IDW
INSTITUT DER WIRTSCHAFTSPRÜFER

Institut der Wirtschaftsprüfer
in Deutschland e. V.

Wirtschaftsprüferhaus
Tersteegenstraße 14
40474 Düsseldorf
Postfach 32 05 80
40420 Düsseldorf

TELEFONZENTRALE:
+49 (0)211 / 45 61 - 0

FAX GESCHÄFTSLEITUNG:
+49 (0)211 / 454 10 97

INTERNET:
www.idw.de

E-MAIL:
info@idw.de

BANKVERBINDUNG:
Deutsche Bank AG Düsseldorf
BLZ 300 700 10
Kto.-Nr. 7480 213

Ms Stephenie Fox
Technical Director of the
International Public Sector Accounting Standards
Board (IPSASB)
International Federation of Accountants
277 Wellington Street West
Toronto Ontario M5V 3H2
Canada

Düsseldorf, 31 March 2009
523

Dear Ms Fox

Consultation Paper „Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities:
The Objectives of Financial Reporting – The Scope of Financial Reporting – The Qualitative Characteristics of Information Included in General Purpose Financial Reports – The Reporting Entity“

We appreciate the opportunity to comment on the Consultation Paper mentioned above. We welcome the IPSASB developing a Conceptual Framework and thus providing the opportunity to discuss its concepts, as such a discussion is of fundamental importance for the future development of International Public Sector Accounting Standards. We would like to submit our comments to the specific questions as follows:

<u>Preliminary View 1 – The Authority of the IPSASB Framework</u>

The IPSASB Framework will not establish new authoritative requirements for financial reporting by public sector entities that adopt IPSASs, nor will it override the requirements of existing IPSASs.

In selecting accounting policies to deal with circumstances not dealt with in IPSASs or other guidance issued by the IPSASB, public sector entities will refer to, and consider the applicability of, the definitions, recognition criteria, measurement principles, and other concepts identified in the IPSASB Framework.

GESCHÄFTSFÜHRENDER VORSTAND:
Prof. Dr. Klaus-Peter Naumann,
WP StB, Sprecher des Vorstands;
Dr. Klaus-Peter Feld, WP StB CPA;
Manfred Hamannt, RA

We concur with the Board's approach. It corresponds with the IASB's view in the Exposure Draft of an improved Conceptual Framework for Financial Reporting as of May 2008, paragraph P14. However, in the long-term the IPSASB Framework Project (especially phase 1 to 3) will have an impact on existing IPSASs, e.g. because of the definition of assets and liabilities in phase 2. Therefore, we suggest amending the Preliminary View 1 above. After stating that the IPSASB Framework will not override the requirements of existing IPSASs, it could be added that "if an IPSAS currently on issue conflicts with the IPSASB Framework, the IPSASB may review that IPSAS and, through application of due process, revise it" (see also para 1.5 of the Consultation Paper (CP)).

In particular, it is appropriate that the provisions for specific issues in an individual IPSAS override general provisions of a framework, assuming that the IPSASB's intention to regulate specific issues is reflected rather in the respective provisions of the relevant IPSAS than in general provisions of a framework.

Preliminary View 2 – General Purpose Financial Reports (GPFRs)

GPFRs are financial reports intended to meet the common information needs of a potentially wide range of users who are unable to demand the preparation of financial reports tailored to meet their specific information needs.

We agree with this view which is similar to the basic idea of the IASB Conceptual Framework ED. There are no apparent particularities in the public sector justifying another approach.

Preliminary View 3 – The Users of GPFRs

As a mechanism for focusing on their common information needs, the potential users of GPFRs of public sector entities are identified as:

- *recipients of services or their representatives;*
- *providers of resources or their representatives; and*
- *other parties, including special interest groups and their representatives.*

The legislature is a major user of GPFRs. It acts in the interest of members of the community, whether as recipients of services, providers of resources, or citizens with an interest in, or need for, particular services or activities.

We agree. However, some may take the view that because the legislator, in particular, is able to demand financial reports from public sector entities, the legislator's information needs may not be relevant to determinate the objectives of

GPFRs (see above "Preliminary View 2"). Nevertheless, the legislator's information needs seem suitable to determinate the objectives of financial reports, because these information needs are derived from the constituents' information needs. The legislator is – subject to a democratic constitution – representative of its constituents, none of whom as an individual may be able to demand the preparation of financial reports from public sector entities. The legislator in total, i.e. including the political opposition, as a democratically elected body is one of the major user of GPFRs, as it acts in the interest of the members of the community in general. Therefore, we support including the legislator as a user for the purpose of determining the objectives of GPFRs, even though in a democracy the legislator has no original, but only "derivative" information needs as a representative.

Furthermore, we noticed that the IPSASB has chosen a rather wide approach in identifying and clustering potential user groups of GPFRs. With respect to resource providers (or their representatives) one could argue that they have different views and informational needs. For example, a private bank as a resource provider will have other interests than a public authority funding another public sector entity. Defining these two groups as one class of "resource providers" would imply that they would have the same information needs.

Preliminary View 4 – The Objectives of Financial Reporting

The objectives of financial reporting by public sector entities are to provide information about the reporting entity useful to users of GPFRs for:

- *accountability purposes; and*
- *making resource allocation, political and social decisions.*

We welcome the inclusion of the accountability aspect of stewardship. While we acknowledge that there is a relationship between the objective to provide information for accountability purposes and the objective to provide information for making resource allocation, political and social decisions, the accountability aspect which is also concerned with monitoring past transactions and events seems especially important for the public sector. In relation to the connection between the objective of accountability as part of stewardship, we note that this has further implications for a conceptual framework for financial reporting. To this effect, we refer to the IDW Concept Paper "Additional Issues in Relation to a Conceptual Framework for Financial Reporting" of September 17, 2007.

Additionally, we would like to have an (adapted) reference to the key features of the objectives of GPFRs proposed by the IASB (as outlined in CP 2.8). Bearing

in mind that private sector resource providers (such as lenders and creditors) are included in the group of users of public sector GPFRs, the provision of information that is useful to lenders and other creditors in making (economic/ financial) decisions in their capacity as capital providers should not be excluded from the public sector objectives. This objective should be mentioned separately as, in our view, it is not covered by the description above.

Preliminary View 5 – The Scope of Financial Reporting

The scope of financial reporting encompasses the provision of financial and non-financial information about:

- *economic resources of the reporting entity at the reporting date and claims to those resources;*
- *the effect of transactions, other events, and activities that change the economic resources of the reporting entity and claims to those resources during the reporting period, including cash inflows and outflows and financial performance;*
- *the reporting entity's compliance with relevant legislation or regulation and legally adopted or approved budgets used to justify the raising of monies from taxpayers and ratepayers;*
- *the reporting entity's achievement of its service delivery objectives; and*
- *prospective financial and other information about the reporting entity's future service delivery activities and objectives, and the resources necessary to support those activities.*

It also encompasses explanatory material about: (a) the major factors underlying the financial performance of the entity, the achievement of its service delivery and other objectives and the factors which are likely to influence its performance in the future; and (b) the assumptions underlying and major uncertainties affecting the information included in GPFRs.

Financial reporting is characterized by financial information. While non-financial information may contribute to achieving the objectives of financial reporting, only such non-financial information should be included that is linked to the presented financial information. Other non-financial information should be subject to separate reports.

We concur with the view that reporting in relation to the budget is a key element for discharging accountability by a government to its constituents. We therefore

share the opinion that the inclusion in GPFRs of information to assist users in assessing the entity's compliance with legally adopted or approved budgets will enhance the usefulness of GPFRs for accountability purposes. A precondition for that is, however, that the basis is the same for the approved budget and the statement of financial performance (accruals based) − i.e. that the figures are comparable (see CP 4.25). Even if public sector entities report on accruals basis, many governments still prepare their budget on cash basis. In these cases the GPFRs should include a reconciliation of budget and actual figures.

Preliminary View 6 – Evolution of the Scope of Financial Reporting

The scope of financial reporting should evolve in response to users' information needs, consistent with the objectives of financial reporting.

We concur with the scope.

