ITC 11 sub 3

New South Wales
TREASURY

Professor David Boymal
The Chairman
Australian Accounting Standards Board
PO Box 204
Collins Street West
Vic 8007

Contact: D. McHugh
Telephone: (02) 9228 5340
Our Reference:
Your Reference:

Dear Professor Boymal

IASB Discussion Paper on the Conceptual Framework

Please find attached comments on the Invitation to Comment *Request for Comment on 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'*, together with a copy of comments submitted to the International Accounting Standards Board (IASB).

The Conceptual Framework is the foundation for Australia's policy on transaction neutral accounting. Therefore, the proposed IASB Conceptual Framework could have significant implications to the Australian Accounting Standard setting process, and the not-for-profit sector in particular.

NSW Treasury believes that the three issues raised by the four national standard-setters on the IASB Discussion Paper, particularly insufficient emphasis given to the accountability or stewardship objective, are equally relevant to the private sector.

Therefore, NSW Treasury believes that the AASB should lobby the IASB for greater emphasis on accountability and past performance (instead of future cash flows). In arguing for this, the AASB at the same time will be arguing to incorporate the commonalities between the for-profit and not-for-profit entities to the maximum extent possible. This is imperative to ensuring that Australia is able to continue with sector or transaction neutrality and a single Accounting Standard setting process.

Accordingly, NSW Treasury would also urge the IASB (and the AASB to argue to the IASB) to continuously consider not-for-profit entities throughout the development of the project. The national standard-setters' paper provides an important input into this process.

If you have any queries regarding the attached comments, please contact either myself on 02 9228 3019 or Dianne McHugh on 02 9228 5340.

Yours faithfully

Robert Williams
for Secretary

Specific Matters for Comment –
IASB Discussion Paper on the Conceptual Framework

What matters do you consider require attention if this revised Framework were also to be applied in Australia to not-for-profit entities in the private and public sectors and for-profit entities in the public sector?

NSW Treasury largely agrees with the findings of the national standard-setters in their report *Application to not-for-profit entities in the private and public sector* (2006) and in particular, their views regarding:

- Insufficient emphasis on accountability / stewardship;
- Need to broaden the identified users; and
- The inappropriateness of the pervasive cash flow focus.

NSW Treasury believes that many of the comments made by the national standard-setters are also applicable to the private sector, particularly insufficient emphasis on accountability or stewardship. In most respects, NSW Treasury believes that the differences between the public and private sector are more differences of emphasis rather than fundamental differences.

Therefore, NSW Treasury believes that the AASB should lobby the IASB for greater emphasis on accountability and past performance (instead of future cash flows). In arguing for this, the AASB at the same time will be arguing to incorporate the commonalities between not-for-profit and for-profit entities in the new IASB Conceptual Framework. This is essential to the concept of transaction neutrality and the single Accounting Standard setting process in Australia, as it will minimise the potential for future divergences between not-for-profit and for-profit entities.

Accordingly, given the commonalities between the private and public sector and the work already done by the national standard-setters, NSW Treasury would also urge the IASB (& the AASB to lobby the IASB) to urgently reconsider its decision to exclude not-for-profit entities from the scope of the draft Framework. NSW Treasury believes that the IASB should review the implications on not-for-profit entities continuously throughout the project.

Further, it would assist Australian transaction neutrality, if the terminology used in the draft Framework was more inclusive. This could be achieved by describing the primary users in more generic terms (such as used previously in SAC 2), rather than more narrow terms such as ‘investors’ and ‘creditors’. In this respect, therefore, NSW Treasury prefers the use of terms such as ‘resource providers’ and ‘recipients of goods and services’ (per SAC 2), rather than the more specific terminology proposed by the national standard-setters i.e. ‘present and potential funders and financial supporters’.

Finally, NSW Treasury believes that the AASB should resist any attempts (at this stage) at differentiating the public sector too much. This may be tantamount to giving up transaction neutrality and a single Accounting Standard setting process prematurely.

