context, we believe that the 'look back' contemplated in Phase H to consider whether issues addressed in earlier phases of the project require revision in the light of subsequent debate is an essential element of the development of a coherent framework and encourage the Boards not to underestimate the importance of this phase.

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In Appendix I, we have included our comments and recommendations related to the more significant aspects of the Exposure Draft. As discussed in Appendix 1, our greatest concerns relate to the apparent determination to choose the entity perspective before the matter is fully exposed and debated in Phase D *The Reporting Entity*. While we agree that a reporting entity exists apart from its owners and so support the entity perspective over the proprietary perspective, we believe that financial statements should be presented from the perspective of the parent company's shareholders.

Appendix 2 includes our responses to the specific questions posed by the Boards.

We invite the Boards to address questions in relation to this letter to any of the following individuals. We suggest, however, in order that we may respond in the most timely manner, that the IASB initially contact either Richard Keys (+44 20 7212 4555) or Peter Hogarth (+44 20 7213 1654), while the FASB initially contact either Dave Kaplan (+1 973 236 7219) or Valerie Wieman (+1 973 236 5887).

Yours faithfully,

PricewaterhouseCoopers LLP

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APPENDIX 1

Exposure Draft - Conceptual Framework for Financial Reporting:
The Objective of Financial Reporting and Qualitative Characteristics and Constraints of Decision-Useful Financial Reporting Information

CHAPTER 1: THE OBJECTIVE OF FINANCIAL REPORTING

While we agree with the articulation of the objective of financial reporting, we have the following observations and recommendations regarding the Exposure Draft in the areas of (a) the entity perspective; (b) stewardship; (c) purpose of primary financial statements; and (d) references to management's explanations.

Entity Perspective

There continues to be a high level of confusion on the meaning of "entity perspective" vs. "proprietary perspective" vs. "parent approach." It is therefore very unclear exactly what has been decided in Phase A, as opposed to the issues to be debated in Phase D *The Reporting Entity*. We have strong concerns about how this topic has been presented.

The Boards conclude in paragraph OB5 on the preferability of the entity perspective. However, given the contents of the basis for conclusion (paragraphs BC 1.11 - BC 1.16), the Boards appear to have only debated a choice between the entity and proprietary perspectives. In essence, the Boards have chosen the entity perspective because of the belief that the entity that is the subject of a set of financial reports exists separately from its owners.

We agree that it would be inadvisable for general purpose financial reporting to include the assets of a company's owners[1]. We therefore would not support the proprietary perspective. A decision on this specific fact is appropriate in a discussion about the objectives of financial reporting as it begins to provide boundaries of financial reporting, and provides insight into what may be considered "decision-useful."

While we agree that a company exists apart from its owners, this is unrelated to the perspective from which financial reporting should occur. We believe that the discussion confuses the objective of financial reporting with the manner in which financial information is presented, and in so doing presupposes a conclusion currently being debated in the Reporting Entity phase (that is, whether financial reporting should be a generic rendering of a company as a whole, or designed to provide parent company shareholders with decision-useful information). We explain in our comment letter on Phase D why we believe that information regarding an entity's performance from the perspective of the parent company's shareholders is of primary importance. In our view, information presented for the economic entity, without regard to the needs of the primary users of financial reporting, appears to be contrary to the objective of financial reporting, which is to provide decision-useful information. Furthermore, we do not believe that the perspective of the non-controlling interests, who rarely, if ever, consider the consolidated financial statements when making investment decisions, is relevant.

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[1] While we understand that not all reporting entities are "companies", we are using the term in order to avoid confusion when discussing the entity perspective.

We believe that paragraph OB5 should be edited to avoid the implication that a decision has already been made on matters that have not yet been subject to sufficient due process. For example, the statement in paragraph OB5 that financial reports are intended to "reflect the perspective of the entity rather than the perspective of the entity's equity investors, or any other group of capital providers" should be removed. As noted above, the rationale for such a determination is not included in the Basis for Conclusion and a decision on the most useful perspective is both inappropriate and unnecessary in this Phase.

Stewardship

The issue of stewardship is an aspect of the Conceptual Framework that has attracted considerable comment among a variety of constituents, including a number of investors and other users of financial statements. We note that two members of the IASB objected to the description of the objective of financial reporting as originally proposed in the Boards' July 2006 Discussion Paper as a result of stewardship not being addressed. We believe that the description of the objective of financial reporting in the Exposure Draft is appropriate and that the revisions since the Discussion Paper address the previous concerns we expressed in our comment letter dated November 3, 2006.

Purpose of Primary Financial Statements

We support the addition of descriptions of the uses of the primary financial statements. We believe, however, that certain aspects of the descriptions should be modified to improve their accuracy and clarity. For example, paragraph OB23 states that "capital providers use information about cash flows to help them understand an entity's business model and operations..." While this may be true in the context of historical financial information, capital providers also use information about an entity's business model and operations in order to help them understand and predict cash flows. Hence, we believe that the way in which capital providers generally use financial statements is more accurately described in the reverse. That is, capital providers use information about an entity's business model and operations to help them to predict cash flows.

