



European Financial Reporting Advisory Group ■



Conseil national de la Comptabilité

Pro-active Accounting Activities in Europe

■ PAAinE



DISCUSSION PAPER

ELEMENTS OF THE FRAMEWORK DEBATE

THE CONCEPTUAL FRAMEWORK
Starting from the right place?

October 2006

COMMENT PERIOD

The objective of this paper - and indeed of this Pro-active Accounting Activities in Europe (PAAinE) project as a whole - is to stimulate discussion and debate. You are therefore invited to comment on the issues raised.

Your comments should be addressed to jerome.chevy@cnc.finances.gouv.fr or commentletter@efrag.org no later than 18th March 2007.

THE CONCEPTUAL FRAMEWORK STARTING FROM THE RIGHT PLACE?

PAAinE DISCUSSION PAPER

About the PAAinE

EFRAG and the European National Standard Setters have agreed to pool some of their resources and work together more closely so that Europe as a whole can participate more effectively in the global accounting debate. It was agreed that this initiative should in the beginning concentrate on long-term pro-active work. The objective of the initiative is to stimulate debate on important items on the IASB agenda at an early stage in the standard-setting process before the IASB formally issues its proposals. The initiative has the joint ambitions of representing a European point of view and exercising greater influence on the standard-setting process. This initiative is known as the 'Proactive Accounting Activities in Europe' (or PAAinE) initiative.

Several projects have commenced under the PAAinE initiative, and this paper is the result of the PAAinE project that relates to the joint IASB/FASB project on the Framework.

Work carried out under the PAAinE initiative can take a number of different forms and the full objectives of the initiative are :

- to stimulate, carry out and manage pro-active development activities designed to encourage the debate in Europe on accounting matters and to enhance the quality of the pro-active input to the IASB ;
- to co-ordinate and resource monitoring work of IASB and FASB projects ; and
- to try to ensure, as far as is practicable, that the messages Europe gives the IASB are consistent.

A further description of the PAAinE initiative is available on the EFRAG website (www.efrag.org).

THE CONCEPTUAL FRAMEWORK STARTING FROM THE RIGHT PLACE?

PAAinE DISCUSSION PAPER

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1 INTRODUCTION

Overview

- 1.1. The IASB and FASB have started a long-term project that is intended to improve and converge their existing conceptual frameworks. This paper, which has been prepared as part of the European PAAinE initiative (see below) to stimulate debate within Europe and more widely, asks in effect whether that work has started from the right place. It raises those issues which the working group considers should be addressed prior to a revision of the framework. The views expressed are those held by the majority of the working group although reference is, where considered appropriate, made to alternative views.
- 1.2. The IASB/FASB project on the conceptual framework may be summarised as follows :
 - a) the two Boards are carrying out a joint project that is designed to improve and converge their two frameworks ;
 - b) the project has been broken down into phases, and each phase will result in the publication of a consultative paper ; and
 - c) Although a discussion paper on the first phase was published in July 2006 the project as a whole is not expected to be completed before 2010.

The PAAinE project on the elements of the conceptual framework debate

- 1.3. The PAAinE Framework project is being led by staff of the French Standard-setter, the CNC. The staff team is assisted in its work by a pan-European working group. The working group comprises members from a variety of countries and backgrounds, and includes standard setters, academics, preparers, and auditors. A list of working group members is set out in Appendix 1.
- 1.4. The overall objective of the PAAinE Framework project is to stimulate timely debate within Europe on the IASB/FASB project in order to make it easier for Europe to participate actively and influentially in the global debate on the Framework.
- 1.5. In order to meet that objective, the intention is to issue more discussion papers. The joint IASB/FASB project is being undertaken in stages and each stage will result in its own consultative paper. The PAAinE project team might, if deemed useful, also issue a paper to stimulate debate on each IASB/FASB consultative paper and possibly on other issues relating to the Framework.

- 1.6. The paper has been approved and issued by the French standard-setter, the CNC (Conseil national de la comptabilité) and EFRAG. The paper (in near-final draft form) was considered at the quarterly meeting between EFRAG and representatives of the European national standard-setters (ENSS) on 11 October 2006, and the representatives of the ENSS confirmed that they were content for the paper to be issued to stimulate debate. The paper has been posted on the CNC and EFRAG websites and the intention is that it will also be posted on other ENSS websites. A limited number of copies of the paper will also be available in a printed form.

The objectives of this paper

- 1.7. The original intention for the PAAinE project had been to start by issuing a paper discussing issues arising from the work being carried out by the IASB and FASB on the objectives of financial statements. However, it soon became apparent that there were a number of fundamental issues for the framework that needed to be addressed first.
- 1.8. The following four issues which should be researched before developing a conceptual framework were identified by the working group :

What is the purpose of the framework ?

Section 2 deals with the purposes of the framework and addresses its role with respect to :

- (a) Standard setting
- (b) Preparation of financial reporting

For both standard setting and the preparation of financial reporting the authoritative status of the framework is a major issue.

This section therefore asks :

- **“Should the framework be mandatory and, if so, for whom ?”**

Who are the users of financial reporting and what are their information needs ?

The IASB/FASB July 2006 Discussion Paper-Conceptual framework for financial reporting § OB 10 indicates that the proposed framework addresses “general purpose external financial reporting directed to the needs of a wide range of users rather than only to the needs of a single group.”

In §OB13 the Discussion Paper stipulates : “By focusing primarily on the needs of present and potential investors and creditors, the objective of financial reporting encompasses the needs of a wide range of users.”

Some of the related issues are dealt with in section 3 of the paper which asks :

- **Are general purpose financial statements for all stakeholders a valid concept ? (see section 3.2.)**
- **Do investors and creditors represent a homogeneous enough group to be chosen as primary users ? (see section 3.3.)**

To which entities should the framework apply ?

BC1.24 of the July 2006 IASB/FASB discussion paper stipulates that “the boards concluded that the objective of general purpose external financial reporting should be the same for all entities that issue such reports.”

The related issue discussed in section 4 of this paper is :

- **Do the users of financial reporting of different types of entity have similar needs (see 4.2. and 4.3.) ?**

To which types of financial reporting should the framework apply ?