Preliminary View 7 – The Qualitative Characteristics of Information Included in GPFRs

The qualitative characteristics of information included in GPFRs of public sector entities are:

- *relevance, which encompasses confirmatory value, predictive value, or both;*
- *faithful representation, which is attained when depiction of economic or other phenomena is complete, neutral, and free from material error;*
- *understandability;*
- *timeliness;*
- *comparability; and*
- *verifiability (including supportability).*

Constraints on financial reporting are materiality, cost, and achieving an appropriate balance between the qualitative characteristics.

This view corresponds mostly with the IASB Conceptual Framework ED, chapter 2. In a comment letter to the IASB we pointed out that we do not support the substitution of the fundamental qualitative characteristic "reliability" (as included in the present IASB Framework) with "faithful representation". In our opinion, the concept of reliability should be retained, given that this encompasses faithful representation.

Concerning the addition to the constraints, we do not consider "achieving an appropriate balance between the qualitative characteristics" by the preparer of a financial report to be a constraint on financial reporting. According to the IASB Conceptual Framework ED there is no balance between relevance and faithful representation possible, because both characteristics must be met in order to convey decision-useful information The other qualitative characteristics contribute to an improvement of the usefulness of relevant and faithful represented information. There could be a competing relationship between the individual characteristics so that in this respect balancing regarding these characteristics would be necessary. However, it is not clear to us that there might be particularities in the public sector which justify adding such a balance as a constraint of financial reporting in contrast to the IASB Conceptual Framework ED.

Therefore, we recommend explaining more specifically in which areas an adjustment has been seen to be necessary and why. For example, the question remains open why the IPSASB decided not to distinguish between "fundamental" and "enhancing" qualitative characteristics like the IASB. We do not see where the public sector differs from the private sector in that respect and what justifies the deviation.

Preliminary View 8 – Characteristics of a Reporting Entity

The key characteristic of a reporting entity is the existence of users who are dependant on GPFRs of the entity for information for accountability purposes, and for making resource allocation, political, and social decisions.

A public sector reporting entity may be an entity with a separate legal identity or other organisational structure or arrangement.

We acknowledge that not-for-profit entities are not envisioned as reporting entities in the Conceptual Framework (see CP 5.3). In our view, clarifying that the reporting entity definition includes organizational structures, administrative arrangements, or activity without a legal identity would better reflect the requirements of the public sector (CP 5.1. and 5.9). In CP 5.10 the IPSASB describes exceptions to the key characteristics of reporting. In our view it would be helpful to state one or more specific practical examples to illustrate what is meant by these exceptions.

Additionally, as this is a quite generic description, it could be useful to add as an example that governmental units (in particular, the states) and other public sector entities with a separate legal identity are reporting entities in any case, because they meet the described key characteristic of a reporting entity.

Preliminary View 9 – The Composition of a Group Reporting Entity

A group reporting entity will comprise the government (or other public sector entity) and other entities when the government (or other public sector entity):

- *has the power to govern the strategic financing and operating policies of the other entities (a "power criterion"); and*
- *can benefit from the activities of the other entities, or is exposed to a financial burden that can arise as a result of the operations or actions of those entities; and can use its power to increase, maintain, or protect the amount of those benefits, or maintain, reduce, or otherwise influence the financial burden that may arise as a result of the operations or actions of those entities (a "benefit or financial burden/loss" criterion).*

We support the outcome of the criteria above. However, we suggest clarifying that there is a relationship between the power criterion and the benefit or financial burden/loss criterion.

In comparison, IASB takes into account the power criterion as the determining factor (IASB Discussion Paper "Preliminary Views on an improved Conceptual Framework for Financial Reporting - The Reporting Entity", paragraph S6). The benefit or financial burden/loss criterion is referred to as well, but in a direct relation to the power criterion ("Control of an entity is the ability to direct the financing and operating policies of an entity, **so as** to access benefits ..."; IASB Discussion Paper "Preliminary Views on an improved Conceptual Framework for Financial Reporting - The Reporting Entity", paragraph 49). This additional criterion is for clarification because in the end a controlling position will only be taken to "benefit" from it. Deviation from the IASB approach only seems appropriate if there are particularities in the public sector.

We would be pleased to answer any questions that you may have or discuss any aspect of this letter.

Yours sincerely

Norbert Breker
Technical Director
Accounting and Auditing

Viola Eulner
Technical Manager

IDW

INSTITUT DER WIRTSCHAFTSPRÜFER

IDW Concept Paper

Additional Issues in Relation to a Conceptual Framework for Financial Reporting

17 September 2007

IDW
INSTITUT DER WIRTSCHAFTSPRÜFER

IDW Concept Paper:

Additional Issues in Relation to a Conceptual Framework for Financial Reporting

Executive Summary ... 3
Section 1: Introduction ... 8
1.1 Purpose of the Paper ... 8
1.2 Main Issues ... 8
Section 2: Qualitative Characteristics: Costs vs. Benefits and Reliability ... 9
2.1 Costs vs. Benefits ... 9
2.2 Reliability ... 10
2.3 Need for Comprehensive Reassessment of Qualitative Characteristics of Financial Reporting Information ... 11
Section 3: The Relationship between The Objective of Financial Reporting and Stewardship ... 11
3.1 Financial Reporting, Decision-Usefulness, Stewardship, and Accountability ... 11
3.2 Accountability, Accounting, and Justification ... 12
Section 4: Measurement, Evidence, Documentation and Systems ... 13
4.1 Accounting Measurement ... 13
4.2 Accounting Evidence ... 14
4.3 Accounting Documentation ... 16
4.4 Accounting Systems ... 16
Section 5: Quality Control, Internal Control and Quality Assurance ... 18
5.1 Quality Control over Financial Reporting ... 18
5.2 Internal Control Over Financial Reporting ... 19
5.3 External Quality Assurance Over Financial Reporting ... 21
Section 6: Conclusions ... 22

INSTITUT DER WIRTSCHAFTSPRÜFER

Executive Summary

IDW Concept Paper:

Additional Issues in Relation to a Conceptual Framework for Financial Reporting

1. The purpose of this Paper is to address additional issues in relation to the objective of financial reporting and their impact upon the qualitative characteristics of financial reporting information.
2. In the International Accounting Standards Board's (IASB's) "Preliminary Views on Qualitative Characteristics of Decision-Useful Financial Reporting Information" (hereinafter referred to as the "Preliminary Views"), the IASB chose not to undertake a fundamental review of the concepts forming the foundation for a conceptual framework for financial reporting. This Draft IDW Concept Paper takes the view that a more thorough examination of the cost-benefit concept, of the reliability aspect of decision-useful information, and of the stewardship objective for financial reporting, would indicate that the Preliminary Views' approach to financial reporting may be inadequate because it may lead to accounting standards setting that focuses on financial reporting outcomes without addressing the financial reporting processes and related costs needed to achieve those outcomes. Furthermore, these issues may have an impact upon the consistent application of IFRSs on a worldwide basis.
3. The Preliminary Views treat the costs and benefits of financial reporting information as a constraint, rather than treating the consideration of costs and benefits as the underlying overall *objective* of financial reporting. This under-emphasis of the issue of costs vs. benefits may have contributed to the Preliminary Views giving insufficient prominence to the concept of "reliability" by replacing it with "faithful representation" and "verifiability".
4. This Paper suggests that a proper understanding of the term "reliability" appears to lead to the conclusion that it is still needed as a separate concept. The reliability of accounting processes, as well as the concept of evidence together with its verifiability, may also have a significant impact upon the consistency with which IFRSs are applied at an international level because different views about the meaning and importance of these may have an impact upon how accounting processes and evidence/verifiability concepts are actually applied in preparing IFRS financial statements. These matters also lead to another important issue: the full meaning of the "stewardship" objective and its implications for accounting standards setting.

IDW
INSTITUT DER WIRTSCHAFTSPRÜFER

5. The stewardship objective also involves consideration of *accountability* for the financial reporting process: financial reporting includes not only the ability of management to provide an *accounting* to users, but also to be able to *justify* that accounting. A case may be made that what ails the IASB's current approach to financial reporting is the disconnect between *accounting* and *financial reporting*, between what preparers must do to be able to report and the reporting itself. On this basis, the Paper proposes that the starting point for the financial reporting process is *accounting measurement* (as applied by measurement theory) – that is, the subsumption of entity circumstances and events under the recognition, measurement, classification, presentation or disclosure requirements in the standards and that such subsumption involves management being able to support its arguments in its decision-making process on these matters.