In addition, we believe that use of the term "directly interested" in paragraph OB6(a) implies that there is a direct relationship between the perception of an entity's cash flows and its equity share price. Equity investors understand that there are numerous factors within a company and at a macroeconomic level that impact the price of equity and the investor's ability to realize a return on investment. We believe that deletion of the word "directly" will avoid the suggestion that the perception of cash flow is a primary driver of share price.

We also believe that the description of the uses of the individual statements in paragraphs OB15 to OB24 should be preceded by a description of the value of evaluating the financial statements as a whole, including the interaction of the primary statements and notes.

Reference to Management's Explanations

We support the assertion in paragraph OB25 that financial reporting should include explanations and other information to enable users to better understand a reporting entity's transactions, financial position, and explanations of underlying estimates and assumptions. It is unclear to us whether paragraph OB25 is referring to financial statement notes, management commentary or both. We believe that the Boards intent was to describe information currently required to be included in the notes to the financial statements, but paragraph OB25's reference to "management's explanations" implies management commentary, especially the phrase "management's explanations of underlying assumptions". To avoid confusion, we do not believe it is necessary to attribute the explanations to management. For example, we suggest that OB25 refer simply to the need to include disclosure of underlying assumptions.

That said, we believe that decision-useful information should go beyond explanations of specific items of income, expense, assets and liabilities. We maintain our view, expressed in our April 28, 2006 comment letter in response to the IASB's discussion paper on *Management Commentary*, that narrative reporting is fundamental to a full understanding of business performance and is of critical importance to the future of annual reporting. We believe that the value of corporate reporting may be undermined in the absence of a serious commitment to the development of management commentary and believe it should be a key component of the Conceptual Framework. For that reason, we believe that the importance of management commentary, including disclosures typically found in management commentary, should be acknowledged explicitly.

CHAPTER 2: QUALITATIVE CHARACTERISTICS AND CONSTRAINTS OF DECISION-USEFUL FINANCIAL REPORTING INFORMATION

We note that there are currently four alternative presentations of what constitutes decision-useful information. US GAAP and IFRS each contain their own formulation, while the Boards have proposed very different presentations in both the July 2006 Discussion Paper and the Exposure Draft. In this section, we share observations and recommendations about the most recent proposal, but each of the proposals had strengths and weaknesses; all of the terms and characteristics are important. Because different users have different needs, even within the category of 'capital providers', determining whether information is decision-useful will always be user specific. Each user will make their own determination of the quality of information by creating their own priority of characteristics.

While understanding the Boards' differentiation between enhancing and fundamental characteristics, we see this structure as reducing the importance of enhancing characteristics. As noted above, each user will determine what is more or less important for their intended use. Hence, we do not believe that any particular priority should be embedded in the conceptual framework. However, we believe that in practice all characteristics will continue to be assessed with equal priority.

While we are in general agreement with the articulation of fundamental and enhancing characteristics, we have the following observations and recommendations regarding the exposure Draft in the areas of (a) understandability; (b) verifiability; (c) cost and materiality; and (d) comparability.

Understandability

While we agree with the description of understandability, we believe it is more accurately classified as a fundamental characteristic, on par with relevance and faithful representation.

The Boards note that enhancing characteristics, either individually or in concert, cannot make information useful if that information is irrelevant or not faithfully represented. It is in this description that the Boards have attempted to differentiate enhancing from fundamental characteristics. While we agree with these statements, we equally believe that information cannot be assessed as being either relevant or decision useful if it cannot be understood.

We believe that the Boards correctly describe the attributes of the users of financial reports in paragraph QC24. Capital providers are assumed to have reasonable knowledge of business and economic activities and to be able to read a financial report. Further, they are expected to review and analyze information with reasonable diligence, which may include seeking the aid of an advisor or other expert.

Given this level of assumed competence, if information is provided that cannot be understood it has failed the objective of presenting decision-useful information. As such, we believe that understandability is a required and fundamental characteristic of decision-useful information.

Verifiability

We do not believe that the Boards have adequately explained the characteristic of verifiability. While the word itself invokes perhaps an inappropriate association with 'auditable', we would be less concerned with the word used if the description was clearer.

We question *how* information should be verifiable and *by whom*. As written, we struggle with the application of this principle to the preparation of financial reports (from the perspective of the preparer) and the development of standards (from the perspective of the standard setter).

We are aware that accounting under certain existing standards is dependant on management's intent (for example, hedge accounting under both IFRS and US GAAP). One possible reason for including verifiability as an enhancing characteristic may be the Boards' desire to limit allowable alternative treatments based on a management decision that cannot be verified. Verifiability is then appropriately included in the conceptual framework, but would be applicable only to standard setters.

