



September 28, 2008

**Comment Letter: Exposure Draft of An Improved Conceptual Framework for Financial Reporting**

Dear Sir/Madam,

I am writing on behalf of Publish What You Pay in regard to the exposure draft issued by the International Accounting Standards Board (IASB) in May 2008 of “An Improved Conceptual Framework for Financial Reporting.”

Publish What You Pay (PWYP) is a global civil society coalition that helps citizens of resource-rich developing countries hold their governments accountable for the management of revenues from the oil, gas and mining industries. Natural resource revenues are an important source of income for governments of over 50 developing countries. When properly managed these revenues should serve as a basis for poverty reduction, economic growth and development rather than exacerbating corruption, conflict and social divisiveness.

PWYP members use information that is only available from the financial statements issued by financial entities in the course of our work. That work requires us to monitor corporate governance and the engagement of corporations in developing countries, taxation issues and the compliance of companies with international standards and with the law.

As such, recommendations included in or that will flow from the exposure draft you have issued will have direct impact upon our work, all of which is ultimately aimed at the poverty reduction, economic growth and development.

In the comments below, I first respond to the specific questions that have been raised in the exposure draft and then go on to provide alternatives that PWYP considers desirable.

Thank you very much for this opportunity to comment on this important subject.

Best regards,

A handwritten signature in black ink that reads 'Radhika Sarin'.

**Radhika Sarin**

*International Coordinator*

Publish What You Pay

c/o Open Society Foundation

4th Floor, Cambridge House

100 Cambridge Grove, London W6 0LE

The United Kingdom

Tel: +44 (0) 20 7031 0204

Mob: +44 (0) 7917 885 302

Fax: +44 (0) 20 7031 0247

E-mail: [rsarin@publishwhatyoupay.org](mailto:rsarin@publishwhatyoupay.org)

## Questions arising from Chapter 1 of the Exposure Draft

1. The boards decided that an entity's financial reporting should be prepared from the perspective of the entity (entity perspective) rather than the perspective of the owners or a particular class of owners (proprietary perspective). Do you agree with the boards' consultations and the basis for it? If not, why?

PWYP agrees with the boards' conclusion.

In our experience, companies do not behave as if they are extensions of shareholders. This is particularly true of transnational corporations (TNCs) operating in emerging economies, where few people have direct relationship with them as shareholders and the behaviour of these companies suggests that they are independent entities acting in their own right. As such, we think that the boards are correct in presuming business entities (reporting in accordance with IFRS) to be entities in their own right.

2. The boards decided to identify present and potential capital providers as the primary user group for general purpose financial reporting. Do you agree with the boards' conclusion and the basis for it? If not, why?

PWYP does not agree with the boards' conclusion on this matter.

We note that the objectives of the IASC Foundation are, according to its constitution:

“(a) to develop, *in the public interest*, a *single* set of high quality, understandable and enforceable global accounting standards that require high quality, transparency and comparable information in financial statements and other financial reporting to help participants in the world's capital markets *and other users* make economic decisions;  
(b) to promote the use and rigorous application of those standards;  
(c) in fulfilling the objectives associated with (a) and (b), *to take account of, as appropriate, the special needs of ....emerging economies*; and  
(d)....”

(We have edited, as appropriate, those items not relevant to our submission and have italicised and made bold those elements we think important to our argument.)

Firstly, we do not believe that the boards have fulfilled the mandate of the IASC Foundation in suggesting, as the Exposure Draft does, that their duty is largely to:

“...assist in the efficient functioning of economies and the efficient allocation of resources in the capital markets by developing high quality financial reporting standards.” (Para OB3)

We believe the boards have paid insufficient attention to other areas that affect the public interest in relation to economic decision-making and the special needs of emerging economies, though their mandate makes clear they have a duty to do both.

Secondly, and relatedly, the boards have failed to give equal weight to the needs of users of financial data other than those participating in the world's capital markets. There is nothing in the wording of the IASC Foundation Constitution to suggest that one group should be considered superior to others. (In fact, the use of the conjoined transition word 'and' rather suggests equal weight is required, as opposed to other phrases that might have been used when referring to other users, like 'as well as'.)

We note that the boards refer in the Exposure Draft to a range of users:

- equity shareholders, loan capital providers, employees, suppliers, customers and other groups (Para OB6)
- regulators (Para BC1.39)

- governments and members of the public (OB8)

We consider this to be a fairly comprehensive list and the mandate requires that the needs of all these groups be considered.

