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Release of preliminary views documents on conceptual framework for financial reporting

In July, the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) published for 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**. The Boards are seeking comments by 3 November 2006.

These documents, identical in all significant respects, are the first in a series of anticipated 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.

Ken Wild, Deloitte's global IFRS leader, says:

"The release of these documents has sparked an intense debate over the place of stewardship in financial reporting, which highlights a fundamental difference between the UK/European and the US understanding of its role. In the discussion paper, stewardship is effectively demoted to a secondary ranking of financial reporting objectives, which is consistent with how it has traditionally been viewed in the US. In Europe, the notion of retrospective accountability for the use of resources entrusted to management is seen as equally important as reporting the future wealth-generating potential of those resources. Already some investor groups are objecting to the apparent downgrading of stewardship. This is significant, because when investors, seen as the primary users of the accounts, are saying that the IASB and FASB are getting it wrong, the Boards must take notice."

Objective of the project

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

The discussion paper has two chapters:

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

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 discussion paper, that overall 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 discussion paper 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 that the information these groups require typically meets the needs of other users of financial reports.

The discussion paper states that financial reporting should provide information that enables these users to assess the amounts, timing and uncertainty of the entity's future cash flows; its 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 considered whether stewardship should be a separate objective of financial reporting. Although there were strongly-held views on both sides of this issue, the Boards concluded that providing information useful in assessing how management has fulfilled its stewardship responsibility should remain as part of the overall objective of providing information useful in making resource allocation decisions. They were reluctant to eliminate any discussion of stewardship, as this could erroneously imply that they do not think that financial reports should provide information that is useful in assessing stewardship.

The Boards note that users of financial reports should be aware of the limitations of the information included in such reports – specifically, that the information, to a large degree, is based on estimates rather than exact measures. Additionally, users should recognise 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 discussion paper also outlines 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 (including consistency) and understandability.

The discussion paper defines these characteristics as follows:

- Relevant information is capable of making a difference in users' decisions by helping them either 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 (making information available before it loses its capacity to influence decisions) 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 discussion paper as the absence of bias intended to attain a predetermined result or induce a particular behavior. **Neutrality** is incompatible with **conservatism** (or prudence) 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 either from period to period within an entity or in a single period across entities.

- **Understandability** enables users who have a reasonable knowledge of business and economic and financial activities and financial reporting, and who study with reasonable diligence to comprehend the information. **Understandability** is enhanced when the information is classified, characterised 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 discussion paper notes that these characteristics 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 – consequently, a uniform threshold cannot be established. The benefits of the financial information should justify the costs of providing and using it. Standard-setters should seek information from constituents, including preparers and users, 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 outlined in the discussion paper, the Boards determined that these characteristics are either already incorporated within the characteristics identified above, or that they 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.

Comment deadline

The comment deadline for the proposals is 3 November 2006.

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