With regard to the preparer, verifiable may be misunderstood to mean audited, although as described, we believe it more closely resembles the idea of accuracy, or perhaps sound judgment. That is, information is verifiable if a reasonable individual with all facts and circumstances would arrive at a similar conclusion. Described in this manner, verifiability seems to be integral to the accurate accounting for transactions, and as such is better described as a component of faithful representation.

We believe that the Boards need to better explain what they mean by the term *verifiability*. It might be helpful to describe how the concept the Boards are trying to convey is currently addressed in IFRS, as decision-usefulness has been assessed under that framework without any reference to verifiability. In view of the association with 'auditable', the Boards may also consider using a different term.

Based on further analysis, it may be appropriate to eliminate verifiability, include it as a component of faithful representation or clarify its impact as an enhancing characteristic.

Cost and Materiality

We agree that financial reporting imposes costs and that the benefits of financial reporting should justify those costs. While we agree that the Conceptual Framework is to be used by both standard setters and preparers, the Exposure Draft should clarify that cost is only a pervasive constraint for standard setters. We support the Boards' continued analysis of the relative cost of complying with proposed standards and determining prior to adopting new financial reporting requirements that the benefits exceed such costs. It would be inappropriate, however, for preparers to make an individual assessment that the cost of providing required information exceeds its benefit.

We note in paragraph BC2.64 that the proposed framework stops short of committing standard-setters to demonstrate that the benefits of a proposed requirement would justify the related costs. We understand why the Boards do not wish to raise expectations beyond what is feasible, but would nevertheless expect the Boards to develop a clear and transparent process for conducting cost-benefit analyses and to share the results of those analyses during the development of future standards.

In addition, paragraph QC28 explains materiality as information that if omitted or misstated "could influence the decisions that users make on the basis of an entity's financial information." As decisions may also be made on the basis of non-financial information, we believe 'financial information' should be replaced with 'financial reporting'. Likewise, the last sentence in paragraph QC28 discusses the consideration of whether 'financial information' is faithfully represented. Again, as we believe that it is important for non-financial information to be faithfully represented, for example, disclosure of risks and uncertainties, we suggest that the word 'financial' be deleted.

Comparability

In discussing comparability, the final sentence in paragraph QC19 states that "permitting alternative accounting methods for the same economic phenomenon diminishes comparability and, therefore, may be undesirable." We agree that allowing alternative methods within the standards to reflect the same economic phenomenon in different ways is inadvisable, and recommend that the Boards make a more definitive statement to this effect.

If modifying paragraph QC19, we believe it is important to maintain the language that acknowledges that a single economic phenomenon can be faithfully represented in multiple ways. Different individuals may come to different, but equally acceptable conclusions on how to best reflect the substance of certain transactions. It is vital to the integrity of financial reporting that nothing impair the ability of professionals to apply reasonable judgment in the context of a framework of robust fundamental principles.

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APPENDIX 2

Exposure Draft - Conceptual Framework for Financial Reporting:
The Objective of Financial Reporting and Qualitative Characteristics and Constraints of Decision-Useful Financial Reporting Information

Chapter 1 - The Objective of Financial Reporting

Question 1 – The Boards decided that an entity's financial reporting should be prepared from the perspective of the entity (entity perspective) rather than the perspective of its owners or a particular class of owners (proprietary perspective). (See paragraphs OB5–OB8 and paragraphs BC1.11–BC1.16.) Do you agree with the Boards' conclusion and the basis for it? If not, why?

PwC Response:
As discussed in our cover letter, while we agree that a reporting entity exists apart from its owners and so support the entity perspective ahead of the proprietary perspective, we believe that financial statements should be presented from the perspective of the parent company's shareholders. We believe it is inappropriate to presume a conclusion to the matters currently being debated in Phase D *The Reporting Entity*. This issue, however, is discussed in more detail in our response to the Board's Discussion Paper on the Reporting Entity.

Question 2 - The Boards decided to identify present and potential capital providers as the primary user group for general purpose financial reporting. (See paragraphs OB5–OB8 and paragraphs BC1.19–BC1.22.) Do you agree with the Boards' conclusion and the basis for it? If not, why?

PwC Response:
We agree with the Boards' conclusion and basis for identifying the primary users of general purpose financial reporting.

Question 3 - The Boards decided that the objective should be broad enough to encompass all of the decisions that equity investors, lenders, and other creditors make in their capacity as capital providers, including resource allocation decisions as well as decisions made to protect and enhance their investments. (See paragraphs OB9–OB12 and paragraphs BC1.23–BC1.29.) Do you agree with that objective and the Boards' basis for it? If not, why? Please provide any alternative objective that you think the Boards should consider.

PwC Response:
We agree with the Boards' conclusion and basis for identifying the primary users of general purpose financial reporting. We also agree that our concerns about the absence of a focus on stewardship raised in connection with the July 2006 Discussion Paper are adequately addressed by the modifications to the stated objective of financial reporting, which now encompasses all decisions made in the capacity of capital providers.