For example, members of the public in areas producing extractive resources are sometimes legally and contractually entitled to a proportion of profits generated. However, they are often unable to monitor whether they are receiving the appropriate amounts under current reporting requirements and this is clearly not in the public interest.

Therefore, we are of the opinion that, by suggesting that present and potential capital providers be considered the primary user group for general purpose financial reporting, the boards are failing to fulfil their mandate of promoting global accounting standards that are in the public interest.

Finally, even within the overly narrow focus on capital providers as the primary user group, we believe the boards have omitted key capital providers. Please see ‘Additional Observations’ at the end of this submission for further commentary on this issue.

3. The boards decided that the objective should be broad enough to encompass all the decisions that equity investors, lenders and other creditors make in their capacity as capital providers, including resource allocation decisions as well as decisions made to protect and enhance their investments. Do you agree with that objective and the boards’ basis for it? If not, why? Please provide any alternative objective that you think the boards should consider

As noted above, PWYP does not think that the boards have correctly identified the principal users of financial statements according to their own mandate.

We would like to stress that we completely accept that providers of capital to a company have special interests in its financial reporting and do have particular needs for information that may not be of interest to other users of financial statements but which are of sufficient significance to justify their provision nonetheless.

It is, however, our opinion that, even for providers of capital, not all of their information needs for allocating capital are met by the existing models of disclosure promoted by the boards and that additional disclosures of the types noted in this submission are needed (see ‘Additional Observations’ at the end of the submission). We stress that in making this comment we are restricting our observations to financial data, and not to that additional, and supplementary, information of a non-financial nature which it has now become customary for many TNCs to supply.

Also, we are aware of the opinion that the boards are, by restricting their consideration of the needs of users to their decisions undertaken in their sole capacity as providers of capital, denying them the information they need to make economic decisions across the full spectrum of their economic decision making.

Therefore, we do not think that the boards’ approach is broad enough to meet the needs of the suppliers of capital or other users.

### **Questions arising from Chapter 2 of the Exposure Draft**

#### **1. Do you agree that:**

- (a) **relevance and faithful representation are fundamental qualitative characteristics? (See paragraphs QC2–QC15 and BC2.3–BC2.24.) If not, why?**

Yes. But please note our comments made below which suggest that the choice of primary user the boards have made will, in our opinion, restrict the usefulness of this understanding

because the financial data that the boards propose to supply will not be adequately relevant for all users and will, due to incompleteness fail to be a faithful representation of the economic events to which they relate.

- (b) **comparability, verifiability, timeliness and understandability are enhancing qualitative characteristics? (See paragraphs QC17–QC35 and BC2.25–BC2.35.) If not, why?**

Yes. However, as with the previous question please note our comments made below which suggest that the choice of primary user the boards have made will, in our opinion, restrict the usefulness of this understanding because the financial data that the boards propose to supply will not meet the needs of all relevant users.

- (c) **materiality and cost are pervasive constraints? (See QC29–QC32 and BC2.60–2.66.) If not, why? Is the importance of the pervasive constraints relative to the qualitative characteristics appropriately represented in Chapter 2?**

Materiality and cost must be pervasive constraints on the production of financial information. We would however stress that neither is, in our opinion, a constraint with regard to the production or supply of the country-by-country information that we request, below. We offer these reasons:

- (i) This information is material to the understanding of financial statements by both suppliers of capital and other users of those statements. Its omission would, therefore, breach the fundamental and enhancing qualitative characteristics noted in the previous answers. Any breach of those characteristics must be material, and accordingly there is a cost over-ride in this case.
- (ii) Given due notice of the need to prepare the information to which we refer below, the cost of its preparation would be largely a one-off and modest cost. The cost of providing financial statements prepared on an entity basis incorporating the information we request below would, in our opinion, be small in proportion to the benefit provided.

**2. The boards have identified two fundamental qualitative characteristics — relevance and faithful representation:**

- (a) **Financial reporting information that has predictive value or confirmatory value is relevant.**

We agree, but note our comments on the following questions.

- (b) **Financial reporting information that is complete, free from material error and neutral is said to be a faithful representation of an economic phenomenon.**
- (i) **Are the fundamental qualitative characteristics appropriately identified and sufficiently defined for them to be consistently understood? If not, why?**
- (ii) **Are the components of the fundamental qualitative characteristics appropriately identified and sufficiently defined for them to be consistently understood? If not, why?**

We note these two questions but believe it is appropriate to answer them together.

