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December 13, 2011

Professor Mervyn E. King
Chair
International Integrated Reporting Committee
(IIRC)

By E-mail: dpresponses@theiirc.org

Dear Professor King,

Re.: Comment Letter on IIRC Discussion Paper "Towards Integrated Reporting: Communicating Value in the 21st Century"

We would like to thank you for the opportunity to provide the International Integrated Reporting Committee (IIRC) with our comments on the IIRC Discussion Paper "Towards Integrated Reporting: Communicating Value in the 21st Century" (hereinafter referred to as the "paper").

We welcome the initiative by the IIRC to determine whether, and if so how, corporate reporting could be better integrated, more comprehensive, focused, and hence useful to stakeholders. It is clear that the financial reporting alone does not appear to provide all of the information that stakeholders need and that the information in financial reports is linked to other important information, such as corporate responsibility, governance, sustainability, etc. Consequently, we appreciate the efforts undertaken by the IIRC to explore the issue of integrated reporting and find favour with the objective of developing an international approach to integrated reporting. We are particularly pleased to see the broad international representation on the IIRC itself and its other bodies, but for greater balance would like to suggest that the IIRC seek additional participation from outside common law jurisdictions. In particular, many institutions in Continental Europe, including our organization in Germany, would be pleased to be able to contribute technical expertise to the IIRC's deliberations.

We support the IIRC seeking views on its ground-breaking initiative, which provides a forum for the debate on the important issues identified by the paper. In this respect, there are a number of issues that we would like to address in our comment letter for consideration by the IIRC. To this effect, we have provided our comments to the consultation questions posed in the Appendix to this letter.

In our view, it would have been helpful if the “discussion paper” had provided an analysis of the relevant reporting issues, including of the pros and cons of potential means of dealing with the issues identified. The paper appears to seek to provide the building blocks for the basis for a proposed “Framework” for integrated reporting, but the paper would have been able to make a greater contribution to the debate by including explicit arguments supporting the elements of the proposal. In this sense, the Paper represents a “proposal”, rather than a “discussion paper”, that seeks comments on the proposal. Furthermore, the paper just assumes that the elements described in the building blocks are the right ones: we believe that it is important that such papers set forth a comprehensive conceptual foundation for the proposals made based on the initial diagnosis of problems. In this respect, we note that there appears to be a disconnect between the diagnosis of reporting problems identified in the paper and the derivation of the reporting solutions proposed – that is, it is not clear why the specific proposals made will actually mitigate the reporting problems identified.

In this context, we would like to emphasize that the development of integrated reporting needs to be based upon a sound conceptual foundation, which should be set forth in a Framework. A Framework can only serve as a basis for developing standards for integrated reporting – not as a basis for that reporting by entities directly. Such a Framework would analyze the relevant reporting issues and provide a conceptual underpinning that justifies the proposals made. We also believe that to develop a solid conceptual foundation for integrated reporting, the IIRC would need to consider some of the work done on the conceptual foundations of information, measurement and reporting. We refer to a number of potential sources in this respect.

We do support the general move towards greater focus and comprehensiveness in reporting. However, we should be aware that greater comprehensiveness and focus can also lead to less information for users. There is always a trade-off between more detailed information (which can lead to information overload) and excessive summarization of information across different areas, which leads to a lack of information for users because they fail to recognize important complexities.

One matter that could also be addressed is the fact that some of the areas that integrated reporting seeks to cover (natural capital, human capital, social capital, etc.) are matters that largely relate to externalities – that is, matters for which there is no market price and that are therefore not included in the “cost” of the activities of entities. Consideration could be given as to how governments at an international level might seek to have entities internalize externalities by providing a market or other pricing mechanisms so that entities contribute to the costs of the externalities that they generate.

We also suggest that it may be more useful for the IIRC to take a “bottom-up” approach to developing integrated reporting standards by considering the needs of SMEs and then adding additional requirements for larger or public interest entities, rather than developing requirements for these entities and then seeking to provide exemptions for SMEs.

We would be very pleased to have the opportunity to provide further assistance to you or answer any questions that you may have in relation to our comments.

Yours truly,

Klaus-Peter Naumann
Chief Executive Office

Norbert Breker
Technical Director Accounting and Auditing

APPENDIX:
Responses to Consultation Questions

Q1.	(a) Do you believe that action is needed to help improve how organizations represent their value-creation process? Why/why not?