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Chapter 2 - Qualitative Characteristics and Constraints of Decision-useful Financial Reporting Information

Question 1 - Do you agree that:

a. *Relevance* and *faithful representation* are fundamental qualitative characteristics? (See paragraphs QC2–QC14 and BC2.3–BC2.24.) If not, why?

b. *Comparability, verifiability, timeliness,* and *understandability* are enhancing qualitative characteristics? (See paragraphs QC16–QC26 and BC2.25–BC2.34.) If not, why?

c. *Materiality* and *cost* are pervasive constraints? (See QC28–QC33 and BC2.58–BC2.64.) If not, why? Is the importance of the pervasive constraints relative to the qualitative characteristics appropriately represented in Chapter 2?

> ***PwC Response:***
> We agree that *relevance* and *faithful representation* are fundamental characteristics. As discussed in Appendix 1, we have concerns about the characterization of *understandability* as an enhancing characteristic. We also question the inclusion of *verifiability*. In addition, while we agree that *materiality* and *cost* are appropriate pervasive constraints for consideration by the standard setters, we would question a user's consideration of *cost* when determining the application of authoritative guidance.

Question 2 - The Boards have identified two fundamental qualitative characteristics—*relevance* and *faithful representation:*

a. Financial reporting information that has *predictive value* or *confirmatory value* is relevant.

b. Financial reporting information that is *complete, free from material error,* and *neutral* is said to be a faithful representation of an economic phenomenon.

(1) Are the fundamental qualitative characteristics appropriately identified and sufficiently defined for them to be consistently understood and useful? If not, why?

(2) Are the components of the fundamental qualitative characteristics appropriately identified and sufficiently defined for them to be consistently understood and useful? If not, why?

> ***PwC Response:***
> We agree that *relevance* and *faithful representation* are fundamental characteristics. We believe these terms are appropriately identified and sufficiently defined. We believe, however, that *understandability* should also be considered fundamental.

Question 3 - Are the enhancing qualitative characteristics (*comparability, verifiability, timeliness,* and *understandability*) appropriately identified and sufficiently defined for them to be consistently understood and useful? If not, why?

> ***PwC Response:***
> As noted in Appendix 1, we believe that certain aspects of *comparability* are applicable only to standard setters. We believe that *verifiability* is not sufficiently well defined to be consistently understood. We do not agree that *understandability* is an enhancing characteristic and believe it should be considered fundamental.

Question 4 - Are the pervasive constraints (*materiality* and *cost*) appropriately identified and sufficiently defined for them to be consistently understood and useful? If not, why?

PwC Response:
While we agree that *materiality* and *cost* are appropriate pervasive constraints for consideration by the standard setters, we would question a user's consideration of *cost* when determining the application of authoritative guidance.

PRINCIPLES-BASED ACCOUNTING STANDARDS

January 2008

A MESSAGE FROM THE CEOs OF THE INTERNATIONAL AUDIT NETWORKS

Welcome to the fourth Global Public Policy Symposium. We are very glad that you are attending and look forward to a thought-provoking discussion on many issues of keen interest to all capital markets stakeholders.

Over the past several years, a growing dialogue has developed about the future of financial reporting and the public company audit profession. In order to advance that dialogue, during the past year, we have engaged in discussions with stakeholders around the world on a number of issues critical to the long-term strength and stability of global capital markets.

In these talks, we have been struck by the breadth of support for International Financial Reporting Standards (IFRS) as a single set of high-quality, accounting standards that ultimately can be used around the world. Stakeholders indicated their support for IFRS in part because it is more principles-based than U.S. GAAP. There was, however, a lack of consensus on the key characteristics of principles-based standards.

We will continue the dialogue on this important topic at the Symposium. The attached White Paper is intended to stimulate our collective thinking. The Paper proposes a framework to use in developing principles-based standards including the changes needed on the part of participants in the financial reporting process to support such a system.

Thank you for joining us at the Symposium, and we look forward to continuing to work together with you on these important issues.

Sincerely,

Samuel A. DiPiazza, Jr.
Global CEO
PricewaterhouseCoopers

Timothy Flynn
Chairman
KPMG International

David McDonnell
Chief Executive Worldwide
Grant Thornton International

James H. Quigley
Chief Executive Officer
Deloitte Touche Tohmatsu

Frans Samyn
Chief Executive Officer
BDO International

James S. Turley
Chairman & CEO
Ernst & Young

INTRODUCTION

Today, work is underway around the world to shift toward a single set of high quality standards through the global adoption of IFRS. As IFRS is adopted in more nations, regulators, preparers, auditors and investors will face the challenge of working together with the IASB to make sure that IFRS is principles-based. Toward that end, a dialogue among global capital markets stakeholders regarding what constitutes a high-quality principles-based standard is needed.