6. Justification by management of its decision-making processes in relation to *accounting measurement* implies the need for *accounting evidence* to support those decisions. It is management's responsibility to gather *accounting evidence* to support the arguments used in its accounting decision-making process. Of course, evidence to support some kinds of accounting decisions will be of greater strength than for others, and this would affect the ability of certain accounting treatments to meet the stewardship objective. The nature and extent of evidence will also have an impact on the reliability of financial reporting. After-the-fact justification of accounting decisions implies that management needs to document accounting evidence by means of *accounting documentation,* and apply *accounting systems and processes* to gather and process such documentation, to enable the preparation and presentation of reliable financial statements.

7. Consequently, when deliberating on the content of a conceptual framework for financial reporting and on specific financial reporting requirements, the IASB ought to consider the need for a treatment of accounting evidence and documentation, as well as of the accounting systems and processes, needed to enable the preparation and presentation of reliable financial statements. Furthermore, when considering new financial reporting requirements, the IASB ought to examine the impact of different proposed accounting treatments on the ability to obtain and document accounting evidence and their impact on accounting systems and processes, and hence on the assessment of the resulting costs of proposed financial reporting requirements in relation to the prospective benefits.

8. Quality control over accounting processes is important for the quality of the preparation and presentation of reliable financial statements. Quality control over the financial reporting process can be achieved through the design, implementation and maintenance of appropriate accounting processes or by designing, implementing and maintaining other adequate internal controls over financial reporting. Consequently, achievement of the justification aspect of the stewardship objective and the generation of reliable financial reporting information is predicated upon adequate quality

control and internal control over financial reporting. For this reason, quality control and internal control over financial reporting need to be addressed in a conceptual framework for financial reporting.

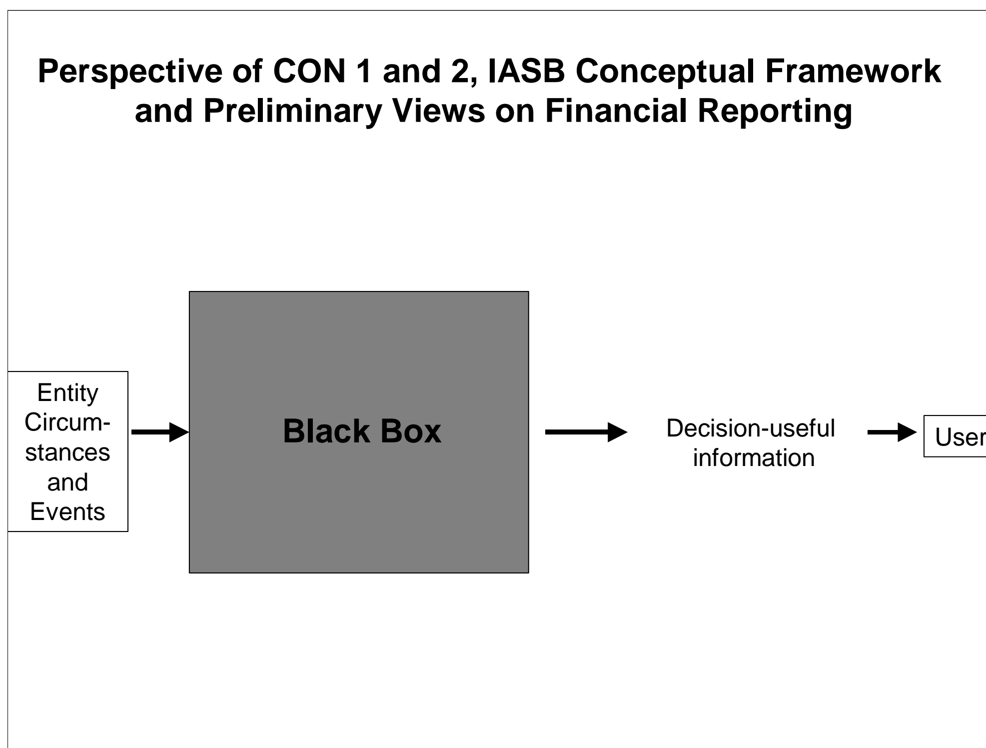
9. When setting financial reporting requirements, the IASB ought to consider the accounting processes and internal controls necessary to meet those requirements: accounting standards setting ought to involve more than just setting required accounting treatments, but should also address the potential inherent risks arising from those accounting treatments and the controls necessary to respond to those risks. Such consideration also assists in the assessment of the costs and benefits of such treatments. We surmise that in the long run such considerations may lead to simpler financial reporting standards and financial statements that are less prone to material misstatement.

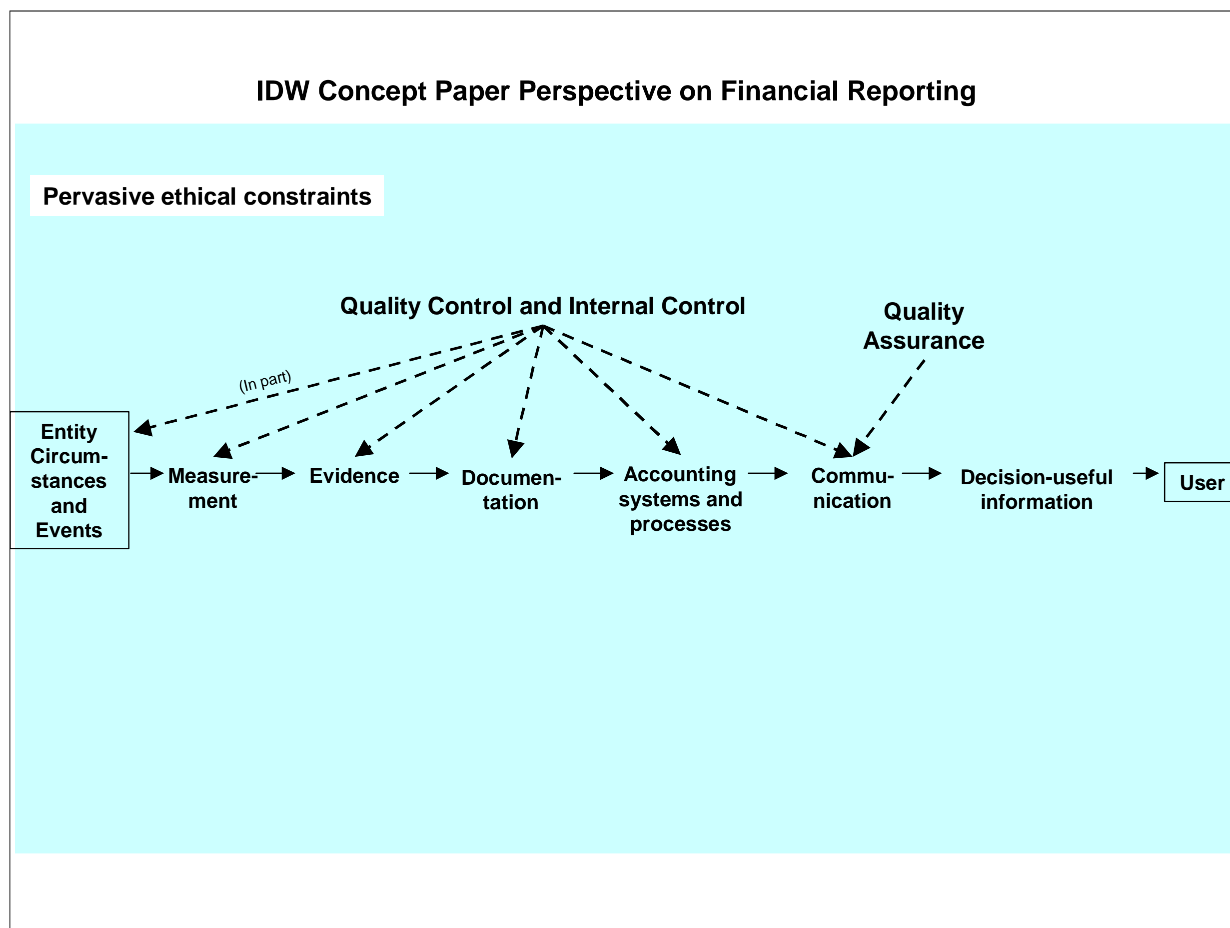
10. Although external quality assurance over financial reporting (e.g., audits and reviews of financial statements) is beyond the remit of the IASB, the accounting treatments required by financial reporting standards do have an impact on the verifiability and hence auditability of financial statements. This means the potential verifiability or auditability of accounting treatments required by financial reporting standards is clearly within the responsibility of the IASB by reference to the stewardship objective of financial reporting. It follows that the reliability and stewardship accountability considerations (measurement, evidence, systems and processes, control) in relation to accounting treatments considered by the IASB would need to be addressed in a conceptual framework for financial reporting, and hence potentially in financial reporting standards.

