

***Discussion Paper: Preliminary Views on an Improved Conceptual Framework for
Financial Reporting***
Comments submitted to IASB by David Heald

BACKGROUND

- (1) I am Professor of Financial Management at the University of Sheffield Management School, and my academic research is partly in the area of public sector accounting. I am a member of the Financial Reporting Advisory Board to HM Treasury (FRAB approves accounting standards for most of the UK public sector excluding local government) and a specialist adviser on public expenditure and government accounting to the Treasury Committee of the House of Commons. These comments are solely on my responsibility, and must not be attributed to any of the above organisations.

THE OBJECTIVES OF FINANCIAL REPORTING

- (2) **AV1.1-AV1.7:** With regard to financial reporting by the private sector, I wish to support the position argued by the two dissenting IASB members. Stewardship is not the same as decision-usefulness, nor can it satisfactorily be subsumed. They should have equal status as objectives of financial reporting.
- (3) With regard to the public sector, the downgrading of stewardship, which cannot there be subsumed under 'decision-usefulness', has far-reaching consequences. This is especially the case when the primary user is 'present and potential investors and creditors (and their advisers)', a choice that some commentators will not consider appropriate. The worst-case scenario would be for the International Public Sector Accounting Standards Board to develop public sector standards not articulated with those of the IASB.
- (4) **P8:** The Boards have made a serious error of sequencing when deciding to:
... focus initially on business entities in the private sector. Once concepts for those entities are developed, the boards will consider the applicability of those concepts to financial reporting by other entities, such as not-for-profit entities in the private sector and, in some jurisdictions, business entities in the public sector.
- (5) There are four issues raised by this decision:
- (i) Consideration of users and user needs in the private not-for-profit sector and the public sector ought to have been included at Phase A (Objectives and qualitative characteristics), but 'Application to Not for Profit entities' is not scheduled until Phase G, which is the last phase before finalisation. By then all the main decisions will have been taken and all participants in this process will be exhausted.
- (ii) The reference to 'business entities in the public sector' suggests misplaced focus. In many jurisdictions these have long followed best-commercial practice. The relevant arena concerns government and its agencies, with regard to which pioneering countries such as New Zealand and Australia set the example of sector-neutral accounting in the 1990s. The United Kingdom followed in 2001-02 and the *Financial Reporting Manual* (FReM), prepared by HM Treasury and approved by FRAB, is close to UK GAAP. A shadow IFRS-based FReM is currently in preparation so that there can be a smooth transition from UK GAAP to International GAAP. The UK Accounting Standards Board issued in August 2005 *Exposure Draft: Statement of Principles for Financial Reporting - Proposed Interpretation for Public-Benefit Entities*, with the emphasis being on common

principles. As the defining class of user, this substitutes 'funders and potential funders' (public-benefit entities) for 'present and potential investors' (profit-oriented entities). The joint IASB/FASB conceptual framework project is therefore of profound importance to the future of sector-neutral accounting; the primary user has to be defined in a way that can readily be extended to public-benefit entities.

- (iii) During the UK implementation of accrual accounting in central government, I argued that a crucial advantage of sector-neutral accounting is that the adoption of UK GAAP provides an anchor for public sector accounting. When HM Treasury proposes deviations from UK GAAP in light of the particular circumstances of the public sector, FRAB tests the arguments from a refutable assumption that new/modified standards will be applied. The delegation of standard-setting applicable to government to a private body (effectively the ASB) is vulnerable to criticism on the grounds of legitimacy. However, the practical advantages, particularly the anchoring role and consequent access to a much greater pool of accounting and financial management skills, have prevailed. There is a psychological hurdle to overcome when transferring this role from a national body to an international body (effectively the IASB), but practical advantages can be argued. However, the legitimacy of sector-neutral accounting anchored on international standards is more vulnerable to challenge, especially if those developing the conceptual framework are seen to regard applicability to public-benefit entities as a side-issue.
- (iv) **OB3:** For there to be applicability to the not-for-profit and public sectors, it requires to be made clear that future economic benefits may not necessarily materialise in the form of cash.

QUALITATIVE CHARACTERISTICS

- (6) **QC16-QC34:** The case for substituting 'faithful representation' for 'reliability' is unconvincing. The Boards should consider the following points:
 - (i) Although there may have been imprecision attached to 'reliability', a potential trade-off between 'relevance' and 'reliability' is something to which users will readily relate. There is no such intuition behind 'faithful representation'. It will take a considerable time for that to develop within the accounting community, and may never develop outside. The dissenting IASB member notes that 'reliable' needs to be reintroduced within 'faithful representation', as in the term 'reliable evidence' (**AV2.1**).
 - (ii) My preference would be (a) to substitute 'reliability' for 'faithful representation' and (b) to make explicit 'substance over form'. I believe that the importance that has become attached to the latter is an important reason why the United Kingdom did not have the accounting scandals that troubled some jurisdictions in the late 1990s and early 2000s. In my view, the value of emphasis here trumps concern about possible redundancy.

(iii) The following qualitative characteristics would therefore apply:

- **Relevance**
 - ◆ predictive value
 - ◆ confirmatory value
 - ◆ timeliness
- **Reliability**
 - ◆ verifiability
 - ◆ neutrality
 - ◆ completeness
 - ◆ substance over form
- **Comparability**
- **Understandability**

(iv) If the Boards are insistent on retaining 'faithful representation' as a qualitative characteristic, I would amend this to:

- **Relevance**
 - ◆ predictive value
 - ◆ confirmatory value
 - ◆ timeliness
- **Reliability**
 - ◆ faithful representation
 - verifiability
 - neutrality
 - completeness
 - ◆ substance over form
- **Comparability**
- **Understandability**

(7) The language in which the Conceptual Framework is expressed must meet the double test of carrying technical precision and of resonating with a broad range of users.

CONCLUSION

(8) I welcome the opportunity provided by the Boards to comment at an early stage on their ambitious project to establish a single conceptual framework within which converged accounting standards can be developed. Quite apart from the substantive benefits that will be derived from these Comment periods, the due process will also contribute to the legitimacy of international accounting standards.

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