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**International
Accounting Standards
Board**

This document is provided as a convenience to observers at the World Standard Setters meeting, to assist them in following the discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.

Note: These notes are based on the staff papers prepared for the World Standard Setters meeting. Paragraph numbers correspond to the paragraph numbers in the staff papers.

INFORMATION FOR OBSERVERS

Meeting: ***World Standard Setters meeting, September 2005, London***
Agenda Paper 3A

Conceptual Framework

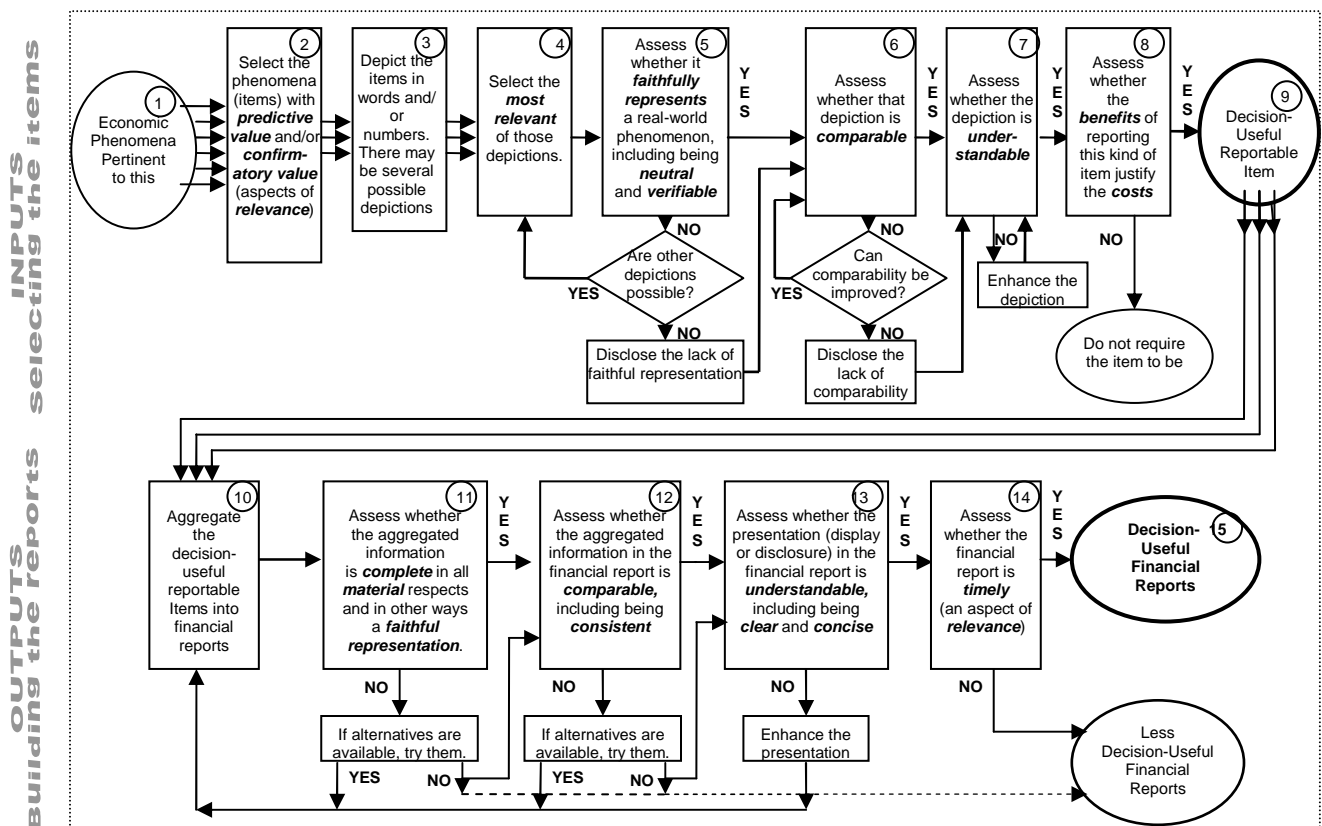
The Process for Assessing Qualitative Characteristics

INTRODUCTION

1. This paper is based on Agenda Paper 15B for the September IASB meeting. It represents the latest developments of a process for assessing the relationships between qualitative characteristics.
2. In existing conceptual frameworks, qualitative characteristics of financial reporting information, including relevance, faithful representation, comparability, understandability, and their sub-qualities, sometimes suggest different answers to standard setting and financial reporting issues. Previously, discussion of such differences has focused on hierarchies (that is, which characteristics prevail over others because they are ranked higher) or bargaining (that is, how much of one quality the Board is willing to “trade-off” to get more of another quality). The Boards have agreed that it would be better to view consideration of the qualitative characteristics of financial reporting information as steps in a *process* that results in decision-useful financial reporting. This paper considers that process.