The IASB and FASB in their July 2006 discussion paper on the conceptual framework define the objectives and qualitative characteristics of financial reporting without determining to which kinds of financial reporting the framework should apply.

The related issues discussed in section 5 of the paper are :

- **Do financial statements and other types of financial reporting have (a) similar objectives (see 5.3.) and (b) similar qualitative characteristics (see 5.4.) ?**
- **Can all kinds of financial reporting be dealt with by the same framework (see 5.5.) ?**

- 1.9. This paper is not a direct response to the IASB/FASB’s Discussion Paper “Preliminary Views on an improved Conceptual Framework for Financial Reporting.” However, the subjects discussed in this paper pertain to the global debate related to the revision of the framework and therefore help understand the underlying issues and should be read in conjunction with the Discussion Paper of the IASB.

Views on this paper are invited

- 1.10. The objective of this paper — and indeed of this PAAinE project as a whole — is to stimulate discussion and debate. You are therefore invited to comment on the issues raised. Your comments should be addressed to jerome.chevy@cnc.finances.gouv.fr or commentletter@efrag.org no later than 18th March 2007.

2 PURPOSES OF THE FRAMEWORK

2.1. Introduction :

- 2.1.1. A fundamental preliminary issue to be addressed in revising the framework is to determine for what purpose it will be used. The framework may have different characteristics according to whether it is to be used essentially for standard setting or for the preparation of financial reporting or both.
- 2.1.2. The authoritative status will also have a determining effect on the way the framework is drawn up and is linked to the issue of the level of detail at which it is written. These issues should be addressed at an early stage because of the far reaching consequences for the characteristics of the framework.
- 2.1.3. It may, therefore, appear surprising that in the current IASB/FASB project the definition of the purposes of the framework does not form part of the first stage.
- 2.1.4. This section deals with the purposes of the framework and examines successively its role with respect to :
- (a) Standard setting
 - (b) The preparation of financial reporting

For both standard setting and the preparation of financial reporting the authoritative status of the framework is a major issue.

This section therefore asks :

- **“Should the framework be mandatory and, if so, for whom ?”**

2.2. The role of the framework in standard-setting

- 2.2.1. A conceptual framework has a fundamental role for standard setting in a principles based system. As stated in P3 of IASB Discussion Paper Conceptual Framework for Financial Reporting July 2006 : “A common goal of the boards - a goal shared by their constituents - is for their standards to be clearly based on consistent principles. To be consistent, principles must be rooted in fundamental concepts rather than being a collection of conventions. For the body of standards taken as a whole to result in coherent financial reporting, the fundamental concepts need to constitute a framework that is sound, comprehensive and internally consistent.”
- 2.2.2. It is however open to discussion whether the framework should only be a guide to standard setters or whether its application is mandatory for standard setters.

Arguments for mandatory status

- 2.2.3. The framework provides a conceptual basis for developing IFRSs and it is therefore logical that standards should be derived from it in a principles based system. The strict application of the framework ensures the consistency and coherence of financial reporting standards.
- 2.2.4. It follows from this that all newly issued standards should be in conformity with the framework and that where standards issued prior to the publication of the framework deviate, they should be subsequently revised.
- 2.2.5. It is argued that, if it were acceptable for new standards to deviate from the framework:
- a) the frame of reference will be lost and there will be no consistency as to when deviations from the framework occur, and the framework will be devalued,
 - b) the strong consistent conceptual underpinning of standards will be lost and their development will be much more ad hoc. As a result, inconsistencies between standards will emerge and
 - c) without a clear definition of the content of financial statements, users will remain uncertain as to the nature of the information they will be provided with. A mandatory framework contributes to the understandability of financial statements since the underlying concepts and principles derived from the framework are known.
- 2.2.6. It is further argued that a framework in a principles based system sets out concepts and principles which are mandatory for standard setting because they are of a sufficiently high level to leave some flexibility in their application. Indeed some commentators consider there is an interdependency between the authoritative status of the framework and the level of detail at which it is written. They believe that the higher the level of principles the more mandatory a framework should be. It is only when the framework is written at a detailed level that it becomes inflexible and difficult to operate.

On the other hand, some would argue that high level principles might be more open to interpretation and therefore would not necessarily ensure consistent application in standard setting.

Arguments against mandatory status

- 2.2.7. Other commentators argue that the conceptual framework is continually evolving in response to new thinking and changes in the business environment, but those changes are only occasionally reflected by issuing a revised framework. It is thus really just a matter of administrative convenience whether, when the framework has evolved, that evolution is reflected first in a standard or in a revised framework ; and it would not therefore be inappropriate if a new standard reflecting latest thinking is inconsistent with the most recently issued framework if that framework has not been updated to reflect that latest thinking.
- 2.2.8. It is certainly true that new thinking often occurs when new transactions or problems are being analysed as part of the development of a new standard. It is often easier to incorporate that new thinking in the new or revised standard and revise the framework later ; if standards always had to be consistent with the framework, the framework would have to be revised first (or maybe at the same time) and that will often mean a delay in finalising the standard.
- 2.2.9. Over a long period of time it is unreasonable to expect all new standards to be consistent with the framework since a framework can only ever be a guide ; standard-setting involves applying pragmatism, recognising what is possible at any given time, etc, and that means it will not always be possible to achieve complete consistency between a new standard and the framework.
- 2.2.10. That would be particularly so if the status of the conceptual framework was a description of what the IASB believes accounting should be like in the future—i.e. a sort of blueprint. If the framework were like a blueprint, the role of new standards would be to move accounting practice in the direction of that blueprint. However, that journey may not be accomplished in one go ; several small ‘steps’ might be needed to complete the journey. That would mean that standards and the framework might not be fully in line. (Some commentators would argue that, if the framework is some sort of blueprint for the future, it might not be appropriate to require entities to consider the framework when there are no specific standards applicable—because the framework would be a description of where accounting is going, not where it is now.)