PWYP believes that information that is complete, free from material error and neutral is necessary as the basis for economic decision making. We regret that we do not think that this is

likely to be provided if the approach to the conceptual framework noted in the exposure draft is adopted.

This is because we believe that the principal users of financial information have been incorrectly identified by the boards and information that they need to ensure these characteristics are met would, if the exposure draft is adopted in its current form, not be made available for their use. We note that information and who those other users might be below.

Our concern here is to note that the decision not to supply this information is, in our opinion, incorrect because that decision does not portray the necessary characteristic of neutrality that the boards consider a fundamental qualitative constituent of appropriate financial reporting. As a result the information that it is proposed be supplied is, in our opinion, incomplete and likely as a result to contain material error in that economic decisions based on that information will have to be made on the basis of insufficient data to ensure an objective conclusion on the part of the user.

In that case the information to be supplied by the boards cannot, in our opinion, be considered a faithful representation of the economic phenomenon that financial statements prepared in accordance with standards promulgated by the boards should seek to describe.

As a result whilst we agree with the boards' definitions we do not think they have been correctly used in the proposed conceptual framework and as such it is inappropriate for use in its current form.

**3. Are the enhancing qualitative characteristics (comparability, verifiability, timeliness and understandability) appropriately identified and sufficiently defined for them to be consistently understood and useful? If not, why?**

Yes.

**4. Are the pervasive constraints (materiality and cost) appropriately identified and sufficiently defined for them to be consistently understood and useful? If not, why?**

Yes.

**Additional observations**

Having answered the questions the boards' have posed, we address the deficiencies to which we have alluded in the exposure draft as follows:

**A. Those additional users of financial information that we believe should be considered to have distinct, separate and appropriate needs for information that inadequately addressed in the Exposure Draft are:**

**a. Governments**

We are concerned to note that governments are not noted as suppliers of capital to business entities in the exposure draft, although it is clear that they are significant creditors of such enterprises in the form of unpaid taxes and other unpaid dues as well as providers of loans, grants and tax exemptions.

Additionally, governments have particular needs for information from those entities that are likely to report using the standards promoted by the boards and this will be particularly true in developing and emerging economies to which it is noted in the IASC Foundation Constitution that the IASB owes a special duty of care. We have particular concern with regard to those TNCs engaged in the extractive industries that operate in these economies. This is because:

- Those entities tend to be few in number but highly material in individual economic impact when working in developing and emerging economies;
- Most developing and emerging economies have difficulty in collecting reliable economic data concerning economic activity within their domains and as such the reports of material private sector entities will be vital to them in the conduct of their management of their economies;
- Many governments in developing and emerging economies are seeking to break their dependence upon aid by establishing sustainable taxation revenues to meet the needs of their populations. This can only be achieved if they have reliable information on the income streams of those entities that trade within their domains on the basis of which they can form economically appropriate decisions.

It is unlikely that the governments of developing and emerging countries will be able to secure this information from existing sources because existing data will be based on the reporting of legal entities and will not as a consequence be geographically constrained to their domain; nor will it be consolidated to show the full impact of the trading entity net of intra-group transactions within the domain when prepared on a sub-consolidated entity basis.

For this reason whilst legal entity data is also of significance to governments for the purpose of imposing taxes, consolidated country data is vital as well if sufficient data is to be available to ensure a developing and emerging economy government is to have the data it needs that is complete, free from material error and neutral for its use in determining national economic policy, particularly with regard to the extractive industries.

For this reason we believe that governments need this data, which is not available at present from financial reports prepared from a proprietary perspective.

#### **b. Local trading partners**

There are many other providers of capital to companies:

- local suppliers,
- local employees,
- local customers.

The boards say they have concern for all these groups. But it is unclear that their information needs are adequately addressed.

Firstly, few developing and emerging economies require that the financial statements of local trading entities be made available for public inspection, and this remains the case even if they are the subsidiaries of TNCs. Even if they are made available this is often only possible by way of personal inspection, a near impossible task for many who live in such countries due to economic circumstances, difficulty and cost of travel and the inefficiency of many local bureaucracies. Many of these are now able to access data on a TNC through the internet, whose spread within emerging and developing economies is now becoming commonplace. This highlights the need to include key data of importance to these users in financial statements that are routinely published on the internet.

However, most such providers of capital will have difficulty in identifying the relevant financial statements. Thus financial statements need to:

- (i) identify if the TNC is trading locally;
- (ii) state the names of its local subsidiaries.