To begin with, however, we may be well served by acknowledging that neither a purely rules-based nor a purely principles-based system has ever existed or will ever exist. Every accounting standard will exist somewhere along a spectrum between rules and principles. The goal must be to seek the "sweet spot" on that spectrum.

Today in the U.S., we are too far skewed toward the rules-based side of the spectrum. An appropriate reform agenda should focus on pushing the pendulum toward a system which would enable principles-based standards and a greater use of judgment to become the norm. Defining this "sweet spot" on the rules/principles spectrum can be aided by establishing a set of generally accepted characteristics that should define an effective and achievable new standard.

In this White Paper we explore the characteristics that we believe are the key elements of a high-quality, principles-based accounting standard:

1. Faithful presentation of economic reality
2. Responsive to users' needs for clarity and transparency
3. Consistency
4. Based on an appropriately-defined scope that addresses a broad area of accounting
5. Written in clear, concise and plain language
6. Allows for the use of reasonable judgment

Further, preparers, regulators and auditors will have to consider other changes that they may have to undertake in order to ensure the successful adoption of a principles-based system.

Preparers of financial statements will need to be able to put more emphasis on the exercise of professional judgment to faithfully report the economic substance of their enterprise. The financial reporting process will be less driven by seeking to identify the rule that directs how to record a transaction or make a disclosure, and will place more emphasis on the exercise of professional judgment. Investors are best served when financial reports are clear and easy to understand and use. In order to deliver on that goal, preparers and auditors must be given the space to exercise professional judgment and to feel confident that their judgment, so long as it is fundamentally sound and documented, will not be subject to second-guessing. Regulators will need to focus on the soundness of the underlying judgments that are the very essence of good business reporting and external auditing.

For our part, the audit profession must continue to act as an advocate for investors and provide reasonable assurance that financial statements are fairly stated in accordance with the standards. That is true today. It will be all the more critical as we shift from a more rules-based to a more principles-based system that relies on sound professional judgment that cannot seek constant clarification and interpretation from the standard-setter.

These important changes, along with the adoption of principles-based standards based on the characteristics discussed below are all part of the issues that must be discussed and considered carefully as the global capital markets transition toward a single set of high-quality accounting standards that are based on principles.

A PROPOSED FRAMEWORK FOR ESTABLISHING PRINCIPLES-BASED ACCOUNTING STANDARDS

Establishing high-quality, principles-based accounting standards first requires establishing a set of universally agreed upon characteristics for what constitutes such a standard. The following six characteristics are meant to serve as a framework upon which it will be possible to begin the long process of building out principles-based standards.

While each of the following six characteristics is fundamental to the success of any principles-based system, it is worth noting that the first two characteristics discussed below are "first among equals." These two characteristics speak to the critical importance of ensuring that any future principles-based system promotes financial reports that: (a) faithfully present the economic reality of transactions; and (b) are responsive to users' need for clarity and transparency.

These two characteristics should be self-evident. Indeed, the whole purpose of requiring companies to publish audited financial statements is to provide investors a tool to gauge economic performance and prospects. Yet, the reality is that under today's rules-based accounting standards this basic goal is often not met. The fact is that today, companies can comply with the strict letter of the law, yet fail to provide the information that provides a clear picture of the economic state of the enterprise.

Above and beyond all other concerns, principles-based accounting standards must be judged by the extent to which they address this issue.

1. Faithful presentation of economic reality

In order to meet the needs of investors, a principles-based system must result in financial reporting that faithfully represents the economic consequences of the transactions, the economic reality of balances purported to be represented and the economics of the business as a whole (for this purpose, phrases such as (1) *representationally faithful*, (2) *reflect the economic substance*, (3) provide a *true and fair presentation* and (4) *present fairly* are viewed as roughly equivalent). Faithful representation in this context denotes a good portrayal of economic outcomes or reality.

To be sure, arriving at accounting standards that promote a more faithful representation of economic reality is extremely challenging. Indeed, as some have argued, the economics of a transaction are often in the eye of the beholder. Yet this fact must not serve as an excuse for abandoning the effort to arrive at a system that encourages preparers, auditors and standard-setters to work toward financial reports that more closely track a reasonable interpretation of economic reality.

In order to promote that outcome, a standard-setter must explain its view of the economics of transactions in the objectives to the standard or in the Basis for Conclusions. If there are competing views about how to faithfully represent the economics of a transaction, then the standard should state whether there is more than one acceptable treatment and the Basis for Conclusions should state why that conclusion was reached. Preparers and auditors could then use this information to reconcile the economics of a transaction to their understanding of the objectives of the standard-setter. This would be the application of reasonable judgment, as further described below.

Importantly, the transition to principles-based accounting standards which faithfully represent the economics of transactions may cause increased volatility to be reported in earnings. The fact is economic volatility is a market reality. Rather than using arcane rules to obscure this volatility, investors and all stakeholders will ultimately be better served by having access to clear information about the volatility that actually exists.

