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International
Accounting Standards
Board



**INFORMATION FOR OBSERVERS**

**SAC Meeting:** **June 2007, London**

**Project:** **Conceptual Framework**
**Phase A: Chapter 1 – Stewardship**
***(Agenda Paper 1B)***

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## PURPOSE OF THIS MEMO

1. At the Boards' February meetings, the staff presented an analysis of comments received related to the Discussion Paper (DP), *Preliminary Views on an Improved Conceptual Framework for Financial Reporting: The Objective of Financial Reporting and Qualitative Characteristics of Decision-Useful Financial Reporting Information*. At those meetings, the staff announced its intention to meet with respondents to discuss comments raised on the issue of **stewardship**. The staff had several such meetings in April. In May, the staff met with the conceptual framework project's IASB advisors to discuss our findings. In this paper, the staff discusses the results of those constituent meetings and the staff's preliminary analysis of the issue. At this meeting, we will seek SAC member comments on the completeness of the analysis, as well as their advice on the issues raised.

## RELEVANT DISCUSSION PAPER SECTIONS

2. In the DP, the Boards proposed the following:

> OB2. The objective of general purpose external financial reporting is to provide information that is useful to present and potential investors and creditors and others in making investment, credit and similar resource allocation decisions.
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> OB3. To help achieve its objective, financial reporting should provide information to help present and potential investors and creditors and others to assess the amounts, timing, and uncertainty of the entity's future cash inflows and outflows (the entity's future cash flows). That information is essential in assessing an entity's ability to generate net cash inflows and thus to provide returns to investors and creditors.
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> …..
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> OB27. Management of an entity is accountable to owners (shareholders) for the custody and safekeeping of the entity's economic resources and for their efficient and profitable use. Management's stewardship responsibilities include protecting the entity's economic resources, to the extent possible, from unfavourable economic effects of factors in the economy such as inflation or deflation and technological and social changes. Management is also accountable for ensuring that the entity complies with applicable laws, regulations, and contractual provisions. Because management's performance in discharging its stewardship responsibilities significantly affects an entity's ability to generate net cash inflows, management's stewardship is of significant interest to users of financial reports who are interested in making resource allocation decisions.
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> OB28. Users of financial reports who wish to assess how well management has discharged its stewardship responsibilities generally are interested in making resource allocation decisions, which include, but are not limited to, whether to buy, sell or hold the entity's securities or whether to lend money to the entity. Decisions about whether to replace or reappoint management, how to compensate management, and how to vote on shareholder proposals about management's policies and other matters are also potential considerations in making resource allocation decisions in the broad sense in which that term is used in the framework.

Thus, the objective of financial reporting stated in paragraph OB2 encompasses providing information useful in assessing management's stewardship. In addition, the information [about an entity's resources, claims to those resources, and changes in resources and claims] is useful in assessing how well management has discharged its stewardship responsibilities because management is responsible for the entity's resources and related claims and changes in resources and claims.

## SUMMARY OF RESPONDENT COMMENTS ON STEWARDSHIP

3. Approximately 30 comment letters included a specific discussion of information useful for assessing stewardship as an objective of financial reporting. Those comment letters came from a variety of constituent types, including user groups, standard setters, regulators, auditors, and preparers. The group consisted of mostly European entities, although there were some multi-jursidictional respondents included. The staff sorted the respondents who addressed stewardship according to the extent of coverage of the issue that appeared in each respondent's letter. The staff then selected a sample of respondents, giving preference to those whose comment letters contained the most substantive discussion of the issue, and met with each of them to further discuss their comments. This section summarizes the staff's understanding of the comments on stewardship that we received during the comment letter process and as a result of the follow-up meetings with selected respondents. We asked several questions of each of the respondents when we met with them in April. The questions that elicited the most useful responses were:

   - Is the decision usefulness objective as expressed in the DP complete, or are there uses of financial reporting that are not encompassed in the objective but should be?

   - How would financial reporting differ if the proposed objective in the DP was broadened to explicitly include providing information useful for assessing management's stewardship?

   - Can the performance of management in discharging its responsibility to capital providers be distinguished from the overall performance of the entity? What is the role of financial reporting in making this distinction, if any?

   - If the proposed objective were to explicitly include providing information useful for assessing management's stewardship, would that risk confusing financial reporting issues with corporate governance issues?

Their responses to those questions are discussed below.

**Is the Decision-Usefulness Objective Complete?**

4. Respondents generally agreed that the objective of financial reporting is to provide information that is useful for making decisions. However, they were concerned that the DP focuses only on resource allocation decisions; seemingly to the exclusion of other types of decisions that users routinely make using financial reporting as an input. Respondents stated that investors and creditors make decisions in their capacity as capital providers that involve influencing the management of the entity itself. For example, shareholders must decide how to vote on whether to retain directors and/or managers or replace them and how management should be compensated for their services. Capital providers also decide whether to use their influence as capital providers to affect the operating and financing decisions that management makes. For instance, bondholders often have contractual rights to approve or block certain actions of management that might have an impact on the bondholders' investment. For another example, a lender who has the power to call a loan may use / threaten to use that power to persuade management to take a specific course of action in managing the business. Examples of matters of interest to capital providers are performance and strategy of management, corporate governance, and social responsibility.

