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Mr David Boymal
Chairman
Australian Accounting Standards Board
P.O. Box 204
Collins Street West VIC 8007

Dear David

Exposure Draft 164: The Objective of Financial Reporting and Qualitative Characteristics and Constraints of Decision-useful Financial Reporting Information

Thank you for the opportunity to comment on this exposure draft.

We support the development of an improved conceptual framework, however, we have a number of specific queries and concerns regarding the proposals in the Exposure Draft. Our most fundamental concern relates to the replacement of the current qualitative characteristic of 'reliability' with 'faithful representation'. We question whether 'faithful representation' is an improvement on 'reliability' and propose that 'reliability' should be maintained in some form. We consider 'faithful representation' as a sub-set of 'reliability' and professional judgement is required in either notion. Our position is outlined to a greater degree in the attached response.

Detailed comments on all other matters raised in the Exposure Draft are also attached to this letter.

Should you have any queries on our comments, please contact Alane Fineman, Senior Manager of Financial Policy at Alane.Fineman@anz.com.

Yours sincerely

SHANE BUGGLE
Group General Manager Finance

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). Do you agree with the boards' conclusion and the basis for it? If not, why?*

We note that the proposed Conceptual Framework for Financial Reporting[1] establishes concepts for financial reporting as a whole, which is broader than the applicability of the current Framework to general purpose financial reports. We further note the boards' have not reached conclusions on the boundaries of financial reporting including "whether financial reporting should include prospective information or forecasts and, if so, how that information should be provided" (paragraph BC1.5). Against this background, we consider it premature to accept that the entity concept is necessarily appropriate for all forms of financial reporting. However, in relation to general purpose financial reports, we agree in principle that the objective of financial reporting should be from the entity perspective, although we note that proprietary perspective still has a major impact on current accounting procedures. We therefore question whether it will ever be possible to adopt a 'pure' entity perspective

We consider a number of matters should be clarified regarding the adoption of the entity concept.

- **Under the entity perspective, capital providers are mainly interested in obtaining a return of, as well as a return on, their investment. By contrast, under the proprietary perspective, the determination of the net worth of the owner is the main focus. Although the Exposure Draft asserts that capital providers are interested in information about the economic resources of the entity and the claims on those resources, as well as the changes therein, the view may be taken that the entity perspective places more emphasis on the income statement (as highlighting the return on investment) whereas the proprietary perspective places more emphasis on the balance sheet (as highlighting the net worth of the owner). The boards' should consider whether adopting the entity perspective would give the income statement primacy over the balance sheet.**
- **The Exposure Draft highlights that, under the entity perspective, an entity obtains economic resources from capital providers in exchange for claims on those resources. Although the Basis for Conclusions notes that the "claims of different capital providers have different priorities and different rights with respect to the reporting entity" (para. BC1.12), we consider the nature of these different priorities and rights should be more clearly articulated in the proposed concepts themselves. For example, lenders typically have a specifically determinable claim on assets whereas equity investors have a residual claim over the assets in the event an entity is wound-up. It is important that the Framework highlight this distinction because the entity concept can be interpreted as meaning that the claims of all capital providers have equal standing. We would be concerned if the logical conclusion of this view is that all interest payments to lenders and creditors should be regarded as a distribution of profits (dividends) rather than an expense.**

[1] We note that "the exposure draft uses *general purpose financial reporting*" (para. BC1.10) to refer to the type of financial reporting covered by the proposed conceptual framework. We query why this terminology has not been used in the title of Chapter 1 (which refers to "The objective of financial reporting" and the title of the overall proposed conceptual framework (which refers to "The objective of financial reporting". Other parts of the proposed Framework also refer to "financial reporting" rather than "general purpose financial reporting".

- **The status of minority shareholder interests (or "non-controlling interests") under the entity perspective should be clarified.**
- **We note that the perspective frequently adopted in accounting for transactions is that of the management of the entity as distinct from the entity per se. The boards' should clarify how the entity perspective operates alongside the perspective of management in accounting for transactions and other events.**

2. *The boards decided to identify present and potential capital providers as the primary user group for general purpose financial reporting. Do you agree with the boards' conclusion and the basis for it? If not, why?*

   We agree that present and potential capital providers should be identified as the primary user group for general purpose financial reporting on the basis that they "have the most direct and immediate interest in an entity's ability to generate net cash inflows" (para. BC1.19).