11. On the whole, it appears that the Preliminary Views do not create the comprehensive conceptual foundation necessary to address the nature of financial reporting information. The lack of a comprehensive conceptual framework for financial reporting may have serious consequences for future accounting standards setting because deliberations on the content of proposed financial reporting standards would involve the application of inadequate concepts from the Framework in the standards setting process. This may lead to standards that are less useful than they otherwise might have been in helping to generate reliable, consistent IFRS financial statements that also meet the stewardship objective.

12. This summary contains two diagrams below that attempt – in stark terms – to depict the difference between the perspective on financial reporting in the Preliminary views and that described in this Paper. In fact, it appears that the Preliminary Views treat important aspects of the financial reporting process as if they were a “black box”. These comparative diagrams represents an oversimplification of the issues, but it is hoped that they nevertheless help shed some light on the fundamental difference in perspective. It should be noted that these diagrams do not represent the financial reporting or accounting process, but rather attempt to show the interrelationship be-

tween the concepts. The theoretical foundations for these concepts are depicted in the diagrams included in the full Paper.





13. It was noted that the Board had concluded that "comprehensive reconsideration of all concepts would not be an efficient use of their resources" and "many aspects of their frameworks are consistent with each other and … do not seem to need fundamental revision". In contrast, this Paper suggests that a fundamental revision *is* needed. These views break new ground with respect to accounting standards setting at an international level. However, these views appear to be borne out by both underlying theories and practice. The concern is that, by neglecting the broad foundations of accounting and financial reporting that arise from a proper understanding of the stewardship objective and the need for reliable financial reporting, the IASB may also be neglecting the "nuts and bolts" of accounting and financial reporting in their broader sense, which includes considerations of accounting evidence and documentation, accounting processes and systems, and control over financial reporting. These considerations ought to have a major impact on the information that financial reporting standards require to be reported.

Section 1: Introduction

1.1 Purpose of the Paper

14. The purpose of this Paper is to address additional issues in relation to a conceptual framework for financial reporting that have not been addressed appropriately in the International Accounting Standards Board's (IASB) Preliminary Views "Conceptual Framework for Financial Reporting: Objectives of Financial Reporting and Qualitative Characteristics of Decision-Useful Financial Reporting Information" (hereinafter referred to as the "Preliminary Views").

1.2 Main Issues

15. In P7 of the Preface of the Preliminary Views, the Board concluded that "comprehensive reconsideration of all concepts would not be an efficient use of their resources" and "many aspects of their frameworks are consistent with each other and … do not seem to need fundamental revision". Furthermore, in P6 of the Preface the Board states that the "goals for the project include updating and refining existing concepts to reflect changes … in the two or more decades since the concepts were developed" and "to improve some parts of the existing frameworks, … as well as to fill some gaps in the frameworks". In contrast, in P3 of the Preface, the Board states "the fundamental concepts need to constitute a framework that is *sound*, *comprehensive*, and internally consistent" [italics added for emphasis]. In S1 of the Summary, the Board adds "a framework is a coherent system of concepts …".
16. The question arises whether it is feasible to update and refine existing concepts to reflect changes in the two or more decades since the concepts were developed and improve the existing framework, as well as filling some gaps in the frameworks, without a comprehensive reconsideration of all concepts. The question also arises whether a treatment of decision usefulness (including stewardship) objectives (the outcomes) can be undertaken without examining the prerequisites for their achievement (the accounting process), and whether the treatment of the qualitative characteristics of financial reporting information in the Preliminary Views suffices.
17. By pronouncing only upon the outcomes of financial reporting without considering, or pronouncing upon, the process needed to achieve the outcomes, the Board may leave itself open to the charge by some critics that the IASB's pronouncements do not reflect the realities of the conditions necessary for an accounting process to achieve the desired outcomes. This may lead to an improper assessment of the costs of proposed accounting treatments and of their feasibility, which has lead to increasing criticism of which we have become aware, that the Board's pronouncements have ceased to be practical and that IFRS financial statements are becoming unauditable. Furthermore, there is a question whether some of these issues may

have an impact upon the consistency of application of IFRSs on a worldwide basis. It should be noted that some countries have standards and guidance on the accounting process for their national financial reporting standards, but these have not been designed for IFRSs.

Section 2: Qualitative Characteristics: Costs vs. Benefits and Reliability

2.1 Costs vs. Benefits

18. An examination of some of the narrative in Statement of Financial Accounting Concepts No. 2 (hereinafter referred to as "CON 2") shows that its treatment of the qualitative characteristics of financial reporting information was based primarily upon what appears to be a not particularly systematic and selective application of parts of decision theory (see, for example, the discussion in CON 1.09), information theory (see, for example, footnote 5 in CON 2) and measurement theory (see, for example, footnote 2 in CON 1 and footnote 9 in CON 2). However, a comparison between these three theoretical foundations on the one hand, and the current IASB Conceptual Framework (hereinafter referred to as the "Framework") and CON 1 and 2 on the other hand, appears to indicate that basic concepts from these foundations, in their state of development when the IAS Conceptual Framework and CON 1 and 2 were issued, were either not applied or misapplied in the Framework and CON 2. This inadequate application of these theoretical foundations is carried forward in the Preliminary Views. A few examples of such inadequacies can be identified at first glance.

19. In consonance with the Framework and CON 2, the Preliminary Views treat the costs and benefits of financial reporting information as a constraint. We recognize that the determination of the benefits of particular accounting treatments in this context is more difficult than the determination of costs, since the benefits are comparatively diffuse, whereas the costs are borne by preparers. Nevertheless, it is possible to develop a sense of the direction (increase or decrease) of benefits in this context. In any case, treating the concept of costs vs. benefits as a constraint on financial reporting, rather than as the underlying overall *objective* of financial reporting (that is, having financial reporting provide information with a cost-benefit relationship that most closely serves the risk preferences of users as a group), does not accord with decision theory.

20. This difference in perspective (that is, costs vs. benefits as the objective, rather than as a constraint) in conceptual frameworks for financial reporting may have a significant impact on how benefits and costs are taken into account when accounting stan-

dards setters deliberate prospective financial reporting requirements. There may be a case that treating the costs vs. benefits issue as a constraint rather than as the objective diminishes the weight given to this issue when accounting standards setters consider accounting treatments for financial reporting standards. This raises the question as to whether accounting standards setters, such as the IASB, place insufficient emphasis on the issue of costs vs. benefits. Furthermore, under-emphasis of the issue of costs vs. benefits may have led to insufficient prominence being given to certain concepts, in the Preliminary Views, that need to be considered by accounting standards setters when developing standards. One of these concepts is "reliability". In particular, a conceptual framework for financial reporting needs to be recognize that there is a significant cost to a lack of adequate reliability.

2.2 Reliability

21. In the Preliminary Views the Board chose to replace the concept of "reliability" with "faithful representation" and "verifiability". An examination of the use of these latter two concepts in the Preliminary Views suggests that they do not appear to provide comprehensive coverage of the meaning of reliability. In particular, the term verifiability appears to contain two aspects: direct verification and indirect verification, but does not address the issue of the reliability of the accounting processes needed to achieve faithful representation. In addition, the concept of "verification" is predicated upon the existence of another concept – "evidence" – which is also not addressed in the Preliminary Views.

22. It should be noted that, unlike in the Preliminary Views, in which both verifiability and neutrality are included under "faithful representation", measurement theory clearly distinguishes the term "reliability" from the concept of validity (which includes the concept of "representational faithfulness" using different terminology). Furthermore, measurement theory addresses neither evidential concepts (which is the province of the science of evidence), nor the concept of verification, the application of which depends upon a concept of evidence.