Tentative view

- 2.2.11. A framework with mandatory status is the most useful for standard setters in that it provides a stable conceptual basis for developing standards and ensures the coherence and consistency of financial reporting standards.
- 2.2.12. Exceptions to the consistency between new standards and the existing framework could be accepted (e.g. to take account of new transactions and economic evolution) provided such exceptions were justified in the Basis for Conclusions of the new IFRS and a commitment to revising the framework was given.
- 2.2.13. However, in order to maintain a stable conceptual reference, a framework should not be subjected to frequent change. Moreover, before changing the framework it is necessary to evaluate the impact of the change on IFRSs as a whole.

2.3. The role of the framework in the preparation of financial reporting

- 2.3.1. The current framework (“Purpose and Status §2”) “does not define standards for any particular measurement or disclosure issue. Nothing in the Framework overrides any specific International Accounting Standard.” The existing framework goes on to say in §3 that in a limited number of cases where there may be a conflict between the framework and a standard it is the requirements of the standard that prevail. Management is only expressly required to consider the framework for financial reporting if no standard or interpretation specifically applies or deals with a similar or related issue (see IAS 8 §10 and 11).

Arguments for using the framework in the preparation of financial reporting

- 2.3.2. Whilst the IASB only requires the framework to apply by exception to financial reporting, some argue in favour of using the framework more systematically to ensure the presentation of a true and fair view. They believe that the true and fair view should be applied as an overriding principle whenever necessary. According to this point of view, the framework contains the essence of a true and fair view and preparers should therefore check their financial statements against the framework and eliminate any inconsistencies even if this requires a departure from the IFRSs.
- 2.3.3. This argument reflects the view that, however hard standard-setters try to avoid making their standards transaction-specific, it is inevitable that they will take into account only the transaction types currently undertaken and those that can at the time of development be foreseen. The standards will not necessarily be as appropriate for new, unforeseen transactions. In such circumstances, rather than apply inappropriate standard, entities would be required to comply with the more broadly based (and less time-specific) principles in the framework. Such an argument reinforces the importance of the true and fair view requirement and emphasises that it is not necessarily the same thing as simply complying with the standards.

Arguments against using the framework in the preparation of financial reporting

- 2.3.4. The framework represents a set of concepts and principles and is not an accounting standard. It may not be directly applicable to the preparation of financial reporting. The framework should, therefore, only be used as guidance in the absence of relevant IFRSs.

- 2.3.5. If the principles set out in the framework were used to override specific standards this would tend to favour subjective interpretations. The reason is that the principles set out in the framework would be of a general conceptual nature and might give rise to a range of interpretations. Individual standards would normally already represent specific applications of the framework principles. There would, therefore, have to be exceptional grounds for looking to the framework rather than to an individual standard.
- 2.3.6. A set of IFRSs derived from the framework should normally be assumed to lead to the presentation of a true and fair view. It should not therefore be necessary other than in exceptional circumstances to override IFRSs to obtain a true and fair view.

Tentative view

- 2.3.7. The framework represents a set of concepts and principles and is not a standard. The direct application of the framework in financial reporting would, therefore, only be appropriate in the absence of a specific standard or interpretation.
- 2.3.8. However, in the absence of specific standards or interpretations the framework should be considered to have authoritative status.
- 2.3.9. The framework should not be used to override IFRSs as this leads to subjective interpretations of high level principles and could only be justified in exceptional circumstances.

3 USERS OF FINANCIAL REPORTING

3.1. Introduction

- 3.1.1. The existing framework defines its scope in its paragraph 6 as follows :

“The Framework is concerned with general purpose financial statements.... directed toward the common information needs of a wide range of users. Many users, however, have to rely on the financial statements as their major source of financial information and such financial statements should, therefore, be prepared and presented with their needs in view.”

This focus is maintained in the IASB July 2006 Discussion Paper –Conceptual Framework for Financial Reporting.

- 3.1.2. The objectives, content and form of financial reporting should logically be determined by user needs and consequently, by information useful to their decision making process. Determining the users of financial reporting and their corresponding needs is therefore a priority issue to be dealt with at an early stage when revising the framework.
- 3.1.3. The Boards in their current Discussion Paper have chosen investors and creditors as primary users without defining their information needs.

3.1.4. In the following paragraphs two different approaches to defining primary users and their needs are examined :

- a) an approach based on different concepts of reporting, one directed to all stakeholders and another one which focuses on a specific category of users, the investors
- b) a pragmatic approach based on the different goals of user groups

3.1.5. The issues dealt with in this section can be summarised as follows :

- **Are general purpose financial statements for all stakeholders a valid concept (see 3.2.) ?**
- **Do investors and creditors represent a homogeneous enough group to be chosen as primary users (see 3.3.) ?**

3.2. Are general purpose financial statements for all stakeholders a valid concept ?

3.2.1. Accounting literature, as well as the two Boards in their current Discussion Paper, commonly refer to two different perspectives for reporting which have fundamental consequences for the determination of categories of users :

- a) the entity perspective : the financial reporting responds to all stakeholders needs including employees, pension holders, creditors, shareholders, etc...
- b) the proprietary perspective : the reporting focuses on existing common shareholders.

3.2.2. The above two concepts lead to defining primary users as either :

- a) “stakeholders” (entity perspective), or
- b) “shareholders” (proprietary perspective).

3.2.3. This has major consequences for the focus of reporting. General purpose external reporting addresses the information needs of the widest possible range of users and is consistent with the stakeholder approach. The focus on one class of users, shareholders in the proprietary approach, would not necessarily be consistent with general purpose external reporting.

3.2.4. Economic literature focusing on the shareholder (principal) - management (agent) relationship has been used to support the proprietary approach, while theories emphasising the description of the company as a “nexus of contracts” have been the basis for the entity approach.

3.2.5. However it appears difficult to find in this literature decisive arguments to choose between the two approaches. Some consider that this choice may be a purely “philosophical one”. Whatever the basis for the choice, it should be specified.