   We note that the users forming part of the primary user group may change as the boundaries of general purpose financial reporting are determined. For example, as community expectations change, the primary user group may extend beyond capital providers to a broader group of stakeholders.

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. 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.*

   We disagree that the objective of general purpose financial reporting should be expressed as covering *all* the decisions that equity investors, lenders and others make in their capacity as capital providers. We prefer instead that the objective be stated as covering *economic decisions* made by capital providers insofar as those decisions relate to allocating their resources to a particular entity.

   Other matters

   The Exposure Draft states that "financial reporting should include management's explanations and other information needed to enable users to understand the information provided" (para. OB25). We query why this has been included in the proposed Chapter 1 on 'The Objective of Financial Reporting'. We consider that the presentation and disclosure phase of the conceptual framework project may be the appropriate time at which to consider the need to include management's explanations and 'other information'.

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?

We agree that the distinction between fundamental and enhancing qualitative characteristics and pervasive constraints on financial reporting are useful in understanding how the qualitative characteristics interact and how they apply in obtaining useful financial reporting information.

However, to further understand the interactions among the qualitative characteristics, we consider that there should have been more discussion of the trade-offs among the qualitative characteristics. For example, a trade-off between 'relevance' and 'faithful representation' may be necessary in meeting the objective of general purpose financial reporting. We are concerned that relevance has been elevated above faithful representation under the proposed framework. For example, paragraph BC 2.56 states that "the boards also concluded that relevance is the quality that should be considered first" and that the "boards then concluded that faithful representation is the quality that should be considered next". We prefer instead that relevance and reliability (in place of faithful representation) be given equal importance, with professional judgment being applied to determine their relative importance in particular cases.

1 a) *Do you agree that relevance and faithful representation are fundamental qualitative characteristics? If not, why?*

We agree relevance is a fundamental qualitative characteristic. However, we consider 'faithful representation' is only a fundamental qualitative characteristic when expressed as part of a broader fundamental qualitative characteristic based on 'reliability'.

Although the Exposure Draft refers to the difficulties the boards' experienced in determining an acceptable definition of reliability, and therefore the boards' decision to replace the term reliability with faithful representation, we consider the way in which faithful representation is defined in the proposed framework does not represent an improvement on the existing Framework (refer to our comments in relation to Question 2). In addition, professional judgement is required in determining whether there is faithful representation just as much as it is required to determine reliability. Therefore, there seems to be no particular advantage in replacing 'reliability' with 'faithful representation'.

We note the Exposure Draft states that "some minimum level of accuracy is also necessary for an estimate to be a faithful representation of an economic phenomenon" (para. QC11). Although we do not favour the term "accuracy" (as the accuracy of a measure implies that the 'true value' of a particular item is known which, given the nature of accounting, would be difficult or impossible to determine), we agree that accounting estimates need to be of some minimum level of 'reliability' to be decision useful. To support this position we consider that the existing qualitative characteristic of "reliability" should be retained as a fundamental qualitative characteristic (with faithful representation included as part of this characteristic) and that the existing definition of reliability in the Framework should be retained.

b) *Do you agree that comparability, verifiability, timeliness and understandability are enhancing qualitative characteristics? If not, why?*

We agree that comparability, verifiability, timeliness and understandability are enhancing qualitative characteristics.

c) *Do you agree that materiality and cost are pervasive constraints? If not, why? Is the importance of the pervasive constraints relative to the qualitative characteristics appropriately represented in Chapter 2?*

We agree that materiality and cost are pervasive constraints that limit the information provided by general purpose financial reporting.

2. *The boards have identified two fundamental qualitative characteristics - relevance and faithful representation:*
   - *Financial reporting information that has predictive value or confirmatory value is relevant.*
   - *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?*

Relevance

It is proposed that "information is relevant if it is capable of making a difference in the decisions made by users in their capacity as capital providers" and that "information about an economic phenomenon is capable of making a difference when it has predictive value, confirmatory value or both" (para. QC 3). From the foregoing we interpret relevance as relating to financial information itself. However, subsequent descriptions of 'relevance' create an impression that it relates to the underlying economic phenomena which are subject of general purpose financial reporting. For example, paragraph QC 12 states that "relevance refers to the economic phenomena" and paragraph QC 13 states that "once relevance is applied to determine which economic phenomena are pertinent to the decisions to be made ...". The boards' should ensure that there is a consistent description of relevance throughout the Framework.

