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London
STOCK EXCHANGE

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Dear Ms Lian,

INVITATION TO COMMENT
IASB Discussion Paper, Preliminary Views on an improved Conceptual Framework for Financial Reporting

Thank you for the invitation to comment on your project team's discussion paper on preliminary views for an improved Conceptual Framework for Financial Reporting.

The London Stock Exchange is one of the world's leading exchanges. We facilitate the raising of capital and the trading of securities for companies from 59 countries. We are the most international exchange by trading in the world and Europe's largest pool of liquidity. Currently, there are 1,590 Main Market and 1,607 AIM companies quoted on our markets. Collectively, these companies are worth over £4.2 trillion.

Our comments in the attached appendix are intended to reflect significant concerns raised by market participants (companies trading on our markets, investors, investment banks, accountants and lawyers) that the principles-based corporate governance environment for which the UK is internationally renowned is at risk of erosion through your work towards convergence of accounting standards and the development of a highly detailed conceptual framework.

The boards' goal is for standards to be clearly based on consistent principles. However, market participants have noted that the framework strives too hard to reconcile to the principles. This results in excessive detail and definition, which then encourages the need for more clarification as statements are challenged in practice. There is a risk that a momentous cycle of detail-definition-clarification-challenge-detail is created with the output becoming interpreted less as clarification and more as 'rules' as time passes. The ultimate unintended consequence might be to inadvertently encourage compliance to a set of 'rules' through a 'box-ticking' approach.

Our correspondents provide feedback that may provide the source of this perceived risk. In general, they perceive an excessively detailed and theoretical debate taking place within some accountancy bodies only. They also perceive a

lack of engagement by your boards with market participants (particularly companies and investors), a lack of due regard for market impact, an apparent bias towards a rules-based format and little regard for the consequential business impact of proposed changes.

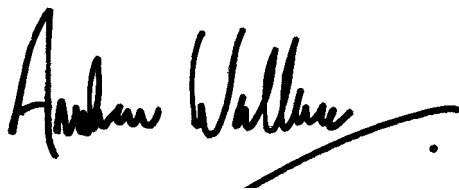
The perception that the boards are not communicating effectively with market participants would seem to lie at the heart of concerns raised. We propose two areas where the boards might consider simple action to redress such concerns.

Firstly, we would urge the IASB to widen the direct participation in the Conceptual Framework project to the UK ASB and other national standard-setters, which would enable more representative and efficient market feedback on proposed changes and their consequences as well as providing a 'check' on overly theoretical debate.

Secondly, we would strongly suggest that the boards publish, at an early stage in the process, the consultative evidence for any proposed changes. This would be a simple way to back any claims made in discussion papers and reassure market participants that a rigorous and balanced consultation has indeed taken place.

We recognise that the work you are undertaking is complex and important. We hope this response and our proposals are taken in the spirit of contributing positively towards the boards' work. The London Stock Exchange would be pleased to offer a route to a variety of participants in our markets if so requested.

Yours sincerely

A handwritten signature in black ink that reads "Andrew Wallace". The signature is fluid and cursive, with a long horizontal stroke extending to the right from the end of the name.

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Appendix

London Stock Exchange response to the IASB Discussion Paper, Preliminary Views on an improved Conceptual Framework For Financial Reporting

The importance of an intelligent corporate governance regime

Public companies rely on an efficient capital market structure and the foundation to this is an intelligent corporate governance regime. The strength of the UK's approach to corporate governance is that it provides companies with the flexibility to comply with broad principles or state the business case for non-compliance.

We believe that the principles-based, 'comply or explain' approach strikes the right balance between allowing management the flexibility they need whilst meeting the needs of investors and stakeholders in terms of transparency, protection and confidence.

We also believe that the UK approach to corporate governance enables market forces to exert pressure on company management in their duties towards shareholders or other stakeholders in a variety of areas, and it is only because they have the flexibility of a non-prescriptive regime that this can occur.

Put simply, if shareholders or stakeholders decide that a company's approach is unacceptable, they will vote through the market mechanism. A succession of surveys has demonstrated the superiority of the UK approach in delivering the most intelligent standards of corporate governance in the world.