1 Yes, we welcome the efforts to improve the information provided to stakeholders to support resource allocation decisions that are consistent with sustained value-creation and longer-term economic stability, to the extent that such information improves the comparability, reliability, and relevance of information disclosed by entities without unduly increasing reporting costs. The IDW agrees that the disclosure of non-financial information in addition to financial information is important in the context of the current challenges that entities and their stakeholders face in making resource allocation decisions. Indeed, improving the disclosure of non-financial information may serve to further increase the number of European entities fully integrating sustainability and responsibility into their core strategies and operations in a more transparent way.

2 However, the proposed framework for integrated reporting has to be based on a clear understanding of whom the respective organisations are reporting to – that is, to which stakeholders such reporting is primarily directed. The nature of information provided – and indeed, the very meaning of the term “value” when used in the context of “value creation” depends upon the different perspectives held by different stakeholders. We address this issue further in our response to Question 4.

3 Clear principles are needed to help define the reporting requirements. These requirements must be flexible enough to allow companies to tailor the reporting to their circumstances in a practical and consistent manner and to avoid ‘boiler-plate’ information.

Q1.	(b) Do you agree that this action should be international in scope? Why/why not?

4 Yes, this action should be international in scope because establishing a Framework and requirements on integrated reporting at a national or European level would not give due consideration to the international dimension of this issue.

Q2.	Do you agree with the definition of Integrated Reporting? Why/why not?

5 Although the proposed definition describes the objective of the process of integrated reporting rather than integrated reporting itself, it can, in our view, at least in part be taken as a helpful first step for developing the draft definition further. Regarding the proposed definition, the following aspects are of particular concern:

- We agree that relevant information should only be included if material. However, further clarification as to whom this information should be material, how it has to be calculated or measured and how it should also be comparable is needed. This ties into our concern about to whom these integrated reports are directed (i.e., who are the stakeholders?).
- In addition, “material” can be interpreted differently, for instance, material to assess performance in time, material to the core business of the organisations, hence the context of materiality should be further explained.
- Integrated Reporting is stated as to provide “a clear and concise representation of how an organisation demonstrates stewardship”. It remains unclear to whom stewardship is shown?
- Other important questions are: How value should be defined and measured, and whose viewpoint should be taken, i.e., there needs to be a consideration of what “value” means to whom and how it should be measured (see the materials from the Value Measurement and Reporting Collaborative website).

6 There is a need for a common understanding of what integrated reporting means to ensure it is feasible and can be consistently applied. Care must be taken in order to avoid the creation of any new expectation gaps.

7 It is unclear whether, in the long term, integrated reporting would replace existing reporting (Financial Statements, Governance and Remuneration, Sustainability, Management Commentary, etc.) or whether it would bring the key matters included in other reporting together. We believe that the output of Integrated Reporting should not necessarily be one single report unless integrated reporting refers to an integrated summary of the key matters from the other reports. Especially from the assurance point of view it may be preferable to leave it up to the preparers whether they chose Integrated Reporting in one or more reports. The latter alternative would,

for example, allow assurance providers to report on different information using different levels of assurance or using other attest engagements (e.g. agreed-upon-procedures engagements), or to not be involved in certain information at all, if such involvement is not desired by stakeholders. In our opinion, the objectives of Integrated Reporting (showing the connectivity between financial and non-financial information, explaining the ability to create and sustain value etc.) can also be met by two or more reports.

8 The discussion paper suggests that one of the main expected benefits of Integrating Reporting is to simplify the current reporting regime, including harmonization of the approaches and reduced "red tape". We believe that this is an ambitious expectation. Therefore it would be necessary to think in terms of criteria to prioritize and assess how reporting requirements should be replaced in practice. Moreover, the question of how and whether ultimately Integrated Reporting will replace other reporting still needs to be further addressed by the IIRC. Our understanding is that existing reporting, such as Financial Reporting or Sustainability Reporting, may still be needed in addition to Integrated Reporting, because it is unlikely that a short integrated report would be able to meet the reporting needs and hence objectives of all stakeholders.

Q3. Do you support the development of an International Integrated Reporting Framework? Why/why not?

9 Whether we support the development of an International Integrated Reporting Framework depends upon the meaning of "integrated" (i.e., a summary from other reports, or a stand-alone report that replaces other reporting) and the meaning of "Framework". A Framework would need to set forth a comprehensive conceptual foundation for the proposals made without providing specific "requirements" and guidance for integrated reporting, which would need to be dealt with by means of standard-setting pronouncements, rather than a Framework. In principle, the IDW supports the development of an International Integrated Reporting Framework within these confines. In particular, we believe there is a need for a broader explanation of performance than that used in traditional reporting. Such an explanation should be based on an organisation's business model and cover the ability to create and sustain value not only in the short term but also and especially in the medium and long term. In this

context it has to be clarified how "short", "medium" and "long term" are defined.

