

Conceptual Framework for Financial Reporting: The Objective of Financial Reporting and the Qualitative Characteristics of Decision-Useful Financial Reporting Information

Background paper for roundtable - 21 September 2006

1 Introduction

1.1 The International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) are undertaking a joint project to develop a common conceptual framework that both Boards can use in developing new and revised accounting standards. The project is being undertaken in phases, as follows:

<u>Phase</u>	<u>Title</u>
A	Objectives and qualitative characteristics
B	Elements, recognition and measurement
C	Measurement
D	Reporting entity
E	Presentation and disclosure
F	Purpose and status
G	Application to Not-for-Profit entities
H	Finalisation

1.2 A 'Preliminary Views' discussion paper on the first phase (A) of the project was issued by the IASB and FASB on 6 July, with a comment period running to 3 November.

1.3 The purpose of this paper is to provide a concise discussion of some of the issues that arise in connection with the subject matter of the preliminary views paper in order to assist those who are interested in commenting on the paper and in participating in the debate on these issues. While the conceptual framework may seem like an academic subject far removed from the day to day world of accounting, it has far-reaching practical implications in that the framework will heavily influence the future direction of financial reporting. Given that the conceptual framework should set out a coherent frame of reference of what should be the ideal qualities of financial statements, the paper also provides an indication of implications for later phases of the project.

1.4 The Phase A document sets out the preliminary views of IASB and FASB on the first two chapters of the converged framework:

- (a) Chapter 1 - the objective of financial reporting; and
- (b) Chapter 2 - qualitative characteristics of decision-useful financial reporting information.

2 The objective of financial reporting

2.1 In the view of the IASB and FASB (the Boards), the objective (note the singular) 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".

2.2 To help achieve this objective, the Boards state that financial reporting should "provide information to help present and potential investors and creditors and others to assess the amounts, timing, and uncertainty of the entity's future cash inflows and outflows (the entity's future cash flows). That information is essential in assessing an entity's ability to generate net cash outflows and thus to provide returns to investors and creditors".

2.3 The proposals in Chapter 1 of the discussion paper highlight some important issues that could have far-reaching implications.

One objective: what happens to stewardship?

2.4 The first issue relates to the proposal that the converged framework should specify only one objective of financial reporting, with a focus on decision-usefulness.

2.5 The existing frameworks of both the IASB and the FASB focus on providing information that is useful in making economic decisions. The ASB's 'Statement of Principles for Financial Reporting' also specifies that the main objective of financial statements is to provide information that is useful in making economic decisions. However, as part of that stated objective, the ASB's Statement of Principles refers specifically to providing information that is useful in assessing how management has fulfilled its stewardship responsibility. In the section of the IASB's current Framework that covers the objective of financial statements (paragraphs 12-14), reference is made to the fact that financial statements also show the results of the stewardship of management.

2.6 In the converged framework, the Boards are proposing to continue to subsume stewardship within a decision-usefulness objective, but they acknowledge that providing information useful in assessing management's stewardship is of significant interest to users of financial reports who are interested in making resource allocation decisions.

2.7 Two IASB members disagree with the proposal and have set out an alternative view in the discussion paper to argue that stewardship be identified as a separate objective of financial reporting. This alternative view reflects concerns expressed by constituents in the UK¹ at the proposal not to retain stewardship as a specific objective. While acknowledging that the importance of stewardship can depend on the particular legal framework in any jurisdiction, the view is that one of the purposes of financial reporting is to provide shareholders with the information they need to make decisions as owners of the business. These decisions are not merely whether to sell their shares, or buy more, but also include their rights, as owners, to change the direction of the business, or the management, in jurisdictions where they have those rights. In not having stewardship as an objective, there is a danger in the future that information useful for stewardship purposes, for example in an area such as related party disclosures, may not be included in financial statements on the grounds that it is not thought to be 'decision-useful' for resource allocation purposes.

2.8 There is also a concern that the emphasis in the discussion paper on the ability to forecast the future does not fully capture the requirements of stewardship, where the emphasis is more on monitoring past transactions and events. The sole focus on decision-usefulness could imply that investors, in particular, look to financial statements only to make decisions to buy, sell or hold securities - and that the quality of an accounting standard should be judged wholly by whether it provides information that informs such decisions.

