Lloyds Chambers

1 Portsoken Street

London E1 8HZ

United Kingdom

Tel: +44 (0)20 7702 0888

Fax: +44 (0)20 7702 9452

www.hermes.co.uk

Li Li Lian
Assistant Project Manager
International Accounting Standards Board
30 Cannon Street
London
EC4M 6XH

November 3 2006

Dear Ms Lian,

Preliminary views on a Conceptual Framework for Financial Reporting

By way of background, Hermes is one of the largest pension fund managers in the City of London and is the principal manager of the BT Pension Scheme and the Royal Mail Pension Plan. We also respond to consultations such as this on behalf of the British Coal Staff Superannuation Scheme, the BBC Pension Trust, and some 200 other clients. We have £65 billion under management and a further £15 billion under advice (as at end September 2006). We are well-known for our involvement and expertise in matters of long-term ownership and take a close interest in such matters in all markets in which our clients have investments.

We welcome the opportunity to respond to the discussion paper on the Conceptual Framework. This raises important issues and we welcome the international debate which the discussion paper has sparked. Our response covers a range of issues raised in the discussion paper, including issues of clarity, stewardship, the focus on cashflows and the qualitative characteristics. We would welcome the opportunity to discuss these issues further with IASB staff if that would be helpful to you.

Clarity of focus

We are concerned that there appears to be a lack of focus in the IASB and FASB proposals in a number of areas. We believe that this has not helped in creating clarity in the proposed framework and thus that it risks failing to generate clarity in the reporting standards which will be developed underneath it. We deal with each of these areas of apparent lack of focus in turn.

Clarity of focus – authoritative status of the framework (P2)

We would argue that there needs to be certainty as to the authoritative status of the framework before this project is begun. We further believe that it is highly unsatisfactory that it is unclear what the status of the framework will be under US GAAP. Without clarity as to the status of the framework, it is hard to be clear as to the meaning and purpose of much of it. We would welcome FASB acknowledging that the conceptual framework will

have authoritative status in US GAAP and act as a set of principles guiding and shaping reporting standards *and* their interpretation.

We believe this is a necessary first step towards having greater clarity and certainty in the Conceptual Framework and in its implications.

Our strong view is that the value of an overarching framework comes in two ways:

- it highlights those areas where more detailed reporting standards are needed
- it avoids the need for excessive prescription in those reporting standards because it establishes a set of principles which mean that the need for detailed rule-making is dramatically reduced

We are firm believers in the value of principles-based standards and the associated reduction in bright-line detailed rules-based standards. We recognise that principles-based standards require professional judgement by directors and auditors, and we welcome this.

Clarity of focus – the user (OB10-12)

We note the statement in BC1.15 that:
"Without a defined group of primary users, the framework would risk becoming unduly abstract and vague".
We agree, and we fear that the Conceptual Framework suffers from exactly this problem. By proposing such a wide range of primary users, the Framework does indeed verge on abstraction and vagueness.

We would support the suggestions of some constituents discussed in BC1.17 that existing ordinary shareholders should be deemed the primary users of financial reporting. Ordinary shareholders have the residual interest in a company after its contractual obligations are paid. The other interested parties in a company, as listed in OB6, are all protected by contractual or other rights – whether they be creditors, suppliers, employees, customers, governments and regulators, and the public. Because current shareholders do not share the same protections by contractual or other rights, their reporting requirements extend well beyond the needs of any of these other individual parties. Thus reporting which serves the purposes of current shareholders will also serve the needs of those other stakeholders. The clarity which would come from designating current shareholders alone as primary users would, we believe, be extremely valuable.

Furthermore, our view is that *potential* investors do not need to be named separately as primary users. They will not have interests in reporting which differ from current investors, and their inclusion in the definition of primary users risks adding apparent additional obligations for directors and auditors which are not appropriate in all legal jurisdictions.

Our view is thus that the current shareholders alone should be designated as the primary users of financial reporting. This focus reflects the origins of auditing and of accounting standards, as discussed below.

Clarity of focus – the entity approach (OB10)

Regardless of whether a more focused approach to the definition of user is taken, we regard it as necessary for the conceptual framework to take a proprietary approach rather than follow the entity approach as currently proposed. The use of the entity approach risks obscuring important issues and introducing confusing elements to reporting – it obfuscates rather than reveals. While we acknowledge some intellectual attractions of the entity approach, we believe that there are not so many flaws and problems with the proprietary approach that it should be overturned. Users – whether they are current or potential shareholders, creditors or other stakeholders – understand the proprietary

approach and find practical value in those disclosures. To overturn these practical advantages to users for the sake of a theoretical approach does not seem to us to be a worthwhile pursuit.

Stewardship (paragraphs OB2; BC1.32-41, AV1.1-7)

We strongly believe that the concept of stewardship should be retained as a separate objective of financial reporting. We are therefore supportive of the Alternative View, and we accept the arguments made there with regard to the problems which arise through agency theory.

The Framework suggests that to include stewardship as an objective confuses financial reporting with corporate governance matters. We feel on the contrary that financial reporting and the audit are by origin corporate governance issues: the audit and financial reporting standards were invented precisely for reasons of good governance, to ensure that the directors account effectively and accurately to their shareholders for their performance over the given period. Auditing, and accounting standards, were created to fill a gap in accountability, to address the agency problem. To assert that there is not an intimate relationship between financial reporting and corporate governance misunderstands the intellectual basis for audited financial reports, and the legal requirement for them found in many countries around the world.

