Comptroller General
of the United States

United States Government Accountability Office
Washington, DC 20548

November 8, 2006

Mr. Robert H. Herz, Chairman
Financial Accounting Standards Board
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File Reference 1260-001

Subject: Financial Accounting Standards Board's (FASB) *Preliminary Views on the Conceptual Framework for Financial Reporting*

This letter provides the U.S. Government Accountability Office's (GAO) comments on the FASB's Preliminary Views on the *Conceptual Framework for Financial Reporting: Objective of Financial Reporting and Qualitative Characteristics of Decision-Useful Financial Reporting Information.* Updating the Conceptual Framework is an important step in moving to useful, principles-based, credible and generally accepted accounting standards. We applaud the FASB and the International Accounting Standards Board (IASB) for undertaking this project and for cooperating to arrive at a basis for converging accounting standards throughout the world. We believe that a common framework in a single document will enhance understanding and usefulness of financial reporting for preparers, auditors, and users.

The preface to the Preliminary Views Document indicates that the International Accounting Standards Board's (IASB) intended audience for the Conceptual Framework is both financial reporting standard-setters and management, which differs from the intended audience of the FASB's framework. We agree with the IASB Framework's requirement for management to consider the Framework if no standard or interpretation specifically applies or deals with a similar or related issue. We believe that the FASB should write its Framework so that it is an integral part of the GAAP hierarchy in the United States that is used by entity management and those responsible for preparing financial reporting information.

In addition to being useful and relevant to both the financial reporting standard-setting community and the preparers of financial reporting information, the Conceptual Framework has important implications for auditing standard-setters and auditors. We believe that FASB and IASB should consider the audit implications of proposed standards when developing financial accounting and reporting standards. In doing this, they may wish to consult with those who develop auditing standards.

Along with the fundamental comments discussed above, we are providing additional comments in the areas listed below. In addition to including these items in the Conceptual Framework, we also believe that the FASB's codification project should discuss the concepts in the second, third, and fourth bullets below in some level of detail.

- tradeoffs between relevance and faithful representation
- evidence to support faithful representation
- management's responsibility for financial reporting, including related assertions
- other concepts

Tradeoffs between Relevance and Faithful Representation

The Preliminary Views Document indicates that in order to be useful, reported financial information needs to be both relevant and a faithful representation of the real-world economic phenomena that it purports to represent. The Preliminary Views Document further elaborates that to be a faithful representation, information must be verifiable, neutral, and complete.

We believe that the Preliminary Views Document needs to recognize that sometimes there may be tradeoffs between relevance and faithful representation (which includes verifiability). FASB's Statement of Financial Accounting Concepts Number 2 recognizes that "although financial information must be both relevant and reliable (a faithful representation), information may possess both characteristics to varying degrees. It may be possible to trade relevance for reliability or vice versa, though not to the point of dispensing with one or the other."

We believe the Preliminary Views Document needs to prominently discuss this tradeoff and the factors and risks to be considered in making this tradeoff. For instance, in some cases the degree to which information faithfully represents the underlying economic events will vary depending on the nature of the information involved. When faithful representation (which includes verifiability) appears to be subordinated to relevance, there are implications for decision makers and for auditors.

Evidence to Support Faithful Representation

The framework should state that, in order to provide a faithful representation, financial reporting should be based on sufficient, supporting evidence that preferably is generated by systems that have effective internal control. The need for supporting evidence should be added to or integrated with the discussion about verifiability and faithful representation. The discussion about the need for evidence and the different types of evidence will cause preparers to more carefully evaluate the accounting and resulting financial reporting.

We agree with the discussion in paragraph QC26 that states: “Direct verification is more helpful in assuring that information faithfully represents the economic phenomena that it purports to represent because direct verification tends to minimize both error and bias in method and application.” This discussion should be expanded to describe the type of supporting evidence used by those verification procedures. For instance, direct evidence is better than indirect evidence. Different types and amounts of evidence may be appropriate for different information, depending on the nature of the information. Analytical procedures are important tools for accumulating evidence and should be added to FASB’s discussion of evidence and verification.