If shareholders trust management to run their businesses and make crucial business decisions surely they also trust them to make the correct judgements in respect of accounting for them (and other front end directors report and "OFR" narrative reports) - subject to appropriate review and policing by auditors.

FD, listed company

Perceived erosion of the principles-based approach

A variety of our constituents have raised serious concerns that the Conceptual Framework could represent a risk to the UK's corporate governance advantage, leading by stealth to a rules-based accounting standard regime where a principles-based regime would be superior.

Eroding subjective assessment based on clear principles that are sensibly interpreted through professional scrutiny can only lead to a 'box-ticking' attitude. It encourages the strict application of precise rules, removes elements of fairness and legal precedent and increases the costs and regulatory burdens for all concerned. We agree with the sentiment of the ASB in their letter to the project team of the 3rd August 2005, stating that:

'A standard may be fairly judged to be 'principles-based' provided its underlying aim and objective is clear enough to be implemented without the need for lengthy and detailed supporting requirements, irrespective of whether or not its principles can be reconciled to the framework'.

However, despite assertions that the boards' goal is for standards to be clearly based on consistent principles¹, market participants have noted that the framework strives too hard to reconcile to the principles, ultimately resulting in excessive detail and definition and consequently encouraging the need for a more 'rules-based' format.

An important example involves the proposals around 'faithful representation', which would seem to replace the commonly understood concept of 'reliability' and introduces the concept of 'verifiability'. The definition of 'faithful representation' is not intuitive and will require much clarification. 'Verifiability' is a concept open to wide misinterpretation and could be taken to refer to the nature of audit evidence that may be obtainable. Again, an area where much clarification will be required.

Market participants fear that the straightforward and workable concept of 'substance over form' is being removed to be replaced by proposals around 'faithful representation'. They perceive the absence of the substance over form concept in US GAAP as having led to a rules-based system, which helps to explain the serious concerns raised by some of our market participants as to the progress of the boards' work.

Another example quoted to us is the potential extension of the 'fair value' concept in terms of measurement. Such a move will require a slew of definitions for each and every circumstance which in itself gradually encourages a rules-based, 'tick-the-box' approach.

The Principle of "substance over form" is being ditched in the headlong desire to bring the US accounts into the fold.

FD, listed company

¹ Para P3

A move to rules based accounting inevitably leads to people structuring issues to get the right "rules based" result when the substance can/would result in a much lower profit. At the end of the day, and what has worked very well in the UK historically and is a core reason for the success of the LSE and the high regard of UK accountants, the rules should be based on the directors of companies and auditors having the professional skills to make appropriate and sensible judgements, not on the basis that they need strict rules to understand and report every set of transactions.

FD, listed company

It would be impossible to create rules to sensibly reflect the myriad of accounting and business issues encountered day in day out by directors and auditors.

FD, listed company

The biggest issue for the UK's public limited companies will be a move to rules ...or heavily in that direction. In practice though IFRS brings us a long way there. The frustrating thing about rules is the lack of a materiality opt out...which always comes in a principles based system.

Non-executive director – several listed companies

Perception of bias towards 'rules-based', US-GAAP

Market participants have commented that there seems to be a strong US influence on the process towards convergence, citing the fact that more changes have been made to IFRS than to US GAAP.

The perception of bias was also raised in the ASB roundtable meeting of the 21st September. The real issue is not the potential for bias in the debate, but whether that will ultimately extend to the practical application of convergence. Put simply, will the US system reduce detail in a move towards a more principles-based approach or will IFRS adopt more detail in a move towards a rules-based approach?

We should not be aligning with the US at all costs [*and should*] avoid US style rule based accounting methods, which allowed Enron & WorldCom to happen.

FD, listed company

The onus on reporting should be on the directors that all is a true and fair and representative record of the company rather than hiding behind the small print of what is reported according to accounting standards. The defence behind those accused at Enron was that they reported what was required and that will be the case, whatever new reporting is required.

