

The IASB/FASB Conceptual Framework Project's
Preliminary Views on an Improved
Conceptual Framework for Financial Reporting:

**The Objective of Financial Reporting and Qualitative
Characteristics of Decision-useful Financial Reporting
Information**

**Application to not-for-profit entities
in the private and public sector**

Chairs and Senior Staff of:
Australian Accounting Standards Board
Canadian Accounting Standards Board
Canadian Public Sector Accounting Board
New Zealand Financial Reporting Standards Board
United Kingdom Accounting Standards Board

What this Report is About and Why it has been Prepared

This Report has been prepared by a group of chairs and senior staff members of the standard-setting bodies of Australia, Canada, New Zealand and the United Kingdom. It comments on the applicability to not-for-profit entities in the private and public sector of the concepts proposed in the first Discussion Paper in the IASB/FASB Conceptual Framework Project. The IASB/FASB Conceptual Framework Project is, for the time being, focusing exclusively on concepts for private sector businesses. The objective in publishing this Report is to highlight the key issues the group has identified:

- for the information of the IASB; and
- to inform the not-for-profit constituencies of the standard-setting bodies about issues that they may wish to consider and comment on.

Summary of the Report

- S 1 Not-for-profit entities have different objectives, different operating environments and other different characteristics to private sector businesses (profit-seeking entities). These differences are discussed in Appendix A to the Report which recognises that there are also many similarities between not-for-profit entities and private sector businesses.
- S 2 The Preliminary Views document on the Objective of Financial Reporting and Qualitative Characteristics of Decision-useful Financial Reporting Information issued by the IASB and FASB covers private sector businesses only – this Report considers how some of the differences in the not-for-profit sector affect the possible application of the concepts proposed by the IASB and FASB to these other entities.
- S 3 Part 1 of this Report considers the applicability of the proposed Objective of Financial Reporting to not-for-profit entities in the private sector. It raises three issues:
- insufficient emphasis on accountability/stewardship;
 - a need to broaden the identified users and establish an alternative primary user group; and
 - the inappropriateness of the pervasive cash flow focus.

It also highlights a risk that the scope of financial reporting may implicitly be narrower than is necessary for it to meet the needs of users in the not-for-profit sector.

- S 4 Part 2 of this Report considers the applicability of the proposed Qualitative Characteristics of Decision-useful Financial Reporting Information to not-for-profit entities in the private sector. It notes that:
- some of the issues raised in Part 1 are also pertinent to the proposed qualitative characteristics; and
 - different cost-benefit assessments may be appropriate when considering not-for-profit entities because of the different objective for these entities, the different primary user group and because of the different incidence of benefits and costs.
- S 5 Appendix B comments on issues regarding the Objective and Qualitative Characteristics of Financial Reporting from the perspective of not-for-profit entities in the *public* sector.

Preface

Background

P1 On 6 July 2006 the International Accounting Standards Board (“IASB”) and Financial Accounting Standards Board (“FASB”) published the first in a series of publications as part of a joint project to develop a common Conceptual Framework for Financial Reporting. The first document is entitled “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 *Preliminary Views* document). Comments have been requested by 3 November 2006.

This Report

P2 This Report comments on the applicability of the concepts proposed by the IASB and FASB to not-for-profit entities in the private sector and, in Appendix B, to public sector entities that do not have a profit objective. The Report results from the efforts of a “monitoring group” consisting of board chairs and senior staff members of the standard-setting bodies of Australia, Canada, New Zealand and the United Kingdom.

P3 When the IASB and FASB commenced their joint Conceptual Framework project, they decided to focus initially on business entities in the private sector. Once concepts for those entities have been developed, the boards have indicated they will consider the applicability of those concepts to financial reporting by other entities, such as not-for-profit entities in the private sector and business entities in the public sector.¹

P4 The writers of this Report were concerned about the implications of the IASB/FASB Conceptual Framework project for not-for-profit entities² and encouraged the IASB and FASB to consider these entities continuously throughout their project but this was not accepted. At a later stage, the writers proposed that the implications for not-for-profit entities be considered at the end of each phase of the IASB/FASB project but this was also not agreed to.

¹ Paragraph P8 of the *Preface* to the *Preliminary Views* document.

² Their concerns stem from the fact that the standard-setters involved have a responsibility to develop standards for not-for-profit entities and are committed to using the pronouncements of the IASB in their work.