23. The reliability of accounting processes and evidence, together with its verifiability, may also have a significant impact upon the consistency with which IFRSs are applied at an international level because different views about the meaning and importance of these may have an impact upon how accounting processes and evidence/verifiability concepts are actually applied in preparing IFRS financial statements. All in all, there does not appear to be a strong case for eliminating the concept of reliability from measurement issues (as defined by measurement theory) in financial reporting.

24. Issues in relation to reliable accounting processes and beyond reliability in relation to the evidence and its verifiability also lead to another matter: the full meaning of the stewardship objective and its implications, which is addressed in Section 3.

2.3 Need for Comprehensive Reassessment of Qualitative Characteristics of Financial Reporting Information

25. The issues noted above in relation to costs vs. benefits, reliability, verifiability and evidence suggest that a more comprehensive reassessment of the qualitative characteristics of financial reporting information may be needed. For example, there are matters that both preparers and users must consider beyond sheer costs and benefits and decision usefulness. In particular, there are requirements (e.g., legal statutes, regulations, administrative rules, court decisions, professional or industry codes of professional conduct, entity ethical requirements, community standards) which we have subsumed under the term "ethical constraints" that constrain the ability of preparers to prepare or report (e.g., confidentiality requirements), and users to receive or use (e.g., conflicts of interest) valuable information. In other words, given both of the issues noted, there are matters relating to the *suitability* of financial reporting information beyond decision-usefulness. The Framework ought to provide an adequate treatment of the constraints beyond decision-usefulness that may have a major impact on the content of financial reporting standards.[1]

Section 3: The Relationship between The Objective of Financial Reporting and Stewardship

3.1 Financial Reporting, Decision-Usefulness, Stewardship, and Accountability

26. OB2 in the Preliminary Views states that "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." QC 1 and 2 then link this objective to the need for financial reporting to provide *decision-useful* information to these users. Furthermore, OB28 states, "the objective of financial reporting stated in paragraph OB2 encompasses providing information useful in assessing management's stewardship." However, this latter statement is not without controversy, since two IASB members disagree with the subsumption of the *stewardship* objective within the *decision usefulnes*s objective (see AV1.1 to AV1.7).

27. In particular, this alternative view points out that stewardship is concerned with the *accountability* of management or those charged with governance of an entity to its

[1] See the abridged version of the FEE Issues Paper „Principles of Assurance: Fundamental Theoretical Issues With Respect to Assurance in Assurance Engagements", (FEE: Brussels, April 2003), pp. 15-29, for a more thorough treatment of suitable information.

owners, which is at the heart of the financial reporting *process* in many jurisdictions (see AV1.3). There is some merit to this view, but there appear to be additional substantive reasons beyond those provided in the alternative view as described in the Preliminary Views.

28. The two dissenting IASB members correctly point out that financial reporting is a *process* (see AV1.3) by which information is prepared, presented, delivered and used. In this sense, the *stewardship* objective encompasses an *accountability* function, which encompasses more than just the end product (decision-useful information, whether for investment, credit, and similar resource allocation decision, or for stewardship), but also involves consideration of the *accounting process* by which the information is produced and presented.

29. The very word *stewardship* refers to the office, term or duties of a steward – one who is entrusted with the management of property, finances or other affairs not his or her own. By definition, stewards are *accountable* to owners, which means that they are liable to being called *to account* by those owners and are therefore responsible for an *accounting* to those owners. The provision of such an *accounting* goes beyond just the provision of information useful to users in relation to stewardship: it means that stewards must be in a position to support such information that they have provided to owners. This goes to the very heart of the meaning of *accountability* and *accounting*.

3.2 Accountability, Accounting, and Justification

30. As noted in the previous subsection, the concepts *stewardship* and *accountability* not only encompass the provision of information (an *accounting*) to owners, but also the ability to support such information. Both the Preliminary Views and the IASB Alternative View on the stewardship objective do not appear to address this essential aspect of stewardship. Yet the very words “accountability” and “accounting”, which are derived from the verb “to account”, signify that accounting, and hence financial reporting, involve more than just the provision of information: they encompass the ability of stewards (management, or those charged with governance, in a business enterprise) to *justify* the accounting provided to owners and other users – independent of whether an audit thereof is performed, since audits represent a “verification” of that support.

31. Such *justification* of an *accounting* can only be provided by the books, records and other documents created by the *accounting process* that is maintained by management of an entity. For this reason, partnership and corporate law in most industrialized countries require management to maintain adequate books and records in some form (whether by statute, regulation or through court decisions). Furthermore, accounting regulators and enforcement authorities have a particular interest in the ability of management to justify an entity’s financial reporting information.

32. By focusing on only the “end product” of the financial reporting process (decision-useful information), the IASB does not appear to recognize that *financial reporting* is much more than a set of financial statements, etc. provided to users: it represents the end of the chain of *accountability* through *accounting*. A case may be made that what ails the IASB’s current approach to financial reporting is the disconnect between *accounting* and *financial reporting*, between what preparers must do to be able to report and the reporting itself. The analysis in this Paper suggests that it is important to put *accounting* (the ability of management to *justify* its financial reporting) back into *financial reporting.*

33. By refastening financial reporting to its accounting roots, the conceptual framework, and hence financial reporting standards, would reflect the fact that accounting, and hence financial reporting, is not an academic exercise, but a *practical* one. This Paper is not suggesting a reversion to the almost entirely process-driven financial reporting standards prior to the 1970’s at the expense of decision-useful information. Rather, the Paper seeks to bring a sense of balance back into financial reporting standards by having the conceptual framework foundation of those standards recognize the interplay between the needs of the accounting process and useful financial reporting information.

34. To this effect, this Paper examines some of the important accounting issues that form the prerequisites for justification in financial reporting, including measurement, evidence, documentation, systems, quality (internal) control, and the conclusions that would be drawn for qualitative characteristics of financial reporting information.

Section 4: Measurement, Evidence, Documentation and Systems

4.1 Accounting Measurement

35. The word “measurement” as used by the IASB is confined to the determination of monetary amounts, which is rather narrow compared to the meaning of the term in “measurement theory”. Using the term as applied in measurement theory, *measurement* in accounting refers to the mapping of empirical phenomena (an entity’s circumstances or events) to accounting objects (e.g., particular recognition, measurement, classification, presentation or disclosure requirements for particular items in the financial statements, as defined by the IASB). The starting point to support an accounting is the ability of management to justify the decisions that it has taken with respect to accounting measurement decisions. Such justification involves management being able to support the arguments in the entity’s decision-making process to recognize, measure (as defined by the IASB), classify, present or disclose (or not to

do so) certain entity events or circumstances in a certain way. The arguments involve the use of *evidence* to support a particular decision (see next subsection).

36. It should be recognized that the arguments for some decisions would be stronger than for others depending upon the circumstances or events and the requirements in the standards. For example, the arguments supporting measurement decisions (as the IASB uses the term) leading to some accounting estimates (e.g., fair values where no suitable market prices are available) may have less support than arguments supporting some other accounting measurements (e.g., the historical costs of property, plant and equipment). The fact that some arguments have less support means that it is more difficult in those cases for management to be held to account for its decisions and therefore more difficult to meet the stewardship objective. It also suggests that some arguments may be less reliable than others.

37. The analysis in this Paper suggests that the IASB may need to recognize in its conceptual framework that the basis for accounting and hence financial reporting is the subsumption of entity circumstances and events under the recognition, measurement, classification, presentation or disclosure requirements in the standards, the basis for which is measurement theory, and that such subsumption involves management being able to support its arguments in its decision-making process on these matters. Furthermore, the IASB may also need to recognize that the arguments supporting some kinds of accounting decisions will be of greater strength than for others and that this would have an impact upon the ability of certain accounting treatments to meet the stewardship objective and on the reliability of financial reporting. The "measurement" issue is important because the lack of a common understanding of this issue may lead to inconsistent application of IFRSs on a worldwide basis.

4.2 Accounting Evidence

38. Evidence is information that is used to support or undermine a particular assertion with respect to a certain matter. When management seeks to support the arguments in its decision-making process to recognize, measure, classify, present or disclose (or not to do so) certain circumstances or events relating to the entity in a certain way, it uses information (evidence) to support the assertions embodied in its arguments. The existence of circumstances or the occurrence of events in relation to an entity generally leave behind evidence about these. Furthermore, the formulation of arguments in the decision-making process about the recognition, measurement, classification, presentation and disclosure of such events and circumstances also represent evidence supporting the arguments in that decision-making process. The underlying theoretical basis for evidence as a concept can be found in epistemology and the newly founded interdisciplinary science of evidence.