FD, listed company

A perceived lack of understanding as to practical market impact

The application of accounting standards has as great an impact on the market as the application of statutory standards. Market participants have raised concerns that the cause and effect of changes to accounting standards needs to be considered much more carefully.

A recent example might include the recent IASB debate around creating an accounting standard for management commentary. We were supportive of *guidance* on this issue, rather than the creation of a standard, which risked creating additional burden on listed companies and held the potential for the creation of ‘clarification points’ interpreted as ‘rules’.

An IFRS on management commentary (a non-statutory accounting standard) would likely have similar impact for companies as the original OFR provisions contained within the Companies Act 1985 (a statutory standard). Of course, the OFR clauses have since been repealed in the spirit of reducing unnecessary burdens from UK companies – an acknowledgement of the cause and effect of such regulation.

The standard-setters’ perception of IFRS seems to be merely that similar information is being presented in a different format. However, this attitude fails to acknowledge that there is a material impact on the financial markets, whether positive or negative, and not just at a company level, an entire sector can be affected. One good example surrounds the amortisation of R&D, which had a material effect on the valuation of technology companies.

Institutional investor

Changing an accounting standard alters the economics of a business and if the boards’ intention is to maintain a principles-based approach, then accounting standards should reflect the economic operation of companies. However, we understand that the perception in the market is that the reverse is true with companies altering their business models to fit standards.

One example given to us involves the definition of a reporting entity. For those companies seeking a listing in the UK that have complex financial histories, the definition of a reporting entity² is a crucial consideration for the UK Listing Authority when assessing individual listing applications, one that could potentially affect whether or not a company is eligible to list on the London Stock Exchange’s Main Market.

We receive comments from market participants that they are beginning to lose the intuitive feel they have for their accounts as a consequence of the drive

² Para P6

towards increasing complexity and more detailed disclosures. However, the question has been raised whether such complexity is really required by users of financial information.

An example concerns the requirement to split intangible assets to a greater extent, the practical effect of which is increased workload to comply with standards that investors care nothing for.

For us it has been the single most significant, time consuming and expensive audit and accounting issue which is hugely frustrating given no investor or analyst I have spoken to cares to any extent whether the intangible assets are classed as goodwill, customers, contracts, brands etc.

FD, listed company

No consideration, in the rush to implement new reporting standards, seems to have been given to the impact on the reporting company. For example we are now required to provide financial information for each of our reporting divisions. However one of our divisions makes a very significant return and profit by whatever yardstick is used. When our clients read this they will demand lower rates. Our profit will then drop and hence our investors' interests are poorly served. It is inevitable that a body without representatives from other areas will not consider this. It is easy for auditors to take a 'disinterested view' but this can be simply inimical to the well being of the companies and hence the investors.

FD, listed company

Your paper advocates a wider class of user and makes assumptions as to what they require in terms of financial information. However, comments from market participants suggest that closer consultation with companies and investors is required at an earlier stage to ensure that new standards are of practical use. Generally, commentators cite the need for the IASB to become less theoretical and consider more closely aspects that core users of financial information require.

Few if any read the detail, even the analysts.

FD, listed company

From the discussions I have had with my investors the views of the presenters* are if anything too moderate. More is now being required to be disclosed than anyone needs.

* referring to presentations at the ASB roundtable (21st September 2006) by Messrs Lever and Elwin

FD, listed company

There is a risk of information overload resulting in users having too much information and being deflected or distracted from the core business drivers and key profit and cashflow messages within financial statements.

FD, listed company

The IASB is becoming overly theoretical and is not considering what core accounts users are interested in. As a general principle if analysts and investors add back or adjust for a new accounting item it strongly, to my mind, suggests the change wasn't appropriate

FD, listed company

The danger of a 'one-size fits all' approach

It is a perception that a quoted company is naturally large and supra-national in operation. However, this is not necessarily the case. Many companies on both AIM and the Main Market are predominantly UK-centric. For example, the UK Main Market comprises some 1,300 companies of which nearly half have a market capitalisation up to £100m, whilst nearly 80% of AIM companies are UK-based and have an average market capitalisation of £38m.