5. All of the constituents that we met with agreed that these decisions are **aided** by financial reporting information. They also argued that using financial reporting as an input for those types of active business decisions is a legitimate use of financial reporting information, which, in their view, means that the objective of financial reporting should encompass providing information useful for making those decisions as well as resource allocation decisions.

6. Respondents pointed out that the objective in OB2 is restrictive in that it refers to usefulness for making "investment, credit and similar resource allocation decisions." Respondents argued that information useful for making capital provider-type decisions (voting on shareholder proposals, influencing management

actions, etc) are not encompassed in the phrase "investment, credit, and similar resource allocation decisions."

7. The staff asked respondents to comment on potentially broadening the primary objective of financial reporting as expressed in paragraph OB2 of the DP to include the decisions that capital providers make in addition to resource allocation decisions. The following is one potential revised objective that the staff suggested for respondents' consideration:

> **The objective of general purpose external financial reporting is to provide financial information that is useful to present and potential investors and creditors in making decisions in their capacity as resource providers or potential resource providers to the reporting entity.**

8. The constituents generally preferred the modified objective to the objective in paragraph OB2, stating that the modification would be a good first step in allaying their concerns about stewardship. They noted that other changes would be necessary in later paragraphs of the DP to establish that resource allocation decisions are only one type of decision that is aided by financial reporting information.

9. Some prefer the objective as stated in paragraph 7 because it encompasses more of the decisions that users have told us that they make based in part on their reliance on financial reporting, while remaining focused on the primary user group and the legitimate uses that group has for financial reporting information. Proponents argue that the objective stated above encompasses the assessment of stewardship better than the proposed objective in the DP without overstating its importance relative to resource allocation decisions. Therefore, they think the objective stated above would be more consistent with the assertion in paragraph OB28 that the decision-usefulness objective "encompasses providing information useful in assessing management's stewardship."

**How Would Financial Reporting Differ if the Objective was Broadened?**

10. Most respondents did not elaborate on how financial reporting would be affected by broadening the objective. During our follow-up meetings with respondents, the staff asked whether the respondents could identify specific information that might be omitted from financial reporting under the proposed objective but would be included in financial reporting if the objective was broadened. Respondents stated that it was not clear that there would be any difference in the information included in financial reporting, but that it was possible that there would some differences.

11. Respondents stated that some financial information might be more important for assessing stewardship than making resource allocation decisions. The most common example was information about transactions between the entity and its management. Respondents asserted that the magnitude of that type of related party transaction might be immaterial from the point of view of the entity but might be material in assessing management's stewardship. Respondents also cited disaggregated information about discontinued operations as an example of information that might be more important to an assessment of stewardship than it would be for assessing future cash flows. They argued that the net amounts required by current accounting standards are adequate for assessing future cash flows, but disaggregated revenues and expenses would be required for an effective assessment of management's past decision-making concerning the discontinued operation. In other words, different information would be required to assess the impact on future cash flows from the discontinued operation than would be required to assess management's past decisions regarding the efficient and profitable employment of the discontinued operation.

12. The question of whether assessing stewardship requires financial information beyond that required for resource allocation decisions seems to be a different question than the question of whether the proposed objective is complete and appropriate. The staff thinks the Board should reason from first principles when developing the conceptual framework. To do so would require that the Board first

identify the objective of financial reporting, and then determine what information should be provided to meet the objective. Based on that reasoning, it is not necessary, and perhaps not appropriate, to ask how financial reporting would differ based on whether or not providing information that facilitates assessment of stewardship was identified as an objective of financial reporting. If the Boards think that the objective of financial reporting should be broader than the proposed objective as stated in the DP, then the proposed objective should be broadened even if the Board has not identified any effects that would have on the rest of the framework and financial reporting.

13. Respondents generally acknowledged that any information that would be useful for assessing stewardship would be useful for making a resource allocation decision. Respondents accept as common sense that the competence and integrity of management has a bearing on the future cash flows of the entity and would therefore be factored into the resource allocation decisions of a rational capital provider or potential capital provider. However, most respondents told us that it is still useful to include providing information useful for assessment of stewardship as part of the objective of financial statements. They argued that it was a matter of emphasis – information that helps a user assess the effectiveness of management would be more likely to be required by standard-setters if the objective were to encompass that information.