39. It is management's responsibility to gather evidence to support its accounting decision-making process (see the treatment of documentation in the following subsec-

tion). Without such evidence, management is not in a position to justify its decisions on accounting treatment, and management would therefore be unable to meet its stewardship responsibilities. In fact, without evidence, oversight of those charged with governance over management and enforcement over financial reporting by enforcement authorities would not be feasible. We suggest referring to such evidence as “accounting evidence” to distinguish it from “audit evidence”. *Accounting evidence* enables management to meet its stewardship responsibilities (and those charged with governance their oversight responsibilities) regardless of whether or not that evidence is then also used to support the contents of the financial statements when audited.

40. As noted in the previous subsection, it is the *accounting evidence* in relation to the existence of circumstances, occurrence of events and their subsumption under the requirements in financial reporting standards that lends its support to particular arguments supporting management decision-making on accounting treatment. Arguments are of greater or lesser strength because the evidence supporting them is of greater or lesser strength. For example, evidence supporting the recognition of a cash receipt deposited onto an enterprise’s bank account may be of significantly greater strength than evidence supporting the recognition of revenue for a complex sales contract. In some circumstances the appropriate accounting treatment for given financial reporting requirements may depend upon management applying its judgment in weighing the evidence.

41. This analysis suggests that the IASB ought to consider including the concept of *accounting evidence* in the conceptual framework and recognize that it is management’s responsibility to gather, and weigh, evidence to support the arguments used in its accounting decision-making process. A number of IASB pronouncements, such as implementation guidance, already include such evidential considerations. However, this issue has not been addressed in a systematic manner. When considering prospective financial reporting requirements, the IASB ought to examine their potential impact on the ability of management to obtain accounting evidence and the cost of obtaining that evidence.

42. As a consequence, at a later stage, it may also be worth considering whether a standard on accounting evidence may need to be developed and whether individual standards ought to include specific requirements or guidance on the evidence needed to support certain accounting treatments. Furthermore, the IASB may need to recognize that the *accounting evidence* supporting some kinds of accounting decisions will be of greater strength than for others and that this would have an impact upon the ability of certain accounting treatments to meet the stewardship objective or to provide reliable financial reporting information. This is important because differing views about the accounting evidence necessary to support certain accounting treatments may lead to inconsistent application of IFRSs internationally.

4.3 Accounting Documentation

43. When management engages in its accounting decision-making processes, management not only needs to be able to justify these decisions, based upon the evidence, at the time they were made, but also subsequently as part of management's stewardship responsibilities, which involves an "after-the-fact" accounting to the owners. Consequently, if owners or representatives of the owners (e.g., those charged with governance), auditors, accounting enforcement authorities, or regulators, need to verify management's justification of its accounting treatments subsequent to the time in which management accounting decisions are made, management must ensure that the entity *documents* the evidence supporting the accounting decisions made. Consequently, management is responsible for entity *accounting documentation*.

44. Documentation of accounting evidence would encompass the evidence supporting the existence and nature of circumstances or the nature and occurrence of events relating to the entity as well as of the arguments supporting the accounting decision-making process. Documentation can take the form of accounting books, records and other documents, and can be in electronic, paper or other forms. Key is that the documentation can be made human-readable in a reasonable time and that it be structured such that a third party expert in accounting (such as accounting enforcement authorities) without any previous experience in the entity is in a position to understand the accounting evidence supporting the arguments in the accounting decision-making process within a reasonable time. The creation and maintenance of adequate accounting documentation is prerequisite for meeting the justification aspect of the stewardship objective and enables the preparation and presentation of reliable financial statements. The IASB ought to consider the impact of prospective financial reporting requirements on the need for, and cost of, documentation.

45. The analysis in this Paper suggests that the IASB may need recognize the importance of accounting documentation in the conceptual framework, and clarify that the maintenance of such documentation is the responsibility of management. The framework should note that accounting documentation covers the evidence supporting the existence and nature of circumstances and the nature and occurrence of events relating to the entity that give rise to accounting issues, as well as covering the evidence supporting the arguments in the accounting decision-making process. As a consequence and at a later stage, consideration may be given as to whether a standard on accounting documentation may be necessary, and as to whether specific documentation requirements and guidance may be necessary in particular financial reporting standards.

4.4 Accounting Systems

46. The needs of double entry accounting, the large number of transactions and other events in most business enterprises, the complexity of many business processes

leading to financial reporting information, and the complexity of financial reporting requirements, means that *documentation* of accounting evidence needs to be collected and processed (recognized, measured, classified, aggregated, presented and disclosed) in accordance with the requirements in financial reporting standards, and transmitted and disseminated to external users through the use of an *accounting system* (an accounting system is part of an entity's *internal control* – see the next section). This means that an accounting system allows management to support the contents of its financial statements. Consequently, management is responsible for designing, implementing and maintaining an adequate accounting system not only to be able to provide *reliable* decision-useful information to external users, but also to perform these tasks to meet its stewardship (justification) responsibilities.

47. Paragraphs QC53 to QC 59 in the Preliminary Views as well as Section 2 of this Paper point out that the benefits of financial reporting information should justify the costs of providing and using it. It should be noted that it is impossible to consider the costs and practicality of financial reporting requirements without considering the impact of these requirements on the design, implementation and maintenance of the accounting systems and processes necessary to meet those requirements. Consequently, given the impact of financial reporting requirements on accounting systems and processes, and the need for such systems for management to be able to meet its stewardship (justification) responsibilities and to be able to generate reliable financial reporting information, accounting systems represent a fundamental concept for financial reporting, and in particular, for stewardship and reliable financial reporting information.

48. For these reasons, consideration ought to be given as to whether the conceptual framework needs to include a treatment of the role of accounting systems (including information technology) in financial reporting. Furthermore, when deliberating on new financial reporting requirements, the IASB ought to examine the impact of different proposed accounting treatments on accounting systems and processes and hence on costs. As a consequence, at a later stage, consideration may need to be given as to whether a standard on accounting systems may be appropriate, and whether needed accounting processes in relation to particular financial reporting requirements ought to be addressed for particular standards. It should be noted that differing views about the accounting processes necessary to generate reliable financial reporting information may result in IFRS financial statements of differing reliability. Hence, the issue of accounting systems and processes is fundamental to consistent application of IFRSs.

Section 5: Quality Control, Internal Control and Quality Assurance

5.1 Quality Control over Financial Reporting

49. As noted in Section 3, accounting and hence financial reporting represents a process. Accounting involves the processing of inputs (financial reporting requirements and the events, business processes and circumstances relating to the entity) into an output: the financial statements. Consequently, the quality of the financial statements depends upon the quality of the accounting inputs and the quality of the accounting process. In this Paper, the term "quality" refers to the degree to which the properties of an object satisfy stated or implied purposes.

50. Accounting standards setters are responsible for promulgating one of the accounting inputs (financial reporting requirements), and are therefore responsible for the quality of financial reporting requirements, whereas the management of an entity is responsible for the other accounting input (the entity inputs: the events, business processes and circumstances relating to the entity or responses to events and circumstances beyond management control) and for the accounting process. Consequently, management is also responsible for the decisions that affect the quality of the events, business processes and circumstances (or, if not, for the quality of the responses to events and circumstances beyond management control) relating to the entity and for the quality of the accounting process.

51. The quality of financial reporting requirements promulgated by an accounting standards setter, such as the IASB, is often gauged by reference to the degree to which the application of the financial reporting standards satisfies the qualitative characteristics of financial reporting information and thereby meet the objectives (i.e., the purposes) of financial reporting. However, this Paper seeks to demonstrate that the qualitative characteristics of financial reporting information identified by the IASB in its conceptual framework project may require further revision, and may not be complete.

52. The quality of the entity inputs into the accounting process (the events, business processes and circumstances relating to the entity or responses to events and circumstances beyond management control) from an accounting point of view represent an as yet largely unexplored topic. Nevertheless, there is no doubt that some inputs (e.g., events, such as cash receipts, or business processes, such as collection of accounts receivable) clearly facilitate the consistent application of accounting requirements more than others (e.g., events, such as the incurrence of environmental damage, or business processes, such as the fulfillment of complex sales contracts).