Market participants have raised the apparent blanket approach to convergence as having a disproportionate impact on smaller, quoted companies for which the benefits are much less apparent.

Why are there no simple standards for specific sectors? All software has a shelf life and under the IFRS standards we are required to review this each year. Why does this not apply to acquisitions? For some companies to write off acquisitions over 7 years, some 20 and some never is illogical.

FD, listed technology company

Nowhere have I seen anything meaningful discussing the merits of 'de minimis' reporting. The smaller company is clearly disadvantaged by having to adopt the same rules as the larger one.

FD, smaller listed company

Perceived lack of market participation in the IASB due process

Your published due process handbook explains the consultative procedure undertaken prior to issuing an IFRS³. However, we are increasingly receiving comments from market participants, including companies and investors, that appropriate market consultation is not sufficiently robust in practice.

Market participants perceive that Discussion Papers are issued with commentary presented as a *fait accompli*, with the boards' Conceptual Framework an example. Certainly, there is no accompanying justification as to the process undertaken to arrive at the conclusions made in your paper. Broader IASB updates refer to the Boards' 'deliberations' or 'discussions' but make no mention of any market consultation to arrive at their conclusions prior to issuing a consultation. And although your paper expresses your plans as part of due process⁴ the market perception seems to suggest that this process is not working effectively. Our comments are supported by the sentiment expressed at the ASB public meeting on the 21st September:

'The tone of the paper was along the lines 'standard setters know best; users don't really know best and will get what standard setters give them; preparers are not to be trusted''

'The framework should be practical, to be applied to standards reflecting the business activities of entities applying those standards, and not a manifesto for a theoretical accounting model'

One example involving a lack of early market participation involving users and preparers of financial information is the apparent relegation of the concept of stewardship from being a primary objective to being an element of the decision-usefulness objective. The perceived 'axing of the stewardship concept' has created public criticism from market participants such as investors who obviously need to assess the performance of management. As the ASB noted in their letter to the project team on the 3rd August 2005:

'There are...some matters that are very significant in the context of stewardship – such as major illegal acts, or directors' remuneration: it seems a mistake to imply that accounting standards can only require disclosure of such matters if their relevance for 'making economic decisions' can be demonstrated.

The ASB roundtable on the 21st September 2006 demonstrated the strength of feeling over this issue and whilst your paper does debate the theory and sets out the alternative view, it provides no indication as to the extent of background

³ IASB Due Process Handbook, April 2006, pp. 20-24

⁴ Para P11

market consultation amongst users of financial information prior to the boards' conclusions.

Another example centres on the concept of predicting cash flows. Your paper notes that financial reporting should assist the providers of capital to understand the amounts, timing and uncertainty of future cash flows⁵. However, there is no discussion around the potential information that could be provided to address this objective. Further work, involving dialogue with analysts, would be beneficial in developing the subsequent exposure draft.

If the audience at the ASB roundtable is any way indicative of the members who are drawing up the conceptual framework then it is no surprise that the current proposals are so onerous. The board must be more representative of other parties, especially the investment fraternity and also the reporting companies.

FD, listed company

An absence of demonstrable attempts at cost benefit analysis

Your due process handbook⁶ refers to gaining an insight on the costs and benefits of standards through consultations, etc. and that the IASB's views are 'reflected explicitly in the basis for conclusions published with each exposure draft'.

We acknowledge that to perform a rigorous cost-benefit analysis around the financial reporting issue would be technically difficult and potentially beyond what is practical. However, market participants are suggesting that this area of analysis requires more consultative effort at an earlier stage. We are therefore pleased to note that the boards have concluded that '*the improved framework should go further in the area of assessing benefits and costs than the existing frameworks do*⁷,' and suggest that a more effective consultative process would help in this regard.

...the common view that changes and additional disclosure requirements should undergo sensible cost benefit review before implementation is sensible but does not appear to be followed by the IASB at the moment.

FD, listed company

⁵ Para S3, p12

⁶ IASB Due Process Handbook, April 2006, pp24-25

⁷ BC2.72