Yet, it is to be expected that in the near-term, the increased volatility which would begin to appear in financial reports could have an unsettling effect on markets. Smoothing this transition requires preparers to be prepared to explain this volatility to investors. Over time, it is clear that markets will adapt to and appreciate well explained volatility that actually exists as compared to artificial accounting volatility or failure to report real volatility (e.g. smoothing mechanisms such as those observable in pension corridors). Furthermore, if faithful representation displays actual volatility that exists, then preparers will be encouraged to discuss the economic consequences of transactions and market changes.

It is worth noting that as investors come to accept volatility as being natural, a potential consequence will be a shift in mind-set that de-emphasizes short-term earning measures and puts greater emphasis on underlying business fundamentals. As recent debates around the potentially harmful impact of over-reliance on quarterly financial reports illustrates, stakeholders in the capital markets share a desire to promote more long-term analysis rather than the current obsession with numbers that may provide an artificial sense of the true state of a company. The adoption of more principles-based accounting standards may contribute to the promotion of that important goal.

2. Responsive to users' needs for clarity and transparency

Transparent disclosure and management commentary will be vital to ensure that investors understand and have confidence in financial reports developed under more principles-based accounting standards. Financial statements must be prepared with the end user — the investor — top-of-mind, rather than as an afterthought. As noted above, today's financial statements are often so complex that even sophisticated investors find it difficult to fully understand the information being provided to them. Principles-based accounting standards must be developed with the clear goal of promoting financial reports in which investors can easily find and understand the information they need.

With that in mind, it is worth considering the kinds of information most relevant for the end user.

Certainly, investors are interested not only in how financial statements reflect the current state of the business, but also in how they can be used as a predictive tool (e.g., enable users to predict future cash flows). Principles-based standards should be designed to elicit information that can empower investors in this regard and also continue to report on the stewardship of management.

Further, faithful representation of the economic consequences of transactions can be enhanced by supplementing information about the underlying cash flows via disclosures. For example, measurement of an item at fair value may [illegible] flows, but will not provide information about the timing and risks associated with those expected cash flows, even though those risks have been reflected in the fair value measurement.

Finally, investors will want to understand the fundamental judgments being made by preparers and external auditors. Under a more principles-based system, both preparers and auditors will increasingly be called upon to exercise sound judgment as a replacement for rigid adherence to the compliance process of a rules-based system. This is a positive development, as it will promote clear and understandable financial statements that faithfully reflect a company's economic condition. Yet at the same time, it is clear that a system which relies on judgment requires that those judgments be clearly communicated in order to ensure comparability.

3. Consistency with a clear Conceptual Framework

At the heart of a high-quality principles-based system is an overarching, internally consistent Conceptual Framework. This Conceptual Framework must be designed to provide preparers, auditors and investors a clear understanding of the broad approach underpinning the various standards. This consistency must be reflected in the Basis for Conclusions for each standard, which should clearly and plainly describe how the standard complies with the Conceptual Framework.

Over time, it is to be expected that instances will arise in which a conflict emerges between a proposed principles-based standard and the Conceptual Framework. In such an instance, standard-setters will be called upon to examine the standard and ask themselves: "is the principle of this standard appropriate?" If the standard-setters determine that the principle is appropriate, then they need to consider if amendments to the Conceptual Framework are needed to restore internal consistency.

If a temporary departure from the Conceptual Framework is adopted for some reason, then the Basis for Conclusions should clearly explain what that departure is, and why, so as to avoid having preparers and auditors inappropriately analogizing to the position as an application of the framework.

Currently, thresholds used to recognize and derecognize assets and liabilities vary by standard and are often not explicit. Recognition and derecognition thresholds should be explicitly articulated in each standard. The result would be principles-based standards that are both internally consistent and consistent with other standards covering similar transactions, thereby causing similar transactions to be treated similarly.

Even as we lay out our support for consistency with the Conceptual Framework, we also recognize the significant challenges that this issue raises.

First, there are divergent views on what measurement basis to use across assets and liabilities. Some argue that a single measurement basis should be used across all assets and liabilities. Others argue for the need to employ different measurement bases for different types of assets and liabilities, while others still call for permitting choices between more than one acceptable measurement basis for different types of assets and liabilities.

Without resolving the debates around measurement and recognition/derecognition models, the Conceptual Framework at a minimum should provide the standard-setter with objective ways to think about selecting between a limited number of different measurement bases and recognition/derecognition models. The guidance should give primacy to information seen as faithfully representing the economics and as having relevance to users' decision-making. Then the underlying concepts should be applied consistently for similar assets and liabilities when developing principles-based standards.

In highlighting these issues, it is clear that FASB and IASB will do well to consider focusing their standard-setting activities on finalizing their Conceptual Framework project, even at the cost of delaying other projects. While teams working on different projects may be able to coordinate with the Conceptual Framework teams, a long period of standards seeking consistency with a framework that is to be replaced, or with a framework that has not yet been finalized, will be a significant barrier to achieving principles-based standards.