These comments are further elaborated on as part of NSW Treasury’s submission to the IASB (refer attached).

New South Wales
TREASURY

Li Li Lian
Assistant Project Manager
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Contact: D. McHugh
Telephone: (02) 9228 5340
Our Reference:
Your Reference:

Dear Li Li

Discussion Paper on the Conceptual Framework

Please find attached comments on the 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'*.

New South Wales Treasury has significant concerns regarding the general approach of the Paper and project, as well as the proposals itself. The approach taken in the Paper lacks academic rigour and is based on the false premise that there is a consistent global model of corporate governance and law, based on the US federal system.

In terms of the proposals, NSW Treasury believes that the main issues of concern have already been identified for not-for-profit entities by the four national standard-setters in their paper *Application to not-for-profit entities in the private and public sector*. However, these issues are equally applicable to private sector entities i.e.

- Insufficient emphasis on accountability / stewardship;
- Need to broaden the identified users; and
- The inappropriateness of the pervasive cash flow focus.

To ensure robust conclusions, NSW Treasury would urge the IASB to urgently reconsider its previous decision and to review the implications on not-for-profit entities continuously throughout the project.

If you have queries regarding NSW Treasury's comments, please contact myself on 612 9228 3019 or Dianne McHugh on 612 9228 5340.

Yours faithfully

Robert Williams
for Secretary

PRELIMINARY VIEWS ON AN IMPROVED CONCEPTUAL FRAMEWORK FOR FINANCIAL REPORTING
NEW SOUTH WALES TREASURY COMMENTS

1. Introduction

NSW Treasury has significant concerns regarding the Discussion Paper. The main concerns with the general approach of the Paper and project are that it:

- Lacks academic rigour as it does not examine alternative views.
- Is based on a protracted phased approach that will be difficult to implement.
- Does not accommodate or reflect the different legal frameworks of countries such as the UK, Australia and European countries.
- Is premised on the false presumption that there is a consistent global model of corporate governance and law, based on the US federal system.

In terms of the Paper's proposals, NSW Treasury believes that the main issues of concern have already been identified for not-for-profit entities by the four national standard-setters in their paper *Application to not-for-profit entities in the private and public sector* (2006). However, these issues are also applicable to private sector entities i.e.

- Insufficient emphasis on accountability / stewardship;
- Need to broaden the identified users; and
- The inappropriateness of the pervasive cash flow focus.

These concerns largely stem from using the US federal system as a surrogate for a unified global corporate governance and legal framework, which in fact does not exist.

The primary purpose of financial reporting under the US federal system is to price shares. Accountability is therefore restricted to buyers and sellers in secondary markets. The emphasis is on ensuring companies don't make fraudulent statements, rather than more generally protecting company assets and shareholder rights. This is because, in the US, shareholder rights and corporate governance matters are largely State issues.

In contrast, in countries such as Australia, UK and Europe, the primary purpose of financial reporting has been accountability to shareholders. Therefore the financial report is meant to show the truth of the company's operations and how well it has been run.

Therefore, the Discussion Paper, which reflects the US bias, has the following potentially negative consequences for countries, such as Australia, whose legal frameworks have an accountability focus:

- Weakening of shareholder rights.
- Earnings or valuation focus for predictive purposes, rather than a more rounded or balanced view based on both income and the balance sheet.
- Greater rules based approach rather than substance over form.
- Greater focus on secondary market users, who are one step removed from the process.
- Greater possibility that real and consequential loss will not be identified.
- Disconnect between the objectives of the company and the objectives of financial reporting.
- GAAP will lag business failures rather than pre-empt them.
- Objectives of financial reporting may be potentially inconsistent with the scope of financial reporting.

2. The paper is not a Discussion Paper – it lacks academic rigour and presents views without discussing alternative options

NSW Treasury has significant concerns with the general approach of the Discussion Paper. While the document is described as a 'Discussion Paper', it is instead the IASB's 'Preliminary Views'. The Paper, therefore, lacks academic rigour as it does not adequately discuss the major issues and alternative propositions.