Q4. (a) Do you agree that the initial focus of Integrated Reporting should be on reporting by larger companies and on the needs of their investors? Why/why not?

(b) Do you agree that the concepts underlying Integrated Reporting will be equally applicable to small and medium enterprises, the public sector and not-for-profit organizations?

We acknowledge the decision of the IIRC to focus on larger companies as a starting point for the discussion, but would like to relate the following concerns:

10 As presented under the definition of Integrated Reporting, investors and other stakeholders should be considered. We are not convinced that an approach initially focussing on long-term investors' needs is likely to cover the main needs of the other stakeholders. This is important because who the stakeholders are, who have different perspectives, involves consideration of what "value" means to whom and how it should be measured (see the materials from the Value Measurement and Reporting Collaborative website). For example, if information is directed at stakeholders with sustainability interests, the opportunity costs of externalities would need to be measured and reported as performance indicators. Hence, the very meaning of "value", "capital" and "performance" depends upon the stakeholders being addressed.

11 According to our general observations, policy and regulation is often set in the first instance for larger publicly listed entities and then subsequently is cascaded down to SMEs within a "one size fits all" solution. For example, IFRS was initially developed for capital markets and listed entities, and yet for many years was often imposed by national regulators on all companies irrespective of size, complexity and public interest or accountability. In the face of concerns over the complexity of IFRS and the resulting preparation burden, as well as concern over its lack of relevance to SMEs and their users, the IASB opted for a differential approach culminating in the IFRS for SMEs. Some might argue that had the IASB considered the entire universe of entities when it first developed IFRS, it might have been able to develop one standard suitable for all with additional guidance and requirements for the benefit of larger listed entities. Hence, when

developing a framework it is vital, for the sake of efficiency, that one consider the entire population of entities to which a reporting regime in that framework is likely to apply, whether directly or indirectly through the supply chain.

12 The bulk of global value creation, as well as use of resources, is accounted for by the SME sector. Therefore, a framework should also be scalable and applicable to those entities. We believe that adopting a bottom-up approach (i.e. agreeing what the minimum proposals might be for all entities and then allowing additional layers for larger entities) would represent a suitable approach, particularly given the growing recognition that small-and medium-sized enterprises are instrumental to wealth and job creation not only in the EU (and with the EC's commitment to simplification) but worldwide as well.

13 Although it may be convenient to take larger companies as a starting point in the process for the development of the Framework, we recognize the serious risks that this would pose to the success of this project. As a consequence, we are convinced that a bottom-up approach should be seriously considered as one that could lead to achieving the IIRC's objectives.

14 The risks of a top down approach include:

- SMEs that operate as suppliers to large firms will be required to meet the same information obligations as their large firm customers. This will raise the operating costs of SMEs and so alter the economic landscape, with potentially sub-optimal consequences for market structure and macro-economic performance. As a consequence, it is essential that the information that is reasonable for SMEs to prepare is properly defined so that this can be taken into account when designing the obligations to be placed on large businesses.
- Further reporting requirements are likely to be seen as an additional administrative burden, and therefore undesirable. As a result, it is essential that any additional information requirements are seen to be of tangible benefit to both business owners and to a wider cross-section of society (such as customers, consumers, financiers and suppliers). This will only be achieved if the additional information requirements enable better and more informed business decisions, and in order to achieve this the requirements will need to be closely tailored to the information needs of the majority of SMEs.

15 Relevant and practical concepts should be equally applicable to SMEs, public sector bodies and not-for-profit organisations. Encouraging those sectors to participate in the Pilot Programme would ensure issues specific to them are identified and adequately addressed.

16 Standards will need to be developed with sufficient consideration for the expectations of the end user as well as to potential assurance issues.

Q5. Are: (a) the organization's business model; and (b) its ability to create and sustain value in the short, medium and long term, appropriate as central themes for the future direction of reporting? Why/why not?

17 If Integrated Reporting is better aligned to information that management requires for decision-making (with integration of relevant and material financial data and non-financial information about an organisation's performance), it will be critical to a meaningful assessment of an organisation's long-term viability, business model and strategy.

18 For instance, under the current reporting, an organisation could very well be misleadingly assessed as a high quality operation based on its results without providing the link to relevant information which could impact on this assessment (e.g., information about elements of their supply chain being subject to lower standards such as labour). Integrated Reporting could address any tendency to disclose only 'good' information.