**Can Management Performance Be Distinguished from Entity Performance?**

14. Paragraph BC1.35 of the DP notes the Board's concern that "to make stewardship a separate objective might risk implying that financial reporting can and should separate management performance from entity performance." Respondents agreed with the Boards that financial reporting cannot make that distinction. However, most of the respondents that we interviewed stated that financial reporting should provide information that that is helpful to users in assessing the performance of management. Most respondents asserted that assessing the competence and integrity of management is a critical part of assessing an entity's ability to generate

net cash inflows and provide a return to capital providers. In other words, while respondents agreed that management should not be asked to assess their performance separately from the entity's performance, it is appropriate and necessary for financial statement users to do so. Users must be provided with the financial information necessary to enable them to evaluate the decision-making of management over a period. To do so effectively, users tell us that they make judgements about the performance of the entity that is specifically attributable to management's decision-making and the performance that is outside of management's control, such as general economic and industry conditions.

15. According to respondents, assessment of management's decision-making ability focuses more on the performance statements (income statement and cash flow statement) than the balance sheet. Disaggregated information about performance over a number of periods, when compared to the same information from similar entities, gives users valuable information about the effectiveness of a particular entity's management. That information can then be used to make decisions about the future, whether they be resource allocation decisions or other business decisions. Some respondents indicated concern that if the proposed objective is adopted without modification, future standard-setting activities might overemphasize the role of the balance sheet (more important for valuation) and underemphasize that of the performance statements (more important for assessing past performance).

16. Some respondents noted that the concept of stewardship arose from the principal-agent relationship that exists between capital providers/owners and the managers that they have appointed to manage the day to day operations of the entity. An important objective of financial reporting is to allow the agent to report to the principal so that the owner can assess whether management has employed the assets of the entity efficiently and profitably. Based on that assessment, the owner makes decisions regarding the retention or replacement of management, compensation of management, and whether to provide operational guidance to management.

**Does a Stewardship Focus Confuse Financial Reporting Issues with Corporate Governance Issues?**

17. Paragraph BC1.38 notes the Boards' observation "that those who consider providing information useful in assessing management's stewardship to be a broader objective than decision usefulness may be mixing financial reporting and corporate governance issues." The paragraph also notes that while sound financial reporting information often may be helpful in assessing matters pertaining to corporate governance, that assessment may require information beyond that appropriately provided by financial reporting.

18. Respondents objected to this characterization. They noted that while it is true that financial reporting cannot be expected to satisfy all of the information needs for an assessment of matters pertaining to corporate governance, it is equally true that financial reporting does not satisfy all of the information needs for making resource allocation decisions. They argue that financial reporting information is a useful input for corporate governance decisions just as it is a useful input for resource allocation decisions. Capital providers make both types of decisions and they rely on financial reporting information as one of many inputs when making those decisions.

19. Whether information useful for assessing matters of corporate governance is within the boundaries of financial reporting has not yet been decided by the Boards. The boundaries of financial reporting are expected to be established by the Boards during a later phase of the conceptual framework project, Phase E – presentation and disclosure. The staff thinks that it is inappropriate to assume that information useful for assessing governance is outside of the scope of financial reporting in advance of that phase of the project; however, it also thinks it is inappropriate to presume that the IASB and FASB can set governance standards or establish a framework for governance of corporations, partnerships, or trusts.

## OTHER CONSTITUENT OUTREACH ON STEWARDSHIP

20. In addition to the aforementioned comment letter process, one-on-one respondent meetings, and consultation with the IASB advisors, the staff discussed stewardship with the User Advisory Council of the FASB in April 2006. Comments received from that group were similar to those received from other sources. Some of the more significant comments from users present at that meeting were:

> Stewardship is not an activity that takes place only in the past. Management must be able to look forward and adjust to risks and opportunities that it predicts will occur. Trusting assets to management implies stewardship going forward, not just reporting on what it has done in the past. If management is not looking forward and predicting outcomes and other items, it is not being an effective steward.
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> Some investors do want to know what happened, using historical information. To some degree there can be more certainty with historical cost information. Once the historical cost information is provided with a higher level of certainty, various interested parties can use that information as they see fit to develop forward-looking predictions.
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> It is important to define the users of the information and what should be provided to those users. In the case of the Board's tentative decisions, the users are investors, creditors, and their advisors. They need information to help them make decisions. The focus at this stage should remain simple and not proceed to recognition and measurement issues until the basic questions of who are the users and what are their needs are addressed.

**QUESTIONS FOR SAC**

21. Does the summary of respondent comments and staff analysis presented here provide an adequate basis for the Board to make decisions on the completeness and appropriateness of the proposed objective? If not, what additional information is needed?

22. Based on your experience, and the analysis of constituent responses to the DP provided in this memo, what do you believe is the objective of financial reporting? Do you prefer the proposed objective as stated in paragraph OB2 of the DP, as suggested in paragraph 7 of this memo, or another objective? Why?

23. Respondents gave some examples how financial reporting information may differ based on whether or not providing information for assessing management accountability/stewardship is included within the objective. Do you agree with those examples? Are there other examples of how financial reporting information might be different based on the objective ultimately developed by the Boards?