2.9 Financial statements should not aspire to provide information that is sufficient for a valuation of the company to be made, nor should that be their exclusive focus. Whilst the information in financial statements should be useful, relevant, and helpful (to cite some of the commonly used words) they will never provide all the information that is necessary to make informed investment decisions. (This point is acknowledged in the ASB's Statement of Principles at paragraph 1.8.)

2.10 If the sole aim of financial statements were to be to influence decisions about buying, selling or holding the company's securities, it is arguable that the most useful form they could take is a summary of management's expectations for the future. While there is no question that forward-looking financial information would be useful, it is not expected to supplant the current form of financial statements.

2.11 An obvious fact about current financial statements is that they are historical – the information is nearly all about financial position at a past date and changes in that position over a past period. The framework needs to articulate clearly why this

¹ See, for example, the paper written by Tim Bush 'Divided by Common Language – Where economics meets the law: US versus non-US financial reporting models (ICAEW, 2005)

information is useful. In particular, transactions are of central importance to economic activity, and so the summary which is provided by financial statements of past transactions and their economic impact on the entity is useful in assessing the extent to which similar transactions might recur in the future and how they might affect the entity. If, for example, sales have grown strongly but margins are squeezed, this is important information for assessing both future sales and their profitability. On this basis, the framework should clearly identify the reporting of information about past transactions as a central feature of financial statements.

Who should be the primary users?

2.12 A second issue concerns the identification as the primary users of financial reports "present and potential investors and creditors, and their advisors".

2.13 In common with the existing IASB and FASB frameworks, the ASB's Statement of Principles identifies a wide range of users who use financial statements in order to satisfy some of their different needs for information. It then narrows that focus to a particular, defining class of user: in the ASB's case, present and potential investors.

2.14 The ASB's defining class of user is therefore narrower than proposed for the converged framework. But the ASB is aware of concerns expressed in the UK, but also elsewhere that maybe the primary users as identified in the ASB's statement is too wide a class and that the defining class should be narrowed further to focus upon the existing common shareholders only. For example, a recent report by the CFA Institute² argues that the financial statements should be viewed from the position of an investor in the common shares of the company (ie an existing common shareholder). Any hierarchy of users of financial reports, it has been suggested, should start with the current shareholders, as the owners of the business, in order to give the framework more clarity and focus. This could affect the debate as to whether a proprietary view or an entity view is used to determine the boundary of a reporting entity (to be considered in Phase D of the project).

2.15 In the discussion paper, the Boards have adopted the entity view as the basic perspective underlying financial reports, having concluded that this is consistent with the focus on a wide range of users because it views the effects of transactions from the perspective of the entity as a whole rather than only a part of it.

Financial statements, or financial reporting?

2.16 Another particular issue to note with regard to this chapter is that it refers to 'financial reporting', not just the financial statements. The Boards have concluded

² CFA Centre for Financial Market Integrity 'A Comprehensive Business Reporting Model: Financial Reporting for Investors' (CFA, October 2005)

that prepared the Discussion Paper 'Management Commentary', that was published by the IASB in October 2005.

2.22 The figure below sets out the project team's view of financial reporting:

The IASB Constitution and *Preface* refer to financial reporting and acknowledge the role of information accompanying the financial statements in meeting the objectives of the IASB.

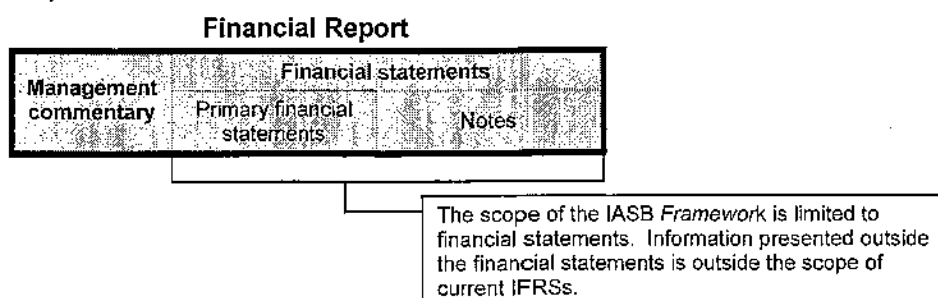


Figure 1.1 The IASB Constitution, *Preface* and *Framework* and their relationship to financial reporting

2.23 The responses to the Management Commentary discussion paper are still being analysed, but the feedback on this issue will inform help the work on boundaries that will be undertaken in a later phase of the conceptual framework project.

