

# **Financial Reporting Advisory Board**

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## **From the Chairman**

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### **RE: 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 Financial Reporting Advisory Board (the Board) welcomes the opportunity to comment on the Discussion Paper on *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 Paper). This letter summarises the Board's views and the Annex provides more detailed comments on the Paper.

2. The Board welcomes the IASB's decision to issue this material in the form of a discussion paper, thereby providing an opportunity for the Board to contribute to the debate on, and the development of, the content of the proposed Conceptual Framework.

#### **Background to the Board and its interest in an improved Conceptual Framework**

3. The Financial Reporting Advisory Board (the Board) acts as an independent element in the process of setting accounting standards for government. The Treasury is required by the Government Resources and Accounts Act 2000 to consult the Board on financial reporting principles and standards. The Board exists to promote the highest possible standards in financial reporting by government and to ensure that any adaptations of, or departures from, Generally Accepted Accounting Practice are justified and properly explained. In conducting this process the Board ensures that an even and sector neutral accounting approach is consistently applied. The Board reports annually to Parliament

about its activities and highlights areas of concern. More details about the work of the Board can be found on its website at [www.frab.gov.uk](http://www.frab.gov.uk).

4. The Board views the proposed Conceptual Framework as fundamentally important to the future development of International Financial Reporting Standards, and consequently, to the future Financial Reporting framework that will apply in the United Kingdom, including its subsequent implications for Public Benefit Entities, i.e. for not for profit entities within the public sector for which the FRAB retains a particular interest.

5. We consider it essential that there should be one all embracing Conceptual Framework which encompasses and reflects the various sectors of both profit and not for profit entities, and our comments on the Paper reflect this.

### **Summary of general concerns with the Paper**

6. The Board is concerned about the proposed Framework's treatment of stewardship and accountability. The Board believes it to be wrong to treat stewardship as a sub-objective of the resource allocation decision usefulness objective, and strongly supports the view that stewardship should be identified as a separate but parallel objective of financial reporting. The Board is of the view that the downgrading of stewardship is likely to lead to difficulty in the Board maintaining a sector neutral accounting approach in dealing with financial reporting by government. Whilst the Board agrees that an objective of general-purpose financial statements is to provide decision-useful information for both profit and not for profit entities, it is also generally accepted, and the Paper acknowledges, that a further objective of financial statements is to provide information that enables users of the statements to assess the stewardship and accountability of management. This latter objective is equally applicable to both profit and not for profit entities; it can be regarded as a decision-useful tool, and it is considered by the Board to be complementary to the decision-useful objective.

7. The Board considers that the inclusion of the class of user 'funders and financial supporters' is a necessary step towards achieving a single comprehensive framework, which reflects complementary objectives of financial reporting. The Paper states that the objective of general purpose external financial reporting "is to provide information that is useful to present and potential investors and creditors and others in making investment, credit and similar resource allocation decisions" (OB2). Potential users of financial reports and their information needs are defined in the paper (OB6), but the Board considers that this definition is too narrow in that it does not include as a class of user 'funders and financial supporters' related to not for profit entities from both the private and public sectors.

8. In the context of not for profit entities, the Board considers that cash flows are as equally important as they are for profit making entities. However, for the former, other aspects are generally more significant, such as how well the

organisation is meeting its objectives, and the effectiveness and efficiency of goods or service delivery. The Paper states that “Present and potential investors and creditors have a common interest in the ability of an entity to generate net cash inflows. Accordingly, information about that ability is the primary focus of financial reporting because it helps satisfy the needs of investors and creditors. (OB13)” Indeed, the Board notes that a concentration and focus on the ability to assess cash flow prospects is evident through the discussions in the Paper, but there is little emphasis on other aspects, from a not for profit perspective, that are usually more significant.

9. In principle the Board supports the decision to extend the scope of the Conceptual Framework to cover some or all financial reports that are not financial statements. However, it has concerns over the current process for achieving this. The Paper is explicit in its proposal that the scope of the Framework will be extended from general purpose financial statements to include other types of general-purpose financial reports. The Paper clearly considers that the term ‘financial report’ has a very wide meaning, but no attempt has yet been made to define what the boundary of financial reporting will be. The Paper suggests that this issue may be addressed later in the project, but this provides practical difficulties now in responding to the Paper as currently drafted, as the boundary is undefined. In that context it cannot be necessarily assumed that the concepts that apply to financial statements will equally apply to all forms of financial reports.

10. The Board has concerns over the proposal to clarify what is currently the qualitative characteristic of reliability, by replacing ‘reliability’ with ‘faithful representation’, which should have as sub-characteristics verifiability, neutrality and completeness. Although the Paper argues that this change is not one of substance, the Board disagrees. The Board is of the opinion that a move to faithful representation does represent a change in substance, in that it is not the same thing as reliability, and, when combined with the absence of the principle ‘substance over form’ and subsequent reliance on ‘verifiability’, would be problematic to introduce in practice. We believe that ‘faithful representation’ is a less well-understood notion that would be differently interpreted in practice, and consequently would be unlikely to lead to consistency in financial reporting. This suggests that further work needs to be carried out on this proposal, including better defining the notion before its replacement of reliability as a qualitative characteristic of financial information.

## **Conclusion**

11. The Financial Reporting Advisory Board welcomes the development of an improved conceptual framework that will underpin the future financial reporting framework. However, it does have concerns over several aspects proposed in the Discussion Paper, as noted above. The Board believes it is essential that the ongoing project encompasses and reflects the various sectors and requirements of both profit and not for profit entities within one overall framework.