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3. The paper discusses each step in the process, briefly discussing each of the qualitative characteristics and its relationship to the others. The Illustration, which appears on page 2 and is referred to throughout the paper, is reproduced in larger form on the final page so that it can be separated from the rest of the paper and used as a reference tool when reading and considering the paper’s proposals. The Appendix to Agenda Paper 3, includes a summary of Board decisions to date, including the Boards’ working definitions of the qualitative characteristics.
4. Participants at the World Standard-setters meeting in September are requested to review this paper as the basis for discussing the case studies presented in Agenda Paper 3B.
5. **Illustration: Using the Qualitative Characteristics for Standard-Setting and to Build Decision-Useful Financial Reports** (a larger version of this illustration is provided on the last page of this paper)



*Process for Assessing Qualitative Characteristics***An overview of the process**

6. The process of applying qualitative characteristics in standard setting takes place on two levels, as shown in Illustration 1. First, on the top half of the process diagram, the inputs are processed—the items to be reported are selected. The items that satisfy the qualitative characteristics in steps 2, 3, 4, 5, 6, 7 and 8 to make it to step 9 are decision-useful items, information about which should be included in financial reports. Then, in the lower half of the process diagram, the decision-useful reportable items are aggregated (step 9) and then built into decision-useful financial reports—the outputs of the process—by applying the other qualitative characteristics in steps 11, 12, 13, and 14.
7. The considerations underlying this process—finding the right items to report and then aggregating them into a useful report—should seem at least somewhat familiar to anyone who has prepared financial statements. The process described also might serve well to guide preparers and auditors in considering what to include in, and how to prepare, a set of financial statements in the absence of accounting standards, for example, in determining the appropriate accounting for an unusual transaction or circumstance. The terminology used reflects that financial statement preparation focus. However, in the Framework the purpose of this process is different: it illustrates the steps standard-setters should take in considering what should be required, permitted, or precluded by financial reporting standards. Standard-setters generally consider such matters for broad classes of economic phenomena, for example, lease transactions, pension obligations, or changes in prices, rather than for individual phenomena.¹
8. The next section of the paper discusses each step in the process.

Step 1: Economic Phenomena Pertinent to this Entity

9. The inputs into the process are *all* real-world economic phenomena—resources, obligations, changes in resources or obligations, purchase prices, sale prices, fair values, interest rates, tax rates, downside risks, upside potentials, physical dimensions, new orders from customers or to suppliers, discoveries in the entity's laboratories, new production processes, employees starting work or leaving, changes in inflation or

¹ In contrast, preparers and auditors generally focus on individual phenomena rather than broad classes.

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national income, and many more—that *pertain* in some way to the entity preparing the financial report. Those phenomena are *economic* because they are “of or having to do with the production, distribution, and consumption of wealth.”² They are *real-world* because they actually exist rather than being merely representations of what exists: they are the terrain, not the map.

10. What do not enter into the process at all are items that are not real-world economic phenomena, for example, amortization of intangible assets, deferral of revenues, and other conventional accounting actions; those items may have a role in financial reporting if they happen to be sufficiently faithful representations of real-world economic phenomena, for example, reduction in value through use or as-yet-unsatisfied obligations to customers, but they are only representations, not the phenomena that the process is intended to capture and portray.
11. What also do not enter into the process at all are items that are real-world economic phenomena but are not pertinent to this reporting entity. Those include most (but perhaps not all) resources and obligations of other entities that have no dealings with this entity, purchase or sale prices of items that this entity does not use or produce, and national income or inflation statistics in countries in which this entity has no presence, among many other items.