We are concerned that financial information need only be 'capable' of making a difference in a decision to be relevant. This potentially casts a wide net of potentially relevant financial information that must be disclosed. The difficulties of determining information capable of making a difference in a decision are referred to in paragraph BC 2.5 which notes that "whether or not it is possible to demonstrate conclusively that a particular item of information will affect, or has affected, users' decisions, the boards take steps to understand how capital providers use reporting information and how financial reports might better serve their needs". The remainder of paragraph BC 2.5 then goes on to outline steps that the boards' take to provide them with "knowledge about the types of information that are capable of affecting users' decisions". This would seem to reflect the perspective of the board rather than those of the reporting entity!

Faithful representation

We consider that completeness, neutrality and freedom from material error are aspects of the broader characteristic of 'reliability' rather than faithful representation.

Under the current Framework, "to be reliable, information must represent faithfully the transactions and other events it either purports to represent or could reasonably be expected to represent" (para. 33). We now note that faithful representation must now reflect *economic phenomena*. For example, paragraph QC 7 states that "to be useful in financial reporting, information must be a faithful representation of the economic phenomena that it purports to represent". While we endorse the premise that accounting should reflect economic reality, we are concerned that some items shown in financial reports are not representations of economic phenomena but simply accounting notions. For example, certain items in the balance sheet, such as deferred debits and deferred credits, may not be reflective of underlying economic phenomena. Would such items therefore not be shown on the balance sheet because they do not represent economic phenomena? Furthermore, although many accountants depreciate assets using the straight-line method, would this method now be in question because the resultant depreciation expense and carrying amount of assets is not representationally faithful of underlying economic phenomena? For example, paragraph QC 4 comments that "straight-line depreciation of plant and equipment may be highly predictable from year to year but may not be very helpful in assessing an entity's ability to generate cash inflows". The boards' should clarify its position on these issues.

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

Relevance

The descriptions of the confirmatory and predictive components of relevance are adequate. However, we query whether 'relevance' should also pertain to financial information that is used for decisions that do not involve predictions or which are not confirmed from past expectations. The boards' should clarify this matter.

Faithful representation

- Completeness —we consider the description of completeness as requiring the inclusion of "all information that is necessary for faithful representation of the economic phenomena that it purports to represent" (para. QC 9) as unlikely to be achieved in practice due to the constraints of costs and materiality. Although cost and materiality are identified elsewhere in the proposed framework as pervasive constraints on information provided by financial reporting, we would prefer that these constraints be specifically built into the description of completeness. This is the approach taken in the existing Framework which states that "to be reliable, the information in financial reports must be complete within the bounds of materiality and cost" (para. 38). We also note that the proposed framework states that although completeness is desirable, "a representation to imply a degree of completeness ... that is impracticable would diminish the extent to which the information faithfully represents the economic phenomena that it purports to represent" (para. QC 11). We are also concerned by the implication of the next sentence in paragraph QC 11 which states that "to attain a faithful representation, it may be sometimes necessary to disclose explicitly the degree of uncertainty in the reported financial information". This sentence implies that disclosure can be used to overcome the lack of reliability of accounting information.

- **Neutrality - the description of neutrality is adequate.**
- **Freedom from error - the description of freedom from error is adequate.**

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?*

   The enhancing qualitative characteristics of comparability, timeliness and understandability are appropriately identified and sufficiently defined to be consistently understood and useful.

   Further explanation of the verifiability in paragraph QC 20 may be required to clarify certain matters. For example, this paragraph states that "verifiability implies that different knowledgeable and independent observers could reach general consensus, although not necessarily complete agreement" that information faithfully represents the economic phenomena that it purports to represent. Are these "knowledgeable and independent observers" the users in the primary user group? The boards' should clarify this matter.

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

   These pervasive constraints are appropriately identified and sufficiently defined. However, we would prefer that materiality be defined in terms of its influence on 'economic decisions' that users make (the proposed framework refers to 'decisions').