- 3.2.6. Although the two Boards have chosen the entity approach, they still focus on investors, extended to creditors, as primary users. In doing so, they neither choose one nor the other perspective. In spite of the fact that the two perspectives lead to opposite conceptual directions, the IASB/FASB Discussion Paper on the conceptual framework avoids choosing one or the other concept.
- 3.2.7. This view has the merit of avoiding choices between diverging, and sometimes conflicting views of the purpose of financial reporting.
- 3.2.8. However, the entity and proprietary views lead to different accounting treatment in numerous cases e.g. disclosure of minority interests, measurement of goodwill etc., equity/liability.
- 3.2.9. There is no extensive study of the consequences of avoiding the choice between the two perspectives. Therefore, it may lead to conflicting views, inconsistencies and lack of clarity in future accounting developments.
- 3.2.10. Also, one of the rationale for avoiding the choice appears to be questionable, as there seems to be little evidence of the rationale put forward : for the IASB and FASB, it is assumed that the needs of the investors cover most of the needs of other users.

Is there evidence of common users needs ?

- 3.2.11. In the proposed framework, the Boards assumed that the needs of the investors and creditors cover most of the needs of other users.
- 3.2.12. The current framework gives a long list of potential users in its paragraph 9 ; namely Investors, Employees, Lenders, Suppliers and other trade creditors, Customers, Governments and their agencies, Public. The IASB July 2006 Discussion Paper – Conceptual Framework for Financial Reporting OB6 proposes a similar list of potential users.

It then summarises (§9) the information needs of different categories of users of financial statements, for example :

- a) employees “are interested in information about the stability and profitability of their employers...and the ability of the entity to provide remuneration, retirement benefits and employment opportunities.”
- b) Suppliers and other trade creditors “are interested in information that enables them to determine whether amounts owing to them will be paid when due.”
- c) Governments and their agencies “require information in order to regulate the activities of entities, determine taxation policies and as the basis for national income and similar statistics.”
- d) etc.

It does not provide any further evidence that those needs are covered by investors needs, as it does not give any further evidence of common or different information requirements per user category.

- 3.2.13. The framework does not indicate to what extent those requirements are satisfied by the financial statements or other financial information. Indeed, the definition of the objectives of financial statements set out in §12 to 18 of the current framework does not appear to be derived from an analysis of individual users' needs. Instead, in defining the supposed needs of investors the framework asserts that "Financial position, performance and changes in financial position" will be useful to other users.
- 3.2.14. The IASB July 2006 Discussion Paper –Conceptual Framework for Financial Reporting also acknowledges that the needs of various other user groups are lesser known than the needs of creditors and investors :

"Investors and creditors (and their advisers) are the most prominent external groups who use the information provided by financial reporting and who generally lack the ability to prescribe all of the information they need. Investors' and creditors' decisions and their uses of information have been studied and described to a greater extent, and thus are better understood, than those of other external groups. "

Tentative view

- 3.2.15. The assumption underlying general purpose financial statements is that the needs of investors and creditors cover most of the needs of reporting needs of other user groups. Little or no evidence is provided to justify this assertion.

Economic theory and accounting perspectives do not justify, at this stage, the choice to focus on any particular category of users.

In order to avoid misleading conclusions, more evidence should be gathered to justify the current IASB/FASB's proposal if it were to be pursued.

Therefore, it is essential that :

- a) more research work be undertaken with regards to the conceptual rationale for the two perspectives,
- b) in the meanwhile, the focus should be put on the definition of homogenous categories of users with regards to their needs.

3.3. Do investors and creditors represent a homogeneous enough group to be chosen as primary users ?

- 3.3.1. In the absence of evidence that there might be common user needs for large groups of different users, the focus of the framework should be to define a homogeneous enough group of primary users. This is in order to derive the objectives of both financial reporting and financial statements from the needs of a homogeneous user group.
- 3.3.2. Current work on the revision of the framework has put forward the idea of a group of "primary users" that, at the same time, would be specific enough to permit a clear identification of user needs, as well as being large enough so as not exclude major participants in the financial markets.

3.3.3. A group composed of both investors and creditors has seemed a likely candidate for the IASB/FASB. The IASB July 2006 Discussion Paper –Conceptual Framework for Financial Reporting stipulates in OB 12 :

“Investors and creditors (and their advisers) are the most prominent external groups who use the information provided by financial reporting and who generally lack the ability to prescribe all of the information they need”

3.3.4. However, it is questionable if a category defined in such broad terms would be a grouping of sufficiently homogeneous needs to permit a clear focus for financial statements.

3.3.5. Further study should be conducted in order to determine the needs of several categories of users. Homogenous groups cannot be established at this stage without defining their common needs.

3.3.6. The current framework puts the emphasis on the investors’ decision making process with regards selling, holding or buying the shares of a company, as well as the ability of the company to pay dividends. There has been a recent shift of focus towards the mere selling, holding and buying shares, as the capacity of the company to pay dividends is actually part of this decision making process.

3.3.7. According to the Discussion Paper, in order to be able to efficiently exercise their decision making process, investors will require a wide range of information, notably on the liquidity, solvency etc... of the company.... This wide range of information is most likely to cover all the information needs of other categories of users.

3.3.8. Although, many categories of users may have some basic common requirements (e.g. with respect to the solvency and development of an entity) their main focus (e.g. trade creditors vs. long-term investors) may be quite different.

Consequently, it is not clear whether their different information requirements will or can be met by the financial statements or by other specific supplementary information within the scope of the framework. This information would not necessarily be provided by the financial statements. This raises the issue discussed in section 5 as to which other financial information might be treated within the scope of the framework.

3.3.9. As a preliminary to this major issue, some differences between various categories are listed below :

3.3.10. Different types of investors :

The community of investors is diverse, and include long term investors, short term traders, existing shareholders, potential shareholders. Their information needs may well be quite different. Some users have little use for IFRSs. A typical example of it would be short term traders who use chart analysis, and have very little use of IFRS in their day to day trading.

3.3.11. Different investors require different useful information

- a) selling, holding or buying the shares of a company, are the decisions envisaged by the Discussion Paper,
- b) other goals may be identified, for decision useful information. Notably, financial statements, and financial reporting may help shareholders in assessing whether to make their decisions to keep or change the management of the company, define the general orientations of the business, vote in annual shareholder meetings etc.

