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Mr David Boymal
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Dear Mr Boymal

David

**EXPOSURE DRAFT ED 164 - AN IMPROVED CONCEPTUAL FRAMEWORK FOR
FINANCIAL REPORTING: THE OBJECTIVE OF FINANCIAL REPORTING AND
QUALITATIVE CHARACTERISTICS AND CONSTRAINTS OF DECISION-USEFUL
FINANCIAL REPORTING INFORMATION**

Thank you for the opportunity to comment on Exposure Draft 164 regarding the International Accounting Standards Board's *Conceptual Framework*. This letter details the Heads of Treasuries Accounting and Reporting Advisory Committee's comments on ED 164 for consideration by the Australian Accounting Standards Board in forming its comments to the IASB. A copy of HoTARAC's comments to the IASB are also included for your information.

Although HoTARAC acknowledges that there have been some improvements in the IASB Exposure Draft, HoTARAC's overall view is substantially unchanged from the views expressed by HoTARAC to the AASB regarding the Preliminary Views Paper.

It is HoTARAC's opinion that the Conceptual Framework outlined in the Exposure Draft is inappropriate for the public sector. This view is consistent with the issues identified by the four national standard-setters in their Paper *A Report on the Application to Not-for-profit Entities in the Private and Public Sectors, July 2008* on the IASB Exposure Draft. These issues are substantially unchanged from the standard-setters' 2006 Paper on the IASB Preliminary Views. These specific issues are:

- insufficient emphasis on accountability / stewardship;
- a need to broaden the identified users; and
- too much emphasis given to the assessment of cash flows.

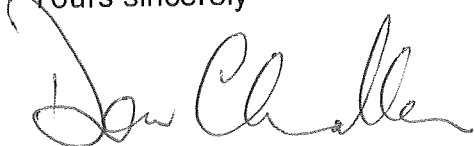
HoTARAC strongly encourages the AASB to lobby the IASB to address these issues and ensure that the Conceptual Framework is appropriate for the public sector. This is essential to the concept of transaction neutrality and the single Accounting Standard-setting process in Australia, as it will minimise the potential for future divergences between not-for-profit and for-profit entities.

However, HoTARAC agrees with the AASB preliminary view that, until such time as the IASB addresses these issues, it may be necessary to limit the applicability of those new or revised concepts to for-profit entities only. This may also be necessary to allow time for the AASB to consider the ramifications of the International Public Sector Accounting Standards Board's Conceptual Framework for Australian not-for-profit public sector entities.

In this regard, HoTARAC would strongly encourage the AASB to take an active role in the IPSASB's Conceptual Framework Project.

Please contact Robert Williams on 02 9228 3019 or Dianne McHugh on 02 9228 5340 from New South Wales Treasury if you wish to discuss these matters further.

Yours sincerely



D W Challen

CHAIR

HEADS OF TREASURIES ACCOUNTING AND REPORTING ADVISORY COMMITTEE

21 August 2008

Encl

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EXPOSURE DRAFT ED 164 - *An improved Conceptual Framework for Financial Reporting: The Objective of Financial Reporting and Qualitative Characteristics and Constraints of Decision-useful Financial Reporting Information*

- (a) *The AASB would welcome comments on the issues that would need to be considered if the proposed concepts 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*

Consistent with the views of the four national standard-setters in their Paper A *Report on the Application to Not-for-profit Entities in the Private and Public Sectors, July 2008*, HoTARAC believes that the following specific issues will need to be considered if the proposed concepts are also to be applied to the public sector in Australia:

- insufficient emphasis on accountability / stewardship – HoTARAC believes that stewardship / accountability needs to be included as a separate objective, rather than as a subset of “decision usefulness”;
- a need to broaden the identified users – HoTARAC believes that more generic or inclusive terms need to be used, such as “resource providers” and “recipients of goods and services”; and
- too much emphasis given to the assessment of cash flows - HoTARAC believes that decision usefulness needs to be expanded to allow an assessment of how well an entity is meeting its objectives, rather than focusing on cash flows.

This is further discussed in the attached response to the IASB Exposure Draft.