4. Based on an appropriately defined scope that addresses a broad area of accounting

By definition, an appropriate principles-based system must be broad in its scope. Indeed, a fundamental flaw in the existing rules-based accounting standards is that they create unnecessary complexity around each specific element of accounting. Thus, the process of financial reporting and auditing is forced to focus more and more on the "trees" and less and less on the "forest" in terms of providing investors with a clear picture of the overall economic state of the company.

Principles-based standards must break through this problem by having broadly defined scopes. Eventually principles-based standards might consist of (a) the Conceptual Framework; (b) a limited number standards addressing key balance sheet and transaction categories (e.g., financial assets, non-financial assets, financial liabilities, non-financial liabilities, equity, consolidation, derecognition, revenue and income) and (c) select topic-specific standards illustrating how the core standards are applied to the most typical categories of transactions (e.g., leases, pensions, etc).

Exceptions from the scope or principles should be avoided, as the scope and principles themselves should be written with a goal that all intended transactions will be included. To achieve this goal, attention should be paid to defining terminology carefully, yet in an understandable way, so that it is clear to those reading the standards what is intended to be covered. Exceptions from the scope and principles imply (1) that the scope and principles were written too narrowly or too broadly, (2) that the standard-setter deviated from the Conceptual Framework, or (3) that legacy scope exceptions have been grandfathered, such as those for particular industries. Although some exceptions may be necessary from time to time, the long-term goal should be to refine standards so that the majority of scope exceptions are eliminated.

5. Written in clear, concise and plain language.

As the "consumers" of financial reports, investors have the right to information presented in a clear and understandable fashion. The same should hold true for the accounting standards themselves.

Attention should be paid to clearly articulating the scope of the standard and the terms and definitions used therein. Although it would be unrealistic to suggest that application guidance will not be sought, if principles-based standards are properly written, there should be less need for formal interpretations, or extensive implementation guidance. One way that an interpretive body can continue to add value is by discussing application issues, rather than providing issue-specific interpretive guidance. In so doing, the interpretive body could identify any underlying problem in the relevant standard.

Standard-setters should consider following a uniform structure, including scope, recognition, initial measurement, subsequent measurement, presentation, derecognition, disclosure, effective date and transition. Each section should identify the relevant principles separated from other text. A principle should ideally be drafted to have the flexibility to deal with new situations that were not originally envisioned by the standard-setter. Therefore, principles-based standards should contain clearly-articulated over-arching objectives that make intuitive sense and are organized in a logical fashion.

Such standards should be concise and avoid explaining the same theory in multiple locations in different ways. Just how concise they should be will always be a matter of judgment and debate; however, in theory, the standards should deal with the main issues related to a particular type of transaction category and should resist attempting to answer every possible question. This will leave most other interpretive issues to be dealt with by reference to the core principles and the use of reasonable judgment. Sufficient, but limited, additional guidance should be provided — in the form of explanations in the standard itself, examples for major classes of transactions, and explanations of how to interrelate the principles to major issues to enhance the reader's understanding of how to apply the principles. The amount of additional guidance should be sufficient to make the principles operational.

Just how much application guidance a standard should contain is also a matter that requires careful consideration. In thinking this challenge through, some have questioned what the standard-setter's target audience should be when drafting principles-based standards. Clearly, one's views on how concise a standard can be is impacted by whether one views the target audience as an audit partner in the national office of a large accounting firm, the controller of small private company, or a relatively unsophisticated investor. It would seem to make sense that if reasonably well-informed preparers, acting in good faith, must frequently seek out significant advice to be able to apply the standard in the manner intended by the standard-setter, then the standard will have failed to achieve the criterion of clarity.

Finally, a principles-based standard should contain a well thought-out and articulated Basis for Conclusions. Today's Basis for Conclusions may not address clearly the standard-setter's conclusions about the economics of a class of transaction, which presumably is very important in establishing the principles of accounting for that class of transaction (e.g. the substance of a finance lease is a financing of the acquisition of an asset). The Basis should clearly articulate the standard-setter's underlying thinking particularly focused on its view of the economics of the transaction being accounted for, and the impact of the transaction on the balance sheet and the entity's performance. A Basis for Conclusions should not include interpretative guidance.

6. Allows for the use of reasonable judgment

The last key criterion for a principles-based standard is that it should allow for the appropriate use of reasonable judgment. The expert judgment of highly-trained preparers and auditors could provide value by providing improved clarity. But under today's rules-based systems, there is insufficient room for professional judgment.

Defining an appropriate judgment is, of course, a somewhat subjective exercise. But broadly speaking, appropriate judgments can be considered in those cases where it can be demonstrated that the judgment was reasonable at the time it was made in light of the facts and circumstances present at that time. Judgment should be applied as necessary to meet the overriding objectives or principles set forth by the standard-setters.