Step 2: Selecting the Relevant Phenomena

12. Of the vast array of real-world economic phenomena that enter into the process in step 1 of Illustration 1, all but a tiny fraction are turned away in step 2 as having neither predictive value nor confirmatory value and thus being irrelevant³, either because they do not pertain to the reporting entity (for example, sales by others of products the entity does not make or buy) or because they are not useful in making investment and credit decisions about the entity (for example, employees’ shoeshine expenditures or the paperclips in desk drawers). The step 2 process is iterative (the search for a better

² Webster’s New World Dictionary, 2nd College Edition, (New York: 1984), Simon & Schuster, p.442.

³ Having either predictive value or confirmatory value is a *necessary* condition for relevance, and therefore an item having neither is not relevant. However, having one or the other is not a *sufficient* condition for relevance, since the information reported to investors also must be timely. Timeliness is a quality of the completed financial report, not individual items, and can be assessed only later in the process, in step 14 on the Illustration. While a belated report might eventually reduce or destroy their relevance, for convenience this paper and the Illustration refer to items that have been selected in step 2 as relevant.

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alternative will uncover, for example, retail sales of the entity's products and employees' salaries, which *are* relevant) and repetitive (all other pertinent economic phenomena need to be considered too.) The process also is prioritized, rather than random (for example, the search starts with an entity's assets and liabilities and the transactions, other events, and circumstances that affect them, and focuses first on the aspects of those things that seem to have the most predictive value and/or confirmatory value). If a phenomenon is not relevant to the reporting entity and there is no better alternative, that's the end of the process—there is no point in reporting irrelevancies to investors and creditors.

13. For some complex business arrangements, for example, lease agreements, securitizations, or business combinations, many relevant phenomena will be selected in this step. Prices, payments due, duration, contingencies, options, seniority, credit quality, estimated fair values, sensitivities of those estimates, and more. The first part of the process considers each of those phenomena separately. Whether the financial report gives a complete and otherwise faithful representation of the complex business arrangement is considered in the second part of the process, in step 11.

Step 3: Depicting the Item

14. For the relevant phenomena that make it through step 2 of the flow process in Illustration 1, the next step is to develop a proposed depiction of the item, in words, numbers, or both. That might be (1) a brief description and measure for recognition in a financial statement, or (2) it might be a description and/or a quantification for disclosure in notes to a set of financial statements, in Management's Discussion and Analysis, or in some other way of reporting financial information to users.

Step 4: Selecting a Depiction

15. Often there will be several possible depictions of the same phenomenon, for example, different descriptions or different measures. Judgment is needed to select the depiction that provides the most predictive and/or confirmatory value and thus is (potentially) the most relevant.

Step 5: Assessing Whether the Depiction Is a Faithful Representation

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16. The flow process then considers whether that depiction is a faithful representation of the relevant phenomenon, including representing the item, being faithful in that representation, and being neutral and verifiable.⁴ This process is also iterative—finding that a depiction is not a faithful representation triggers a search for other possible relevant depictions, which might be a different depiction of the same phenomenon or a depiction of a different phenomenon. If other depictions are possible, the process returns to step 4 to pick from the other depictions the next most relevant one.
17. If no faithful representation of a relevant phenomenon can be developed, that could be the end of the process—on the grounds that there is no point in reporting information, even about a relevant phenomenon, if that information is a false representation, is biased, or is an unverifiable assertion. Alternatively, as depicted in the Illustration in this memorandum, the process could continue to the next step if the lack of faithful representation is disclosed in the financial report—on the grounds that information that is relevant but is unavoidably non-representative, unfaithful, biased, or unverifiable is better than no information. That is an issue that Board members are requested to resolve at the September meetings. The staff recommends the approach depicted in the Illustration: lack of faithful representation is undesirable but is not the end of the process *if* that lack can be adequately communicated by disclosure.

Step 6: Assessing Comparability

18. The next item for consideration in the process flow of the Illustration is to assess whether the depiction of the item is comparable. Comparability is the quality that enables users of financial reports to identify similarities in and differences between the economic phenomena the reports are trying to portray. Comparability includes but goes beyond consistency—the consistent use of accounting methods. The purpose of consistency is to achieve comparability; that is consistency is a means to an end, whereas comparability is the desired end.

⁴ One sub-quality of faithful representation, completeness, is not really assessable on an individual item basis. That is considered in the aggregate, later in the flow process, in step 11. While incompleteness might eventually reduce the faithfulness of the representation, for convenience this paper and the Illustration refer to items that have been selected in step 2 as faithful representations.