- (b) *Whether the proposals would result in financial reports that are useful to users*

For the IASB proposals to be useful to users, the AASB will need to add extra material or modify the proposals so that they will be relevant to the public sector and not-for-profit sector user requirements. As currently drafted, the IASB proposal is inappropriate for the public sector.

- (c) *Whether the proposals in the Exposure Draft are in the best interests of the Australian economy*

As above, for the IASB proposals to be in the best interests of the Australian economy, the AASB will need to add extra material or modify the proposals so they will be relevant to the public sector and not-for-profit sector.

IASB EXPOSURE DRAFT - *An improved Conceptual Framework for Financial Reporting: The Objective of Financial Reporting and Qualitative Characteristics and Constraints of Decision-useful Financial Reporting Information*

Summary

As the Conceptual Framework is the primary instrument used in developing and maintaining accounting standards, it is essential that it adequately recognises the financial reporting needs and objectives of all users of financial reports.

While HoTARAC acknowledges that there has been an attempt to address some of the key areas of concern raised by many commentators in response to the Boards' Preliminary Views Discussion Paper, it remains concerned that the Exposure Draft is inappropriate for the public sector, due to its focus on capital markets and capital providers. In this regard, the key issues remain:

- insufficient emphasis on accountability / stewardship;
- a need to broaden the identified users; and
- too much emphasis given to the assessment of cash flows.

Although the Exposure Draft claims otherwise, HoTARAC is concerned that there is still a strong implication that the objective of financial reporting is to provide information for decisions about whether to buy, sell or hold securities. This view is reinforced by:

- the use of the term "capital providers" as the primary user group, which excludes other resource providers;
- reducing stewardship or accountability to part of "decision usefulness";
- the focus on the future rather than the past, that is making rather than evaluating decisions; and
- adopting a narrow interpretation of "stewardship" or "accountability" based on information to "protect or enhance" investments.

HoTARAC believes that any proposed Framework will need to accommodate different legal frameworks, including jurisdictions such as Australia, where primacy is given to accountability and stewardship. Therefore, HoTARAC is concerned that the Exposure Draft does not clearly indicate the importance of accountability as a concept in its own right (i.e. separate and additional to decision usefulness).

HoTARAC believes that these issues are equally applicable to for-profit entities, although they may become more apparent when considered from the public sector or not-for-profit viewpoint.

In regard to the qualitative characteristics, HoTARAC's main issue is with the concept of "faithful representation". HoTARAC believes that this term requires further clarification (e.g. explicit reference to "substance over form") and justification for its use.

Chapter 1 *The objective of financial reporting*

1. *The boards decided that an entity's financial reporting should be prepared from the perspective of the entity (entity perspective) rather than the perspective of its owners or a particular class of owners (proprietary perspective). (See paragraphs OB5–OB8 and paragraphs BC1.11–BC1.17.) Do you agree with the boards' conclusion and the basis for it? If not, why?*

HoTARAC does not believe that it is appropriate at this stage to reach a conclusion on whether an entity or proprietary perspective should be adopted. This is because the Exposure Draft does not adequately explain the implications of the entity perspective, nor does it explain the link between who the users are and the perspective adopted.

This is apparent in the Basis for Conclusions which states:

“...the boards...have not yet considered all the possible implications of that decision [to adopt an entity perspective] on future phases of the framework...The boards observed that adopting the entity perspective does not preclude deciding in future standards also to include in financial statements information that might be viewed as consistent with a proprietary perspective” (para BC1.16 and 1.21)

Until the implications of an entity and proprietary perspective are made clear, HoTARAC believes that it is premature for the Boards to come to a decision on this issue. However, HoTARAC does not believe that resolution of this issue precludes defining the objectives of financial reporting.

Whether or not an entity or proprietary perspective is adopted, in HoTARAC's view, a primary objective of financial reporting in the public sector is to assess the performance of Boards and managers in the delivery and sustainability of programs and outcomes, i.e. stewardship and accountability objectives. Stewardship and accountability, is also relevant in the for-profit sector. HoTARAC does not believe that the adoption of an entity perspective, based on the view that there is a wide variety of users, necessarily prevents including stewardship as a primary objective of financial reporting.

