



BASEL COMMITTEE ON BANKING SUPERVISION

BANK FOR INTERNATIONAL SETTLEMENTS

Chairman

VIA EMAIL: CommentLetters@iasb.org

Sir David Tweedie
International Accounting Standards Board
30 Cannon Street
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United Kingdom

3 November 2006

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*

Dear Sir David

The Basel Committee on Banking Supervision (the Committee) welcomes the opportunity to comment on the 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* published by the International Accounting Standards Board (IASB) in July 2006.

The Committee considers that banking supervisors around the world are among the key users of financial reports and has long supported the development of sound and high quality accounting and disclosure standards for the banking and financial industry. In that respect, the Committee has recently updated the *Core principles for effective banking supervision*, which indicate that banks must maintain adequate records drawn up in accordance with accounting policies and practices that are widely accepted internationally.

The Committee recognises that the discussion paper, upon which it comments, is an early step in the joint effort of the IASB and the US Financial Accounting Standards Board (FASB) to develop a common conceptual framework. However, the Committee holds that certain key conclusions that have been arrived at in this first stage warrant reconsideration as the project moves forward. One issue of importance to the Committee is the need for greater emphasis on the assessment of stewardship as an objective of financial reporting. Another is the replacement of a commonly understood qualitative characteristic of financial reporting, reliability, with the lesser-known concept of faithful representation. In addition, the definition provided for one of its components, verifiability, should be improved.

Please find more specific comments concerning the discussion paper in the attached appendix. These comments have been prepared by the Committee's Accounting Task Force (ATF), chaired by Professor Arnold Schilder, Executive Director of the Netherlands Bank, and approved by the Committee. The Committee trusts that you will find its comments useful and constructive. The

Committee looks forward to contributing further to the various phases of the conceptual framework joint project.

If you have any questions regarding our comments, please feel free to contact Sylvie Mathérat, Director, Commission Bancaire, (+33 1 4292 6579); Jerry Edwards, Senior Advisor on Accounting and Auditing Policy, ATF (+41 61 280 8055), or Linda Ditchkus, Basel Committee Secretariat (+41 61 280 8007).

Yours sincerely,

A handwritten signature in blue ink, appearing to read 'Nout Wellink', with a stylized, flowing script.

Nout Wellink



APPENDIX

Basel Committee comments on the IASB's 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

The Basel Committee on Banking Supervision¹ (the Committee) believes it useful to provide comments on a number of broad conceptual issues in the discussion paper that were identified as being of particular importance to its members.

General comments

The Committee understands that the existing conceptual frameworks for the IASB and the Financial Accounting Standards Board (FASB) in the United States differ in their authoritative status and that such status is presently under review by the FASB. The Committee strongly supports the efforts of the IASB and the FASB to provide the best foundation for developing high quality, principles-based and converged standards by developing a common and improved conceptual framework (the Framework). To encourage consistent application of the resulting Framework, the Committee recommends that the jointly developed frameworks should require express consideration of the Framework by reporting entity management if no standard or interpretation specifically applies or deals with a similar and related issue. This is consistent with requirements of the current IASB framework.

The Committee believes that the principles-based nature of the intended standard-setting process should be affirmed explicitly within the Framework. Standards emanating from the new Framework are more likely to be adaptable to quickly evolving business practices if they are principles-based, as opposed to rules-based. With that in mind, we are concerned with the length and the lack of focus on key issues of the discussion paper. We would encourage the IASB to produce a more structured exposure draft based on the issues addressed in the discussion paper and to more explicitly describe the intended balance between the qualitative characteristics of financial reporting. Notably, the balance between relevance and the other qualitative characteristics and the balance between the sub-characteristics of

¹ The Basel Committee on Banking Supervision is a committee of banking supervisory authorities, which was established by the central bank governors of the group of ten countries in 1975. It consists of senior representatives of bank supervisory authorities and central banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom and the United States. It usually meets at the Bank for International Settlements in Basel, where its permanent Secretariat is located.

relevance, namely predictive value and confirmatory value, should be included in the body of the exposure draft.

The discussion paper's introduction to the Framework notes that the Framework does not establish standards for particular financial reporting issues and that some existing standards may be inconsistent with the concepts set forth in the Framework. While inconsistencies are unavoidable initially between some existing standards and the Framework, the Committee considers that as a matter of principle new standards should not be inconsistent with the Framework. The Committee proposes that the IASB board jointly with the FASB board include in their due process a procedure for assessing and resolving inconsistencies in both existing and future standards and for explaining inconsistencies when they remain. The Committee believes that such an effort would further enhance the convergence influence of the Framework because it would encourage resolution of existing or any future differences between the Framework and standards issued by the IASB and the FASB.

Chapter 1: the objective of financial reporting

Stewardship

The Committee strongly recommends giving more prominence to the assessment of management's stewardship as a separate objective of financial reporting, along with assessing cash flow prospects. In their roles as banking supervisors, Committee members have significant experience with the assessment of stewardship as an objective of financial reporting. Banking supervisors routinely make extensive use of financial reports as a tool in assessing the performance and the strategy of banking management, the strength of past earnings performance and the risks undertaken.

