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Dear Ms Lian

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*

The Australian Accounting Standards Board (AASB) is pleased to provide comments on the abovenamed Exposure Draft. In forming its views, the AASB considered comments it received in response to its Invitation to Comment on the Exposure Draft.

The AASB generally supports the proposed concepts for private sector businesses. However, it also has some significant concerns, related both to technical issues and the process for progressing the Conceptual Framework project. The AASB's comments on the questions in the IASB-FASB Invitation to Comment, including its significant concerns, are in the attached submission.

Improvements to the proposals in the Discussion Paper

The AASB supports the following changes made by the IASB and FASB to the proposals in their July 2006 Discussion Paper on the Objective and Qualitative Characteristics:

(a) broadening the proposed objective to include providing information to capital providers for making decisions about whether and how to protect or enhance their investments, and thereby strengthening the discussion of stewardship/accountability;

(b) clarifying that employees are 'other creditors' and therefore part of the primary user group;

(c) identifying timeliness as a qualitative characteristic separate from relevance;

(d) identifying verifiability as a qualitative characteristic separate from faithful representation;

(e) amending the description of verifiability to refer to consensus among observers that an *appropriate* recognition or measurement method has been applied without material error or bias, rather than simply that the *chosen* recognition or measurement method has been applied without material error or bias;

(f) including in the Basis for Conclusions on Chapter 1 discussion of the view that advances in technology are altering the context of general purpose financial reporting and in some people's view may make the notion obsolete; and

(g) various editorial improvements.

Primary proposals for amendment

The AASB's primary proposals for amending the proposed concepts in draft Chapters 1 and 2 of the revised *Framework* are:

(a) further explanation of the Boards' reasons for adopting an entity perspective in financial reports should be provided;

(b) the objectives of financial reporting should refer to "making *and evaluating* … decisions";

(c) the qualitative characteristics should not be classified into 'fundamental' and 'enhancing' categories, unless more convincing reasons are provided for that classification scheme; and

(d) the concepts of relevance and materiality should be distinguished more clearly.

Process for amending the IASB *Framework*

The AASB considers that the IASB and FASB should not finalise any parts of the revised *Framework* until all parts are complete, unless the Boards are ready to identify all of the implications of the changes they are making. The AASB is concerned that, otherwise, the *Framework* may include contradictions about which users may be unaware. The Boards' identification of all of the implications of the changes made in revised parts of the *Framework* should help ensure that unnecessary contradictions are avoided.

Implications for not-for-profit entities

The AASB considers that, in view of the International Public Sector Accounting Standards Board (IPSASB) of the International Federation of Accountants having issued a Consultation Paper on part of its conceptual framework project (including the Objectives and Qualitative Characteristics), the IASB and FASB should review their plan to complete parts of the revised Framework before considering application of the concepts to not-for-profit entities. The AASB considers that the IASB's recently established closer working relationship with the IPSASB provides an opportunity for the Boards to work together, and make timely progress, on not-for-profit entity issues, and thus not to delay significantly the development of each phase of the project.

Addressing not-for-profit entity issues as part of the Boards' work on each phase of the project would be of considerable assistance to the various standard setters (including the AASB, Canadian Accounting Standards Board, FASB, FRSB and UK Accounting Standards Board) that are responsible for setting accounting standards for both for-profit and not-for-profit entities (at least in the private sector) and intend to adopt or converge with the revised *Framework*. If the Boards retain their plan to deal with not-for-profit entity issues in a later phase of the project, the AASB (and presumably some of the other above-mentioned standard setters) would need to strongly consider deferring the applicability of the revised parts of the *Framework* (or their corresponding Conceptual Framework) in respect of not-for-profit entities until that later phase is completed.

The Appendix to the submission provides the AASB's comments on potential implications of the proposed concepts for not-for-profit entities. Even if the Boards retain their plan to deal with not-for-profit entity issues in a later phase of the project (Phase G), the AASB considers it would be useful for the Boards to be aware of these implications, especially to identify opportunities to use concepts and terminology that are sufficiently broad to apply to private sector businesses and other types of entities.