2. *The boards decided to identify present and potential capital providers as the primary user group for general purpose financial reporting. (See paragraphs OB5–OB8 and paragraphs BC1.18–BC1.24.) Do you agree with the boards' conclusion and the basis for it? If not, why?*

HoTARAC does not agree with the Boards conclusion to identify present and potential “capital providers” as the primary user group for general purpose financial reports. HoTARAC agrees with the conclusions of the four national standard-setters in their review of the IASB Exposure Draft *A Report on the Application to Not-for-profit Entities in the Private and Public Sectors* (2008), that the identified user needs to be broadened for not-for-profit entities. This comment may also be equally applicable to for-profit entities.

In particular, HoTARAC is concerned that the reference to “capital providers” may be misinterpreted. The use of such terminology may imply that the objective of financial reporting primarily relates to providing information for decisions about whether to buy, sell or hold securities. This is reinforced by:

- reducing stewardship or accountability to part of “decision usefulness”;
- the focus on the future rather than the past, i.e. making rather than evaluating decisions; and
- the emphasis on assessing cash flow prospects.

The term “capital provider” is also not well suited to not-for-profit entities which may not have a formal capital structure.

Therefore, HoTARAC supports using more generic or inclusive terms, such as “resource providers” and “recipients of goods and services”. This type of terminology is also being proposed in the IPSASB Draft Consultation Paper on the Conceptual Framework (June 2008) for the public sector (refer IPSASB Preliminary View 5). These terms are broader than “capital providers”, as they include taxpayers, customers, contributors, etc. They are also more consistent with the concept of accountability, as management is accountable to resource providers (not just capital providers) and in a broader sense management is accountable to members of the community (refer also Australian Framework SAC 2, para 14).

However, some jurisdictions believe that, in the public sector, the equivalent notion of “shareholders” and “capital providers”, is the “community” and “resource providers” (including “taxpayers”), respectively. These jurisdictions do not believe that any primary user group should include customers, as they do not believe that the primary purpose of the financial report is to address customer needs.

In the future, however, the needs of other users (that are not capital providers) are likely to become increasingly important, in both the public and private sectors, with the widening perspective of corporate responsibility (e.g. including the impact of an entity’s operations on the environment) (refer also response to question 3).

The use of more inclusive or generic terms is also a more robust approach which will more readily accommodate not-for-profit entities, but which is equally relevant to for-profit entities. Also, it seems contradictory for the Exposure Draft to state that “...general purpose financial reporting is directed to the needs of a wide range of users rather than only to the needs of a single group” (para OB4), and then to identify a narrow “primary user group”.

- 3 *The boards decided that the objective should be broad enough to encompass all the decisions that equity investors, lenders and other creditors make in their capacity as capital providers, including resource allocation decisions as well as decisions made to protect and enhance their investments. (See paragraphs OB9–OB12 and paragraphs BC1.24–BC1.30.) Do you agree with that objective and the boards’ basis for it? If not, why? Please provide any alternative objective that you think the boards should consider.*

HoTARAC does not agree with the draft objective, as stewardship or accountability is reduced to a subset of “decision usefulness”. Instead, HoTARAC supports two separate primary objectives, comprising “decision usefulness” and “stewardship”, “accountability”, for both public and private sector entities. HoTARAC believes that including accountability as a subset of decision usefulness reflects a narrow interpretation which is evidenced by the reference in para OB9 to decisions to “protect or enhance their investments”.

While widening decision usefulness to include a concept of stewardship that is not confined to “resource allocation decisions” is an improvement, compared to the Preliminary Views Paper, it is still insufficient. This is because it does not adequately reflect the original and primary purpose of financial reporting in many countries; that is to hold management to account. HoTARAC believes that it is essential that the proposed conceptual framework accommodates different corporate governance and legal frameworks, including countries such as Australia where there is a greater focus on accountability and stewardship¹.