As the objective currently reads in the discussion paper, the Committee found that it focuses too heavily – if not exclusively (see paragraphs OB2 and OB3) – on information useful for predicting cash flows based on existing assets and liabilities while placing insufficient emphasis on information useful in assessing how entity management has fulfilled its stewardship responsibilities. While recognising the importance of predicting cash flows as an objective of financial reporting, the Committee considers that stewardship and accountability are among the primary reasons why general-purpose financial statements are prepared, and that those aspects are essential to the financial reporting process in many jurisdictions. In that respect, we do not agree with BC.1.37 when it states “financial reporting provides information about an entity during a period when it was under the direction of a particular management, but it does not directly provide information about that management's performance”.

The Committee believes that the definition of the objectives of financial reporting – including stewardship – has a direct link with, and could have major implications for, the qualitative characteristics of financial reporting and notably for the balance between the different components of relevance. In that respect, the Committee recommends that the definition of relevance includes an explicit statement that equal prominence is given to both confirmatory value and predictive value, because the proper assessment of stewardship and cash flow prospects relies also on the confirmatory value of financial reporting.

Potential users of financial reports

The Committee supports the inclusion of creditors as primary users of financial reports, as they provide financial resources to an entity and have a prominent interest in the assessment

of its financial solvency and profitability. As a matter of practice, banking entities are heavy users of financial reports, frequently using such information for purposes of allocating credit resources. Moreover, banking supervisors make extensive use of financial reports to assess the financial condition and performance of banking organisations, for example, as part of their off-site monitoring activities.

Scope of the framework: financial statements or financial reporting

The discussion paper does not clearly identify how its guidance would relate to the broad concept of financial reporting, which goes beyond the information presented in the financial statements. The Committee found reaching a conclusion on whether the objective should focus on financial statements or financial reporting difficult without knowing the boundaries of financial reporting.

While we are not currently expressing a conclusion, we offer two observations that you may find helpful in your deliberations on this issue. Firstly, the Committee recognises that banking supervisors benefit from financial transparency including information provided from a management perspective in the form of a management commentary. In that sense, having a framework that applied to financial reporting, including management commentary and similar information, would be beneficial to improving the quality and consistency of such reporting.

Secondly, as was stated in its comment letter to the IASB regarding a discussion paper on *Management commentary*, the Committee noted the importance of authorities other than accounting standard setters to retain the ability to require certain disclosures deemed appropriate for the benefit of the public, as those disclosures may go beyond the matters governed by existing accounting standards or a conceptual framework. We would encourage the board to consider very carefully the legal implications, in different jurisdictions, of focusing on financial reporting rather than on financial statements.

Chapter 2: qualitative characteristics of decision-useful financial reporting information

Replacement of “reliability” with “faithful representation”

As it noted in a comment letter to the Canadian Accounting Standards Board relative to a discussion paper on *Measurement bases for financial accounting – measurement on initial recognition*, the Committee supports a more robust definition of the concept of “reliability” and objects to the term “reliability” being replaced. Instead of using the new and vague term “faithful representation”, for which we are not sure that there is international consensus on what it means in operational terms, we recommend continuing to use the broader and more meaningful concept, “reliability”. This is important, from our standpoint, in order to prevent obscuring some of the constructive debate that occurred in the past between the IASB and its constituents on the trade-off between relevance and reliability, particularly in the context of the growing use of fair value accounting in the measurement of assets and liabilities. Under the Committee’s suggested approach, reliability would be expanded to include the qualitative characteristics of verifiability, neutrality (enhanced as discussed below), completeness and faithful representation (including the important implicit quality of substance over form).

We believe that “reliability”, rather than “faithful representation”, conveys better the crucial need for well balanced, objective experienced professional judgement and due care for estimates in financial reporting, for example in the process of estimating fair values of the still

significant number of non-financial and financial items which are non-traded, or traded in imperfect and illiquid markets.

We are concerned with the discussion of neutrality as put forth in the discussion paper. We consider that greater emphasis should be given to the fact that overly optimistic outlooks on the price to be received and the costs necessary to market highly illiquid items are inconsistent with the concept of neutrality. Given that, notably, the concept of prudence has been removed, the Committee suggests including an explanation, within the definition of neutrality, of the need for reasonable and well balanced, professional judgement in the face of uncertainty and estimation. Greater emphasis can be accomplished by providing some examples of applying neutrality when estimating values. This is particularly important given the pressures on management to meet market expectations, which could lead to earnings management and other abuses, for example through overvaluing assets and revenues.

Moreover, we have concerns about the Board's discussion of the balance between relevance and reliability. We noted that in principle the Board does not intend to give more prominence to the concept of relevance (see paragraph QC 44). However, the fact that the concept of relevance is the first step in the assessment process could be seen as implying a hierarchical order among the qualitative characteristics and could send a negative signal to companies and auditors indicating that accurate, dependable measurements are of diminished importance within the new conceptual Framework. For these reasons, the Committee recommends further emphasising that the equal importance is given to the concepts of relevance and reliability in the Framework.

Verifiability

The Committee believes that the concept of verifiability should be markedly strengthened in the Framework.

The Committee feels strongly that paragraph QC 23(b) on indirect verification fails to communicate that correct application of a flawed recognition or measurement method does not result in verifiability. It is important, particularly for the highly illiquid items mentioned above, that the chosen recognition or measurement method should not only be applied properly, but also that the method be deemed reasonable based on the available evidence. This should be included in the underlying policies and procedures applied in the internal financial statement preparation process of the reporting entities.