3 Qualitative Characteristics

3.1 The Boards' preliminary views are that the qualities of decision-useful financial information are relevance, faithful representation, comparability and understandability. These qualities are subject to two pervasive constraints: materiality and benefits that justify costs.

3.2 The current IASB Framework lists the four principal qualitative characteristics as: understandability, relevance, reliability and comparability. The same four principal qualitative characteristics are outlined in the ASB's Statement of Principles.

3.3 The main change in the Phase A discussion paper is the proposal to replace reliability with faithful representation. The discussion paper states that to be useful in making investment, credit, and similar resource allocation decisions, information must be a faithful representation of the real-world economic phenomena that it purports to represent. The phenomena represented in financial reports are economic resources and obligations and the transactions and other events that change them. To be a faithful representation of these economic phenomena, information must be verifiable, neutral and complete.

3.4 The Boards are proposing this change on the grounds that there have been "longstanding problems with the qualitative characteristic of *reliability*" and the existence of a variety of notions of what the concept means. For example, the CFA

Institute paper referred to above argues that reliability has been "much misunderstood and much misused in the financial markets". The Boards have concluded that at least some of the problems seem to be related to presenting faithful representation as only one component of reliability, when in fact it encompasses all of the qualities that the current frameworks include as aspects of reliability.

3.5 In the Boards' view the use of the term faithful representation better conveys what the framework means by reliability. However, concerns have been expressed as to whether the change is simply one of terminology, or something more substantial, in particular when considering:

- (a) the proposal not to identify substance over form as a component of faithful representation. The current IASB Framework includes substance over form as a component of reliability, but the proposal from the Boards is to drop this reference in the converged framework, on the grounds that it would be redundant, given that the quality of faithful representation is incompatible with representations that subordinate substance to form;
- (b) the introduction of verifiability as a component of faithful representation. Verifiability implies that different qualified observers would reach general consensus, if not complete agreement, either –
 - that information is free from material error or bias and therefore represents the economic phenomena that it purports to represent (by direct verification); or
 - that the chosen recognition or measurement method has been applied without error or bias (by indirect verification).

3.6 Commentators often focus on the qualities of relevance and reliability and the relationship between them. In the discussion paper, relevant information is described as that which is capable of making a difference in the decisions of users by helping them evaluate the potential effects of past, present, or future transactions or other events on future cash flows (predictive value) or to confirm or correct their previous evaluations (confirmatory value). As noted above, these decisions are often characterised by whether to buy, sell or hold securities of the entity. This in turn implies that financial statements should assist in making an assessment of the value of the entity. This has implications for the measurement phase of the project, as some would suggest that fair value measures are superior to other measures for this purpose. Some have expressed concerns that the implication of this would be to place relevance above reliability, which has the potential for 'softer' numbers to be recognised in the financial statements. This has implications for the recognition phase of the project, given that the current IASB Framework (and the ASB's

Statement of Principles) requires that, to be recognised in the financial statements, an item has to have a cost or value that can be measured with reliability.

3.7 In the discussion paper, the Boards state that relevance must be considered before the other qualitative characteristics because relevance determines which economic phenomena should be depicted in financial reports. Once relevance is so applied, then faithful representation is applied to determine whether the depictions of those economic phenomena are faithful (or unfaithful). The Boards are, however, keen to stress that considering faithful representation after relevance does not mean that faithful representation is secondary to relevance (although some believe it should be). Rather, relevance is considered first because the Boards believe it would be illogical to consider how to faithfully represent a phenomenon that is not pertinent – ie information about it is not relevant – to the decisions of users.

3.8 Comparability and understandability are then considered, in order to enhance the decision-usefulness of financial reporting information that is relevant and representationally faithful.

4 Possible questions for discussion

4.1 In the light of the discussion on the issues above, some questions arise, on which comments would be welcome:

- (a) Do you agree that the objective of financial reporting should focus on decision-usefulness? What do you think should be the role of stewardship and should it be specifically referred to in the objective, or be a separate objective?
- (b) Should the objective designate a primary group of users and, if so, who should they be?
- (c) Should the focus of the framework be on the financial statements only, or financial reporting as a whole (however defined)?
- (d) What are your views on the meaning of faithful representation as a qualitative characteristic and is it a better term to use than reliability? What does verifiability mean to you?