Normally, a discussion paper will present and refer to a wide variety of academic and other literary / professional sources and discuss significant conceptual issues. In contrast, the Discussion Paper makes no such references. The Paper only refers to alternative views in passing (e.g. refer basis for conclusions), to then dismiss them, with the objective of justifying the Board's preliminary views.

NSW Treasury strongly believes that, in assessing fundamental issues, such as the objectives of financial reporting, it is essential that the Boards go back to first principles and revisits the history and the drivers of financial reporting across the world.

In this respect, a major deficiency in the Paper is that it is based on the false assumption that there is a consistent global model of corporate governance and law, based on the US federal system, where this is not the case. At a minimum, the Discussion Paper would need to include an analysis regarding different legal frameworks and how or whether these can be accommodated within a single Conceptual Framework (refer section 4 below).

Further, issues such as faithful representation are not discussed in a meaningful way. That is, there is no discussion regarding what property/ies are being measured. For example, the draft Framework states that whether historic cost or fair value information provides a more relevant and representationally faithful depiction is an issue for standard-setters to resolve. However, NSW Treasury would argue that this is a role for the Framework.

For issues as fundamental as these, a true dialogue is required, which needs to involve all parties to general purpose financial reporting. This dialogue may be better facilitated by a more collaborative approach, including a series of forums, discussion papers and independent viewpoints.

3. Difficulties with general approach to the different phases of the Conceptual Framework

NSW Treasury is concerned with the phased approach of the Conceptual Framework project. While it is appreciated that this is a significant project, a protracted phased approach is problematic given the interrelationship between different phases. For example, it is difficult to comment on qualitative characteristics such as 'faithful representation' without also understanding the implications for 'measurement' which will not be addressed until a later phase.

Further, NSW Treasury is significantly concerned by the Board's decision to delay not-for-profit implications until the conclusion of the project. It is difficult to envisage that after completing most of the phases, the Board will go back and re-consider the application of these concepts to not-for-profit entities in any meaningful way.

The relevance of not-for-profit issues is also illustrated by the four national standard-setters' paper *Application to not-for-profit entities in the private and public sector* (2006). In NSW Treasury's view, the deficiencies identified by the national standard-setters for not-for-profit entities are also applicable to for-profit entities. Accordingly, NSW Treasury strongly believes that the Board should consider not-for-profit entities continuously throughout the phases. This is necessary to ensuring robust conclusions are reached. This is discussed further below (refer section 10).

4. Discussion Paper does not accommodate different legal frameworks and is based on the false assumption that there is a consistent global model of corporate governance

The proposed conceptual framework will need to accommodate different legal frameworks across the world. The Discussion Paper, as currently drafted, seems to reflect a view that there is a consistent global model of corporate governance and law. But this is not the case. Therefore, NSW Treasury has significant concerns with the preliminary views, as drafted.

In particular, it is noted that across the Western world, while there is an appearance of a 'common language', there are in fact significantly different purposes of financial reporting, roles of auditors and relationships with Boards and management. This is illustrated in the publication *'Divided by common language'* by Tim Bush (2005).

Therefore, it is not sufficient to only compare the existing IASB Framework with the US Framework, without also considering the jurisdictions that are now applying IFRS and their legal and previous conceptual frameworks. The current IASB Framework was developed prior to the adoption of IFRS by the European Union and other countries such as Australia. The adoption of the existing IASB Framework by such countries generally occurred without any opportunity to comment or influence the IASB Framework (except as an observer of the international process, which at the time did not directly impact on these countries). Therefore, it is not appropriate to only compare the IASB Framework with the US Framework without also examining the legal framework of the countries that are adopting the IFRS requirements.