If you have queries regarding any matters in this submission, please contact Jim Paul (jpaul@aasb.gov.au) or me.

Yours sincerely

David Boymal

David Boymal
Chairman

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AASB's Specific Comments in Relation to Private Sector Businesses

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?

The AASB supports adopting an entity perspective in financial reports, while providing additional information where necessary to meet the information needs of particular groups of capital providers (consistent with paragraph OB5). However, the AASB is of the view that further explanation of the Boards' reasons for adopting that perspective is warranted. Its suggestions for further explanation are included in its submission on the IASB Discussion Paper on The Reporting Entity (in the context of adopting the entity perspective in preparing group financial reports).

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?

The AASB agrees with using the identified information needs of present and potential capital providers as a proxy for the common information needs of the wide range of users that the proposed objective of financial reporting aims to meet, and therefore with describing present and potential capital providers as primary user group for general purpose financial reporting. This is because the information needs of these users are better understood than the information needs of other users.

However, the AASB is of the view that it is important for the revised *Framework* to clarify that identifying particular users as the primary user group does not mean that information needs of other users should be ignored. Otherwise, identifying present and potential capital providers as the primary user group may appear to be inconsistent with adopting an entity perspective in financial reporting.

The AASB considers that using the term 'capital providers' may cause confusion. The term 'capital providers' implies only lenders or equity holders, although the Exposure Draft explains that it also includes 'other creditors'. The AASB recommends using a term that, in everyday usage, corresponds more closely with the intended meaning (for example, 'resource providers' or 'claimants' [i.e., all parties with claims against the reporting entity's assets]).

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.

Yes, except for the addition to the objective proposed below.

Evaluating decisions

The description of *relevance* in paragraph QC3 includes confirmatory value (that is, it confirms or changes past or present expectations based on previous evaluations). The AASB is of the view that, to integrate with the reference to confirmatory value in the description of *relevance*, it is essential that reference be made to "making *and evaluating* ... decisions" in the objective of financial reporting. Referring to evaluating decisions is particularly important because many users of financial reports rely on information from other sources (typically, information that becomes available before financial reports are issued) to make decisions in their capacity as capital providers, and use financial reports to confirm their previous assessments and provide input to future assessments.

Another reason for referring to *evaluating* decisions is to acknowledge that part of the objective of financial reporting is to help users evaluate the decisions of managements. The Boards' decision to give greater emphasis to stewardship in the objective of financial reporting[1] (for example, the comment in paragraph BC1.27 that decision making may include evaluating how management of the entity performed against management in competing entities in similar circumstances) creates a greater need to refer in the objective to 'evaluating' decisions.

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?

[1] This is discussed in paragraphs BC1.27-BC1.29 of the Basis for Conclusions for draft Chapter 1.

The arguments presented for classifying the qualitative characteristics into 'fundamental' and 'enhancing' categories are insufficient. Without more convincing reasons the AASB does not support that classification scheme.

An implication of the proposed distinction between 'fundamental' and 'enhancing' qualitative characteristics seems to be that information can be decision-useful without being timely or understandable. The AASB does not support such a characterisation of timeliness and understandability.

The AASB notes that comparability is described and explained as a by-product of relevance and faithful representation. Therefore, 'enhancing' seems an inappropriate adjective for comparability.

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

See the AASB's comments on the unnumbered question above.

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

See the AASB's comments on the unnumbered question above.

1(c).	Do you agree that *materiality* and *cost* are pervasive constraints? (See QC29 - QC32 and BC 2.60-2.66.) If not, why? Is the importance of the pervasive constraints relative to the qualitative characteristics appropriately represented in Chapter 2?

Yes, for both questions.

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.

2(i).	Are the fundamental qualitative characteristics appropriately identified and sufficiently defined for them to be consistently understood? If not, why?

