

Getting a Better Framework

ACCOUNTABILITY AND THE OBJECTIVE OF FINANCIAL REPORTING

Bulletin



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Published bulletins:

- Prudence
- Reliability of financial information
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- The asset/liability approach
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This Bulletin is issued by the European Financial Reporting Advisory Group (EFRAG), the French Autorité des Normes Comptables (ANC), the Accounting Standards Committee of Germany (ASCG), the Organismo Italiano di Contabilità (OIC) and the UK Financial Reporting Council (FRC). The publication of Bulletins is part of their strategy to stimulate debate within Europe, and keep European constituents informed, as the IASB develops its Conceptual Framework. Any views expressed are tentative: the issuing bodies will develop their final views after considering responses to this Bulletin and other developments in the debate.

Further information about the work of the project partners, including regular newsletters, is available on the partners' websites.

We welcome views on any of the points addressed in this Bulletin. Specific questions are given at the end of the document. These comments should be sent by email to commentletters@efrag.org or by post to

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So as to arrive no later than 15 November 2013.

All comments will be placed on the public record unless confidentiality is requested.

- 1 Hans Hoogervorst, the Chairman of the IASB, recently said: “There can be no mistake that holding management to account remains a very important purpose of financial reporting.”¹ Many would agree that financial statements should provide information that is helpful in assessing whether, and to what extent, an entity has been managed in the interests of its shareholders. In other words, financial statements should provide information that is useful for an assessment of management’s accountability, or stewardship. This Bulletin considers this view, and whether it is adequately reflected in the IASB’s Conceptual Framework.
- 2 As is explained in Chapter 9 of its July 2013 Discussion Paper *A Review of the Conceptual Framework for Financial Reporting*, the IASB does not plan, as part of its current work, to reconsider the objective of financial reporting, which was dealt with in the new Chapter 1 published in 2010. However, it is important that the Framework provides a foundation for sound and useful financial reporting. It therefore is appropriate to consider whether the current treatment of accountability is adequate.
- 3 The panel provides some illustrative topics where an emphasis on accountability or stewardship may be relevant to financial reporting. They are described in the Appendix.

Related party transactions
Completeness of financial statements
Business combinations
Asset valuations
Discontinued operations
Alternative business strategies
- 4 Many agree that, as set out in the current version of the Framework, the objective of financial reporting should include the provision of information that is useful to existing and potential investors in making decisions about providing resources to the entity. There is, however, considerable controversy about whether accountability, or stewardship, should also be explicitly included.
- 5 The IASB issued a Discussion Paper as part of its Framework project in 2006. It stated the objective of financial reporting as “to provide information that is useful to present and potential investors and creditors and others in making investment, credit and similar resource allocation decisions.” It stated that this “encompasses providing information that is useful in assessing management stewardship”. It took the view that specifying a separate stewardship objective was unnecessary and might cause incorrect implications. (These are discussed in paragraphs 16-20 below.) However, two IASB members dissented from this view, arguing that stewardship should be identified as a separate objective. Most respondents to the Discussion Paper agreed with the dissenting IASB members.

¹ ‘Accounting and long term investment—‘Buy and hold’ should not mean ‘buy and hope’. Speech by Hans Hoogervorst, 9 April 2013, London. Available at <http://www.ifrs.org/Features/Pages/HH-speech-buy-and-hope-April-2013.aspx>



- 6 EFRAG and its partners under the PAAinE initiative issued a paper summarising the broad consensus amongst respondents to the Discussion Paper, urging that “stewardship/ accountability should be retained as a separate objective of financial reporting to ensure that there is appropriate emphasis on company performance as a whole and not just on potential future cash flows”.²
- 7 In the revised edition of the Framework, the objective of financial reporting is essentially the same as that proposed in the Discussion Paper: “to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity. Those decisions involve buying, selling or holding equity and debt instruments, and providing or settling loans and other forms of credit.” It goes on to explain that users require information to help them assess the prospects for future net cash inflows to an entity. It then states: “To assess an entity’s prospects for future net cash inflows, existing and potential investors, lenders and other creditors need information about the resources of the entity, claims against the entity, and how efficiently and effectively the entity’s management and governing board have discharged their responsibilities to use the entity’s resources... Information about management’s discharge of its responsibilities is also useful for decisions by existing investors, lenders and other creditors who have the right to vote on or otherwise influence management’s actions.”
- 8 The Basis for Conclusions explains that “The Board did not intend to imply that assessing prospects for future cash flow or assessing the quality of management’s stewardship is more important than the other. Both are important for making decisions about providing resources to an entity, and information about stewardship is also important for resource providers who have the ability to vote on, or otherwise influence, management’s actions.”
- 9 The Basis for Conclusions also explains that the term ‘stewardship’ was avoided in the Framework because it is difficult to translate into other languages. The PAAinE paper notes that the terms ‘stewardship’ and ‘accountability’ are generally regarded as interchangeable, and expresses a preference for ‘accountability’, as it is more direct and easier to understand. This Bulletin therefore generally uses the term ‘accountability’.
- 10 The Framework and its objectives address the whole of financial reporting. The limits of financial reporting are not defined, but it is clear that financial statements are only one element of financial reporting. Much information that is relevant to accountability is provided in other financial reports, for example, a management commentary. Some may take the view, however, that accountability has implications for the financial statements as well as for these other reports.