3.3.12. Investors and creditors

Investors and creditors would normally have different interests and consequently different information needs. These are based notably on their respective risks and expected “return”. The emphasis has been put on the return on capital. In the case of creditors, this return is contractually determined, whereas it is not in the case of investors. This aspect is of major importance for the content of the financial statements.

For a short term trade creditor, information on the liquidity of a debtor will be most important. An investor or a debenture holder etc would focus more on the longer term such as performance, solvency.

3.4. Tentative views

- 3.4.1. There seem to be some common information needs within the creditors/investors community. However for certain sub categories, main focuses may be different from one category to the other.
- 3.4.2. Different user needs may have significant consequences on major elements of financial reporting, such as for example, the definition, of financial statements.
- 3.4.3. It was therefore concluded that a clear definition of primary users of financial information, and their needs have to be provided before revising the framework.
- 3.4.4. As IFRSs are directed toward the efficiency of capital markets, investors appear a logical candidate as part of a primary user group. It may well be that others, such as specific categories of creditors, like debenture holders, may be also included. However the needs of these various categories should be clearly considered and defined.

4 ENTITIES WITHIN THE SCOPE OF THE FRAMEWORK

4.1. Introduction

4.1.1. The objectives of financial reporting may vary according to the type of entity. It is therefore important to assess whether it is possible to develop concepts and principles in the framework which are common to the financial reporting of all entities, or conversely only applicable to certain types of entity.

4.1.2. An analysis of the needs of users of financial reporting of different types of entity is a key preliminary to assessing whether common reporting concepts and principles are applicable.

4.1.3. This section examines the needs of users of financial reporting of the following types of entity :

- a) Profit-oriented and non-profit oriented entities
- b) SME and large entities
- c) Listed and unlisted entities

There are many common points in the discussion of b) and c) and they will therefore be treated together.

4.1.4. The central issue of this section is :

- **Do the users of financial reporting of different types of entity have similar needs ?**

4.2. Do the users of financial reporting of profit-oriented and non-profit oriented entities have similar needs ?

4.2.1 The first issue is whether the framework is intended to apply to both profit-oriented entities and non-profit-oriented entities (i.e. charities and public benefit entities). The current IASB/FASB project targets “business entities in the private sector” without giving a definition of that term. The discussion in the following paragraphs considers whether this or some other focus might be appropriate. The starting point for the discussion is evidence for and against the existence of common user needs.

Arguments indicating that users have similar needs

4.2.2. Over the years, a number of conceptual frameworks have been developed around the world. Some of those apply just to profit-oriented entities and some to both profit-oriented entities and non-profit-oriented entities. Some of the frameworks that apply to both started as frameworks for profit-oriented entities and were then broadened, and others were from the outset frameworks for all sectors.

- 4.2.3. What is noticeable is that all these frameworks look very similar. Perhaps some important changes were made when broadening the framework (or to allow for the inclusion of non-profit-oriented entities), but even if that was the case the changes tended to be relatively narrow. This suggests that the 'profit-oriented entities v non-profit-oriented entities' issue is perhaps not as fundamental to the development of a framework as it might appear at first glance to be. However, even if that is the case some argue it is better to develop a framework that applies to both sectors from the outset because addressing non-profit-oriented entity issues can provide insights that are also relevant to profit-oriented entities.
- 4.2.4. Some commentators in favour of a common framework argue that there are common concepts underlying the financial reporting of both types of entity e.g. accountability or stewardship and common objectives to their financial reporting e.g. Financial position is interesting to both profit oriented and non profit-oriented entities.

In spite of the IASB's current focus on profit-oriented entities, it is clear that many entities that are not profit-oriented are looking to apply IFRS because it is a high-quality global accounting language, and many would argue that the IASB should not ignore this fact.

Arguments indicating that users have different needs

- 4.2.5. Many believe that the differences in orientation between profit-oriented and non profit-oriented entities have implications for the objectives of their financial reporting : If an entity has a profit orientation, the focus of its financial statements will be on showing the extent to which it is profitable and the extent to which it has invested in things that are expected to generate or contribute to that profitability in the future. As a result, the financial statements provide information that helps in assessing future cash flows and they adopt the form of primary financial statements that we have now. However, if an entity's performance is measured more in terms of, say, the breadth, targeting and quality of the public benefits it provides, it is not clear why a focus on future cash flow information and that particular form of primary financial statements would be the most appropriate way of reporting on the entity's activities and position.
- 4.2.6. The users of financial reports of profit-oriented and non-profit oriented entities are not the same and may consequently have different reporting needs :

The existing framework focuses on investors — the providers of risk capital — as the primary users. However, many non-profit oriented entities are constituted in the form of entities that do not have shareholders and, even when they do have shareholders, the interests of those shareholders in the entity are very different from the interests of investors in a profit-oriented entity. This could have important implications for the objectives that the financial statements are designed to achieve, the information the financial statements should be designed to provide, and other parts of the framework.

- 4.2.7. The IASB/FASB project is currently focusing on "business entities in the private sector" ; the two Boards plan to consider the applicability of the concepts in the framework to other types of entity much later in the project. (Although the term 'business entity in the private sector' has not been defined, it probably has the same meaning as this paper's 'profit-oriented entity', except that public sector profit-oriented entities are not included.)
- 4.2.8. A number of national standard-setters (Australia, Canada, New Zealand and the UK) have questioned this decision.⁽¹⁾
- 4.2.9. The Working Group has also considered whether the approach taken by the IASB and FASB is appropriate. It notes that the approach seems to be consistent with the focus of the IASB's activities, which is described in the constitution of the IASCF as being "to develop, in the public interest, a single set of high quality, understandable and enforceable global accounting standards that require high quality, transparent and comparable information in financial statements and other financial reporting *to help participants in the world's capital markets* and other users make economic decisions." (Emphasis added)

Tentative view

- 4.2.10. The focus on profit-oriented entities as a first step, as proposed by the current IASB Discussion Paper, is consistent with the objective set out in the IASCF constitution of helping participants in the world's capital markets in their decision making and reflects the priority given to profit-oriented entities in the IASB's standard setting activity.
- 4.2.11. However, subject to further analysis of common user needs, it may be possible to extend the scope subsequently to non-profit oriented entities.