In HoTARAC’s view, stewardship is about making and evaluating decisions (Australian Conceptual Framework, SAC 2, para 43). HoTARAC does not believe that this is substantially drawn out in the draft objective. The importance of assessing “past performance” is emphasised by the UK Accounting Standards Board in its paper *Stewardship / Accountability as an Objective of Financial Reporting*, as follows (para 4.9):

“That stewardship objective is about providing information about the past (including, for example, the transactions entered into, the decisions taken and the policies adopted) at a level of detail and in a way that enables the entity’s past performance to be assessed in its own right, rather than just as part of an assessment about likely future performance”.

Therefore, HoTARAC is concerned that the description of stewardship in terms of information useful for making decisions about how to “protect or enhance” investments more strongly communicates stewardship in terms of the impact on the generation of cash flows and future performance. As a forward looking notion this does not clearly indicate the importance of accountability as a concept in its own right (i.e. separate from decision usefulness)², which is to hold the Board and management to account for the past. There may be circumstances, particularly in the public sector, where stewardship or accountability does not fall within the

¹ The significant differences in the purpose and role of financial reporting across the world are illustrated in the publication *Divided by common language* by Tim Bush (2005).

² Andrew Lennard (2006), in commenting on the Discussion Paper, argued that the role of stewardship in facilitating a dialogue between management and shareholders can only be rationalised indirectly ‘with somewhat tortuous logic’ from a decision usefulness objective (paras 3.9-3.14).

decision usefulness objective e.g. accountability to resource providers that lack the capacity to make decisions. In conjunction with the use of the term “capital providers”, the Boards’ proposed objective may also strengthen the view that financial reports are mainly used to make decisions to buy, sell or hold securities.³

The draft of the IPSASB Consultation Paper on the Conceptual Framework (June 2008) is consistent with many of the above comments as it proposes an alternative definition of the objective of financial reporting by public sector entities, which separates accountability from decision making, as follows:

“...to provide information about the reporting entity useful to users of GPFs for accountability purposes and for making resource allocation, political and social decisions” (IPSASB Preliminary View 6).

Stewardship also entails the provision of information relating to how well the organisation is meeting its non-financial objectives. In contrast, the Exposure Draft focuses on decision usefulness in terms of assessing cash flow prospects rather than any non-financial objectives or the broader concept of “economic performance”. Not-for-profit entities do not have a primary objective of generating a return; rather their primary objective is more concerned with the delivery of goods and services in an efficient and effective manner. Therefore, HoTARAC believes that decision usefulness needs to be expanded for not-for-profit entities to allow for an assessment as to how well an entity is meeting its objectives. This may also be relevant to for-profit entities that may have subsidiary objectives other than generating net cash flows.

Therefore, in summary, HoTARAC is concerned that the Exposure Draft has not sufficiently addressed the concerns of commentators; i.e. 86 per cent of respondents who responded to this issue in the Preliminary Views Paper disagreed with the Boards’ assertion that there should be only one objective of financial reporting and disagreed that stewardship should be subsumed within the decision usefulness objective. There are also public sector / not-for-profit concerns that will require further consideration.

³ The UK ASB paper (June 2007) identified a number of implications of not including accountability as a separate objective of financial reporting, which HoTARAC believe still apply under the Exposure Draft’s notion of ‘protecting’ or ‘enhancing’ investments. Also, NSW Treasury in its response to the Discussion Paper (CL 14) identified a list of potentially negative consequences of omitting stewardship, which are still relevant for the Exposure Draft.

Chapter 2 Qualitative characteristics and constraints of decision-useful financial reporting information

Chapter 2 describes the qualitative characteristics that make financial information useful. The qualitative characteristics are complementary concepts but can be distinguished as fundamental and enhancing based on how they affect the usefulness of information. Providing financial reporting information is also subject to two pervasive constraints—materiality and cost. Are the distinctions— fundamental and enhancing qualitative characteristics and pervasive constraints of financial reporting—helpful in understanding how the qualitative characteristics interact and how they are applied in obtaining useful financial reporting information? If not, why?

Subject to the comments below, most HoTARAC jurisdictions agree that the distinction between fundamental and enhancing qualitative characteristics and pervasive constraints of financial reporting is helpful in understanding the interaction and application of the qualitative characteristics.

