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International Accounting Standards Board

This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.
These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting:	**December 2008, London**
Project:	**Conceptual Framework**
Subject:	**Comment Letter summary: Objectives and Qualitative Characteristics (Agenda paper 2A)**

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1. The comment period on the Exposure Draft *An improved Conceptual Framework: Chapter 1: The Objective of Financial Reporting* and *Chapter 2: Qualitative Characteristics and Constraints of Decision-useful Financial Reporting Information* (ED) ended on 29 September 2008.

2. This paper summarizes the main issues that arose from the ED. (The issues that arose from the Preface of the ED are discussed in Agenda Paper 2C/FASB Memorandum 76A.)

3. The staff has given equal weight to all comment letters received. We have not provided a quantitative review of the comments received or attributed comments to individual respondents in order to provide a neutral discussion of the comments received. We also have not provided staff views – these will be presented when the boards commence the redeliberations process at subsequent meetings.

4. As at 12 November 2008, the IASB and FASB received 139 comment letters. A breakdown of the comment letters by respondent type and geographic region is noted below:

Respondent type	Number of respondents	Percentage %
Professional organizations	32	23
Individuals	27	20
Preparers	16	12
National standard-setters	15	10
Investors/ Analysts/ Users	12	8
Accounting firms	7	5
Academics	7	5
Regulators	7	5
Others (NFPs, public sectors)	16	12
Total	**139**	**100**

Geographic region	Number of respondents	Percentage %
Europe	62	44
North America	38	28
Multi-regional	17	12
Australia/New Zealand	10	7
Asia Pacific ex Australia/ New Zealand	8	6
Africa	3	2
Middle East	1	1
Total	**139**	**100**

5. Several respondents suggested specific non-technical drafting changes that are not discussed in this paper. They will be considered when drafting the final chapters.

6. Some constituents recommended that the boards consider the Consultation Paper published by the International Public Sector Accounting Standards Board (IPSASB). A copy of the Consultation Paper can be found here http://www.ifac.org/PublicSector/ProjectHistory.php?ProjID=0066.

CHAPTER 1: OBJECTIVE OF FINANCIAL REPORTING

General Comments

7. Chapter 1 in the ED proposes an objective of financial reporting. It also includes a discussion on who the primary user group is and that financial reports should report on the activities of the entity, rather than its owners.

8. Most respondents supported the proposals in Chapter 1 and noted that the ED had improved, particularly on the proposed objective that now explicitly discusses that users use financial reports for stewardship purposes. However, there were some parts of Chapter 1 on which respondents raised concerns. They include the implications for choosing the entity perspective and whether the boards chose the right primary user group. These issues and others are discussed in more detail in the following section.

The Entity Perspective

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?

9. Most respondents agreed that the entity is distinct from its owners. Therefore, many agreed that financial reports should reflect the perspective of the reporting entity rather than the perspective of the entity's owners. Some also noted that the boards' recent standard-setting had more explicitly acknowledged the entity perspective at the standards level.

10. However, some respondents viewed that the boards were introducing the notion of financial reporting being produced from the entity's perspective for the first time. They also asserted that the boards didn't provide enough information on why it was appropriate to choose the entity perspective rather than other perspectives.

11. Some respondents asked the boards to clarify their position on how to align the entity perspective with the primary users' interest in the reporting entity's ability to generate cash flows.

12. Some respondents who agreed with the boards that the entity is distinct from its owners also argued that the parent company approach should not be abandoned. This is because there may be circumstances in which the parent company approach would provide useful information, such as the presentation of earnings per share and allocation of net income between controlling and non-controlling interests.

13. However, many respondents also challenged the adoption of entity perspective. Their concerns are discussed below.

Confused on what is entity perspective and proprietary perspective

14. Many respondents were confused regarding the meaning of *entity perspective*, *proprietary perspective* and *parent company approach*. Some noted that the boards' understanding of what is the proprietary perspective is wrong.

15. Some respondents urged the boards to explain the different perspectives more fully, rather than merely noting in the basis for conclusions that the boards had yet to consider the consequences of adoption the entity perspective on other phases of the project.

16. A respondent was of the opinion that there was no such concept as entity theory. Rather, there were proprietary views and entity views that are not well defined or well articulated. Therefore, it would be a mistake to assume that there is **the** entity perspective and **the** proprietary perspective because each perspective has different shades. The choice of "orientation" perspective relies on professional judgement. Rather than rely on incomplete, inconsistent or confusing concepts, the boards should exercise its professional judgement and state its view in its Framework.

Applying the Proprietary Perspective

17. Some respondents agreed that the proprietary perspective is not applicable to many entities and therefore has no place in the contemporary corporate world.