Yes, except that the Exposure Draft does not clearly distinguish the concepts of relevance and materiality. This is because it describes both concepts in terms of having the potential to affect users' decisions in their capacity as capital providers.[2] As described, materiality is therefore a redundant concept—in concept, if an item of information is relevant and represented faithfully, it must be reported; and if it is not relevant, it should not be reported.

The descriptions of relevance and materiality fail to convey a subtle but important difference between them, illustrated by the following example. Information about government grants to a private sector business entity is inherently relevant because it informs users of the extent to which the entity's revenues depend on transfers from government. However, the amount of government grants received by a particular reporting entity might be so small that its non-disclosure does not have the potential to affect decisions of users of that reporting entity's financial report. Information about its government grants would be relevant in nature but nonetheless immaterial.

Accordingly, the AASB is of the view that the concepts of relevance and materiality should be distinguished more clearly by describing relevance as a general quality of financial information that, unlike materiality, does not depend on the individual circumstances of the reporting entity. That is:

(a) Relevance should be defined as a *quality* of financial information that exists when it has the potential to affect the decisions of users in general, and not necessarily the users of the reporting entity's financial report; and

(b) Materiality should be defined in relation to the individual circumstances of each reporting entity. Therefore, it should be defined as a threshold (determined by nature and/or amount) used to assess the *extent* to which relevant and representationally faithful information may be omitted, misstated or not disclosed separately without having the potential to affect decisions of users of <u>the reporting entity's</u> financial report.

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2 The Exposure Draft describes 'relevance' as follows:

> "Information is relevant if it is capable of making a difference in the decisions made by users in their capacity as capital providers." (paragraph QC3)

It describes 'materiality' as follows:

> "Information is material if its omission or misstatement could influence the decisions that users make on the basis of an entity's financial information." (paragraph QC28)

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

Yes.

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?

Yes.

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

Yes, except that:

(a) the distinction between materiality and relevance needs clarification (see comment on Chapter 2, Question 2(i)); and

(b) the discussion of costs and benefits does not sufficiently emphasise that, because the conceptual framework is written in the context of regulated financial reporting that attempts to maximise the benefit to cost ratio for all entities collectively:

- individual entities are not entitled to choose their accounting policies on the basis of their own assessment of costs and benefits; and, similarly,
- individual entities cannot use cost-benefit reasons to justify departing from accounting standards.

Therefore, the AASB suggests including commentary along the following lines:

> "Assessments of costs and benefits of reporting particular items of financial information may vary between individual preparers, auditors and other interested parties. Therefore, if assessments of costs and benefits were to be made only by those individuals, the assessments would be likely to be specific to the entity and unable to have regard to the general benefits of financial reporting. Consequently, they may fail to optimise the cost/benefit function of financial reporting generally and may disregard the benefits likely to flow from the inter-entity comparability of financial reports. In the process of setting accounting standards, standard setters seek to consider all costs and benefits in relation to financial reporting generally, and not just as they pertain to individual reporting entities."

Appendix

AASB's Comments on Implications of the Proposed Concepts if They Were Applied to Not-For-Profit Entities

The Proposed Objective of Financial Reporting

Accountability

The AASB is of the view that, if application of the proposed objective were extended to not-for-profit entities, accountability/stewardship may need to be emphasised more in respect of those entities, and consideration should be given to whether accountability or stewardship should be added as a separate objective. In this regard, the AASB agrees with the comments of the International Monitoring Group (NSS-4) on the Not-For-Profit Entity Implications of the IASB-FASB Conceptual Framework Project in its Report on the Exposure Draft entitled *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 ... and Discussion Paper ...* (July 2008).

Many users of financial reports of not-for-profit entities will not have the same ability to make decisions in their capacity as capital providers as occurs for private sector businesses, and will sometimes be interested in financial reports primarily to assess the accountability of the entity's management.

For some not-for-profit entities, if the objective of financial reporting were only to provide information useful for making decisions in a capacity as a capital provider, requiring financial reports to be prepared could not be justified, because there is little demand for their financial reports by those who make such decisions about the entity and cannot command the preparation of financial reports tailored to meeting their particular information needs. However, there is much greater support for requiring those entities to prepare financial reports to demonstrate their accountability.