However, some HoTARAC jurisdictions do not support the distinction between fundamental and enhancing qualitative characteristics, particularly in relation to understandability and verifiability. These jurisdictions do not believe that the Exposure Draft included sufficient argument to justify splitting the characteristics into two groups. They argue that information may be relevant and faithfully represented, but if financial information is not understandable, it will not be useful to users. They believe that lack of understandability is the reason why, in the for-profit sector, general purpose financial reports are being replaced with summary information and / or management discussion reports.

1 Do you agree that:

(a) *relevance and faithful representation are fundamental qualitative characteristics? (See paragraphs QC2–QC15 and BC2.3–BC2.24.) If not, why?*

In principle, most HoTARAC jurisdictions agree that “relevance” and “faithful representation” are fundamental qualitative characteristics, for the reasons put forward in the Exposure Draft and Basis for Conclusions. However, most HoTARAC jurisdictions believe that the term “faithful representation” requires further clarification. This is further discussed in the response to question 2 below.

(b) *comparability, verifiability, timeliness and understandability are enhancing qualitative characteristics? (See paragraphs QC17–QC35 and BC2.25–BC2.35.) If not, why?*

Most HoTARAC jurisdictions agree that “comparability”, “verifiability”, and “understandability” are enhancing characteristics. However, these jurisdictions are unsure about the reasoning as to why “timeliness” is an enhancing characteristic rather than a pervasive constraint. As with materiality, most HoTARAC jurisdictions believe that “timeliness” should be considered when determining whether information is relevant to users. It may also be necessary to consider whether one or more qualitative characteristics may need to be balanced to some degree to increase timeliness.

Further, some HoTARAC jurisdictions do not support the statement in para QC 26 that one or more enhancing qualitative characteristics may be “sacrificed” to maximise another qualitative characteristic. Instead, they prefer the term “balanced”, as the term “sacrifice” infers that a characteristic could be completely disregarded, which may mean that information is not faithfully represented.

- (c) *materiality and cost are pervasive constraints? (See QC29–QC32 and BC2.60–2.66.) If not, why? Is the importance of the pervasive constraints relative to the qualitative characteristics appropriately represented in Chapter 2?*

HoTARAC agrees that materiality and cost are pervasive constraints. However, as discussed above, HoTARAC is unsure about the reasoning behind excluding “timeliness” as a pervasive constraint.

2. The boards have identified two fundamental qualitative characteristics—relevance and faithful representation:

- (a) *Financial reporting information that has predictive value or confirmatory value is relevant.*
- (b) *Financial reporting information that is complete, free from material error and neutral is said to be a faithful representation of an economic phenomenon.*
- i. *Are the fundamental qualitative characteristics appropriately identified and sufficiently defined for them to be consistently understood? If not, why?*

Most HoTARAC jurisdictions agree, subject to the comments below regarding faithful representation, that the fundamental qualitative characteristics are appropriately identified and defined.

Relevance and link with objectives of financial reporting

The concerns regarding the objectives of financial reporting also flow through to the qualitative characteristics, to the extent that “relevance” is linked to information that is useful for decision making (and not separately as accountability or stewardship) by users in their “capacity as capital providers”. Therefore, given the proposed narrow definition of the objective of financial reporting, what is regarded as “relevant” information based on the Exposure Draft may not be appropriate. Similarly, other qualitative characteristics, such as materiality, to the extent that they are linked to the narrow objective of financial reporting, may be inappropriate.

Faithful representation - properties that are to be measured

The draft Framework provides that information must be a faithful representation of the economic phenomena that it purports to represent (para QC7). However, the meaning of “economic phenomena” depends on a discussion on measurement. In particular, to understand the meaning of “faithful representation” (or “reliability”) requires an understanding of the property or properties that are to be measured. As this will not be resolved until the Measurement phase of the Framework is finalised, this illustrates the difficulties in adopting a phased approach and the finalisation of the Framework as chapters are completed (refer to the “other comments” below).