Primary User Group

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?

18. Most respondents agreed that the boards should identify present and potential capital providers (equity investors, lenders and other creditors) of an entity as the primary user group. Those users provide resources to the entity and do not have the ability to compel entities to provide information to meet their needs.

19. However, some respondents suggested that the boards should be careful to avoid neglecting the information needs of other users. A few respondents noted that the needs of present and potential capital providers will meet many of the needs of other users, but not most of the needs of other users.

Different Information Needs of Capital Providers

20. Some respondents argued that having a diverse group as the primary users would oversimplify the relationship between an entity and the individual users in the primary user group. This is because each user group has different information needs.

21. Others suggested that the boards consider how to prioritise conflicting information needs of one type of capital providers over another. For example, debt holders may wish to have more detailed information about risk management strategies. However, that could cause proprietary information (secrets) to be revealed, which could harm the interests of the entity's existing shareholders. Another example cited was the FASB's current project on disclosures of certain loss contingencies. Present equity investors want information about lawsuit contingencies that potential equity investors would prefer that the entity not disclose.

Only existing equity investors as the primary user

22. Some respondents recommended retaining the IASB's current narrow approach of defining investors of risk capital as the primary user group. They acknowledged that all equity investors, lenders and creditors are interested in the entity's ability to generate cash flows to meet their claims. However, because equity investors

provide the resources that bear the highest risks, they therefore should be the primary user of financial reports. Furthermore, these respondents noted that meeting the equity investors' needs would meet the needs of lenders and other creditors in many cases.

Primary user group be renamed as stakeholder

23. Some respondents think that the primary user group should be extended to include employees and governments because they legitimately use financial reports. They also suggested that the term *primary user group* be changed to *stakeholders* to reflect the new focus of this concept.

There should not be a primary user group

24. Some respondents think that all users should be given equal consideration. Identifying particular users as primary might result in ignoring the information needs of other users.

25. Another group of respondents argued that the IASB had failed to fulfil its mandate – to develop, in the public interest, a single set of accounting standards for the world's capital markets and other users to make economic decisions, and to take into account the special needs of emerging economies, as appropriate[1] – in their choice of the primary user group. Users, such as charities and corporate governance monitoring groups, use financial reports to monitor how developing economies transfer resources to their citizens and whether entities are transparent and ethical in their conduct. Capital providers focus on financial information while monitoring groups need information about such things as an entity's local trading partners, royalties paid to governments and key properties of corporations. Respondents cited entities in extractive industries as examples.

Management should be users

26. Some respondents think that management should be considered as users of financial reports. This is because the information that is relevant for capital providers should also be relevant to those who manage the capital. Moreover, reports prepared for internal purposes tend to faithfully represent the entity's business model. Therefore, internal reports and external reports should be similar.

[1] IASC Foundation Constitution, paragraph 2

Users of Not-for-profit entities

27. Some respondents suggested that the primary users for not-for-profit entities should include recipients of goods and services (including beneficiaries, such as community groups), and parties providing a review or oversight function (an example in the not-for-profit public sector, parliaments).

Terminology

28. Some respondents found the term *capital providers* implies a focus on providers of equity capital in common usage. They recommended using the term *resource providers* or *claimants*. *Resource providers* will more appropriately capture the users for not-for-profit entities, thus reducing the need to make changes to the Framework when the boards consider the application of the framework to not-for-profit entities later.

29. However, one respondent noted that *claimant* has strong connotations of claims in litigation.

The Objective: Decision-Usefulness and Stewardship

> 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.

30. Most of the respondents agreed with the proposed objective of general purpose financial reporting. Many believed that it was a major improvement compared to the DP/PV.

31. One respondent also noted that the objective should also make reference to "evaluating decisions". This is because many users rely on other sources of information to make decisions and use financial reports to confirm their previous assessments and provide input to future assessments.

Stewardship/Accountability

32. Some respondents, while agreeing with the boards' proposed objective, thought that stewardship was more than just protecting and enhancing the entity's resources. They suggested clarifying that stewardship was also about how the management performed in light of the risks taken in the past so that the performance and position of the entity in the future could be forecasted.

33. One respondent argued that management's stewardship responsibilities were only to existing equity capital providers. Therefore, the primary user group should only be focused to them.

34. A public sector (governmental) respondent noted that the IPSASB, in its recently published Consultation Paper, noted that stewardship also entails the provision of information relating to how well the entity meets its non-financial objectives such as meeting service delivery objectives. A few respondents noted that there may be circumstances in the not-for-profit sectors where accountability does not fall within the decision-useful objective, such as accountability to resource providers that lack the capacity to make decisions.

