30 Cannon Street, London EC4M 6XH, United Kingdom
Tel: +44 (0)20 7246 6410 Fax: +44 (0)20 7246 6411
Email: iasb@iasb.org Website: www.iasb.org

International
Accounting Standards
Board

INFORMATION FOR OBSERVERS

Board Meeting:	**19 September 2007, London**
Project:	**Conceptual Framework**
Subject:	**Chapter 1 Redeliberations: Stewardship and the Objective of Financial Reporting (Agenda Paper 7A)**

PURPOSE OF THIS MEETING

1. This paper presents two staff recommendations: 1) an amended proposed objective of financial reporting for the forthcoming exposure draft (ED) and 2) a restructured revised working draft of potential ED on Chapter 1 (Attachment A). [Attachment A is omitted from observer notes.] For convenience, the objective that the staff propose is:

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

2. [Paragraph omitted from observer notes.]

3. Attachment B to this paper is for your information. It includes a summary of the decisions made by the FASB on this issue on 29 August 2007.

4. Many parts of this paper may seem familiar to the Board as this paper is an updated version of the consultation paper to the SAC in June 2007.

BACKGROUND

5. 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*. Some respondents disagreed with the boards' preliminary views on the objective of financial reporting and the interpretation of stewardship in the objective.

6. Since that meeting, staff met with a sample of respondents whose comment letters contained substantive discussion of the issue. 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 as well. The staff also consulted with the FASB's technical user group (ITAC) and the IASB's advisory council (SAC). The staff also reviewed a paper prepared by the PAAinE on stewardship. The staff analysis and recommendations in this paper reflects the feedback received from all of these parties.

RELEVANT EXTRACTS FROM THE DISCUSSION PAPER

7. 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.
>
> 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.
>
> …..

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.

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.

ANALYSIS OF ISSUES

Was the Objective Complete?

8. 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. These decisions include those that are made in their capacity as capital providers to influence some of the operating and financing decisions that management makes. Examples are:

   a. Shareholders voting on whether to retain directors and/or managers or replace them and how management should be compensated for their services.

b. Bondholders who have contractual rights to approve or block some actions of management that might have an impact on the bondholders' investment. Another example, a lender who has the power to call a loan may threaten to use that power to persuade management to take a specific course of action in managing the business.

9. All of the interviewed respondents 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 legitimate. In their view, the objective of financial reporting should encompass providing information useful for making those decisions as well as resource allocation decisions.

10. The staff are of the opinion that when the boards were drafting the DP, they did not intend to exclude those type of actions/decisions mentioned in paragraph 7a and b. Paragraph OB27 noted that:

> "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."

How Would Financial Reporting Differ if the Objective was Broadened?

11. Most respondents did not elaborate on how financial reporting would be affected by broadening the objective. During 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. Interviewees 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 be some differences.

12. 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.

13. 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.

14. The staff think that having a stewardship notion is a matter of emphasis on the types of financial information provided to the user. The staff do not think that the information that ultimately appears on the financial reports will differ significantly. However the staff think that by using the term "stewardship", some types of financial information may have more prominence even though they could be considered useful under the umbrella of "useful for assessing resource allocation decisions". These could be whether the entity has operated within the mandates of laws or how much of the entity's activities are through related party transactions.

Can Management Performance Be Distinguished from Entity Performance?

15. 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." Generally, respondents agreed with the Boards that financial reporting cannot make that distinction. However, most of the interviewed respondents 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 evaluate the decision-making of management over a period. To do so effectively, users 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.

16. 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 underemphasise that of the performance statements (more important for assessing past performance).

17. 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. (What the staff mean by management is to encompass management and directors of an entity[1].) Based on that assessment, the owner makes decisions regarding the retention or

1 This is consistent with the definition of key management personnel in IAS 24 where key management personnel are defined as persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any director (whether executive or otherwise) of that entity.

replacement of management, compensation of management, and whether to provide operational guidance to management.

18. The staff agree with the majority of respondents that management should not be asked to assess their performance separately from the entity's performance. The staff think that the ED should continue to express this fact. However, the staff also think that ED should also acknowledge that, in some cases, financial reports may aggregate certain types of information that users will need to assess the management's performance. Such information may include trends of the entity's performance.

STAFF RECOMMENDATION

Recommendation 1: The Objective of Financial Reporting

19. Based on the analysis above, the staff recommends the following objective of financial reporting:

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

20. Generally, constituents 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.

21. The staff prefer the objective as stated in paragraph 19 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. The staff think 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,

the staff 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."

Questions to the Board:

22. Do you agree that the staff's revised objective addresses constituents' concerns about the role of stewardship in financial reporting?

23. In principle, do you agree with the staff's recommended objective in paragraph 19?

Recommendation 2: Flow of Chapter 1 of the DP

24. During redeliberations, both Boards affirmed that the basic underlying perspective for financial reporting is the perspective of the entity that is reporting on its resources and the claims to those resources. The staff think that the chapter should flow logically from that perspective.

25. The staff recommends restructuring Chapter 1 to illustrate the following logical flow:

    a. The basic perspective underlying financial reporting is the perspective of the entity that is reporting.

    b. That perspective involves reporting on the entity's resources (assets), the claims on the entity's resources (liabilities and equity), and the changes in them.

    c. The primary user group is made up of those who have a claim (or potentially may have a claim) on the entity's resources—its present and potential equity investors and creditors (capital providers). Other potential users groups may benefit from financial reporting information, but they are not the focus of the objective.

    d. That primary user group is interested in financial information because that information is useful in making decisions that investors and creditors make in their capacity as capital providers.

e. The decisions made by investors and creditors include resource allocation decisions as well as decisions relating to protecting or enhancing their claim on the resources of an entity.

26. Attachment A is a restructured Chapter 1 that reflects this flow. It is provided to help the Board evaluate the staff's recommendations. [Attachment A is omitted from observer notes.]

Questions to the Board:

27. In principle, do you agree with the staff's recommendation for restructuring Chapter 1 to enhance its logical flow?

28. Do you agree that the revised draft of Chapter 1 (Attachment A) faithfully reflects each of the staff's recommendations on a substantive level?