Faithful representation - substance over form

Most HoTARAC jurisdictions disagree with the conclusion that it is unnecessary to include “substance over form” as a separate qualitative characteristic. These jurisdictions do not believe that there is anything inherent in the term “faithful representation” that implies “substance over form”. The term “faithful representation” could equally be used to support a legalistic interpretation (i.e. HoTARAC understands that some jurisdictions have the concept of “legal substance”).

Further, the concept of substance over form goes to the heart of what is the objective of financial reporting. Although the Exposure Draft explains that the term “faithful representation” refers to “economic substance” (BC 2.19 and QC 7) most HoTARAC jurisdictions believe that the importance of this principle is such that it should be specially identified, at least as a separate component of “faithful representation”. The term “substance over form” is a much more readily understood term than “faithful representation”, as it quickly explains an important, overriding and fundamental concept in accounting to users and preparers alike.

Faithful representation and reliability

The concept of “faithful representation” appears to be a narrower notion than “reliability” (i.e. as previously faithful representation was only one characteristic of “reliability”). Most HoTARAC jurisdictions, therefore, do not believe that the effect of the Exposure Draft is necessarily simply the replacement of the term “reliability” with “faithful representation”. There may also be equal confusion about the term “faithful representation” as there was with the term “reliability”. The Exposure Draft does not sufficiently justify the change.

Faithful representation and verifiable

Some HoTARAC jurisdictions comment that the Basis for Conclusions does not clearly explain why “verifiable” was omitted from the concept of “faithful representation” and replaced with the concept of “free from material error”. They note that the term “verifiable” is a much broader concept than “free from material error”, as it also encompasses the use of the appropriate recognition or measurement method.

- (ii) *Are the components of the fundamental qualitative characteristics appropriately identified and sufficiently defined for them to be consistently understood? If not, why?*

Except for the issue of “substance over form” discussed above (refer response to question 2(i)), most HoTARAC jurisdictions agree with the other components of the fundamental qualitative characteristics.

- 3 *Are the enhancing qualitative characteristics (comparability, verifiability, timeliness and understandability) appropriately identified and sufficiently defined for them to be consistently understood and useful? If not, why?*

Refer comments in response to question 1(b).

Further, HoTARAC believes that for “verifiability” it is important to emphasise that establishing that an inappropriate method has been applied without material error does not constitute verification. This clarification reinforces the relationship with the fundamental qualitative characteristic of “faithful representation”.

- 4 *Are the pervasive constraints (materiality and cost) appropriately identified and sufficiently defined for them to be consistently understood and useful? If not, why?*

Refer comments in response to question 1(c).

Other comments

Difficulties with general approach to the different phases of the Framework

HoTARAC is concerned with the phased approach of the Conceptual Framework project, whereby the IASB will finalise the framework as chapters are completed. While it is appreciated that this is a significant Project, a protracted phased approach is problematic given the interrelationship between different phases. This problem is compounded by the Board’s decision to delay not-for-profit implications until the conclusion of the Project.

Accordingly, given these concerns, HoTARAC strongly believes that the Board should not finalise any part of the Framework until all parts are ready to be finalised, unless the Board is able to identify all the implications of the proposed changes.

Consequences of adopting a wide scope of financial reporting

The Exposure Draft 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 BC1.3-BC1.5). However, HoTARAC believes that unless the boundaries of financial reporting are fully scoped (as widely defined) it is not possible to state whether the proposed objective or the qualitative characteristics of financial reporting are likely to change.

Limitations on general purpose financial reporting

Some HoTARAC jurisdictions do not support reducing concepts in the Framework to a “goal or ideal” as stated in para OB 14. These jurisdictions believe that this reduces the importance of the Framework within the hierarchy of standard-setting and reporting. Instead, these jurisdictions believe that this can be addressed within the concepts of “faithful representation” and “verifiability”, by discussing the use of estimates, judgements and models.

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

Chairs and senior staff of (July 2008):

- Australian Accounting Standards Board;
- Canadian Accounting Standards Board;
- New Zealand Financial Reporting Standards Board;
- United Kingdom Accounting Standards Board

A Report on the Application to Not-for-profit entities in the Private and Public Sectors of the IASB / FASB Conceptual Framework Project's Exposure Draft of An Improved Conceptual Framework for Financial Reporting

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