This is necessary to reflect the fact that the IFRS requirements are applied by a disparate group of countries, subject to different legal or historic influences. As part of the Framework project, the IASB needs to undertake a more fundamental analysis of the objectives of financial reporting across the countries that are applying IFRS.

For example, some key differences between the UK and US models identified by Tim Bush (2005) include:

Attribute	UK	US-SEC
Basis of law affecting core financial reporting framework	Predominantly civil law	Federal regulation
Primary purpose of audited accounts	Accountability	Pricing of shares
Who is overseeing who?	Auditors act for shareholders	Auditors act for boards
Path of accountability	Shareholders to judge whole Board	Independent directors to assess management presentation
Legal basis underpinning accounting standards	Principles - economics	Rules – letter of law
Development of accounting / auditing, as led by law	Income and balance sheets	Focused heavily on earnings

Source: information extracted from Appendix 2 'Divided by Common Language'

From the above, it can be shown that, while at face value, existing US and IASB Frameworks are similar, what underlies the legal frameworks of the countries that adopt them is quite different. This is not recognised in the Discussion Paper. The main difference concerns the primacy given to accountability and stewardship in the legal frameworks of countries such as the UK; which is not given in the US. In Australia, as in the UK, accountability and stewardship are central to the purpose of financial reporting.

In contrast, the US federal system is based on a very limited concept of accountability concerned with the appropriate pricing of shares. That is, the US legal framework and federal model focuses on a prospectus (or forwarding looking) approach, with the objective of ensuring accurate market pricing of shares for the secondary market. Corporate governance and shareholder rights are largely excluded from the US federal model because of constitutional problems.

Therefore, it can be shown that the US mindset has influenced the draft Framework in the following ways:

- A cash flow, earnings and valuations focus;
- An emphasis on the *future* rather than *past*;
- Defining accountability narrowly as only relating to *making* resource allocation decisions (i.e. not *evaluating* resource allocation decisions).
- Specifying accountability or stewardship only as a secondary objective of financial reporting.
- Focusing on investors in the secondary market (to provide information about whether to buy, hold or sell securities) rather than the long term shareholder.

Underlying the proposal to relegate accountability to a secondary objective is the view that corporate governance and financial reporting are two different things. In particular, the Basis for Conclusions argues that those who consider stewardship to be the broader objective may be mixing financial reporting and corporate governance matters (para BC1.38). Again this reflects the US federal regulatory model. That is, under the US federal system, corporate governance matters are largely left to the States. In contrast, under the UK and Australian model, the primary purpose of financial reporting is accountability to existing owners. Therefore, corporate governance and financial reporting are directly linked (also see section 5 below).

The inconsistency between the Discussion Paper and the legal frameworks in countries such as Australia, illustrates the biggest potential danger of the US bias and the drive to harmonise US and IFRS requirements, as Haswell notes:

> "Countries that seek to adopt IFRS for harmonisation purposes run the risk of being inundated with standards that are political compromises fought out in an arena far away and with no particular connection to their own priorities. Australia is the obvious example…" (Haswell, 2006, p 58)

5. Insufficient emphasis on accountability / stewardship

The four national standard-setters (2006) in their review of the IASB Discussion Paper concluded that there was insufficient emphasis on accountability or stewardship in the proposals for not-for-profit entities. NSW Treasury believes that this comment is equally applicable to both for-profit and not-for-profit entities.

In particular, NSW Treasury strongly believes that stewardship or accountability should be the main objective of financial reporting. In countries such as the UK, Europe and Australia, accountability and stewardship is the foundation of the legal frameworks and the main purpose of general purpose financial reporting.

The importance of accountability or stewardship is a reflection of the nature of the corporation and the separation of owners and management. To address the risk of self interest (or the 'agency' problem) in Australia, and other Commonwealth countries:

> "…statutes and regulations have sought to provide that financial statements shall be authenticated by independent auditors appointed for the purpose. The avowed object of prescribing the contents of these statements and of independent auditing is to secure…'a true and fair view' of the results and state of affairs of companies from time to time". (Chambers, 1966, p278).

