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# Heads Up

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# FASB and IASB Jointly Issue Preliminary Views Documents on Conceptual Framework for Financial Reporting

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This month, the FASB and IASB published for public comment an IASB Discussion Paper and a FASB Preliminary Views document, *Conceptual Framework for Financial Reporting: Objective of Financial Reporting and Qualitative Characteristics of Decision-Useful Financial Reporting Information* (collectively "the document"). These documents, identical in all significant respects, are the first in a series of expected publications. The Boards, aiming to replace their separate frameworks, plan to issue other discussion papers and preliminary views documents that will seek comments on improving their conceptual framework for financial reporting. The Boards expect to conduct the project in eight phases.

The Boards' initial focus is on business entities in the private sector. The concepts developed through this project will then be considered for application to financial reporting for other entities, such as not-for-profit entities and business entities in the public sector.

The documents can be downloaded as follows:

- www.fasb.org/draft/pv_conceptual_framework.pdf (FASB)
- www.iasb.org/uploaded_files/documents/8_891_DP_ConceptualFramework.pdf (IASB)

The Boards are seeking comments by November 3, 2006.

## Objective

Currently, the FASB uses the *Statements of Financial Accounting Concepts* and the IASB uses the *Framework for the Preparation and Presentation of Financial Statements*, each of which forms the foundation for the Boards to set consistent standards. Why are the Boards rethinking their existing frameworks? The Boards believe a common conceptual framework that is both complete and internally consistent is essential for the development of accounting standards that are principles-based, internally consistent, internationally converged, and lead to financial reporting that provides the necessary information to financial statement users. That framework will build on the existing IASB and FASB frameworks and consider developments that have occurred since the original frameworks were issued.

The document includes two chapters:

- Chapter 1: The Objective of Financial Reporting
- Chapter 2: Qualitative Characteristics of Decision-Useful Financial Reporting Information

The chapters are discussed below.

## Chapter 1: The Objective of Financial Reporting

Chapter 1 sets out to establish the overall objective of general purpose external financial reporting by business entities. According to the document, the objective 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.

The document identifies investors, creditors, suppliers, employees, customers, governments and regulatory bodies, and members of the public as the significant users of financial reports and discusses their differing needs and financial reporting requirements. The Boards have taken the view that investors and creditors are the most prominent groups who use the information, and therefore the information these groups require typically meets the needs of other users of financial reports.

The document states that financial reporting should provide information that enables these users to assess the amounts, timing, and uncertainty of the entities' future cash flows; their economic resources (assets); and the claims to those resources (liabilities and equity). Information about the effects of transactions and other events that change assets and liabilities is also essential. Financial reporting should also include management's explanations, since management knows more about the entity than external users. Such explanations will provide insight into significant estimates and assumptions used by management.

The Boards noted that users of financial reports should be aware of the limitations of that information — specifically, that the information, to a large degree, is based on estimates rather than exact measures. Additionally, users should recognize that financial reports are but one source of information needed by those who make investment, credit, and similar resource allocation decisions. Information about general economic conditions, political events, and industry outlooks should also be considered.

The document discusses the benefits of accrual accounting and how it provides a better basis for assessing future cash flows than one based solely on an entity's current cash receipts and payments. Without accrual accounting, important assets and liabilities would be excluded from financial statements.

## Chapter 2: Qualitative Characteristics of Decision-Useful Financial Reporting Information

Chapter 2 considers the qualitative characteristics of decision-useful financial reporting information: relevance, faithful representation, comparability, and understandability.

The document defines these characteristics as follows:

- *Relevant* information is capable of making a difference in users' decisions by helping them to (1) evaluate the potential effects of past, present, or future transactions or other events on future cash flows or (2) confirm or correct previous evaluations. *Timeliness* is considered another aspect of relevance.
- For the information to be useful in making decisions it must be a *faithful representation* of the real-world economic phenomena that it purports to represent (this replaces the characteristic of *reliability* that appears in the Boards' current frameworks). Faithful representation ensures that financial reports represent the substance of a transaction rather than solely its legal form. Faithful representation also means the information must be verifiable, neutral, and complete. *Neutrality* is defined in the framework as the absence of bias intended to

attain a predetermined result or induce a particular behavior. *Neutrality* is incompatible with *conservatism* and thus the Boards excluded *conservatism* as a desirable quality of financial reporting information.

- *Comparability* enables users to identify similarities in and differences between two sets of economic phenomena. *Comparability* is accomplished through consistency of accounting policies and procedures.
- *Understandability* enables users who have a reasonable knowledge of business and economic and financial activities to comprehend the information. *Understandability* is enhanced when the information is classified, characterized, and presented clearly and concisely; however, relevant information should not be excluded solely because it may be too complex or difficult for some users to understand.

The document notes that these qualities are constrained by *materiality* and *benefits that justify costs*. Information is considered to be *material* if its omission or misstatement could influence the decisions that users make based on the financial report. ***Materiality* is not a matter to be considered by standard setters but by preparers**. *Materiality* judgments are made based on the nature and the amount of an item; therefore, a uniform threshold cannot be established. The benefits of the financial information should justify the costs in providing and using it. Standard setters should seek information from constituents about the nature and amount of the expected direct and indirect costs associated with a proposed standard and use this information in their deliberations.

The Boards considered additional characteristics such as *transparency*, *true and fair view*, *credibility*, *internal consistency*, *and high quality*. Based on a variety of reasons discussed in the document, the Boards determined these characteristics are either already incorporated within the characteristics identified or should not be considered qualitative characteristics of decision-useful information.

## Future Phases

The Boards and their staffs are currently working on three other phases of the conceptual framework:

- Definitions and recognition of elements of financial statements,
- Initial and subsequent measurement of items in financial statements, and
- The definition and boundaries of a reporting entity.

In a later phase of the project, the Boards will consider matters of financial statement presentation and disclosures, as well as the role that standard setters should play in improving the quality of management commentary that accompanies the financial statements.

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