35. Some respondents also stated that they prefer the term accountability rather than stewardship.

Over-emphasis on 'assessing cash flow prospects'

36. Many respondents stated that the objective of assessing stewardship has not been sufficiently emphasised and that the ED overemphasised that the role of financial statements is providing information to enable users to forecast future cash flows.

37. One respondent stated that because many analysts and practitioners use valuation models based on accounting earnings and book values, the emphasis on future cash flows is unnecessary.

Information about Risks

38. Some respondents encouraged the boards to explicitly discuss the need for information about risks. They think the term *uncertainty*, as used in the ED, was too broad, whereas the term *risk* referred to exposures that were identifiable and manageable.

OTHER ISSUES

General Purpose Financial Reporting

39. Some of the respondents stated that they found it hard to assess the boards' proposals because the difference between financial statements and financial reporting is not adequately explained. Others asked that the boards explain the difference between special purpose financial reporting and general purpose financial reporting and the role of the primary financial statements as compared to the notes.

40. A respondent suggested that the definition of financial reporting should be broad enough to encompass other types of corporate reporting, such as triple bottom line or sustainability reporting[2]. However, another respondent disagreed with the boards' conclusion that financial reporting should incorporate management explanations as it is not within the purview (or remit) of the FASB.

41. Some respondents also suggested that the boards consider the definitions of general purpose financial statements and general purpose framework adopted by the International Auditing and Assurance Standards Board[3] and IAS 1 *Presentation of Financial Statements*[4], so that the definitions of these terms are aligned.

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[2] Triple bottom line or sustainability reports are reports where an entity reports its impact on the community and the environment. More information on these type of reports can be found here: http://www.globalreporting.org

[3] The International Auditing and Assurance Standards Board defines general purpose financial statements as "financial statements prepared in accordance with a financial reporting framework that is designed to meet the common information needs of a wide range of users."

[4] IAS 1 defines general purpose financial statements as "those intended to meet the needs of users who are not in a position to require an entity to prepare reports tailored to their particular information needs". Paragraph 10 in IAS 1 notes that a complete set of financial statements comprises a statement of financial position as at the end of the period; a statement of comprehensive income for the period; a statement of changes in equity for the period; a statement of cash flows for the period; notes; and a statement of financial position as at the beginning of the earliest comparative period.

CHAPTER 2: QUALITATIVE CHARACTERISTICS AND CONSTRAINTS OF FINANCIAL REPORTING

General Comments

42. The ED proposed that (a) the qualitative characteristics that make information useful are **relevance, faithful representation**, **comparability**, **verifiability**, **timeliness**, and **understandability**; and (b) the pervasive constraints on financial reporting are **materiality** and **cost**. The qualitative characteristics were distinguished as either fundamental or enhancing depending on how they affect the usefulness of information.

43. Most respondents agreed with the boards' proposals, but many noted areas that would benefit from additional clarification. For example, some respondents asked whether one should apply the qualitative characteristics and pervasive constraints differently, depending on whether one is a standard-setter or a preparer. Some also suggested that the boards clarify that the cost constraint should only be applied by standard-setters (paragraphs 78–80). Some respondents also requested additional guidance for circumstances in which there are conflicts between the information needs of different capital providers or types of capital providers. Such requests for additional guidance were particularly evident from their questions or concerns about how preparers and others are to apply the components of faithful representation—complete, neutral, and free from material error (paragraph 53).

44. Some respondents also questioned or expressed concerns about classifying the qualitative characteristics as either fundamental or enhancing and using the term **faithful representation** rather than **reliability**. The next section of this paper discusses these general comments and other issues raised by respondents.

Classification of Qualitative Characteristics as Fundamental and Enhancing

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?

45. A majority of respondents supported the boards' decision to classify the qualitative characteristics as either fundamental or enhancing. These respondents also agreed that the distinctions between those characteristics and the pervasive constraints on financial reporting are helpful in understanding how they are applied.

46. Those who disagreed did so because in their view:

    a. The distinction is arbitrary or of little or no use and some also said the boards did not adequately justify the change.

    b. Preparers may view the enhancing qualitative characteristics as optional. They noted that the absence of any one qualitative characteristic entirely is not appropriate because each characteristic is equally important.

    c. Which qualitative characteristics are most important depends on the facts and circumstances being conveyed. Therefore, instead of differentiating among qualitative characteristics, they suggest the boards should make a general reference that professional judgment should be used when determining which qualitative characteristics are to be emphasized.