In fact, the four national standard-setters (2006), note that each of their conceptual frameworks explicitly include accountability or stewardship objectives.

Further, Chambers states that:

> "…the financial aspects of the performance of managers may only be fairly judged on the basis of accounts *about* that performance…" (Chambers, 1966, p285).

In NSW Treasury's view, the main objective of financial reporting is to assess the performance of Boards and managers who act on behalf of shareholders. The financial report provides the mechanism to ensure that they are held accountable to the owners.

Therefore, the proposed Discussion Paper approach is not supported as it relegates stewardship to a secondary objective that is only a subset of '*making* resource allocation decisions'. In NSW Treasury's view, stewardship is about making *and evaluating* resource allocation decisions (per Australian Conceptual Framework SAC 2, para 43).

Accountability, therefore, is concerned both with future *and past* performance and cash flows. This means that stewardship or accountability is wider than the proposed overarching objective of financial reporting (para OB2). As currently defined, the proposal adopts only a limited concept of accountability which is focused on the *future* only.

Accordingly, in NSW Treasury's view, accountability should be broadly defined to encompass both the future and the past, and should be the primary objective of financial reporting. Any assessment of future cash flows should be a secondary objective.

6. Need to broaden the identified users

The four national standard-setters (2006) in their review of the IASB Discussion Paper concluded that there was a need to broaden the identified users in the proposals for not-for-profit entities. NSW Treasury believes that this comment is equally applicable to both for-profit and not-for-profit entities.

In particular, NSW Treasury is concerned that reference to investors and creditors as the primary users of financial reporting may be misinterpreted. Particularly, the concern is that by combining a narrow objective with a narrow primary user group, there may be a perception that the focus is on purchasers and sellers of shares on the secondary markets rather than long term shareholders. This perception is reinforced by referring only to *future* cash flows and *future* decisions, rather than accountability for the *past*. The implication is that rather than reporting an entity's performance, the objective is to inform decisions about whether to buy, sell or hold securities.

For these reasons NSW Treasury supports a more inclusive or generic term that captures the bulk of users. Alternative primary users include:

- Resource providers (including employees, creditors, investors, contributors etc); and
- Recipients of goods and services (including customers and beneficiaries),

and their advisors or representatives.

The above proposed primary user groups are also consistent with the concept of accountability. That is, more broadly, Boards and management of corporations are ultimately accountable to resource providers and recipients of goods and services. This approach is consistent with the Australian Statement of Accounting Concepts SAC 2 *Objective of General Purpose Financial Reporting.*

The use of more inclusive or generic terms is also a more robust approach which will also more readily accommodate not-for-profit entities.

7. The inappropriateness of the pervasive cash flow focus

The four national standard-setters in their review of the IASB Discussion Paper concluded that there was an inappropriate and pervasive cash flow focus in the proposals for not-for-profit entities. NSW Treasury believes that this comment is equally applicable to both for-profit and not-for-profit entities.

In particular, NSW Treasury is concerned that too much emphasis is given to the use of financial reports to assess the amounts, timing and uncertainty of *future* cash flows (para OB3). The 'prospectus' or forward-looking focus of annual financial reporting is used in place of accountability or stewardship for what has past.

As currently drafted, accountability is secondary to cash flow assessments. However, in NSW Treasury's view, cash flow assessments are a subset of accountability rather than the reverse. Providing information for the purposes of future cash flow assessments does not necessarily ensure Board's and management are held accountable for past decisions.

8. Consequences of adopting the proposals in the IASB Discussion Paper

NSW Treasury believes that the combination of insufficient emphasis on accountability, a narrow primary user group and an inappropriate focus of cash flows could have the following potentially negative consequences for countries, such as Australia, which operate under a different legal framework to the US.

Many of these negative consequences were also identified as part of the Tim Bush article *'Divided by Common Language'* (2005).