Information for assessing the entity's future cash flows

The AASB agrees with the comments of the NSS-4 Not-For-Profit Monitoring Group that, if application of the proposed objective were extended to not-for-profit entities, the Exposure Draft's emphasis on reporting information for assessing cash flows would need to be reduced.

Although cash flows are important for not-for-profit entities (including, for public sector not-for-profit entities, information about budgeted cash flows), other aspects are generally more significant. These aspects include:

(a) the ability of the entity's available resources to deliver future goods and services;

(b) the quality, cost and effectiveness of goods and services that have been delivered in the past; and

(c) how well the entity is meeting its objectives, which are not primarily cash-related.

Many assets of not-for-profit entities are held to provide future goods and services without necessarily generating future cash inflows. The AASB acknowledges that not-for-profit entities need cash inflows to carry out their activities and that entities that are more effective in achieving the objectives specified for them are more likely to continue to attract cash inflows. However, the nexus between particular assets of not-for-profit entities and future cash inflows may often be so indirect and difficult to determine that treating those entities' assets as potential sources of future cash inflows (and measuring the assets on that basis, for example by recognising impairments) is unlikely to be practicable or useful to users.

Decisions by users in their capacity as capital providers

The AASB is of the view that if application of the proposed objective of financial reporting were to be extended to not-for-profit entities, the reference in the objective to users making decisions in their capacity as capital providers would be too narrow, because users of financial reports of not-for-profit entities would also be interested in:

(a) whether to vote for an increase in the entity's capacity to provide services to beneficiaries, having regard to the entity's reported assets;

(b) whether to vote for a change in the entity's management, having regard to reported information about the efficiency and effectiveness of the entity's service-delivery activities; or

(c) whether to make a donation to the entity. (Although decisions about whether to make donations are not unique to not-for-profit entities, they tend to be much less significant in respect of private sector businesses.)

Primary user group

The AASB largely agrees with the comments of the NSS-4 Not-For-Profit Monitoring Group that when the revised *Framework* addresses not-for-profit entities, the primary user group needs to be amended to include a reference to present and potential funders and financial supporters (the not-for-profit entity equivalent of present and potential capital providers). However, the AASB prefers the term 'resource providers', which includes creditors, donors and other financial supporters.

In addition, because some users of financial reports of not-for-profit entities will lack the capacity to make decisions in their capacity as capital providers, the AASB is of the view that information useful for present and potential capital providers (and their not-for-profit entity equivalents) is unlikely to be a proxy for the common information needs of all users of financial reports of not-for-profit entities. Therefore, the AASB agrees with the comments of the NSS-4 Not-For-Profit Monitoring Group that the primary users of financial reports of not-for-profit entities should also include recipients of goods and services (including beneficiaries, such as community groups). The AASB also considers that parties providing a review or oversight function (including, in respect of public sector not-for-profit entities, parliaments) should be identified as primary users.

In summary, the AASB is of the view that the primary users of financial reports of not-for-profit entities should be identified as:

(a) resource providers (including creditors, donors and other financial supporters);

(b) recipients of goods and services (including beneficiaries, such as community groups); and

(c) parties performing a review or oversight function.

The AASB observes that these classes of primary users are neutral between all sectors, and therefore recommends their adoption for all entities once the IASB considers not-for-profit entities in the Conceptual Framework project.

Suggestion for using more neutral expression

As noted above, the AASB is responsible for developing a conceptual framework applicable to all Australian reporting entities, regardless of the sector in which those entities operate. Its approach has been to add to the IASB *Framework* text for entities not addressed by that *Framework*, but only to the extent necessary. It would assist the AASB and other national standard setters adopting or converging with the revised *Framework* if the expression used in the revised *Framework* were as sector-neutral as possible. For example, it would be helpful if the revised *Framework* were to refer to capital providers as 'primary users' after the initial discussion of capital providers. This would avoid the need for national standard setters to make numerous amendments to the expression 'capital providers'.