47. Many respondents suggested alternative or additional fundamental qualitative characteristics. They included:

    a. Elevating understandability and verifiability.

    b. Adding prudence, as it would counteract tendencies toward over-optimism or self-interest.

    c. Adding concepts such as substance-over-form, true and fair view, and transparency. One respondent defined transparency as "the stakeholder's right to know," and added that making that a fundamental characteristic would "push the notion of decision-useful financial reports up to a more demanding level of responsibility, namely by strengthening the concept of pertinent information."

Fundamental Qualitative Characteristics

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

Relevance

48. Nearly every respondent agreed that relevance is a fundamental qualitative characteristic. However, some respondents expressed concern that relevance seems to have higher priority than faithful representation. They noted that one should apply relevance and faithful representation together.

49. A number of respondents requested that the boards include a notion of probability in the definition of relevance. These respondents were concerned that "capable of making a difference" is too broad and suggested the definition be altered to read "reasonably expected."

50. A majority of respondents also agreed that predictive value and confirmatory value are identified appropriately as components of relevance. However, some constituents urged the boards to exercise caution when applying the component *predictive value*. They think that general purpose financial reporting should focus on giving the best representation of the past. Therefore, the boards should avoid implying that financial reporting might include forward-looking information, except for specific circumstances such as a going concern uncertainty or measuring the impairment of an asset.

Faithful Representation

51. The majority of respondents agreed that faithful representation is a fundamental qualitative characteristic but many also noted that, in their view, the boards have not adequately justified the replacing of the term **reliability** with the term **faithful representation**. Some suggested that if the boards thought the problem with

reliability is the lack of common understanding, they should or could make the definition of reliability clearer.

52. Many respondents commented on the difference in meanings between faithful representation, as proposed, and reliability. Although some acknowledge that there may be no intent to make a substantive change, they specifically noted that:

   a. Faithful representation does not encompass all of the key elements of reliability because reliability is a broader notion than faithful representation, and it includes a certain degree of uncertainty involved in depicting that economic phenomenon, and in particular, in measuring an item.

   b. A key feature of reliable information is that it can be "depended upon" (relied on), which is not reflected as a feature of faithful representation. While the ED stresses the focus of faithful representation on the depiction of economic phenomena, reliability has a nuance of assessing the economic phenomena itself.

Components of faithful representation

53. Most agreed that a faithful representation of an economic phenomenon should be complete, neutral and free from material error. However, some requested additional guidance on how to achieve these components. For example, for financial information to be considered complete, what elements need to be present, or how much can be omitted?

54. In contrast, some respondents noted that it would be virtually impossible to achieve neutrality and completeness because they view these components as absolutes.

55. Some respondents, however, believe that the choice of the primary user group in Chapter 1 of the ED will restrict the usefulness financial reports. They contend that the information contained in financial reports as proposed by the boards will not be adequately relevant for all users and will, due to incompleteness, fail to be a faithful representation of the economic events to which they relate.

56. Many constituents also suggested the boards explicitly identify substance over form as either a separate component of faithful representation or as a separate fundamental qualitative characteristic.

Neutrality

57. Some respondents expressed concerns about neutrality, saying that neutrality is virtually impossible to achieve. They noted that for information to be relevant it must have purpose, and by definition to have purpose is not neutral. Many of them also noted that because financial reporting is used as a tool to influence decision-making, the nature of financial reporting cannot be neutral.

58. Some also think it is incorrect to assume that bias is always undesirable, especially in circumstances when bias is, in their view, appropriately used to avoid unfaithful representation.

59. Some respondents also suggested the boards include concepts such as prudence (or conservatism) and precision as components of the fundamental qualitative characteristics. This is because, in their view, neutrality does not adequately capture the notion that one should not overstate or understate financial statements.

Free from material error

60. One constituent commented that the term *material* should be removed from freedom from material error as it is redundant due to the materiality and cost constraints.

61. Some constituents proposed that verifiability should be a component of faithful representation rather than freedom from material error. They considered verifiability to be broader than freedom from material error because it also encompasses the use of the appropriate recognition or measurement method.

Enhancing Qualitative Characteristics

Do you agree that *comparability*, *verifiability*, *timeliness*, and *understandability* are enhancing qualitative characteristics and that they are appropriately identified and sufficiently defined for them to be consistently understood and useful? If not, why?

62. The majority of respondents agreed that comparability, verifiability, timeliness, and understandability are enhancing qualitative characteristics.

63. A minority of respondents also proposed that substance over form and prudence should be separate enhancing qualitative characteristics. Also, as stated above, many constituents suggested that understandability and verifiability be elevated to the status of fundamental qualitative characteristics.