8.1 Weakening of shareholder rights

In converging different frameworks, it is necessary to accommodate different legal frameworks, without weakening these frameworks. However, adopting a Framework that demotes stewardship and accountability objectives may weaken existing systems of shareholder rights, in countries such as the UK, Europe and Australia.

8.2 Earnings or valuation focus for predictive purposes

A potential negative consequence of a cash flow focus is an increased bias on 'earnings' or 'valuations' to predict future cash flows for the secondary share market. This contrasts to a more rounded or balanced view based on both income and the balance sheet. Further, this means that any concept of accountability is limited, akin to the US where the objective is to ensure accurate share pricing or valuation. This would exclude from financial reporting, accountability for the past and information relevant to evaluating past resource allocation decisions.

8.3 Greater rules based approach rather than substance over form

Stewardship or accountability is closely aligned with the notion of substance over form and 'true and fair' presentation. Essentially, producing financial reports for accountability purposes is consistent with telling the 'truth' of how well the company is being run. This is also incorporated into Australia's legal framework (i.e. financial reports must present a true and fair value under the *Corporations Act 2001*).

However, if stewardship or accountability is relegated to a secondary objective, behind cash flows, there is a risk that a more rules based approach could prevail. This is because a cash flow approach emphasises earnings, which is based more on notions of precision, exactitude and rules.

The US accounting standards model is predominantly rules, rather than principles, based. Therefore, any US bias in the new Framework increases the risk of more rules-based Standards. This is supported by Haswell (2006) who concludes that there is already ample evidence of rules based Standards issued by the IASB, including IAS 12, IAS 39, IAS 36 and IFRS 2. Many of these Standards have been modelled on US Standards. Therefore, the danger is that the pressure to harmonise with the US will transport many of the US problems to the IFRS requirements.

In contrast, focusing on accountability or stewardship provides a strong and clear purpose for financial reporting. This helps guide Accounting Standard setters, when making individual Accounting Standards, as well as helping preparers of financial reports make difficult decisions about accounting treatments and disclosures. Where there is any doubt regarding the appropriate accounting treatment, notions of accountability and stewardship should drive preparers of financial reports to focus on showing the truth or substance of any transaction or event. In contrast, preparing financial reports for the objective of assessing future cash flows is much more ambiguous.

8.4 Greater focus on secondary market users

Focusing on a narrow group of investors, such as share traders, may result in the omission of information regarding the protection of the company's assets. This again relates to accountability objectives.

This is because the needs of long term shareholders are quite different to purchasers or sellers of shares on the secondary market. The long term shareholder is more concerned about ensuring good controls over business operations. In contrast, the short term trader in the secondary market may be more concerned about the accuracy of earnings in the financial statements rather than the quality of the corporation itself. The implications of this are further discussed in section 8.5 below.

8.5 Greater possibility that real and consequential loss will not be identified

By only focusing on information to assess future cash flows for secondary market users, there appears to be no need to provide information about whether in the past the entity has operated efficiently or operated within its powers. In this respect, financial reporting based on a cash flow focus, emphases reporting controls rather than business controls (e.g. safeguarding assets). This increases the possibility that real and consequential loss, arising from failures of business controls, will not be identified. However, this type of information is fundamental to the shareholders assessment of how well the company is being run.

This is illustrated by Bush (2005) who argues that purchasers or sellers of shares are more concerned with information loss rather than real and consequential loss (refer Appendix 1 to the article).

For example, if sales are diverted and not booked by the entity, the share trader will not be concerned, as long as that information is reflected in the earnings of the entity. In contrast, the long term shareholder would be concerned, as it will be the economic ‘loser’. But if the objective of financial reporting relates to pricing or valuations (& reporting controls rather than business controls), the shareholder may never be made aware of the fact that the Board has not acted in the shareholders’ interests, beyond noting that the earnings have reduced.