19 Therefore, Integrated Reporting should result in entities' increased transparency of their way of doing business. The IIRC should ensure that Integrated Reporting does not result in a competitive disadvantage for those entities opting to adopt an Integrated Reporting approach to their corporate disclosure.

20 In addition, it would need to be clearer how to ensure comparability in Integrated Reporting.

Q6. Do you find the concept of multiple capitals helpful in explaining how an organization creates and sustains value? Why/why not?

21 The concept is useful in getting people thinking but there are practical considerations that should be addressed. We note that some of the "capitals" will be easier to translate into how organisations use them and

impact on them (e.g. “Financial capital”) than others (e.g. “Natural capital”, “Human capital”).

22 It would be helpful to develop further the thinking behind the concept of capitals. Further deliberations and consultation will be necessary to develop practical guidance for organisations on how to capture the use and impact of such “capitals”. (For instance, how to translate the concept into what needs to be measured and how to achieve that measurement).

23 It should be recognized that the concept of “capitals”, which refers to a “stock”, is inextricably linked to the concepts of “value creation” and “extraction or distribution of value”, which are flows. We refer to the material from the Value Measurement and Reporting Collaborative website (www.valuemeasurement.net) developed by a number of leading accountancy bodies for more information. The IIRC needs to integrate the various concepts used (“value creation”, “capital”, “performance”, etc.).

Q7. Do the Guiding Principles identified in the Discussion Paper provide a sound foundation for preparing an Integrated Report – are they collectively appropriate; is each individually appropriate; and are there other Guiding Principles that should be added? Why/why not?

24 The development of Integrated Reporting requires a clear principles-based Framework (see our responses to Questions 3 and 4) under which to report. The identification of Guiding Principles should be at the core of the creation of such Framework. It would be helpful to emphasize that the Guiding Principles identified are meant to build the Framework for reporting.

25 The fact that information needs to be comparable and comprehensive could be further emphasized as a separate Guiding Principle, not just as criteria within the Guiding Principle of reliability of information. While according to the Discussion Paper “reliable information needs to be complete, neutral and free from error” we believe that it needs to be … free from material misstatements.

26 In our view, the reference at the end of page 13 that “reliability” is enhanced by “independent, external assurance” is incorrect. In fact, external assurance is actually directed at enhancing the credibility of information. Management can take measures to improve the reliability of information. In contrast, an external auditors’ role is to increase the credibility of information that management has prepared. Only when external auditors detect material misstatements and propose amendments do external auditors contribute to the reliability of information, but their ability to do this is what lends credibility to that information.

27 If integrated reporting seeks novel approaches to dealing with reporting by entities, it ought to draw on the latest developments in information theory, the theory of evidence, etc. In this respect we note the use (at the end of page 13) of the concepts of “conciseness, reliability, completeness, neutrality and materiality. The use of these concepts does not appear to reflect that latest thinking on these matters. We refer to the documents of the Value Measurement and Reporting Collaborative on its website and the 2003 FEE Paper “Principles of Assurance” in this respect.

28 We note that the IIRC paper does not deal with the consequences of the stewardship function addressed on page 9. The concept of stewardship means that management, or those charged with governance, are accountable to stakeholders, and therefore must be in a position to support the assertions that they have included in their reports, including integrated reporting. Assertions can only be supported by means of “evidence”. We refer to the IDW Concept Paper "Additional Issues in Relation to a Conceptual Framework for Financial Reporting" (a copy of which is attached) from 2007 that may provide some additional food for reflection on this matter.

29 It would be helpful to define materiality further by developing a common understanding of what is material both qualitatively and quantitatively or a common methodology that could be followed to ensure or encourage preparers identify and report negative issues as faithfully as positive ones. This is important and potentially challenging, especially in the case of non-financial information. In our view, this issue should be addressed while developing the Framework for Integrated Reporting. Organisations would then be able to apply this common guidance on materiality to ensure that the information reported is comparable while remaining based on their specific circumstances.

30 We believe that it is important that the information reported provide stakeholders with an understanding of how the values reported have been derived.

31 The Pilot Programme (including involvement of SMEs, public sector bodies and not-for-profit organisations) should help to identify potential impediments and issues for clarification to be addressed to ensure the practical and consistent application of the Guiding Principles, including any related assurance issues.

32 A principles-based Framework for reporting will ensure that information is comparable. However, we acknowledge that further steps will need to be undertaken to develop common standards that are consistently applied in order to develop common presentation and reporting requirements.

Q8. Do the Content Elements identified in the Discussion Paper provide a sound foundation for preparing an Integrated Report – are they collectively appropriate; is each individually appropriate; and are there other Content Elements that should be added? Why/why not?

