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Revision of the IASB "Conceptual Framework":

PROPOSALS FOR A MORE PRUDENT ACCOUNTING ,

CENTRED ON THE "BUSINESS MODEL"

The representation of the firms' activities in present accounting standards and in their conceptual frameworks give excessive prominence to instant valuation, balance sheet-focused approaches which do not respond to investor needs and produce a short term bias.

As a response, the principles of prudence and reliability should be restored and accounting should attach the greatest importance to reflect essentially the "business model" of the firm. Both the conceptual framework and standards should be amended accordingly, and thus re-balanced, for the benefit of our real economies.

An essential, long-awaited debate

There has been a long-standing demand for a debate on the IASB conceptual framework, in particular to decide on whether and how to take into consideration the conceptual innovations incorporated in draft standards such as the draft IAS 37 published in 2005. Between 2006 and 2010, the IASB and FASB did conduct (but did not complete) a joint revision of their conceptual frameworks, but only for the narrow purpose of achieving convergence with American standards. Responding to repeated demands voiced during the 2011 public consultation on its future work programme, the IASB resumed its revision in 2013, which it plans to complete by 2015. If the deadline is met, the revision request will have taken a decade to yield any results.

Limited expectations regarding the IASB's intent to make changes

However, we should not expect this revision to be revolutionary, given that some major issues are not on the agenda or are not moving in the right direction. For instance, the removal of the concept of prudence, decided with the adoption of the first phase of the revision in 2010, is not being reconsidered. Similarly, income and expenses remain defined as changes in assets and liabilities. This choice gives precedence to a balance-sheet approach over a representation of performance via the income statement—not to mention the fact that the very concept of performance remains ill-defined. Lastly, the accounting standard-setter has kept the conceptual framework as a mere reference with no obligation for compliance. This decision weakens the impact of the IASB's revision.

In this context, the French, British, German, and Italian standard-setters are performing major, beneficial work with EFRAG to move the discussion forward by publishing a series of *Bulletins* on specific topics connected with the revision of the conceptual framework. However, the ANC feels the need to go further and express its main objectives directly.

- PROPOSALS

1/ REBALANCE AN ACCOUNTING APPROACH OVERLY FOCUSED ON A SHORT-TERM VISION

Financial statements have been turning into "short-termist" pictures of corporate accounts. This trend has been driven by the determination to incorporate the effects of changes in the economic environment into the accounts as quickly as possible—for the sake of transparency, and to give the timeliest possible vision of a firm's financial position.

The concept of prudence is deemed incompatible with the notion of neutrality, which would imply a symmetrical treatment of unrealised gains and losses. This vision will satisfy investors who want an accelerated recognition of unrealised capital gains for distribution purposes or to obtain a better resale price without waiting for these future gains to be confirmed or not. By contrast, investors giving priority to long-term performance will want to assess the firm's capacity to stay in business and maintain performance in the long run. A presentation of accounts that gives precedence to short-term investors' criteria is therefore not neutral.

Academic research has shown that "good" prudence (or conditional conservatism), which recognises unrealised losses faster than unrealised gains, is appreciated by users of financial statements because it rectifies the lesser capacity to predict bad news than good news. "Good" prudence also leads the firm to be more selective in its investments and so to improve its performance and the returns to shareholders.

The consequences of overestimations of gains or underestimations of losses can be more severe than those of errors in the opposite direction. In the latter case, investors may sell their securities before learning the good news, and hence may suffer an opportunity loss on their selling price. By contrast, an initial overestimation of profits may put the firm into serious trouble later on because of mistaken investment or distribution decisions. As a result, the losses to investors and other stakeholders will be far greater.

a/ Restore the concept of PRUDENCE

For all these reasons, the concept of prudence should be reintroduced in the conceptual framework so as to make the information more valuable and relevant. The IASB and FASB believe that the adoption of a "prudent" approach to valuation will suffice to prevent assets from being overestimated and liabilities from being underestimated. In that case, why remove the concept of prudence?

b/ Restore the notion of RELIABILITY

Similarly, the conceptual framework has replaced the notion of "reliability" with that of "faithful representation", and has eased the "verifiability" requirement. This change makes it easier to immediately recognise variations in the economic environment by treating them as relevant even if they are not reliable. As a result, the real impact of these variations on the firm's cash flows is anticipated by increasing the number of valuations based on estimates, despite their margin of uncertainty. Academic research studies reckon that nearly two-thirds of items in financial statements are now valued in this way. The result could be a cumulative margin of uncertainty that would make the information less relevant. The explanations provided in the notes to financial statements seem insufficient to offset this uncertainty. They may well add even more clutter to this information medium, already viewed as oversized and therefore not used.

In addition, this great uncertainty may generate high volatility in financial statements, of which a large part appears to be due to estimation errors and the instability of external reference items and not to changes in the firm's actual circumstances. A major share of volatility will thus be cancelled in the long run, in step with the firm's actual performance.