² Stewardship/Accountability as an Objective of Financial Reporting: A comment on the IASB/FASB Conceptual Framework Project, June 2007.

WHY INFORMATION ON ACCOUNTABILITY IS IMPORTANT

- 11 One of the main arguments for providing information on accountability is that it enables investors to oversee management behaviour. Although management are appointed by the shareholders, the interests of management and shareholders may diverge. For example, management may have an incentive to undertake risky investments where their entitlement to bonus payments is linked to profits but they do not share in any losses. Or management may prefer to avoid the work that would be required by restructuring the business. Financial statements that fulfil an accountability objective can assist shareholders in detecting where the business is not being managed in accordance with their objectives.
- 12 If financial statements reflect an accountability objective they may control management as well as reporting on them. Because management are aware that they must provide an account of their actions, they are less likely to undertake sub-optimal business strategies or fail to exercise proper diligence, as it will incur the risk that such actions will be detected. Accountability can therefore reduce the risk of investment and so make it more attractive.
- 13 Shareholders are not always able to sell their shares (for example, where the shares are unlisted) or may not wish to do so (for example, where exposure to a particular sector is required to balance their portfolio, or they take the view that long-term prospects for the company are not fully reflected in the current share price). They therefore seek to influence the company's future business strategy and actions: to do so they need information on the development and performance of the company's business, and information that assists them in understanding the prospects for alternative strategies.
- 14 Moreover, an accountability objective serves management as well as shareholders. Both parties want the relationship of principal and agent to work. It will not do so in the absence of trust. Financial statements that fulfil an accountability objective assist them in building that trust.
- 15 Management and shareholders take part in a continuous dialogue. Financial statements are only one example of communication between them. But, because they are prepared in accordance with recognised standards and are audited, financial statements provide a foundation for that dialogue.³ To be fully effective in this role financial statements need to be prepared with an objective of accountability.

³ In a study performed at the joint request of EFRAG and the Institute of Chartered Accountants of Scotland, it is observed that "audited financial statements occupy a unique position in capital markets, despite their limitations. They are unique in being regulated, recurring, standardised and independently verified, and thus enhance the utility of other sources in information, making them flourish." The study will be published later in 2013.




ACCOUNTABILITY, MANAGEMENT AND GOVERNANCE

- 16 In the 2006 Discussion Paper referred to above, the IASB noted that specifying a separate objective of accountability might imply that financial statements should attempt to separate the effects of management's performance from that of events and circumstances that are beyond management's control. The IASB suggested that it was not feasible to make that distinction in financial reporting. Hence it concluded that the inclusion of a separate objective of accountability would exaggerate what financial reporting can accomplish.
- 17 The dissenting IASB members noted that all activities of the entity, including all its risk exposures, are within management control. They therefore agreed that financial statements should not attempt to distinguish what management controls from what it does not.
- 18 Some may take the view, however, that while it is not possible to make a firm distinction between what is and what is not under the control of management, it is possible for financial statements to assist users to make an assessment of the quality of management's actions. For example, separate information can be provided on unusual events, to help form a view whether losses could have been avoided or gains are the result of appropriate risk-taking. (There are a number of ways in which this information could be presented: it is beyond the scope of this Bulletin to discuss what presentation should be used. A Bulletin on the subject of Performance Reporting is in preparation.) Financial statements can also provide an insight into the quality of management by showing the results of the implementation of the business model, and enabling a comparison of the results of similar companies.
- 19 The information provided by financial reporting will not, however, provide all the information that is relevant to an assessment of accountability. The dissenting IASB members agreed, noting that "financial reports are unlikely to provide complete information for any purpose, including the prediction of future cash flows". The same point is expressed in the current Framework, which states: "General purpose financial reports do not and cannot provide all the information that existing and potential investors, lenders and other creditors need." Some may conclude that an accountability objective is appropriate, even if the information is necessarily incomplete and needs to be supplemented from other sources.
- 20 The IASB also noted in its 2006 Discussion Paper that supporters of an accountability objective may confuse financial reporting and corporate governance issues. Their point was that effective corporate governance may require that a great deal of information is provided to shareholders, not all of which is properly within the scope of financial reporting. However, at a more general level, financial reporting is a central part of, and not distinct from, corporate governance, as it provides the principal means by which management reports to shareholders.