33 The appropriateness of the Content Elements depends on (i) how value is defined, (ii) who companies are reporting to and (iii) the timeframe on which value is to be defined. See also the comments above in our response to Q 2, Q 3 and Q 7. As we note in our response to to Question 7, in order to not fall into the same accounting paradigms as the IASB and FASB, the IIRC should draw on cutting edge developments in information theory and the theory of evidence, etc.

Q9.	From your perspective as a key stakeholder: (a) Do you agree with the main benefits as presented in the Discussion Paper? Why/why not? (b) Do you agree with the main challenges as presented in the Discussion Paper? Why/why not?

34 "While the IIRC anticipates that an Integrated Report will ultimately become the primary report for all organisations" and that "individual organisations will follow different routes … towards that end", we believe that the objectives of Integrated Reporting can also be achieved by preparing more than one single report which in fact might be more useful from both a multiple stakeholder and the assurance point of view. We refer to our answer to Q 2 above.

35 <u>Harmonization of approaches and reduced "red tape"</u>: We agree that this can be viewed as a benefit. However, the challenge is to ensure that Integrated Reporting can effectively deliver this expected simplification.

36 <u>Cost internalisation</u>: In the context of enhancing reporting, there is a need for a debate on the most appropriate approach to account for 'externalities', generic risks and significant impacts (e.g. damage caused by carbon emissions). Reports should avoid the risk of 'boiler-plate' text and reflect the most relevant information.

37 <u>Mandatory vs. voluntary</u>: Further thought should be given as to whether (and when) integrated reporting should result in mandatory requirements or voluntary. At this point in time, in our view, Integrated Reporting should represent a voluntary approach.

38 <u>Assurance</u>: If at the end of this "journey" Integrated Reporting will become an organisation's primary reporting, there will need to be mechanisms to provide independent comfort on the reliability of the information reported to respond to stakeholders' demands. In this respect we note however that Integrated Reporting might not necessarily result in one single report, which could be clarified in the Framework.

39 In this case, it will be important to address whether, and if so how, the information to be reported is to be assured including consideration of the level and nature of assurance at the same time as the Integrated Reporting requirements are being developed. Assurance could, for example, be embedded in an Integrated Report, be given in a separate report or in separate reports. The structure of Integrated Reporting will in turn probably affect the way that assurance is reported- for example whether assurance is reported on Integrated Reporting as a whole or only on parts thereof.

40 We agree that independent assurance on Integrated Reporting is likely to require the development of new techniques, standards and reporting mechanisms, also when considering the impact of technology. The IDW is prepared to play a role by contributing to identifying and addressing the matters that will arise around this development in order to ensure that sustainable and global solutions are found with regard to assurance on Integrated Reporting. However, assurance reporting cannot increase the reliability of inherently unreliable information (e.g., forecasts). For this reason, it would be important that a Framework deal with the nature of future-oriented information for reporting and assurance purposes (e.g., the nature of forecasts, forecast methods, the development of assumptions, decreasing reliability into the future).

41 Current audit methodology already requires a thorough understanding of some of the most significant aspects of the information that is likely to be included in Integrated Reporting. For example, an audit requires auditors to understand an entity's business and its interdependencies with the external environment. Auditors, therefore, are well positioned to contribute to the development of assurance standards in relation to Integrated Reporting and to perform assurance engagements on integrated reports.

42 The relevance of management commentary (e.g. strategy, business model, economic analysis), reporting on sustainability and governance is increasing significantly in relation to financial reporting. Hence non-financial information will be an important component of Integrated Reporting. Solely relying on financial information appears no longer sufficient for understanding the realisation of strategic goals, performance and the operation of risk management systems. Auditors can play an important role in reporting on these matters.

Q10.	(a) Do you agree that the actions listed in the Discussion Paper should be the next steps undertaken by the IIRC? Why/why not? Are there other significant actions that should be added? (b) What priority should be afforded to each action? Why?

43 We would like to highlight in particular the importance of ensuring appropriate governance. Developing, through public consultation, the institutional arrangements for the ongoing governance will be an important next step. Ensuring a sound geographical balance as well as a balance of competencies in the governance of Integrated Reporting will be important.

44 Further details on and development of the IIRC's governance, inclusiveness, diversity and representativeness will be essential.

Q11.	Do you have any other comments that you would like the IIRC to consider?

45 <u>Frequency of reporting</u>: We should consider the frequency of reporting, i.e. should it be a "one date" report vs. "more" frequent reports being made available.