In other words, the decision to give precedence to relevance over reliability entails the introduction into the accounts of change-related items that have no connection with the entity's performance and that are—in principle—of little relevance. Financial statements tell us less about the entity than about the immediate changes in its external environment. Admittedly, the environment is essential to an understanding of the firm's operations. But it is already reflected in the accounts through all the parameters describing the firm's operations, such as changes in selling prices, purchasing prices, volumes purchased, produced, and sold, and so on.

Generally speaking, we should avoid confusion about what is "relevant": if we believe that accounting should "provide information", then we can stack up past, present, and future data and try to update it day by day. We shall end up simulating the selling price of a security that will never represent its market value, which incorporates many other factors. But if financial statements are meant to describe the firm's performance and tell us about its own operations, then the accounts should contain only reliable data, to which any further information deemed necessary can always be added in the notes or elsewhere. Investors do not want the accounts to show information that will never be exhaustive nor ever be calculated to meet their respective needs exactly. They prefer to have reliable data and make their own calculations to form their own opinion.

The information should thus preserve a minimum degree of certainty in order to ensure its relevance and predictive capacity. The least certain items—the impermanent items provided for assessment purposes—should be relegated to the notes. **We believe that the principle of information reliability**

should be restored to the conceptual framework (the notion of probability being preserved, and that of verifiability strengthened).

2/ FOCUS INFORMATION ON THE FIRM'S PERFORMANCE GENERATED BY ITS BUSINESS MODEL

a/ ABANDON THE SYSTEMATIC PRE-EMINENCE OF THE BALANCE SHEET

Proponents of the approach based on the definition of assets and liabilities argue that it would be impossible to define income and expenses, or to justify the matching of income and expenses and the separation of financial years in the income statement without referring to the concepts of asset and liability. Yet the proposed new definition of asset and liability in the revision of the conceptual framework separates assets (resources) and liabilities (obligations) from the notion of economic benefits. The concepts of income (inflow of economic benefits) and expense (outflow of economic benefits) could therefore be defined independently and be valued and represented in accordance with specific principles of their own. Furthermore, from an economic as well as legal standpoint, income and expenses have been, can and should be defined autonomously.

In any event, even a definition of income and expenses based on assets and liabilities does not necessarily entail an emphasis on the balance sheet over the income statement or the superiority of one valuation method over others (see *Bulletin* on "The asset/liability approach"). **Many studies of financial-statement users show that they are mainly and foremost interested in the income statement as a picture of performance**. The FASB recognised this preference; the IASB believes that no financial statement takes precedence over the others. Similarly, it is rather widely admitted today that there is no single valuation method ideal in all circumstances and that different methods should coexist on the basis of relevant distinction criteria.

In practice, however, this balance is not achieved in the standards..

b/ Give the BUSINESS MODEL its proper place

Performance is not the result of a sum of changes in the number and value of assets and liabilities between two balance sheets, but rather the net economic benefits generated by, or as a result of transactions related to the firm's operations.

The best criterion for assessing the relevance of a representation of a firm's performance is to determine whether it reflects the impact of the application of the firm's business model(s) on its income statement. In this connection, the business model is an operational process implemented by the firm to create value by achieving cash-flow creation cycles. Thus:

- Business models impact on the performance of firms by determining the volume and phasing of cash flows generated by their operations. Far from short term and instant valuation, the relevant time horizon, for accounting purposes, becomes this of the cash flow cycle, equally relevant to the firm and investors.
- Accounting should reflect what the enterprise does in applying its business model.
- As the models are observable and often repetitive processes, they can be checked and any deviation or change can be identified and treated in the accounts.

The incorporation of the concept of business model thus seems necessary for meeting the goals of the conceptual framework:

- It provides better information on a firm's capacity to generate cash flows.
- It thereby provides valuable, relevant information on the firm's financial position and performance.
- By faithfully reflecting financial positions and performance, it makes them comparable.
- It gives the income statement a high information value, which is what users want.
- It makes it easier to assess executives' performance and stewardship as it reflects the impact of their management.

Consequently (see “The role of the business model in financial reporting”), **<u>the role of the business model in financial statements should be recognised in the conceptual framework and be reflected, whenever necessary, in new or existing accounting standards</u>**.

- CONCLUSION

As we have argued here, the conceptual framework of accounting standard-setting should be rebalanced to allow financial statements to give a faithful, unbiased representation of the firm. To this end, two basic “biases” should be corrected: (i) the preference for an immediate and exhaustive snapshot, as against a description of performance in the long run, focused on the enterprise itself and not on its environment; (ii) the vain attempt to refer to allegedly objective market values outside the firm, rather than representing the firm in a reliable, prudent, and ultimately more modest manner. For such conceptual rebalancing act to have any effect, it must be inscribed in accounting standards that will reflect them.

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