53. Nevertheless, the quality of the financial statements for given inputs can only be as good as the accounting process. Consequently, quality control over the accounting process is central to the quality of the financial statements: For this reason, adequate

quality control over the accounting process is a prerequisite for the achievement of the accountability aspect of the stewardship objective and for the generation of reliable financial statements. This means that quality control over the financial reporting process has an impact upon the consistent application of IFRSs. When considering prospective financial reporting requirements, the IASB needs consider to the impact of these requirements on quality control measures and their cost.

54. Quality control over the financial reporting process can be achieved through the appropriate design, implementation and maintenance of accounting processes, or by designing, implementing and maintaining other *internal controls* over entity inputs and the accounting process (the basis for which can be found in control theory). Since the accounting system, and the accounting process and quality control measures over that process, also represent a part of an *entity's internal control system*, the achievement of the stewardship objective for financial reporting and the generation of reliable financial reporting information is closely linked to *internal control over financial reporting.*

5.2 Internal Control Over Financial Reporting

55. The previous subsection notes that the accounting system and process and quality control measures over that process represent a part of an entity's internal control over financial reporting and demonstrates that internal control over financial reporting is a central financial reporting concept. Consequently, the stewardship objective to enable *accountability* and the ability to generate reliable financial reporting information depend upon the design, implementation and maintenance of adequate internal control over financial reporting by management.

56. There is considerable literature on internal control over financial reporting. Furthermore, different internal control frameworks have been issued in different jurisdictions: e.g., COSO (I and II) in the U.S., CoCo in Canada, and Turnbull in the U.K. Despite the fact that these frameworks are supposed to address internal control in enterprises generally (e.g., safeguarding of assets, effectiveness and efficiency of operations, compliance and communications), they have tended to overemphasize control over external financial reporting, which represents a subset of compliance and communications. On the other hand, the COSO "Internal Control over Financial Reporting – Guidance for Smaller Public Companies" concentrates solely on internal control over financial reporting for smaller public companies.

57. Nevertheless, despite this "overemphasis" on financial reporting in these frameworks (with the exception of the latter guidance), these control frameworks do not provide adequate guidance on internal control over financial reporting to allow preparers of financial statements to determine the effectiveness of their internal control over financial reporting. This is particularly the case because these frameworks do not set forth suitable qualitative effectiveness criteria and because they do not directly link

accounting requirements with particular consequences for internal control over accounting processes.

58. For SEC-Registrants, and through a kind of osmosis also increasingly for other enterprises, the nature of internal control over financial reporting in enterprises has also been heavily influenced by the PCAOB's auditing standard AS-2, which, however, is an auditing – not an accounting – standard that does not apply directly to entities that are preparers of financial statements. The SEC is attempting to remedy this anomaly by having issued guidance for management on management's report on internal control over financial reporting (which is accompanied by the issuance of the new PCAOB auditing standard AS-5 to replace AS-2). However, the SEC guidance represents very high level guidance, contains no specific requirements, does not contain any qualitative effectiveness criteria for internal control over financial reporting, and does not directly link specific accounting requirements to consequences for internal control over accounting processes.

59. The internal control needed over accounting processes flows directly from the interaction between 1. the nature, timing and extent of transactions and other events, and the nature of the circumstances and conditions, relevant to financial reporting in an entity and 2. the accounting requirements applicable to the entity. This interaction leads to inherent risks of material misstatement (whether due to fraud or error) of the financial statements: that is the risk that a material misstatement occurs. Management is responsible for designing, implementing and maintaining internal control adequate to respond to and thereby reduce the risk of material misstatement (that is, the combination of the inherent risks arising from the interaction noted above in the first place together with the risk the internal control over financial reporting will not prevent, or detect and correct such misstatements) to an acceptably low level. Without adequate internal control over financial reporting, the accounting process and hence the financial statements resulting from that process will not be sufficiently reliable for users. Furthermore, differing views about quality control and internal control over financial reporting may lead to differing reliability of IFRS financial statements and have an impact on the consistent application of IFRSs.

60. Consequently, the inherent risks of material misstatement and therefore internal control over financial reporting to respond to those risks are central risk management issues for financial reporting, and therefore these issues also ought to be central issues for accounting standards setters, including the IASB. With a few exceptions,[2] the various frameworks dealing with internal control and, in varying degrees, with internal control over financial reporting, currently do not link their guidance on internal

[2] In Germany, the IDW has an accounting pronouncement (IDW Stellungnahme zur Rechnungslegung: Grundsätze ordnungsmäßiger Buchführung bei Einsatz von Informationstechnologie (IDW RS FAIT 1) ["IDW Accounting Principle: Principles of Proper Accounting When Using Information Technology"] (IDW AcP FAIT 1)) based upon legal requirements that does provide effectiveness criteria and documentation requirements specifically in relation to internal control over financial reporting.

control to the specific requirements of a set of financial reporting standards. In other words, there are no standards on the internal control over financial reporting in accordance with applicable financial reporting standards (including IFRSs), and there is a disconnect between guidance on internal control over financial reporting and applicable accounting standards. The need to resolve this disconnect is made more urgent by the financial reporting implications of XBRL and its potential drill-down features, the implementation of which in entity financial reporting increases the importance of quality and internal control over financial reporting.

61. The current situation with the noted disconnect appears to untenable in the long run. Consequently, this Paper suggests that accounting processes and internal controls over financial reporting necessary to meet financial reporting requirements ought to be addressed in a conceptual framework for financial reporting. Furthermore, when setting financial reporting requirements, the IASB also ought to consider the accounting processes and internal controls necessary to meet those requirements: accounting standards setting ought to involve more than just setting required accounting treatments, but also address the potential inherent risks arising from those accounting treatments, the controls necessary to respond to those risks, and their cost. We surmise that in the long run this may lead to simpler financial reporting standards and financial statements that are less prone to material misstatement.

5.3 External Quality Assurance Over Financial Reporting

62. Thus far this Section has dealt with quality control over the accounting process from within the entity and *internal* control, as opposed to any form of external control over the financial reporting process, and has come to the conclusion that quality control and hence internal control are an inextricable part of an accounting system when appropriately considering the *accountability* aspect of the *stewardship* objective of financial reporting and the need for reliable financial reporting information. Nevertheless, there may be important reasons (often justified by means of agency and control theory) for the establishment of external quality assurance (external controls) over the product of the financial reporting process (the financial statements). Such needs lead to legislators or regulators requiring audits or reviews of financial statements for certain kinds of enterprises or for other forms of financial reporting oversight or enforcement. Based on current professional standards for professional accountants in public practice (referred to as “practitioners”), such engagements performed by practitioners include audits and reviews of financial statements. Some jurisdictions have accounting oversight or enforcement authorities.

63. External quality assurance in relation to financial statements means that an objective (and hence independent of the entity and its management) and competent third party “verifies” whether the financial statements comply with applicable accounting requirements. Standards for such external quality assurance are not within the remit of

accounting standards setters, such as the IASB, but are in the province of auditing standards setters, such as the International Auditing and Assurance Standards Board (IAASB). Nevertheless, as pointed out in the subsection on accounting documentation, the key to documentation (and hence accounting systems and internal controls over that system) is that accounting evidence can be made human-readable in a reasonable time and that it be structured such that a third party expert in accounting (such as an auditor or accounting oversight authority) without any previous experience in the entity is in a position to understand the accounting evidence supporting the arguments in the accounting decision-making process within a reasonable time.

64. Consequently, the *verifiability* (and hence *auditability*) of financial statements prepared in accordance with particular accounting standards is within the stewardship responsibilities of management. This means that the potential verifiability or auditability of accounting treatments required by accounting standards is clearly within the responsibility of accounting standards setters by reference to the stewardship objective of financial reporting. It follows that the *accountability* considerations for accounting treatments required by accounting standards in relation to accounting measurement, evidence, documentation, systems, and quality and internal control over financial reporting, need to be addressed by the IASB in a conceptual framework for financial reporting, and perhaps in financial reporting standards.