Verifiability

64. Some respondents commented that verifiability is not adequately explained in the ED. Questions raised included:

    a. Whether verifiability encompasses a notion of auditability? For example, some questioned whether a preparer may misunderstand verifiable to mean audited, although it seemed to them that the ED intended to mean accurate or sound judgment, which they contend would make verifiability a component of faithful representation.

    b. How should information be verified, and by whom? Some respondents noted that the application of verifiability may differ depending on whether it is from the perspective of the preparer or the standard-setter. For example, standard-setters may require an entity to disclose information based on management's intent. Some believe this type of information cannot be verified.

65. As previously mentioned, some respondents did not understand why verifiability was omitted from faithful representation.

66. Many respondents commented on *indirect verification*, with one suggesting that the boards make it clear that, whenever there is a reasonable method of direct verification, that method should be preferable to an indirect method.

67. Finally, some constituents noted that the term *verifiability* does not fit the description given to it in the ED. Instead, they suggested *supportability*, *objectivity*, or *evidenced*.

Timeliness

68. Some respondents suggested the boards reclassify timeliness as a pervasive constraint because:

a. Providing information too quickly to users could result in a loss of faithful representation, and

b. Information not presented in a timely manner loses its capacity to be relevant and to influence the decision-making process.

Understandability

69. Many respondents expressed concern that understandability is not adequately explained in the ED. Some of these constituents suggested the boards make it clear that financial reporting should be understandable to those who have, at the very least, an understanding of accounting and finance. Some added, however, that if the boards simplify understandability too much, it will lose utility to sophisticated investors and creditors.

70. In contrast, other respondents expressed concern that the description of understandability in the ED appears to place the entire burden of comprehension on the user. These constituents suggest putting some stress on both standard-setters and preparers to avoid unnecessarily complex requirements of financial reporting and to help clarify information for users.

71. Furthermore, some respondents suggested the boards provide a practical benchmark for what constitutes *reasonable knowledge*, and remove the last sentence of paragraph QC24, which refers to users seeking the aid of an advisor. They added that this sentence seems to imply that financial information may require an expertise beyond reasonable knowledge.

Pervasive Constraints

Do you agree that *materiality* and *cost* are pervasive constraints and that they are appropriately identified and sufficiently defined for them to be consistently understood and useful? If not, why?

72. The majority of respondents agreed with the identification of *cost* and *materiality* as pervasive constraints of financial reporting.

73. Those who disagreed noted that:

a. Timeliness should be a pervasive constraint rather than a qualitative characteristic,

b. Materiality should be an enhancing qualitative characteristic rather than a pervasive constraint,

c. The need to strive for balance among qualitative characteristics should be a pervasive constraint, and

d. The boards should consider additional constraints such as conciseness and efficiency.

Materiality

74. Many respondents suggested that materiality be used in conjunction with the qualitative characteristic of relevance, rather than as a pervasive constraint because if information is not material, it is not likely to be relevant. Others believe materiality should only be applied at the standard-setting level.

75. A number of respondents also requested that the boards emphasize the fact that immaterial items should be excluded from financial statements because "when immaterial information is given in the financial statements, the resulting clutter can impair the understandability of the other information provided."[5]

76. Finally, some constituents requested that materiality be applied qualitatively for disclosures in addition to the quantitative calculation of materiality for financial statement figures.

Cost

77. A number of respondents, who agreed with the pervasive constraints overall, noted that the cost constraint cannot always be kept. They stated that it is a constraint that has to be observed by standard-setters and can only be complied with if standard-setting is principles-based.

78. One respondent noted that:

> The discussion of costs and benefits does not sufficiently emphasize that, because the framework is written in the context of regulated financial reporting

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5 Comment Letter #120 from the Financial Reporting Council Accounting Standards Board.

that attempts to maximize 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 individual entities cannot use cost-benefit reasons to justify departing from accounting standards.[6]

79. Another respondent disagreed with the conceptualization of the cost concept, and stated:

> The discussion of cost does not sufficiently emphasize the fact that there is a dichotomy between those parties that are bearing the cost of preparing financial information and those parties that are receiving the benefits of utilizing that information. Cost does not function as an effective determinant for the parties involved because for parties receiving benefits, any real or perceived benefit (no matter how trivial the benefit or costly it is to provide the information) is acceptable.[7]

80. This respondent noted that in order for cost to be a fully functioning constraint, the document should make it clear that, if, over time, it is shown that a particular piece of information has marginal usefulness, or that costs are excessive, then the standard that requires that information to be disclosed should be subject to rescission.

81. Some suggested using the term "cost versus benefits" rather than simply *cost.*

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6 Comment Letter #135 from the Australian Accounting Standards Board.

7 Comment Letter #80 from the New York State Society of Public Accountants.