OB2 talks about resource allocation decisions. There is a very important resource allocation decision which shareholders in most countries have to consider: whether they should keep the resources of the company in the hands of current management or should allocate those resources to a management that it believes is better able to generate returns from them. We disagree with the analysis in OB28 that these decisions fall within the same category of decisions as that proposed to be used in the framework. Rather, this resource allocation decision is of a very different nature from normal investment and credit decisions and requires information of a very different kind: rather than focusing simply on the potential cash generation of the business if it continues to be run as it is, this requires considerations of the potential returns from a reshaping of the business and from its being run more effectively. It requires backward-looking information to highlight the performance (and underperformance) of the investment history of current management. Cashflows may be very different under different management, and shareholders need the tools to enable them to analyse this possibility. We are concerned that this useful – we would say vital – information may be lost if stewardship is dropped as a separate objective of the conceptual framework.

We also strongly support the specific application of the Alternative View to dealings with management: that the threshold for disclosure must be determined by reference to the individual rather than the entity. This is not driven by a prurient interest in excessive remuneration, as BC1.41 attempts to simplify it, but because such an analysis will assist users in taking a view as to whether management is driving full value at the entity, or whether personal motivations may be hindering changes which might otherwise generate additional value.

We do not believe that financial reporting should seek to disaggregate management performance from entity performance, as BC1.35-38 suggest is a necessary implication of an agency/stewardship approach. Any attempt to make such a disaggregation would be futile and would produce meaningless results. But neither should financial reporting obscure management performance, as we fear a model which impairs assets or restates them at so-called ‘fair value’ does. There is a risk that this ensures that every company seems to generate a return of at least the cost of capital, obscuring reality in many cases. To suggest that an entity has a performance independent of its management defies reality: a good management will generate greater cashflows from the same assets than a poor management.

We fear that a good deal of information which is useful to users will not be required if the objective of financial reporting is restricted in the way currently proposed in paragraph OB2. We therefore believe that stewardship needs to be retained as a separate objective of financial reporting.

Cash-flow focus (OB3-4)

We note the intent to focus on information useful in assessing cashflow prospects. We are concerned that this focus solely on a forward-looking measure may limit the value of financial reporting to users. At the extreme, it threatens to introduce a permanent amnesia whereby corporate reporting only looks to the future and does not provide the important contextual data regarding the past and present situation of the business. We are sure that this extreme understanding is not what the IASB intends for its conceptual framework – not least given the comments regarding the need for historic data and accrual accounting, in BC1.31 and elsewhere. However, we would welcome an explicit statement as part of the way the objective itself is stated. A further sentence in OB3 to the effect that "This will include data on capital invested historically and accruals accounting to allow users to understand the company's business model and so develop assessments of future performance" would, we believe, more fully articulate the IASB's intentions.

Accurate reporting of the capital invested in a business enables a more effective analysis of the dynamics of that business. History matters, because it allows users to gain a closer understanding of how an entity generates returns, and therefore provides users with key tools in assessing what future returns will be. We have suggested to the IASB in a previous consultation response that in many cases we have more confidence in the arm's length price paid historically than in any modelled 'fair value' price which might be substituted to give an indication of future cashflows. This need to include historical data is highlighted by the Framework itself when it states at QC10: "Without knowledge of the past, users generally will have no basis for a prediction."

Explicitly including disclosure of the past as a requirement of the objective will help ensure that future accounting standards provide users with that necessary basis for their work.

Qualitative characteristics

We believe that the Conceptual Framework will serve most value if it is a framework of principles with authoritative status. For the principles to be of value to preparers, users and auditors, all groups will need a common understanding of the terms used. We believe that this argues for the retention of some terms which are already well understood. In particular, substance over form is a concept which is well understood and tends to generate accounts which are of most value to users. We would welcome its retention as a qualitative characteristic in its own right, and as one with senior status. Similarly, we believe that the concept of reliability is of considerable value in accounting standards and is understood by parties to the financial reporting process.

We do not believe that it is sufficient for the concept of substance over form in accounting standards to be implicit within the idea of faithful representation. Rather, we would welcome it being given greater status by being made explicit within the short list of qualitative characteristics and we look forward to substance over form continuing to be a central tenet of accounting standards.

We note the discussion in QC18 regarding real-world phenomena and the various possible ways of valuing an asset in a balance sheet. We note that the issue of fair values will be debated by the IASB in due course and that there will be full consultation

on this issue with users. In that light, we understand from QC18 that the concept of faithful representation does not seek to favour one valuation methodology over another. As will be clear from the discussion above, we believe that there is considerable value to users from having historic prices available to them. We have previously noted in a response to the IASB that we are concerned at the prospect of the theory of 'fair value' seeking to substitute modelled and purely theoretical prices for the real prices which have been paid for assets in genuine arm's length transactions. Given the value to users of historic prices, these should not be obscured by the application of a theory of fair value. As OB20 states, "financial reports are not designed to show the value of an entity" and we would welcome the provision of a range of information in accounts rather than single point estimates deriving from models; at the very least, other information on alternative valuation models should be included in notes to the accounts.

We therefore welcome the acknowledgement in QC23 that it is possible to verify a range of possible amounts. Particularly in those areas where standards require adjustments to balance sheet items, users will often gain more useful information from open disclosure of the assumptions which lie behind the calculation than from the single point estimate itself. We would welcome future accounting standards recognising this and requiring disclosure of this material rather than simply the single point estimate.

On the matter of materiality, we welcome the acknowledgement in QC51 that different materiality thresholds apply in different contexts. In particular, we would reiterate the need in relation to dealings with management for the specific application of a materiality threshold determined by reference to the individual rather than the entity.

As stated above, we would welcome the opportunity to discuss these issues further with IASB staff if that would be helpful to you.

Yours sincerely,

PAUL LEE
Director