Section 6: Conclusions

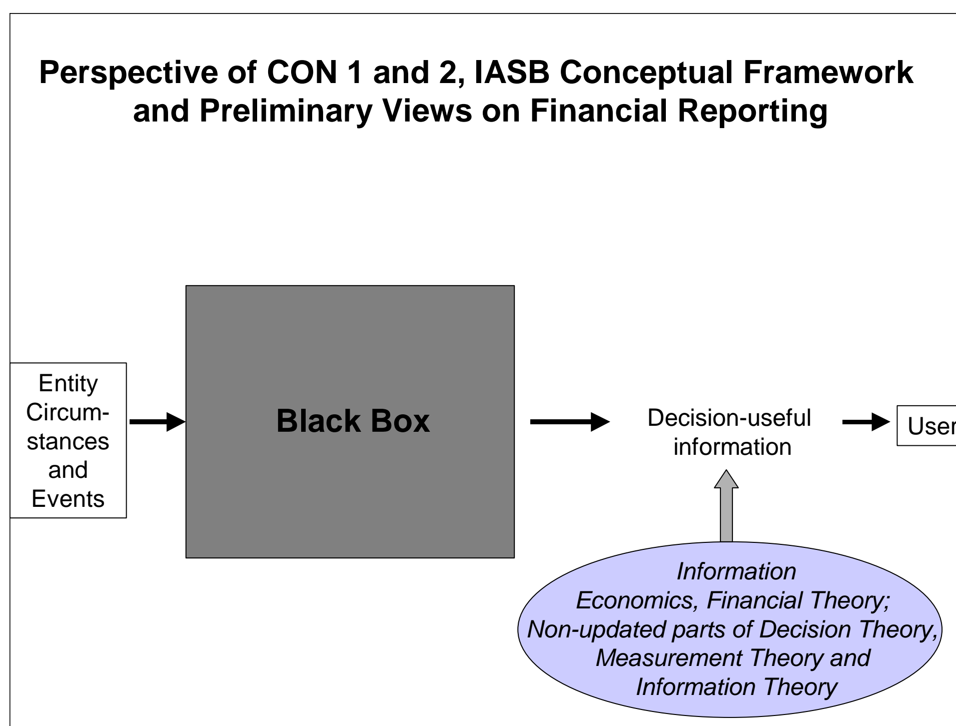
65. The views expressed in this Paper accord with the view expressed by the Board in P3 of the Preface that "the fundamental concepts need to constitute a framework that is sound, comprehensive, and internally consistent" and with its view expressed in S1 of the Summary, that "a framework is a coherent system of concepts". However, the concepts in the Preliminary Views do not appear to meet these goals for the reliability of financial reporting information or the stewardship objective for financial reporting. It appears that the Preliminary Views do not create the comprehensive conceptual foundation necessary to address the nature of financial reporting information. In fact, it appears that the Preliminary Views treat the most important aspects of the financial reporting process as a "black box".

66. The lack of a comprehensive conceptual framework for financial reporting may have serious consequences for future accounting standards setting because deliberations on the content of proposed accounting standards would involve the application of inadequate concepts from the Framework in the standards setting process and thereby lead to standards that are less useful than they otherwise might have been in helping

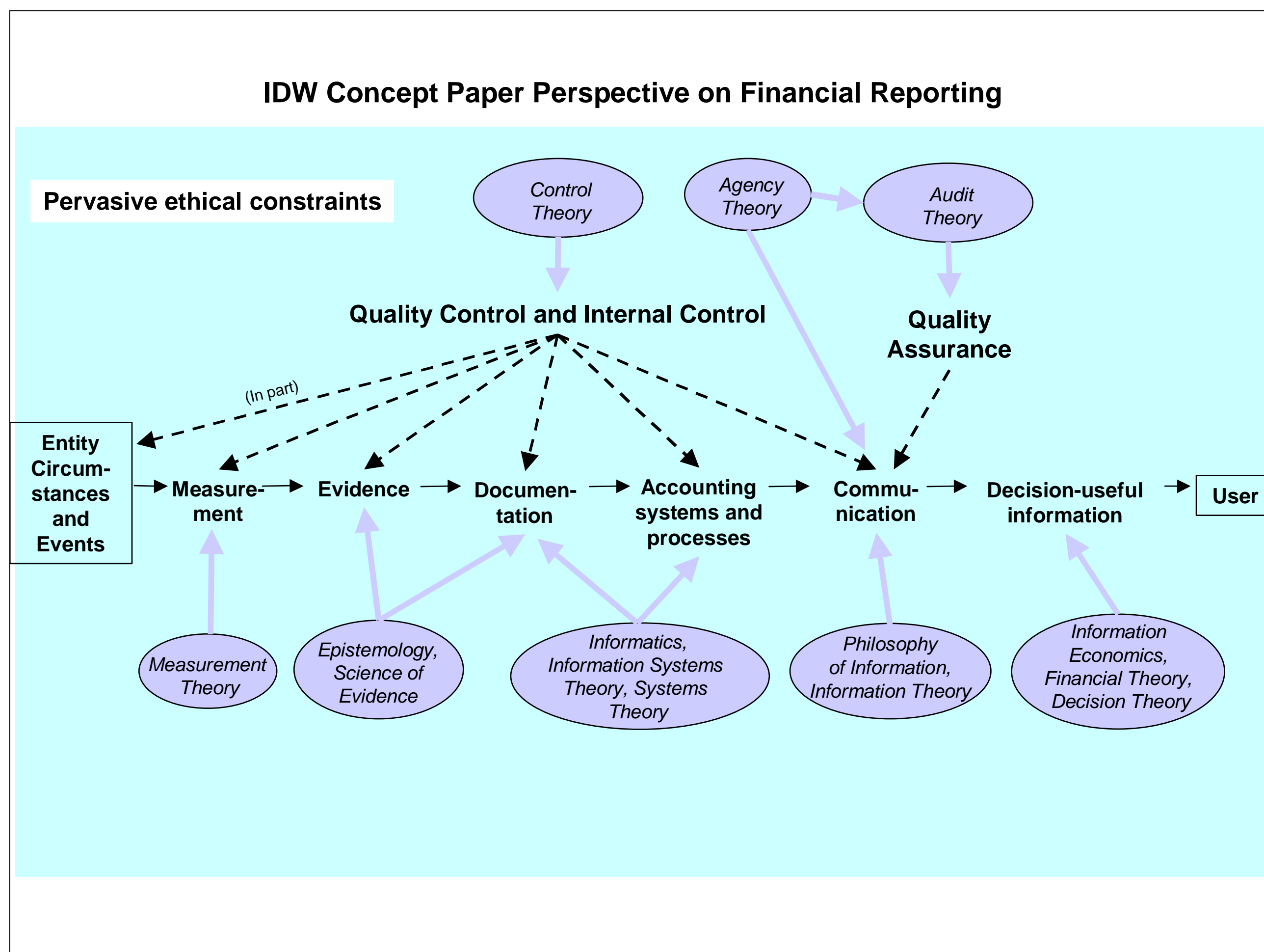
IDW
INSTITUT DER WIRTSCHAFTSPRÜFER

to generate reliable, consistent IFRS financial statements that also meet the stewardship objective.

67. It is said that a picture speaks a thousand words. To this effect this section with the conclusions contains two diagrams below that attempt – in stark terms – to depict the difference between the perspective on financial reporting in the Preliminary views and that described in this Paper. These comparative diagrams represents an oversimplification of the issues, but it is hoped that they nevertheless help shed some light on the fundamental difference in perspective. It should be noted that these diagrams do not represent the financial reporting or accounting process, but rather attempt to show the interrelationship between the concepts. The items in the "bubbles" represent some of the underlying theories supporting the concepts in the financial reporting process.



IDW
INSTITUT DER WIRTSCHAFTSPRÜFER



68. It was noted that the Board had concluded that "comprehensive reconsideration of all concepts would not be an efficient use of their resources" and "many aspects of their frameworks are consistent with each other and … do not seem to need fundamental revision". In contrast, this Paper suggests that a fundamental revision *is* needed. These views break new ground with respect to accounting standards setting at an international level. However, these views appear to be borne out by both underlying theories and practice. The concern is that, by neglecting the broad foundations of accounting and financial reporting that arise from a proper understanding of the stewardship objective and the need for reliable financial reporting, the IASB may also be neglecting the "nuts and bolts" of accounting and financial reporting in their broader sense, which includes considerations of accounting evidence and documentation, accounting processes and systems, control, and ethical constraints. These considerations ought to have a major impact on the information that financial reporting standards require to be reported.