8.6 Disconnect between the objectives of the company and the objectives of financial reporting

A potential negative consequence of the narrow concept of accountability is that the objectives of the company and financial reporting are potentially disconnected. That is, financial reports will not necessarily report on a company’s performance, as accountability for past decisions is excluded from the objectives of financial reporting.

The focus instead of a Framework that emphasises cash flows is more on earnings and the accuracy of the financial statements. Therefore, the risk of this approach is that financial reporting will become an end in itself, potentially disconnected from the main objectives of the company. This further reinforces a compliance mindset.

In contrast, when accountability or stewardship is the primary objective of financial reporting, the objectives of the company, shareholder and directors (i.e. to meet the goals of the corporation) with financial reporting (to assess how well the company performed) are essentially aligned.

8.7 GAAP will lag business failures rather than pre-empt them

An environment that is more focused on cash flows, earnings, precision and rules results in a reactive Accounting Standard setting process. Under such frameworks, it is only when rules fail, that Accounting Standards will be amended. In this sense, Accounting Standards which have a rules bias will usually lag business failures rather than pre-empt them.

8.8. Consequences of adopting a wide scope of financial reporting but a narrow approach

The Discussion paper proposes a wide definition of financial reporting which extends beyond financial statements. However, the Discussion Paper notes that the boundaries of financial reporting and the distinction between financial reporting and financial statements will not be addressed until later phases. The Board believes that this will not significantly change the proposed objective of financial reporting (para BC1.4-BC1.5). This conclusion is then used to restrict the objective to financial statements.

NSW Treasury believes that unless the boundaries of financial reporting are fully scoped (as widely defined) it is not possible to state whether the proposed objective of financial reporting is likely to change.

For example, reference is made to whether financial reporting should include environmental or social information. Examining this area could significantly widen the objectives of financial reporting to include triple bottom line, corporate and social responsibility and sustainability reporting.

9. Difficulties with qualitative characteristics

9.1 Faithful representation - properties that are to be measured

The draft Framework provides that information must be a faithful representation of the real-world economic phenomena that it purports to represent (para QC16). However, the meaning of ‘real world economic phenomena’ depends on a discussion on measurement, which will not be addressed until a later phase. The linkage between these two phases is unclear.

In particular, to understand the meaning of ‘faithful representation’ requires an understanding of the property or properties that are to be measured. As currently used, the term may be seen to imply that there is one identifiable measurement. However, measurements are not of objects *per se* but of a property or properties of objects. The draft Framework limits its discussion on the property to be measured to the concept of ‘economic phenomena’ and depiction in financial terms using words and numbers. It infers that the property of economic phenomena to be measured is clearly understood.

But, in discussing whether historic cost or fair value is appropriate, the preliminary view states that whether one of those methods provides a more faithful representation of an object is an issue for standard-setters to resolve (para QC18). In contrast, NSW Treasury strongly believes that such fundamental principles are for the Framework resolve. In NSW Treasury’s view, to determine what is meant by faithful representation, the Framework needs to be clear about the nature of the property that is being measured.

For example, Chambers (1966) asserts that:

> "Every measurement of a financial property for the purpose of choosing a course of action – to buy, to hold, or to sell – is a measurement at a point of time, in the circumstances of the time, and in the units of currency at that time…We propose, therefore, that the single financial property which is uniformly relevant at a point of time for all possible future actions in markets is the market selling price or realisable price of any or all goods held…If a monetary scale is to serve as a measurement scale at any time, the significance attaching to any unit of it is necessarily its general significance, its general purchasing power" (p91-94).

In short, according to Chambers, the single property that should be measured is purchasing power i.e. the money that can be exchanged for objects. He argues that historic cost information of objects obtained at different points of time are not additive and therefore historic cost is not an appropriate measurement scale (i.e. as it is necessary that all measurements must be made in terms of the same units)

Therefore, a deficiency of the draft Framework is that it does not clearly specify the single property to be measured i.e. whether historic cost or fair value is appropriate. However, in contrast, the Discussion Paper asserts without proper explanation, that deferred charges and deferred credits are *not* real world economic phenomena. This further illustrates the lack of academic rigour and inconsistent approach of the Discussion Paper.