- P5 The representatives of the four countries concerned discussed the possibility of monitoring the project from the perspective of private and public sector not-for-profit entities. The representatives put forward the view, which the IASB accepted, that consideration of matters from a different perspective can “add robustness” to the conclusions reached when considering only the perspective of business entities in the private sector. The representatives were encouraged by the IASB to undertake some monitoring work and have been considering issues on a monthly basis. Issues identified are, where appropriate, drawn to the attention of the IASB and FASB. The International Public Sector Accounting Standards Board is an observer of the monitoring group process and receives all reports.
- P6 The monitoring group considers it is important that the more significant issues it has identified are considered by individuals and organisations considering the *Preliminary Views* document from the IASB and FASB, in particular the not-for-profit constituencies of the standard-setting bodies involved. Accordingly it has prepared this report and made it available publicly.
- P7 The approach taken is to highlight implications of applying the concepts proposed by the IASB and FASB to private sector not-for-profit entities (and, in Appendix B, public sector not-for-profit entities). Because the IASB/FASB project is at this stage developing concepts for private sector businesses only, comments are not criticisms of the material as it applies to the entities for which it is intended³ but rather identify issues that would need to be considered (and most likely addressed) if the material was also to be applied to not-for-profit entities in the private and public sectors.
- P8 Appendix A to the Report describes in general terms some of the characteristics of not-for-profit entities in the private sector and public sector.

³ This Report does not express any views in relation to the appropriateness of the concepts proposed for private sector businesses.

Monitoring group members

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	Jim Paul, Senior Project Manager Australian Accounting Standards Board
Canada	Paul Cherry, Chair Accounting Standards Board
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Principal author

The principal author of this report is Kevin Simpkins, an independent consultant in New Zealand with many years of experience in senior positions in the not-for-profit and public sectors.

Part 1 The Objective of Financial Reporting

- 1.1 The objective of financial reporting is, as stated in the *Preliminary Views* document, the foundation of the Framework. Other aspects of the Framework should flow logically from the objective and help ensure that financial reporting achieves its objective to the maximum extent feasible.⁴
- 1.2 Accordingly, it is essential that the objective of financial reporting is appropriate to the contexts in which it applies.
- 1.3 The objective of financial reporting proposed in the *Preliminary Views* document is as follows:

*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.*⁵

- 1.4 There are three issues that have emerged from our review of the applicability of the proposed objective to not-for-profit entities or from the associated commentary in Chapter 1 of the *Preliminary Views* document. These issues are:
- insufficient emphasis on accountability/stewardship;
 - a need to broaden the identified users and establish an alternative primary user group; and
 - the inappropriateness of the pervasive cash flow focus.

Each of these issues is considered below.

Insufficient emphasis on accountability/stewardship

- 1.5 The IASB and FASB have proposed a decision-usefulness objective, although they acknowledge that the objective encompasses providing information useful in assessing management's stewardship.⁶

⁴ Paragraph OB1 of Chapter 1 of the *Preliminary Views* document.

⁵ Paragraph OB2 of Chapter 1 of the *Preliminary Views* document.

⁶ Paragraph OB28 of Chapter 1 of the *Preliminary Views* document.

- 1.6 In the case of not-for-profit entities, we consider that stewardship or the discharge of accountability is a significant aspect of the objective of financial reporting and should either be identified as a separate objective or recognised within a single objective.^{7 8}
- 1.7 The Conceptual Framework of each of the countries participating in the monitoring group includes accountability or stewardship explicitly within its objective of financial reporting. In some cases this is included as a separate additional objective and in other cases by inclusion within a single objective.
- 1.8 The recent UK exposure draft of the *Statement of Principles for Financial Reporting: Proposed Interpretation for Public Benefits Entities* explains 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.⁹
- 1.9 The Canadian Section 1000 *financial statement concepts* (applicable to for-profit entities and private sector not-for-profit entities) states that the objective of financial statements is to communicate information that is useful to investors, members, contributors, creditors and other users...in making their resource allocation decisions and/or assessing management stewardship.¹⁰ It also states: "Information regarding discharge of the stewardship responsibilities is especially important in the not-for-profit sector where resources are often contributed for specific purposes and management is accountable for the appropriate utilization of such resources."¹¹
- 1.10 New Zealand's *Framework for the Preparation and Presentation of Financial Statements* is the same as the existing IASB Framework except for a small number of modifications. It adds to the IASB's Objective, for **all entities** in New Zealand, as follows: "In addition to making economic decisions ... users of financial statements of New Zealand entities may also be interested in how well an entity has demonstrated its accountability in relation to a range of obligations including the entity's compliance with legislation, regulations, common law and contractual agreements."