Judgment should not be used to circumvent the principles, but rather, should be used to determine (1) the economics of the transaction as articulated by the standard-setter, (2) whether the scope of the principles-based standard applies to the transaction in question and (3) how the principles should be applied to faithfully represent the economic consequences of transactions as explained by the standard-setters. The use of judgment will require contemporaneous documentation of key considerations to be completed and maintained by preparers. Regulators, standard-setters, auditors and users should build an understanding that some diversity that may result from the exercise of reasonable judgment is acceptable.

There are divergent views on how comparability should be achieved. Some believe that comparability is best achieved by limiting the application of judgment and selection amongst possible choices. Others believe that comparability may be achieved through disclosure of the judgments that were made and how they impact the financial results. The more comparability is mandated, the more rules will be required to enforce it. Striving to obtain complete comparability, under detailed rules-based regimes, often defeats the purpose because real comparability is lost through the many bright lines and exceptions created by the rules themselves.

Those relying on rules may believe that they have precisely reported the transaction in question, yet there is no guarantee that what has been reported is a faithful representation of economic reality. There may be false comfort in a mechanistic approach to applying a rule, rather than taking a holistic view to ensure that the accounting treatment aligns with the economics as articulated by the standard-setter.

OTHER STANDARD-SETTING CONSIDERATIONS

In addition to the six attributes proposed for principles-based standards, the following points, which are related to the standard-setting process itself, rather than being characteristics of principles-based standards, are important to the success of principles-based regime.

1. Continuous Improvement

In order to control the volume of standards, it would be preferable if the number of standards issued did not proliferate over time. Instead, standards should be improved, with each standard being assessed both before and after issuance to ensure that they are providing meaningful information to investors. This should include field-testing prior to issuance and a look-back after implementation. Robust field-testing should be performed to ensure that the standard-setter's understanding of the economics of transactions and the operability of their proposals are consistent with expected ultimate practice.

A mandatory look-back after a reasonable implementation period should be conducted to ensure that each newly issued standard is operating as intended and producing decision-useful and relevant, economically sound information to investors.

Interpretations of principles-based standards should focus only on significant issues, which should be limited to circumstances in which the standard-setter believes that the principles are misunderstood and/or not well articulated. Detailed matters should be left to preparers and auditors to exercise reasonable judgment and to provide transparent disclosure. Interpretations and amendments should be incorporated in principles-based standards themselves, by the standard-setter, so that what remains is a single source of high-quality principles-based standards that may be easily referenced by all capital market participants.

Continuous improvement of accounting standards may be thought of within the context of a standards life cycle. First the standard is written, then tested, then implemented. After a period of time, actual experience should be gauged, and issues identified. At this time, relevant aspects of, or wording within, the standard should be reconsidered such that any known issues are resolved through a process that revises the standard itself.

In certain instances, the life cycle of a standard may have run its course and the standard should be rescinded or completely redeliberated and rewritten. However, the objective of continuous improvement should be balanced against the costs of change as tracking, assessing and implementing revisions to standards can be costly for preparers and those who use financial statements.

2. Applying the proposed framework

No one attribute discussed above is viewed as having absolute primacy; rather, each of the attributes should be considered and, if in conflict with others, balanced.

- With that said, (1) faithfully representing the economics of transactions and (2) being responsive to users' needs and promoting transparency are paramount in financial reporting and should be weighted accordingly. Giving primacy to these attributes will allow users to understand a company's underlying business. When a standard-setter deviates from these two criteria in an attempt to balance other attributes, their logic for doing so should be clearly articulated in the Basis for Conclusions so that readers will not inappropriately analogize to the conclusions.

- There is an interrelationship between the optimally-set scope of a principles-based standards, its scope exceptions, its application exceptions and its principles. Therefore, choices made by the standard-setter regarding when to allow a scope exception versus refining the scope and principles themselves will require care, due process, a balanced approach and a clear articulation of logic in the Basis for Conclusions.

SUMMARY AND NEXT STEPS

Achieving balance between the attributes for principles-based standards will not be easy.

Many of the bright lines, scope exceptions, safe harbors and other exceptions to principles in current standards that may cause transactions not to be reported in a manner that clearly represents their economics are the result of requests from preparers and auditors. A re-evaluation of the previous accounting treatment for classes of transactions may be an appropriate start to developing a set of principles-based standards.

The hope is that this paper will act as a mechanism to engage various stakeholders in debate and to build consensus on the approach to use going forward. The next step should be to test any agreed proposals using a practical example to test both (1) whether it can be a helpful tool to assist in optimally designing principles-based standards and (2) whether principles-based standards themselves can be used when accounting for complex business transactions. The practical example should encompass a full actual standard-setting project. The effort will not be easy, but if successful, it would empower standard-setters to make meaningful progress on the use of principles-based standards.