This data, whilst readily accessible to and easily published by TNCs will not by itself, however, in most circumstances enable these suppliers of capital to properly appraise their position with regard to the enterprise with which they engage. That is because the published financial statements of the TNC

will, almost certainly, be prepared on a global consolidated basis. The suppliers of capital to whom we refer will, however, almost certainly trade with a local subsidiary of that TNC with whom they engage using local contract law. It is highly unlikely that the group financial statements will provide these local suppliers of capital with the information they need to appraise the risk that they face when trading with that local subsidiary, whose liabilities need not be guaranteed by the group as a whole. For these providers of capital it is essential that local information, supplied at the very least on a consolidated country basis, be made available so that they can undertake the economic decisions on the effective allocation of their resources, taking risk into account, that the boards believe such providers of capital should undertake if effective capital markets are to be in operation.

The boards have supported the principle of neutrality according to size of capital provided by explicitly stating that employees, who will always be relatively immaterial in the context of the group as a whole, have specific and relevant information needs that should be met by group financial statements. However, if this information is not made available for these providers of capital who only engage with a TNC at a national or local level, whilst that information that is needed by those providers of capital who engage with the group entity at an international level is made available, then we suggest that the information supplied will not be neutral. Inherent bias will have been built into the supply of data to the providers of capital with that bias favouring those suppliers of larger amounts of capital, who are more likely to be located in developed countries.

We would add that this comment reveals an essential dimension of the need to reappraise the concept of **materiality**.

When focusing only upon equity shareholders, these are seen to have consistent needs because each owns separate shares in the enterprise, each carrying equal rights as determined by its constitution. Materiality can, therefore, be appraised with regard to each shareholder as is if all ranked equally, one with another.

This assumption does not hold true when financial statements are to be prepared for all users of financial reports for economic decision-making, whether or not for the primary benefit of the providers of capital, because the needs of that group will differ, and their perspectives of materiality will also vary significantly. In that case materiality must be determined from the perspective of the individual potential provider of capital or other potential user, and not from that of the entity itself.

If, therefore, as the boards presume, the suppliers of capital include employees, the financial statements must supply those employees with that information that is material to their understanding of their economic decisions that they must undertake on the basis of the information that the financial statements should supply to them in a complete, materially correct and neutral basis to enable them to allocate their own economic resources efficiently.

As a consequence, materiality with regard to the supply of information to providers of capital must be defined for all categories of those providers of capital. In the case of local traders, individual consumers and employees, that data can only be relevant within the national/local context in which they trade.

### **c. Other users**

As noted above, we do not agree that there are primary users of financial statements. We think there are just users.

We note that the boards refer in the exposure draft to members of the public as users of financial information (OB8).

However, we do not see these needs reflected in the framework proposed.

## **B. Country-specific reporting as a core element of the framework**

The current structure of financial reporting clearly does not meet the needs of users of financial reports because the data supplied is insufficiently granular and consolidated to a level that makes it immaterial for the needs of most investors, suppliers, customers, employees and governments.

We suggest that the additional information that those users need as identified in this letter and in previous submission made to the boards are disclosed on a country-by-country basis for each country in which the TNC has an operation (defined as a subsidiary, trade or permanent establishment for taxation purposes), without exception being made for any location. We also suggest the following information is needed on a country-by-country basis:

### **1. Benefit streams to government:**

The significant components of the total benefit streams to government and its agencies should be disclosed. At a minimum, this would include separate disclosure of:

- royalties and taxes paid in cash
- royalties and taxes paid in kind (measured in cash equivalents)
- dividends
- bonuses
- license and concession fees.

### **2. Reserves:**

Reserves volumes and valuation measures (if required by a future IFRS) should be disclosed on a country-by-country basis.

### **3. Production volumes:**

Production volumes for the current reporting period should be disclosed on a country-by-country basis. Optional disclosure of production volumes by key products and key properties is encouraged.

### **4. Production revenues:**

Revenues from production should be disclosed on a country-by-country basis, with separate disclosure of production revenue attributable to:

- sales to external customers
- transfers to downstream operations

### **5. Costs:**

The following costs should be disclosed on a country-by-country basis:

- production costs
- development costs.

### **6. Key subsidiaries and properties:**

The names and locations of each key subsidiary and property in each country should be disclosed.

It would also be desirable to include key employment data.

In our opinion if this data were to be made available the needs of many of the other users of the financial statements that we have identified would be adequately met whilst many local suppliers, customers, employees and governments will secure data much more appropriate to their needs, which are primarily as other users and not as suppliers of capital.

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