⁷ We draw your attention to Appendix B to Chapter 1 of the *Preliminary Views* document which indicates that two IASB Board members would prefer stewardship to be identified as a separate objective of financial reporting.

⁸ The latter could be done as currently done in Australia – see paragraph 1.11 below.

⁹ Refer to Paragraph 1.4 of the ED *Statement of Principles for Financial Reporting: Proposed Interpretation for Public Benefit Entities*.

¹⁰ Paragraph 15 of Section 1000 *financial statement concepts*.

¹¹ Paragraph 14 of Section 1000 *financial statement concepts*.

- 1.11 The Australian Framework is also the same as the existing IASB Framework except for a small number of modifications. It has not added to the IASB's Objective but has referred readers to a more detailed discussion in a separate Statement of Accounting Concepts¹². That Statement specifies the objective as being to "provide information useful to users for making **and evaluating** decisions about the allocation of scarce resources"¹³. (emphasis added) It goes on to state a further concept namely that: "Managements and governing bodies shall present general purpose financial reports in a manner which assists in discharging their accountability".¹⁴
- 1.12 The International Public Sector Accounting Standards Board has stated the objectives of financial reporting should be to provide information useful for decision-making, and to demonstrate accountability of the entity for the resources entrusted to it.¹⁵
- 1.13 Not-for-profit entities have an obligation to account for their use of the resources made available to them – resources are typically provided from sources unrelated to the recipients of goods and services delivered by the entities. Users want to know how resources were acquired and used, whether the ability to deliver goods and services has improved or deteriorated from the previous year and how well the goods and services were delivered. While some users will make resource allocation decisions with this information (such as to increase or decrease their support) some will have no such power but will still desire the information. We do not therefore suggest that an accountability or stewardship objective should replace the decision-usefulness objective, but that it should be an additional objective or recognised within a single objective.

A need to broaden the users and establish an alternative primary user group

- 1.14 The *Preliminary Views* document identifies equity investors, creditors, suppliers, employees, customers, governments and their agencies and regulatory bodies, and members of the public as the potential users of financial reports.¹⁶ The document

¹² SAC 2 Objective of General Purpose Financial Reporting.

¹³ Paragraph 43 of SAC 2.

¹⁴ Paragraph 44 of SAC 2.

¹⁵ IPSAS 1 The Presentation of Financial Reports, paragraph 13.

¹⁶ Chapter 1, paragraph OB6 of the *Preliminary Views* document.

goes on to highlight present and potential investors and creditors as the primary users.¹⁷

- 1.15 Not-for-profit entities have a wider group of users. The users include those who provide resources to the organisation in the form of contributions. This category of user might be described as present and potential funders and financial supporters.¹⁸ These users are interested in information about the utilisation of the resources provided to the entity that might be useful in making decisions about resources they may choose, or be required, to provide in the future. They are also interested in stewardship of management of the resources under its control.
- 1.16 In considering the designation of a primary user group, it is important to note that the primary user group designated in the *Preliminary Views* document (present and potential investors and creditors) typically only exists in the form of creditors in the context of not-for-profit entities. We consider the most appropriate primary user group for not-for-profit entities is the funders and financial supporters. These may be described as the not-for-profit sector equivalent of investors.

The inappropriateness of the pervasive cash flow focus

- 1.17 The *Preliminary Views* document states that “to help achieve its objective, 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 inflows and thus to provide returns to investors and creditors.”¹⁹
- 1.18 A concentration and focus on the ability to assess cash flow prospects is evident throughout the discussion of the Objective of Financial Reporting and is also evident in the following chapter on the Qualitative Characteristics of Decision-useful Financial Reporting Information.
- 1.19 For not-for-profit entities, cash flows are also important. However other aspects are generally more significant. These are matters related to the resources that are

¹⁷ Chapter 1, paragraph OB12 of Chapter 1 of the *Preliminary Views* document. The reasons for designating a primary group of users and for the primary user group selected are explained in Paragraphs BC1.14 to BC1.17 of the *Preliminary Views* document.