46 The question of how assurance is to be provided will also need to be considered in the light of how Integrated Reporting evolves with the use of technology, for instance if Integrated Reporting incorporates relevant information which is only further detailed and available online.

IDW Concept Paper

Additional Issues in Relation to a Conceptual Framework for Financial Reporting

17 September 2007

IDW Concept Paper:

Additional Issues in Relation to a Conceptual Framework for Financial Reporting

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.

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.

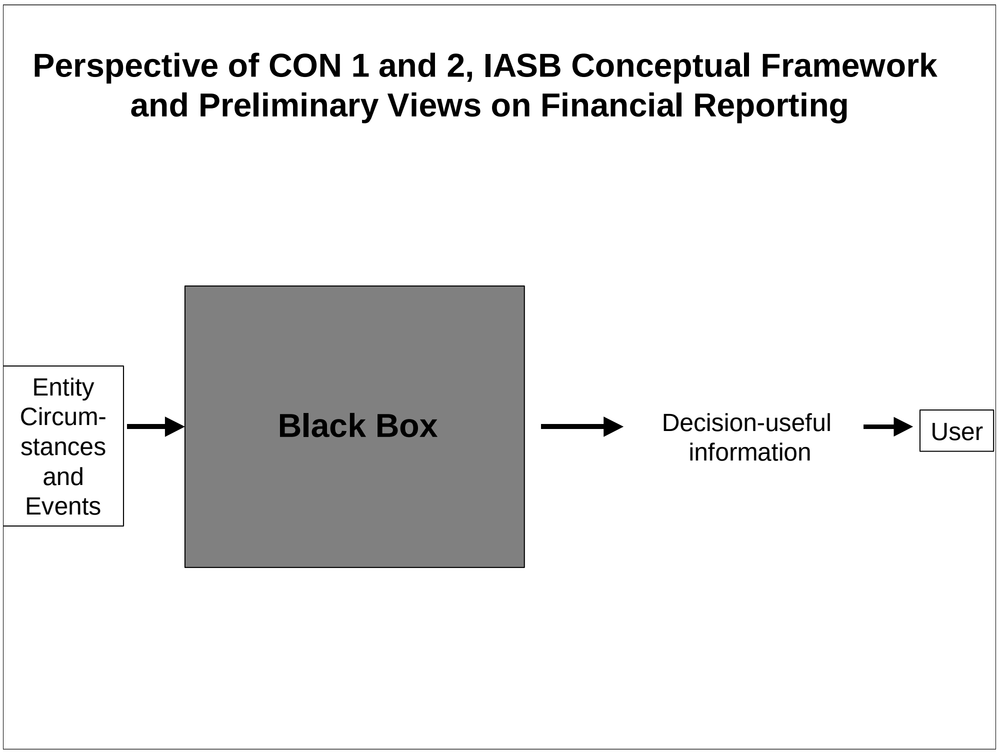
9. When setting financial reporting requirements, the IASB ought to consider the accounting processes and internal controls necessary to meet those requirements: accounting standards setting ought to involve more than just setting required accounting treatments, but should also address the potential 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.