*Yours sincerely*

*Larry Pinkney*

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Approved by the Board on 31 October 2006 and signed in the Chairman's absence

ANNEX

**IASB 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. – FINANCIAL REPORTING ADVISORY BOARD RESPONSE**

**Chapter 1: The objective of financial reporting**

*Stewardship*

1. The Discussion Paper proposes a single objective of financial reporting based on decision-usefulness; although it acknowledges that the objective encompasses providing information useful in assessing management’s stewardship (OB28). The proposed objective is “The objective of general purpose external financial reporting is to provide information that is useful to present and potential investors and creditors and others in making investment, credit, and similar resource allocation decisions.” As other aspects of the Conceptual Framework should expect to flow from this objective, it is very important that from the start of the project that the objective(s) is/are appropriate to the context to which it/they will be applied.

2. The Financial Reporting Advisory Board (the Board) whilst agreeing that an objective of general-purpose financial statements is to provide decision-useful information for both profit and not for profit entities, is concerned about the proposed framework’s treatment of stewardship and accountability. It is generally accepted that that a further objective of financial statements is to provide information that enables users of the statements to assess the stewardship and accountability of management. The UK exposure draft of the *Statement of Principles for Financial Reporting: Proposed Interpretation for Public Benefit Entities* highlights that some users will not have the same ability to make direct economic decisions as occurs for private sector businesses, and will sometimes be interested in the financial statements primarily in order to assess the adequacy of stewardship exercised by the entity’s management.

3. In the Board’s opinion, stewardship and accountability are equally applicable to both public and private sectors entities, and can be regarded as complementary to the decision useful objective, and as a decision-useful tool. While some users of financial statements for not for profit entities may base resource allocation decisions on the available information, many other users are concerned with the direct stewardship and accountability of the entity’s management.

4. The Board therefore believes it to be wrong to treat stewardship as a sub-objective of the resource allocation decision usefulness objective, and strongly supports the view that stewardship should be identified as a separate but parallel objective of financial reporting. The Board is also of the view that the downgrading of stewardship is likely to lead to difficulty in the Board maintaining

a sector neutral accounting approach in dealing with financial reporting by government.

#### *Primary users of financial reports*

5. The Discussion Paper states that the objective of general purpose external financial reporting “is to provide information that is useful to present and potential investors and creditors and others in making investment, credit and similar resource allocation decisions” (OB2). Potential users of financial reports and their information needs are defined in the paper (OB6), and include equity investors, creditors, suppliers, employees, customers, governments and their agencies and regulatory bodies, and members of the public.

6. The Board considers that this definition is too narrow in that it does not include as a class of user ‘funders and financial supporters’, related to not for profit entities from both the private and public sectors, which can be viewed as the equivalent of investors. The wider ranging user group of not for profit entities includes those providing resources to the organisation in the form of contributions, i.e. funders and financial supporters. Such users will be interested in information related to the utilisation of resources provided to an entity for decision-making purposes and in the management’s stewardship of management of the resources.

7. The Board considers that the definition of potential users of financial reports should be widened to include funders and financial supporters, as the inclusion of this class of user is considered a necessary step towards achieving a single comprehensive framework, which reflects complementary objectives of financial reporting.

#### *Focus on cash flow*

8. The Discussion Paper states that ‘Present and potential investors and creditors have a common interest in the ability of an entity to generate net cash inflows. Accordingly, information about that ability is the primary focus of financial reporting because it helps satisfy the needs of investors and creditors (OB 13). Indeed, the Board notes that a concentration and focus on the ability to assess cash flow prospects is evident through the discussions in the paper.

9. The Board considers that cash flows are equally important for not for profit entities as they are for profit making entities. However, for the former, other aspects are generally more significant, such as how well the organisation is meeting its objectives, the effectiveness and efficiency of goods or service delivery. This has a significant impact on the objective of financial reporting for not for profit entities.

#### *Scope of the Conceptual Framework*

10. The Discussion Paper proposes that the scope of the Framework will be extended from general-purpose financial statements to include other types of general-purpose financial reports. In principle, the Board supports the decision

to extend the scope of the Conceptual Framework to cover some or all financial reports that are not financial statements. However, the Board does have concerns over the current process to achieve this.

11. The Discussion Paper clearly considers that the term 'financial report' has a very wide meaning, however no attempt has yet been made to define what the boundary of financial reporting will be. The Discussion Paper suggests that the IASB intends to address the 'boundary of financial reporting' much later in the project. The Board has concerns over the delay in defining the boundary for financial reporting as this provides practical difficulties now in responding to the Discussion Paper as currently drafted, as the boundary is undefined. In that context it cannot be necessarily assumed that the concepts that apply to financial statements will equally apply to all forms of financial reports.

## **Chapter 2: Qualitative characteristics of decision-useful financial reporting information**

### *Faithful representation v Reliability*

12. The Discussion Paper proposes to clarify and replace what is currently the qualitative characteristic of 'reliability' with 'faithful representation'. The latter having as sub-characteristics verifiability, neutrality and completeness. This proposed change contrasts with the present sub-characteristics of reliability (faithful representation, substance over form, neutrality, prudence and completeness). The Board has concerns over this proposal.

13. The Discussion Paper argues that this change is not one of substance, however the Board disagrees. The Board is of the opinion that a move to faithful representation does represent a change in substance, in that it is not the same thing as reliability, and, when combined with the absence of the principle 'substance over form' and subsequent reliance on 'verifiability', would be problematic to introduce in practice. We believe that 'faithful representation' is a less well-understood notion that would be differently interpreted in practice, and consequently would be unlikely to lead to consistency in financial reporting. This suggests that further work needs be carried out on this proposal, including better defining the notion before its replacement of reliability as a qualitative characteristic of financial information.