4.3. Do the users of financial reporting of small, large, listed and unlisted entities have similar needs ?

- 4.3.1. The second issue is whether the framework should apply to entities of all sizes, and the third is whether it should apply equally to listed entities and non-listed entities. Although these are separate issues, they are discussed together here because many of the arguments are similar, and it is difficult to differentiate between arguments that relate to size and arguments that relate to the degree of public accountability involved.

⁽¹⁾ Those standard-setters are also monitoring the applicability to non-profit-oriented entities in the private and public sector of the IASB/FASB project as it progresses. A report on key issues emerging from the proposals in the first preliminary views discussion paper is available on the website at <http://www.frc.org.uk/asb/technical/projects/project0061.html>. In addition, the International Public Sector Accounting Standards Board (IPSASB), at its meeting in July 2006, has decided to take forward a collaborative project with national standard-setters and other authoritative bodies to develop a conceptual framework for public sector entities.

- 4.3.2. The IASB/FASB project appears not to be differentiating between such entities. However, when one compares the financial statements of a big multinational listed entity with those of a very small local entity, it is like comparing two fundamentally different documents because of differences in disclosure requirements and more complex organisation and operations. It is reasonable therefore to ask whether the two sets of financial statements should — or maybe need — to be based on the same concepts. It is reasonable to assume that such potential differences reflect potential differences in user needs.

The following paragraphs deal with the issue of whether the users of the financial reporting of entities of differing size or public accountability have different needs.

Arguments indicating they have similar needs

- 4.3.3. Some argue that the objectives of financial statements and the basic reporting model are the same irrespective of questions of size and public accountability. However, certain disclosure requirements e.g. reporting by business segment may only be relevant to entities of a certain size which are probably listed.

Arguments indicating they have different needs

- 4.3.4. The financial structures of big listed entities tend to be very different from those of small unlisted entities and as a result the users appear to be different too — in one case the users are sophisticated capital market participants and rating agencies and in the other the only external users may be bankers (although the entity's management may also be users). Some of those bankers may even be able specify and receive the information they need directly (in the form of so-called 'special purpose financial reports') and therefore may have little or no use for the (general-purpose) financial statements.

It seems reasonable to suppose that different users may also have different information needs with respect to financial statements. And, if that is the case, the conceptual underpinning of the financial statements may also need to differ.

- 4.3.5. The above discussion would tend to suggest that the model for financial reporting might vary according to the extent and type of interest there is in an entity's financial reports and that, as a consequence, the framework might vary too.
- 4.3.6. There are also cost-benefit considerations relating to differences in user needs. The provision of extensive high quality information leads to additional costs which may be justified for a listed entity that raises capital on the financial markets but would not be acceptable for a small unlisted company.

Tentative view

- 4.3.7. No tentative view has been developed as to whether the framework should apply to entities of varying size and public accountability.
- 4.3.8. It is, however, likely that the focus on a particular category of entity would avoid diluting reporting requirements.
- 4.3.9 We would welcome views on this matter.

5 SCOPE OF FINANCIAL REPORTING

5.1. Introduction :

- 5.1.1. The current framework applies only to financial statements. The new IASB/FASB proposal, contained in their Discussion Paper of July 2006 “Preliminary Views on an improved Conceptual Framework for Financial Reporting”, is to extend the scope of the framework to include financial reporting. However, the Boards have put off to a later stage in their project the definition of what financial reporting includes.
- 5.1.2. Financial reporting is a term generally used to refer to a wide range of financial information. In addition to financial statements ; it may include, for example, “management commentary” and press releases containing forecasts, judgmental and non-financial information.
- 5.1.3. Financial statements, according to the terms of the current framework, present actual “financial position” and past performance with a focus on the reporting of stewardship whereas much of the other reporting information will be concerned with appraising future prospects. This suggests that financial statements may have different objectives and characteristics as compared to other forms of financial reporting. If this is so, the same fundamental concepts and principles may not be applicable to both. It is therefore debatable whether they could be dealt with by the same conceptual framework.
- 5.1.4. Defining the scope of financial reporting to which the framework applies is an essential prerequisite since the main characteristics of the framework depend on it. In postponing the scope definition to a later phase the IASB/FASB project team are taking the risk that the proposed framework might be flawed.
- 5.1.5. Since the first stage of the current IASB/FASB project sets out to define the objectives and qualitative characteristics of the framework without defining the scope of financial reporting to which it applies, this could imply that the Boards consider that all kinds of financial reporting, including financial statements, have the same objectives and qualitative characteristics or at least that the same framework could apply to all kinds of financial reporting. As stated above, this is not self evident. It might, however, also imply that the Boards have already decided to limit the scope of the framework in such a way that the objectives and qualitative characteristics remain valid e.g. in focusing on financial statements and types of information having similar characteristics.
- 5.1.6. This section therefore addresses the following issues :
- **Do financial statements and other types of financial reporting have (a) similar objectives (see 5.3.) and (b) similar qualitative characteristics (see 5.4.) ?**
 - **Can all kinds of financial reporting be dealt with by the same framework ? (See 5.5.)**
- 5.1.7 However, before answering these questions it is necessary to determine what is meant by “financial reporting”. Different possible definitions of what might be included are set out in 5.2. Defining financial reporting.

5.2. Defining financial reporting

5.2.1. In the Discussion Paper of July 2006 “Preliminary Views on an improved Conceptual Framework for Financial Reporting” that was issued by the IASB/FASB, a definition of financial reporting is not provided.

5.2.2. In the current Preface to International Financial Reporting Standards other financial reporting(i.e. other than financial statements) is defined as follows :

“Other financial reporting comprises information provided outside financial statements that assists the interpretation of a complete set of financial statements or improves users ability to make efficient economic decisions.”

5.2.3. An attempt to define the contents of financial reporting has been made by the project team that prepared the Discussion Paper Management Commentary that was published by the IASB in October 2005.