9.2 Faithful representation - substance over form

NSW Treasury disagrees with the conclusion that it is unnecessary to include substance over form as a separate qualitative characteristic. The Discussion Paper asserts that substance over form is implicit in the term faithful representation and therefore it is not necessary to include it as a separate qualitative characteristic. In NSW Treasury's view, this assertion could also be made regarding information that is 'verifiable', 'neutral' and 'complete'. Nonetheless the Discussion Paper still separately lists these qualities as components of faithful representation. For similar reasons, NSW Treasury believes that substance over form should be added to that list.

Further, the concept of substance over form goes to the heart of what, in NSW Treasury's view, is the objective of financial reporting. That is, to provide a mechanism for accountability and stewardship and to show the truth of an entity's operations. Therefore, the concept of substance over form is applicable to the whole financial report and not just individual transactions (refer section 8.3 above).

9.3 Faithful representation - verifiability

NSW Treasury agrees with the Alternative View (para AV2.2) that establishing that an inappropriate method has been applied without material error does not constitute verification. That is, verifiability must include some consideration as to whether the appropriate method has been adopted. This requires specification of the properties to be measured, as discussed above.

9.4 Timeliness could be considered a constraint on financial reporting rather than as part of relevance

‘Materiality’ and ‘benefits and costs’ are listed as constraints on financial reporting. It is unclear why ‘timeliness’ is not also described as a constraint, rather than as part of the qualitative characteristic of relevance. Timeliness constrains relevance in a similar manner as materiality. The only reason put forward is that timeliness constrains only relevance; while materiality constrains both relevance and faithful representation (para BC2.9). However, timeliness may also pertain to faithful representation i.e. it may be possible to obtain financial information which more faithfully represents a phenomena (i.e. more reliable) but it may take too long for that information to be relevant.

10. Not-for-profit specific comments

The Conceptual Framework is the fundamental base on which accounting standard-setting is built and is the foundation for Australia’s policy of transaction neutral accounting and a single set of Accounting Standards for both not-for-profit and for-profit sector entities. Underlying this is the notion that:

- like transactions and events should be treated consistently; and
- there is significant commonality between transactions and events in the for-profit and not-for-profit sectors.

For these reasons, NSW Treasury would urge the IASB to urgently reconsider its decision to exclude not-for-profit entities from the scope of the draft Framework.

It is understood that the Board has previously rejected such proposals to continuously review implications for not-for-profit entities. However, this seems to contradict the Boards support for monitoring the project from the perspective of not-for-profit entities by four national-standard-setters (2006). The IASB in supporting this work conceded that considering matters from a different perspective can ‘add robustness’ to the conclusions.

In NSW Treasury’s view, many of the comments provided by the national standard-setters are also applicable to private sector entities, particularly the comments regarding accountability and stewardship.

Therefore, to ensure robust conclusions, NSW Treasury would urge the IASB to review the implications on not-for-profit entities continuously throughout the project.

References

Bush, T (2005)
Divided by common language: Where economics meets the law: US versus non-US financial reporting models
The Institute of Chartered Accountants in England & Wales

Chambers, RJ (1966)
Accounting, Evaluation and Economic Behaviour
Prentice-Hall Inc, New Jersey

Haswell, S (2006)
'Over-complexity in Accounting Standards and the Emerging Duopoly of US GAAP and IFRS'
Australian Accounting Review, vol 16 No. 2, pp49-59

Chairs and senior staff of (2006):
- Australian Accounting Standards Board;
- Canadian Accounting Standards Board;
- Canadian Public Sector Accounting Board;
- New Zealand Financial Reporting Standards Board;
- United Kingdom Accounting Standards Board

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

Public Accounting Standards Board (1990)
Objective of General Purpose Financial Reporting
Statement of Accounting Concepts SAC 2
AARF, Melbourne.