WHAT DIFFERENCE DOES IT MAKE?

- 21 Decisions as to whether to buy, sell or hold a security are often taken with a short time horizon. They are based on today's price and an opinion of what tomorrow's price is likely to be. Information that is adequate for such decisions may not provide adequate information for accountability purposes, as an assessment of accountability requires a longer-term perspective.
- 22 Rational decisions can only be made on the basis of future prospects. Financial statements prepared with an objective of decision-usefulness therefore need to focus on the future. In contrast, information that is useful for accountability purposes emphasises the need for an account of the events that have occurred in the reporting period. Accountability also requires that the transactions actually entered into by the entity are transparently reported. For example, it may be judged more relevant to report certain investments at current value in order to help judge future prospects, but an assessment of accountability may be affected by a comparison of current value with the price paid. An accountability perspective underlines the importance of reconciling balance sheet values to historical costs or amounts previously reported.
- 23 It was noted above that an accountability objective stems from the need to maintain trust between management and shareholders. This implies that reliability is an important factor in the quality of financial information. Reliability may receive less emphasis if the objective is simply that of providing the most relevant information for resource allocation decisions. The Bulletin 'Reliability of Financial Information' recorded the tentative view that reliability (including the idea of verifiability) needs to be reinstated as a fundamental characteristic of information in financial statements.
- 24 Despite these differences in emphasis, there is a very significant overlap between accountability and decision-usefulness as:
 - Information prepared for accountability purposes necessarily includes information on the financial position at the end of the period: that information will be influenced by projections of the future. For example, the carrying amount of assets is written down to the amount that can be recovered in the future; and
 - The most relevant basis for an assessment of the future is often an account of past events.
- 25 Some may take the view that all the information that is required for accountability is also required by an objective of decision-usefulness. They may therefore question whether it is necessary to specify accountability as a separate objective of financial reporting.

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- 26 However, it is obviously impracticable for accounting standards to require all the information that would be relevant to decision-usefulness: choices must be made and the Framework should guide that choice. In the absence of a clear and specific reference to accountability, it is possible that the IASB would select accounting treatments other than those that are most useful for accountability.
- 27 Some take the view that an accountability objective and decision-usefulness are incompatible, and that therefore the Framework needs to adopt one objective or the other. It has even been suggested that, ideally, two sets of financial statements should be prepared: one to serve accountability and another to provide decision-useful information. However, as argued above, much of the information required by the two objectives is similar. If, in the context of a specific standard, a conflict seems to arise, the IASB will have to exercise judgement to resolve the issue, taking into account the relevance of the information for accountability and decision-usefulness. It is mistaken to assume that the Framework should completely remove the need for judgement in the development of accounting standards.



THE CONCEPTUAL FRAMEWORK FOR FINANCIAL REPORTING 2010

- 28 In the speech referred to above, Hans Hoogervorst noted that a close reading of the existing Framework would confirm that the principle of accountability is there, but conceded that “I can imagine that some might find the essence of the stewardship principle a bit hard to find”.
- 29 This is worrying. In the development of accounting standards, the Framework is inevitably abridged and summarised. If it contains a concise objective of decision-usefulness, that objective will set the focus of the debate, and an explanation a page or two later that decision-usefulness encompasses accountability will be overlooked.
- 30 Some may take the view that the reference to the essential ideas of accountability in the existing Framework is adequate. However, it may be noted that, as described in the Framework, the relevance of information on accountability is limited to that which assists in assessing future cash flows and in taking decisions, such as voting in company meetings. It may be questioned whether it is appropriate to limit accountability in this way.

Our tentative views

31 Having considered the arguments presented above, the partners have, on balance, reached the following tentative views:

- The ASCG and the OIC believe that the IASB adequately addressed the importance and the role of accountability/stewardship in its 2010 Framework;
- The ANC believes that the provision of information on accountability/stewardship is the primary objective of financial reporting; and
- EFRAG and the FRC believe the provision of information on accountability/stewardship is a primary objective of financial reporting, not merely a part of or ancillary to another objective, and should be reinstated as such.



Questions for respondents

We would welcome views on any of the points addressed in this Bulletin.

In particular:

- (i) Are there any arguments for and against the objective of accountability that are not discussed in this Bulletin?
- (ii) Do you believe that the objective of accountability is appropriately reflected in the existing Conceptual Framework? If not, how should the Framework be amended?
- (iii) Do you have any other comments on this Bulletin?