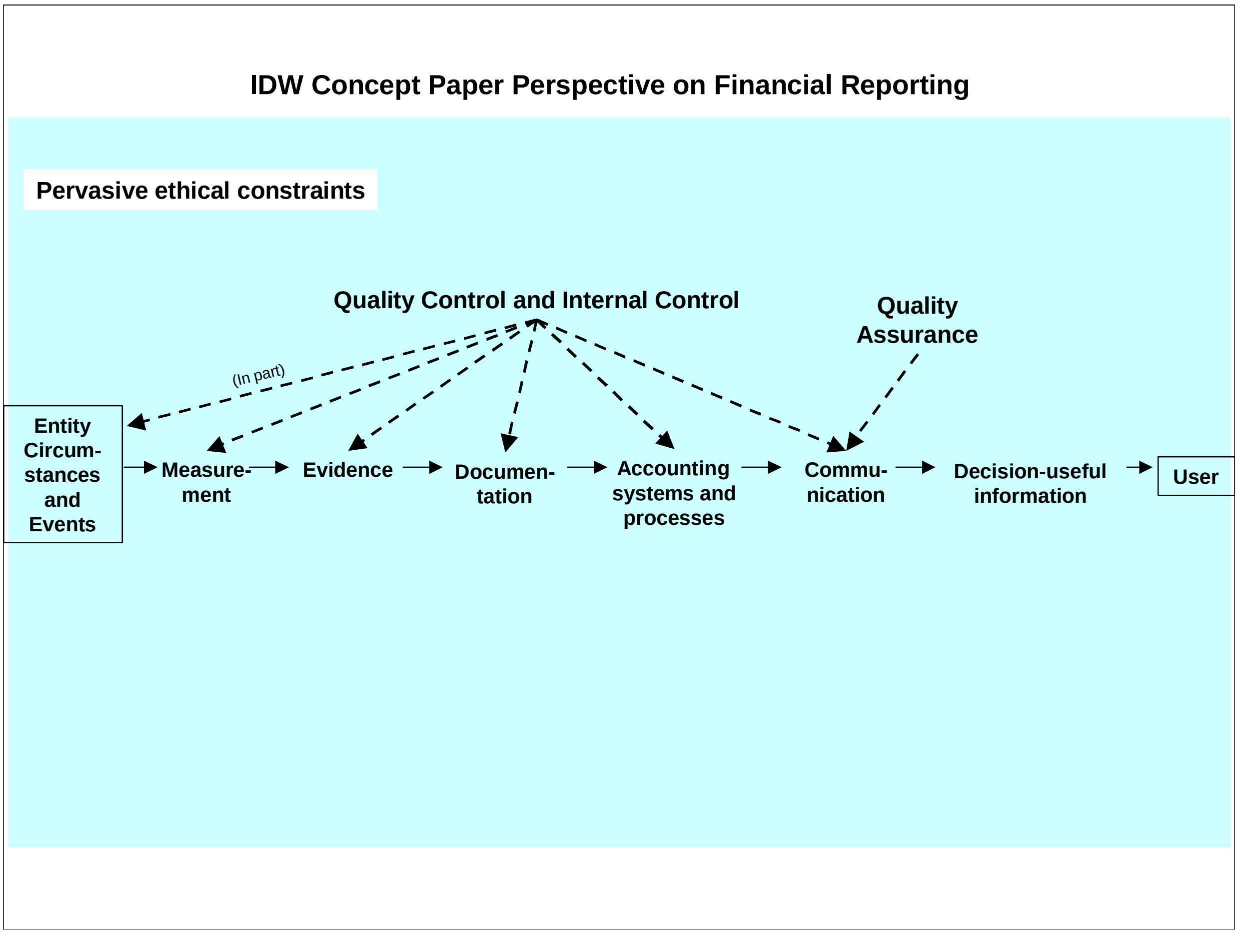
10. Although external quality assurance over financial reporting (e.g., audits and reviews of financial statements) is beyond the remit of the IASB, the accounting treatments required by financial reporting standards do have an impact on the verifiability and hence auditability of financial statements. 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 usefulness* 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.