The figure below sets out the Management Commentary project team’s view of financial reporting :

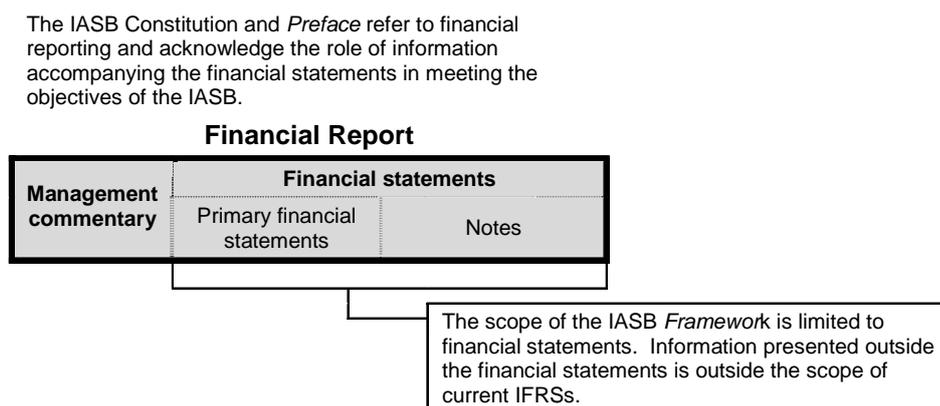


Figure 1.1 The IASB Constitution, *Preface* and *Framework* and their relationship to financial reporting

5.2.4. The capital markets, in particular market regulators, have had a major influence in extending the scope of reporting beyond the confines of financial statements.

As a result, financial reporting may include not only the financial statements, the information contained in the notes to the financial statements, information in the management commentary, but goes much further than that and may also include any type of information that a company may publish outside of its annual accounts (communiqués, press releases and so on, for example). It may include actual financial information but also forecasts, non-financial information including judgements on market trends etc.

Financial reporting is therefore a potentially far-reaching concept and consequently it is legitimate to ask : Do all kinds of financial information correspond to the definition of financial reporting ?

- 5.2.5. It is therefore necessary to define the scope of financial reporting before proceeding further with the framework since it is difficult to determine the characteristics of something not properly defined. One possible starting point for defining the scope could be to select those elements of financial reporting having common objectives derived from the decision-making information needs of a specific homogeneous primary user group. If, for example, long term investors were defined as primary users and it were ascertained that their needs were for information on “sustainable earnings” or “growth” then the reports presenting this information might be selected for the scope definition.
- 5.2.6. Financial statements are the focus of the current framework and remain a central part of the IASB/FASB project for financial reporting (see OB 16 of “July 2006 Discussion Paper-Conceptual Framework For Financial Reporting”).

The following paragraphs address the question of whether financial statements and other forms of financial reporting have common objectives.

5.3. Do financial statements and other types of financial reporting have similar objectives ?

- 5.3.1. The IASB/FASB define the objectives of financial reporting without distinguishing between financial statements and other financial reporting. According to the IASB/FASB Discussion Paper of July 2006 “Preliminary Views on an improved Conceptual Framework for Financial Reporting” S2 and S3 :

“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. 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).”

- 5.3.2. The objective of providing information useful in resource allocation decisions is very broad. Most forms of financial reporting would provide information useful in resource allocation decisions. Most users of financial reporting would also find useful some form of information about future cash flows of an entity. However, the focus of user requirements may be quite different e.g. a trade creditor as opposed to a long-term investor.
- 5.3.3. A natural starting point for the analysis of the objectives of financial reporting is to examine current and proposed views of the objectives of financial statements, since the financial statements remain a central part of financial reporting.

The objectives of financial statements

- 5.3.4. Paragraph 12 of the current framework describes the objectives of financial statements as

“to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions.”

5.3.5. Paragraph 13 of the current framework states that

“Financial statements prepared for this purpose meet common needs of most users. However, financial statements do not provide all the information that users may need to make economic decisions since they largely portray the effects of past events and do necessarily provide non-financial information.”

5.3.6. The current framework therefore distinguishes financial reporting from other kinds of financial information. It recognises the decision usefulness of other financial information which includes implicitly non-historical information (forecasts) and non-financial information.

5.3.7. Paragraph 14 of the current framework adds that “Financial statements also show the results of the stewardship of management, or the accountability of management for the resources entrusted to it” to assist investors in making hold or sell decisions and in deciding whether to keep or replace the management.

5.3.8. There appears to be a contrast between the objective of financial statements to portray “stewardship», presented in the framework as the accountability for past resource management, and that of other financial reporting, including forecasts and non-financial information, directed towards assessing prospects of future growth and profitability.

In particular, actual accounting information and market forecasts and business plans have different qualitative characteristics, which are examined below.

5.3.9. The current framework stipulates that financial statements have the objective of presenting financial position and performance without determining which view of financial position and performance the financial statements are intended to portray.

Paragraph 16 states that “The financial position of an entity is affected by the economic resources it controls, its financial structure, its liquidity its solvency and its capacity to adapt to changes in the environment in which it operates.” Although paragraph 16 proposes definitions of liquidity and solvency it does not opt for one of these terms as a basis for the definition of financial position.

Paragraph 17 refers to performance in terms of “profitability” without determining which view of performance is intended.

There is a clearly a need to define the concepts underlying “financial position” and “performance”. It is suggested that such definitions should be derived from identified user needs.

- 5.3.10. The IASB/FASB Discussion Paper of July 2006 “Preliminary Views on an improved Conceptual Framework for Financial Reporting” does not define separately the objectives of financial statements as they are a part of financial reporting of which the objectives are defined in 5.3.1 above. However, the objectives of financial reporting, as set out in OB 18 to 26 of the paper, focus on providing information about an entity’s resources (assets) and claims (liabilities and equity). Moreover, performance is defined in BC1.30 of the paper by reference to the net changes in its economic resources and claims after eliminating transactions with owners.
- 5.3.11. The focus on resources (assets) and claims (liabilities) is a choice of the IASB/FASB project team. It is not compared to other possible approaches or based on a conceptual justification.

This approach, which has been traditionally applied to financial statements, might not necessarily be suitable for other types of financial reporting which are forecast oriented and may, for example, concentrate on revenue trends derived from accounting or non-accounting sources.