Comments should be addressed to: commentletters@efrag.org, so as to be received before 15 November 2013.

Appendix: examples

In the following examples, an emphasis on accountability may be relevant to the selection of the preferred accounting treatment. The purpose is to illustrate the importance of the issue, rather than to suggest that the views expressed are necessarily conclusive.

Related party transactions

A1 It is important for accountability purposes that transactions with management and other related party transactions are disclosed, as the relationship creates the risk that the transactions are other than those that would be agreed on arms-length terms. Materiality is an important consideration in reporting such transactions, as an amount that is of little consequence to the entity as a whole (and hence of little relevance for a decision-useful objective) may be of much greater significance when viewed as a transaction with an individual party.

Completeness of financial statements

A2 Accountability requires that the financial statements are complete. This implies that, for example, a loss needs to be disclosed, even if steps have been taken to ensure that it cannot recur, because it has implications for an assessment of management's competence. Its irrelevance to future cash flows cannot be used to justify its omission or concealment.

Business combinations

A3 Under IFRS 3 *Business Combinations* the costs of an acquisition are treated as expenses in the period in which they are incurred.

A4 In contrast, an accountability objective would suggest that such costs should be capitalised. This would report the total investment made and provide a relevant basis for assessing future returns on that investment. Impairment of that amount provides a clear signal that an acquisition has failed to deliver what is expected, which may signal a deficiency of management. In contrast, if transaction costs are expensed at the time of acquisition it is difficult or impossible to judge whether they are excessive or justifiable and, without detailed analysis, whether the investment made is justified by subsequent returns.

A5 Similar reasoning supports the recognition of purchased goodwill. The usefulness of this for forecasting future cash flows is somewhat limited, but recognition is necessary if financial statements are to fulfil an accountability objective.

A6 It would also be consistent with an accountability objective to disclose full details of the impact of an acquisition. This would include the amount of debt assumed as a consequence of the acquisition. Also, in order to assess the reasonableness of the adjustments made in accounting for the acquisition, the difference between the fair values at which assets and liabilities are recognised and their historical cost to the acquired entity should be disclosed.



Asset valuations

- A7 An accountability objective may also be relevant to asset valuations. A company may be able to derive significant benefit from a custom-made machine, which might be best portrayed by entity-specific values such as value in use or current or historical cost. A decision-useful objective on the other hand might suggest that a market-based exit value should be used, which reports the value that market-participants would attach to the machine rather than the benefits that will accrue to its current owner. This is the basis of fair value as required by IFRS 13 *Fair Value Measurement*. Whilst IFRS 13 suggests that current replacement cost may be used to represent fair value (Appendix B, paragraph B9), this is unconvincing, especially where there is no other party who can drive the same benefits as the reporting entity. Whilst it is true that, as stated in IFRS 13, such a party would pay no more than replacement cost, it is unclear why the reporting entity's financial position should reflect the hypothetical cost to another party, nor why it should be assumed that the hypothetical sale would take place at the maximum price.
- A8 More generally, accountability would suggest that, where a current value is used:
- Where relevant, the underlying causes of changes in the reported amount could be explained, to assist in forming a view as to the extent to which they are within the control of management. For example, this is one reason why it is helpful to explain the extent to which changes in the fair value of financial liabilities reflect changes in the entity's own credit risk; and
 - In the case of significant assets, the reported amount should be reconciled to historical cost (in the case of assets and liabilities recognised in the period) or to previously reported amounts (in the case of previously-recognised assets) where the differences are material. This provides a link to the transactions actually undertaken by the entity for which management's responsibility is clear.

Discontinued operations

- A9 Separate information on discontinued operations is clearly essential if financial statements are to assist in the prediction of future cash flows. However, presenting only a net amount as a single line item in the primary financial statements implies that it is of no relevance. However, as management is responsible for all activities undertaken by the company in the period, accountability might suggest that the primary financial statements should include all amounts gross, to demonstrate the financial consequences of management's actions. Information on the amounts relating to discontinued operations could be given by a separate column or in the notes to the financial statements, perhaps as part of the information on segments.

Alternative business strategies

- A10 Information on accountability should assist an assessment of the prospects of alternative business strategies, and not merely the strategy currently undertaken. This may require the provision of more detailed information than is necessary for an assessment of future cash flows. For example, the extent to which assets have been pledged as security is of limited relevance to future cash flows as long as the assets will be retained and the debt will be paid out of cash flow from operations, but information about this is helpful to assess the consequences of selling the asset, perhaps as a result of a change in the entity's activities.



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