¹⁸ Refer to Paragraph 1.2(b) of the UK ED *Statement of Principles for Financial Reporting: Proposed Interpretation for Public Benefit Entities*.

¹⁹ Chapter 1, paragraph OB3 of the *Preliminary Views* document.

available to deliver future goods and services, the quality, cost and effectiveness of goods and services that have been delivered in the past and how well the organisation is meeting its objectives.

- 1.20 Assets of not-for-profit entities typically represent a store of future services rather than a means to generate cash flows. This has a pervasive and significant impact on the objective of financial reporting for not-for-profit entities.

A possible future issue - the scope of financial reporting

- 1.21 The objective of financial reporting as stated in the *Preliminary Views* document pertains to all of financial reporting, not just financial statements.²⁰ The monitoring group welcomes this.
- 1.22 However, we note that in the context of not-for-profit entities information about service performance is also important and the issue of what information is necessary to achieve the objective of financial reporting for these entities is a matter of importance to be considered as the project progresses.
- 1.23 The Basis for Conclusions in the *Preliminary Views* document has also indicated that whether financial reporting should include prospective information or forecasts is a matter to be considered later in the project.²¹ In that context, we would note that budgets and the comparison of actual amounts with budgeted amounts are more important in the not-for-profit sector. This can be because the operations of many not-for-profit entities are funded significantly by regular contributions provided on the basis of a formal published budget.
- 1.24 Accordingly, the monitoring group has identified a risk that the boundaries of the objective of financial reporting for private sector businesses may implicitly be narrower than is necessary for it to meet the needs of users in the not-for-profit sector.

²⁰ Paragraphs BC1.3 to BC1.7 of Chapter 1 of the *Preliminary Views* document.

²¹ Paragraph BC1.5 of Chapter 1 of the *Preliminary Views* document.

Part 2 Qualitative Characteristics of Decision-useful Financial Reporting Information

2.1. The *Preliminary Views* document has proposed the following as the qualitative characteristics of decision-useful information:

- relevance
- faithful representation
- comparability; and
- understandability

The qualities are subject to two pervasive constraints:

- materiality; and
- benefits that justify costs.²²

2.2. The qualitative characteristics proposed in the *Preliminary Views* document appear generally to be appropriate to not-for-profit entities. However, each characteristic needs to be interpreted in the context of the objective of financial reporting and, accordingly, our concerns in relation to the objective need also to be borne in mind here. For example, for information to be relevant, it will need to be relevant to users. As some of the users of not-for-profit entities differ from those of private sector businesses, then the nature of relevant information should also be expected to differ.

2.3. Some of the specific concerns raised in relation to the objective of financial reporting manifest themselves in the commentary supporting the qualitative characteristics. For example, paragraph QC8 states, in part, that “*relevant* information is capable of making a difference in the decisions of users by helping them to evaluate the potential effects of past, present or future transactions or other events on future cash flows...” While this statement may be appropriate to private sector businesses, relevant information would, in our view, be described differently for not-for-profit entities. Similarly we note that what is material in the context of the constraints on the

²² Paragraph QC7 of Chapter 2 of the *Preliminary Views* document.

qualitative characteristics will probably differ in some instances for not-for-profit entities.²³

- 2.4. We also note that the concentration on cash flow prospects is evident through the qualitative characteristics material. The quote from paragraph QC8 above is illustrative of this point.
- 2.5. Apart from the flow-on effect of the issues we have raised in relation to the Objective of Financial Reporting, there is only one other issue that we wish to raise. That relates to the pervasive constraint “*that benefits should justify the costs*”.
- 2.6. The discussion of this pervasive constraint, at paragraphs QC53 to QC59 of the *Preliminary Views* document, does not discuss the possibility of a different cost-benefit judgement being made for different types of entities. We note however that paragraph BC1.25 in the Basis for Conclusions for Chapter 1 of the *Preliminary Views* document suggests that cost benefit constraints may sometimes lead standard-setters to provide exemptions from specific requirements or require other differences in reporting requirements for some types of entities. We agree with that statement and the later comment in that paragraph that standard-setters have concluded in these situations that the objective can be satisfactorily achieved by financial reports prepared in accordance with such requirements, not that different requirements are needed because the objective is different. However we would emphasise that different benefit cost assessments may well be appropriate when considering not-for-profit entities because of the different objective of these entities, the broader and sometimes different users and because the incidence of the benefits and costs will differ.