<u>Management’s Responsibility for Financial Reporting, Including Related Assertions</u>

The framework should discuss management’s responsibility for the financial statements and financial reporting, now contained in the auditing literature. For example, The American Institute of CPA’s (AICPA) Statement on Auditing Standards (SAS) No. 106, *Audit Evidence*, states:

> Management is responsible for the fair presentation of financial statements that reflect the nature and operations of the entity. In representing that the financial statements are fairly presented in conformity with generally accepted accounting principles, management implicitly or explicitly makes assertions regarding the recognition, measurement, presentation, and disclosure of information in the financial statements and related disclosures.

A key part of management’s responsibility includes the assertions that are implicit in financial reporting. Assertions also are important in defining what gets reported in financial statements. Thus, the framework should address management’s assertions that are relevant to financial reporting and accounting for assets, liabilities, income and expenses. According to SAS 106, assertions fall into the following categories:

Classes of transactions

- *i. Occurrence*. Transactions and events that have been recorded have occurred and pertain to the entity.
- *ii. Completeness*. All transactions and events that should have been recorded have been recorded.
- *iii. Accuracy*. Amounts and other data relating to recorded transactions and events have been recorded appropriately.
- *iv. Cutoff*. Transactions and events have been recorded in the correct accounting period.
- *v. Classification*. Transactions and events have been recorded in the proper accounts.

Account balances

- *i. Existence*. Assets, liabilities, and equity interests exist.
- *ii. Rights and obligations*. The entity holds or controls the rights to assets, and liabilities are the obligations of the entity.
- *iii. Completeness*. All assets, liabilities, and equity interests that should have been recorded have been recorded.

iv. *Valuation and allocation*. Assets, liabilities, and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded.

Presentation and disclosure

i. *Occurrence and rights and obligations*. Disclosed events and transactions have occurred and pertain to the entity.
ii. *Completeness*. All disclosures that should have been included in the financial statements have been included.
iii. Classification and understandability. Financial information is appropriately presented and described and disclosures are clearly expressed.
iv. *Accuracy and valuation.* Financial and other information are disclosed fairly and at appropriate amounts.

<u>Other Concepts</u>

The following important concepts should be added to the framework:

- **Financial statements taken as a whole** - In addition to the detailed analysis of materiality presented in paragraphs QC49–QC52, the framework should include the concept of "financial statements taken as a whole" in the discussion. This overall concept says that preparers need to consider not just individual transactions or accounts or disclosure but the total financial reporting package; specifically, is the overall presentation a fair and faithful representation of the economic events?

- **Disclosure** - The concept that disclosure is not a substitute for providing financial statement information that is a faithful representation and that is supported by evidence.

- **Substance over Form** - As indicated in the basis for conclusions, substance over form is an important concept in faithful representation; if the accounting doesn't represent the substance, it is not a faithful representation. Since readers may miss this point, we suggest that the concept of substance over form be clearly indicated in the discussion of faithful representation.

- **Stewardship Reporting** - We agree with the alternative view that stewardship responsibilities should be a separate and distinct objective of financial reporting, rather than one included under decision-usefulness. Financial statement users should be able to assess the impact of management's stewardship of entity assets for the period: "how management has discharged its stewardship responsibilities in making resource allocation decisions." This concept goes beyond looking at the bottom line and share price. For example, did management enter into transactions that on the whole increased the entity's bottom line and management's performance, but at the expense and detriment to the surrounding community by contaminating lands or polluting the air? Did management take steps to generate better current results but at the price of mortgaging the future of the organization in one or more critical dimensions?

- **Conservatism -** We support the discussion that indicates that the concept of conservatism is not appropriate for the framework. We agree that neutrality or freedom from bias is the appropriate concept.

We thank you for considering our comments on this important document. We have also submitted these comments in a letter to the International Accounting Standards Board.

Sincerely yours,

David M. Walker
Comptroller General
of the United States

cc: The Honorable Christopher Cox, Chairman
Securities and Exchange Commission

The Honorable Mark W. Olson, Chairman
Public Company Accounting Oversight Board

Mr. Henrik Otbo, Auditor General, Denmark
Chair, INTOSAI Professional Standards Committee

Mr. Harold Monk, Chair
Auditing Standards Board

Mr. James M. Sylph, Technical Director
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