This may also suggest that the IASB/FASB project intends to focus on financial statements and that other forms of reporting to be included in the scope might be purely ancillary to the financial statements.

- 5.3.12. It is a common characteristic of the current and proposed frameworks not to establish a clear and direct link between the objectives of financial statements and users needs even though this has direct consequences for the relevance of financial reporting. The objectives of financial statements are not shown to be derived from the goals and corresponding needs of its primary users. Indeed, no real analysis of those needs is provided in the frameworks.

5.4. Do financial statements and other types of financial reporting have similar qualitative characteristics ?

- 5.4.1. The term financial reporting may be applied to a wide range of different types of financial information including financial statements. Different views of what financial reporting might include are set out in 5.2 above. As explained in 5.3. above, the objectives of financial statements and other forms of financial reporting are not necessarily the same. As a result, there may be differences in the qualitative characteristics of financial statements as compared to some other types of financial reporting. The following discussion addresses this issue.

5.4.2. The IASB/FASB Discussion Paper of July 2006 “Preliminary Views on an improved Conceptual Framework for Financial Reporting” proposes qualitative characteristics for financial reporting very similar to those contained in the present framework which applies only to financial statements. Subject to one change in terminology, the replacement of the term “reliability” by “faithful representation”, the qualitative characteristics are the same :

- Relevance
- Faithful representation (replaces reliability in the existing framework)
- Comparability
- Understandability

5.4.3. It may be useful as part of the discussion to examine the conclusions of the IASB project team on “Management Commentary” as set out in the resulting discussion paper of October 2005. The team considered the applicability of the qualitative characteristics in the current IASB framework to management commentary (MC). Given that MC supplements and complements the financial statements, the project team concluded that these characteristics should be considered in relation to MC. If MC is intended to help investors understand the financial statements, we should expect MC to meet, as far as possible, qualitative standards similar to those applicable to the financial statements.

The team concluded that *understandability* and *relevance* should be applicable in the preparation of MC and accordingly should be reflected in the qualitative characteristics for MC. However, rather than using the *Framework* terms *reliability* and *comparability*, the team believed that MC should exhibit the characteristics of *supportability*, *balance* and *comparability over time*.

5.4.4. As concluded by the “Management Commentary” team above, there may well be difficulties in applying the reliability (or faithful representation) criterion to information outside the financial statements. Forecasts, judgmental and non-financial information for example would probably not satisfy that criterion nor perhaps the comparability criterion.

5.4.5. The comparability characteristic applies more readily to financial statements than to other forms of financial reporting :

- a) financial statements follow standardised principles
- b) other forms of financial reporting including management commentary and other non-financial information will often be more entity-specific

5.4.6. In proposing specific qualitative characteristics for management commentary the MC project team suggests a way forward. In other words it may possible to treat different kinds of reporting information within the same framework by defining qualitative characteristics for the different types of financial reporting within its scope.

5.5. Can all kinds of financial reporting be dealt with by the same framework ?

- 5.5.1. Sections 5.3. and 5.4. set out some of the differences between financial statements and certain other forms of financial reporting. The question to be addressed in this section is whether, as a result of these differences, financial statements and other kinds of financial reporting need to be treated separately.
- 5.5.2. At this stage it is necessary to determine whether there are fundamental differences of objective between financial statements and other financial reporting. Are financial statements and other financial reporting just two different perspectives pertaining to the same overall objective of resource allocation on the basis of cash flow information? This would appear to be the position of the IASB/FASB discussion paper.
- 5.5.3. The specific objectives of financial statements require clarification. Until the objectives of financial statements are differentiated from those of other forms of financial reporting it is not possible to determine whether both forms of reporting can be dealt with by the same framework.
- 5.5.4. Moreover, the concepts underlying financial statements may not be applicable to other forms of financial reporting which are not necessarily based on accounting information or asset and liability measurement.
- 5.5.5. It is, furthermore, clear that financial statements and other forms of financial reporting do not necessarily have the same qualitative characteristics. As stated in 5.4. above, management reports and forecasts, for example, may well not comply with the reliability/faithful representation and comparability criteria required for financial statements.
- 5.5.6. The above-mentioned potential or actual differences between financial statements and financial reporting point to the need for further research before defining the types of financial reporting within the scope of the framework.
- 5.5.7. These differences also indicate that if all kinds of financial reporting were included in the scope of the framework, some kinds of information would have to be dealt with separately because the underlying concepts or qualitative characteristics are not the same as for financial statements.

5.6. Tentative View

- 5.6.1. The IASB/FASB have postponed their decision to define which elements of financial reporting should be included in the scope of the framework to a later stage in their project. This could mean that the objectives and qualitative characteristics defined in their first discussion paper might be subsequently invalidated. This would be the case if certain forms of financial reporting to be included in the scope did not correspond to the proposed objectives and characteristics. The references in the discussion paper to the central role of financial statements and the prominence of information on assets and liabilities suggest that the scope might be restricted to financial statements and ancillary information.

- 5.6.2. Although the Boards make no formal distinction between the objectives of financial statements and other kinds of financial reporting in their joint discussion paper, these two concepts cover a wide range of financial information having quite different characteristics.
- 5.6.3. It is, therefore, suggested that further research is required to clarify the specific objectives of financial statements and determine whether they are compatible with those of other forms of financial reporting. These objectives should be derived from an analysis of the reporting needs of the primary user group.
- 5.6.4. The Boards in their current discussion paper propose that financial reporting should focus on providing information about an entity's resources and claims. This approach may be suited to appraising stewardship from a historical perspective but is not necessarily suited to other forms of reporting which may rely on trends, forecasts and market prospects. It is therefore necessary to investigate whether such other forms of reporting have the same conceptual basis as financial statements.
- 5.6.5. Financial statements have different qualitative characteristics to other forms of financial reporting. Other forms of financial reporting, such as management information, are more subjective or entity specific and therefore would probably not have the same comparability or satisfy the "faithful representation" characteristic.
- 5.6.6. The differences between financial statements and some other forms of financial reporting suggest that they might have to be treated separately and not necessarily within the same conceptual framework.
-