²³ For example paragraph NZ 30.1 of the NZ Framework explains that information may be material where it could influence the decision-making and evaluations of users about the allocation of resources and stewardship of resources, and the performance of the entity, made on the basis of the financial statements.

Appendix A The Nature of Not-for-profit Entities in the Private and Public Sector

A 1.1 In this Appendix we set out some of the characteristics of not-for-profit entities in the private and public sector. At this stage, we do not attempt to define not-for-profit entities.

A 1.2 From our experience in monitoring the IASB/FASB Conceptual Framework Project thus far, the issues that emerge in relation to applying the concepts to all not-for-profit entities can generally be related back to the characteristics of these entities. For that reason we think it is important to explain what some of their general characteristics are.

Private sector

A 1.3 Not-for-profit entities in the private sector generally have the following characteristics:

- their objective is to provide goods and services to various recipients and not to make a profit;
- they are generally characterised by the absence of defined ownership interests that can be sold, transferred or redeemed or that convey an entitlement to a share of a residual distribution of resources, including on liquidation of the entity;
- they may have a wide group of stakeholders to consider (including the public at large in some cases);
- most of their revenues generally are contributions rather than sales. Contributions may be solicited in the form of donations or assessed such as through membership dues; and
- their capital assets are typically acquired and held to deliver services without the intention of earning a return on them.

A 1.4 There are many similarities between business (for-profit) and not-for-profit entities in the private sector. Specifically, the basic accounting systems and the accounting for most transactions is the same. However financial reporting is concerned with the needs of users of financial information and the different objective of not-for-profit

entities does have a significant influence on the needs of the users of their financial reports. Some of these issues emerge in Parts 1 and 2 of this Report.

Public sector

A 1.5 Not-for-profit entities in the public sector have very similar key characteristics to not-for-profit entities in the private sector.

A 1.6 These entities are typically established by legislation and:

- their objective is to provide goods and services to various recipients or to develop or implement policy on behalf of governments and not to make a profit;
- they are almost always characterised by the absence of defined ownership interests that can be sold, transferred or redeemed;
- they typically have a wide group of stakeholders to consider (including the public at large);
- their revenues are generally derived from taxes or other similar contributions obtained through the exercise of coercive powers; and
- their capital assets are typically acquired and held to deliver services without the intention of earning a return on them.

Appendix B Application to Not-for-profit Public Sector Entities

- B 1.1 In this Appendix we highlight some particular issues which emerge from the *Preliminary Views* document in relation to public sector entities that do not have a profit objective.
- B 1.2 Each of the significant issues raised in Parts 1 and 2 of this Report is also an issue in the context of public sector not-for-profit entities. Accordingly this Appendix highlights only those aspects that are particularly significant for these entities or where the slightly different characteristics raise additional aspects deserving comment.
- B 1.3 Accountability or stewardship is a key *objective of financial reporting* for public sector not-for-profit entities such as governments or their sub-entities. For example the Canadian Section PS 1100 *financial statement objectives – federal, provincial & territorial governments* includes as one of its objectives: “Financial statements should demonstrate the accountability of a government for the resources, obligations and financial affairs for which it is responsible by providing information useful in: (a) evaluating the financial results of the government’s management of its resources, obligations and financial affairs in the accounting period; and (b) assessing whether resources were administered by the government in accordance with the limits established by the appropriate legislative authorities.”²⁴
- B 1.4 Public sector not-for-profit entities also have additional and sometimes different *users*. They include funders and financial supporters, including the public through the payment of taxes. They also have governing or oversight bodies that might be described as legislatures or elected/appointed representatives. These representatives are likely to use information to assess the entity’s achievements against objectives including how efficiently and effectively goods and services have been provided.
- B 1.5 In the case of public sector not-for-profit entities both funders and financial supporters and legislatures should be encompassed within the primary user group.
- B 1.6 In relation to *the scope of financial reporting*, budgets have major significance for public sector not-for-profits. Furthermore, because the objective of these entities is not the making of a profit, information about the service performance of the entities is likely to be necessary to meet the needs of users.

²⁴ Paragraph .62 of Section PS 1100.