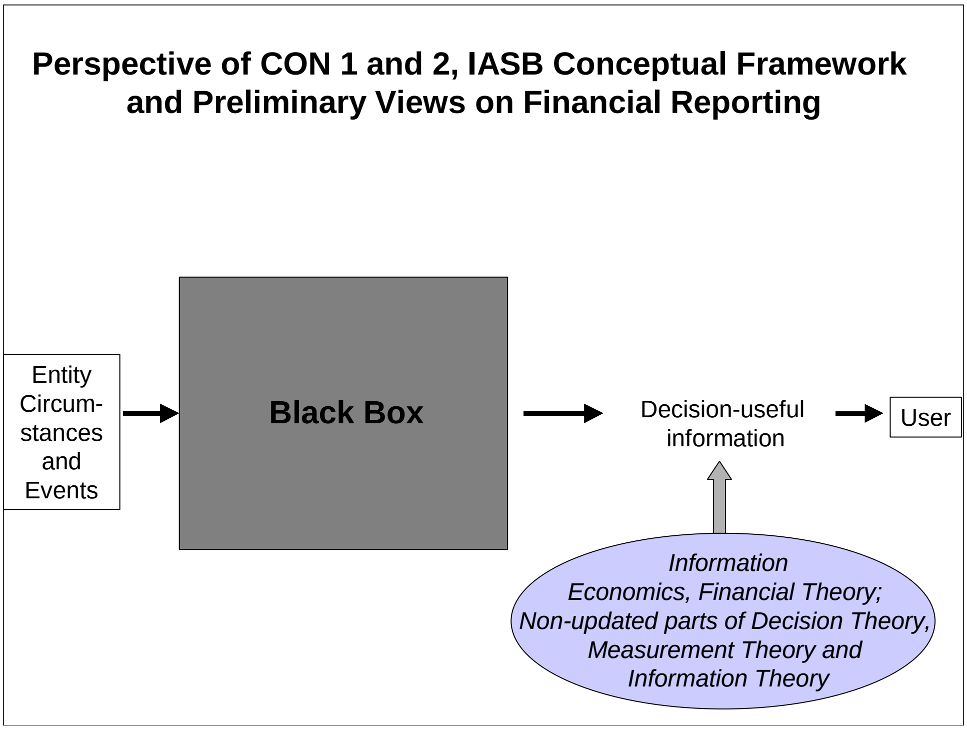
Section 6: Conclusions

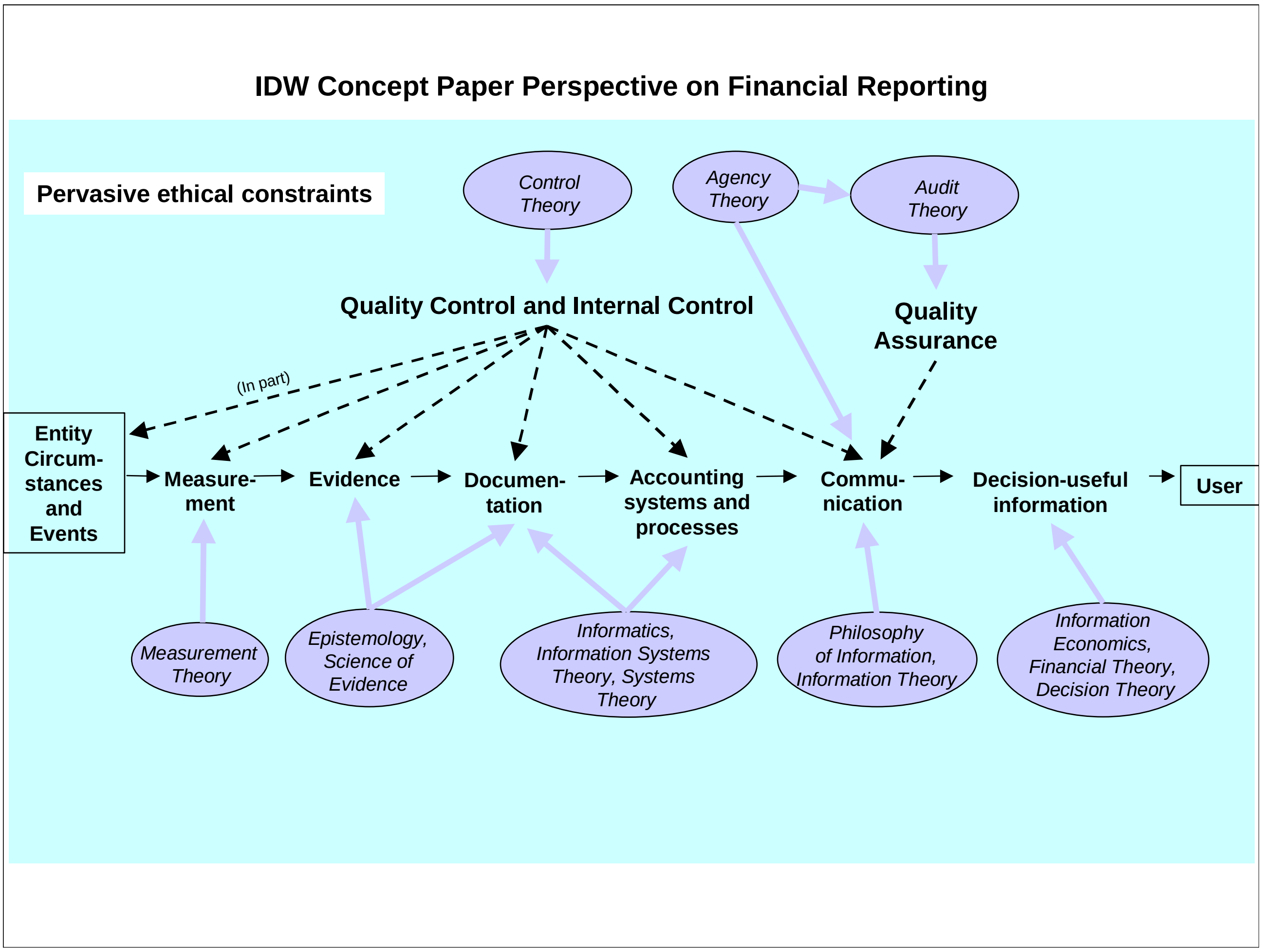
65. The views expressed in this Paper accord with the view expressed by the Board in P3 of the Preface that "the fundamental concepts need to constitute a framework that is sound, comprehensive, and internally consistent" and with its view expressed in S1 of the Summary, that "a framework is a coherent 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

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.





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.