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19. Comparability, while a desirable quality, is not essential (in contrast to relevance and faithful representation). Not all agree on that: some cite the need for greater comparability as the principal reason for having accounting standards. However, making progress in improving financial reporting may sometimes necessitate doing without comparability in order to gain greater relevance or faithful representation, or both. For example, introducing a fair value option for measuring financial instruments will reduce comparability between entities, but will result in some entities providing information that is more decision useful than otherwise would be the case. Care must also be taken to ensure that accounting does not gravitate towards a lowest-common-denominator approach whereby, because a few entities do not provide better information (perhaps because they choose not to or perhaps because they are not able to), others are also precluded from doing so on grounds of lack of comparability.
20. Therefore, any consideration of comparability must come after relevance and faithful representation. If economic phenomena are irrelevant to users of financial statements, or the depiction of an item does not faithfully represent real-world economic phenomena, then there is no need to consider comparability — irrelevant phenomena and depictions that are not a faithful representation cannot be decision useful. As noted by Sterling,⁵ “Comparability alone cannot make information relevant ...”
21. Like the process for considering relevance and faithful representation, the process of assessing comparability is also iterative. As shown in the Illustration, a depiction found not to be comparable triggers a search for improvement, if that can be achieved without making the information less relevant or the representation less faithful. For example, standardized presentations or disclosures might enhance comparability.
22. Unlike the process for considering relevance, lack of comparability does not lead to not reporting the item. That is portrayed in Illustration 1 by what results if there is no better alternative that enhances comparability: one proceeds to step 7, rather than concluding that one should not report the item. The lack of comparability should be ameliorated, albeit not completely compensated for, by disclosures.

⁵ Sterling, Robert, R (1985), “An Essay on Recognition”, paragraph 2.2.2.1.3.

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23. Comparability is considered not only in assessing whether a real-world economic phenomenon is a decision-useful item and, therefore, deemed reportable (e.g., the use of comparable methods as inputs) (step 6), but also in considering the aggregate of decision-useful reportable items (e.g., the use of comparable presentation as outputs) (step 12), as discussed later in this paper.

Step 7: Assessing Understandability

24. The next item for consideration in the process flow of the Illustration is whether the faithfully representative and comparable depiction of the phenomenon with predictive and/or confirmatory value is *understandable*. The Boards have agreed that *understandability* is the quality of information that enables users who have a reasonable knowledge of business and economic activities and accounting and who study the information with reasonable diligence to comprehend its meaning. Understandability is enhanced when information is aggregated, classified, characterized, and presented in a clear and concise manner. Relevant information should not be excluded solely because it is too complex or difficult for some users to understand.
25. Understandability calls for a different iterative process than the other qualities. To provide a non-understandable depiction of an event is unacceptable. That would waste the users' time and possibly mislead them, and it is entirely avoidable by standards that call for understandable information and due care in executing those standards. Therefore, the process calls for enhancing the depiction until it *is* understandable.
26. Understandability also needs to be considered for the aggregate of reportable items—the outputs of the process. That is discussed in step 13 below.

Step 8: Assessing Costs and Benefits

27. The Boards have decided that the converged framework should include information about the types of costs that should be considered in deciding what financial information to provide, as well as criteria to help standard setters decide how to take particular types of costs into account.
28. Additional information about costs and criteria on how to take particular types of costs into account remains to be developed, as well as to consider whether the benefits of

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particular accounting standards changes justify incurring the related costs. That will be a topic for the Boards' October meeting, including particularly consideration of whether the costs and benefits should be weighed differently for small or private companies than for large, public companies.

29. Cost-benefit considerations are a constraint on the process of financial reporting, rather than a qualitative characteristic of the resulting information. It seems clear that considering costs, and benefits, is a necessary step in selecting items to be included in financial reports. The staff suggest that, given current financial reporting technology, cost considerations are much more of a factor in the selection of items to be reported than in the aggregation of those items into financial reports. An assessment as to whether the collective benefits of reporting the item justify the collective costs is, therefore, included as step 8 in the evaluation of inputs. In order to avoid the implication that an entity could decide not to report an item based on its own cost-benefit analysis, the Illustration tells the standard-setter "do not require the item to be reported."

BUILDING THE FINANCIAL REPORT

30. In the process laid out in Illustration 1, the qualitative characteristics discussed thus far apply in selecting the items that should be reported because, having made it as far as step 9, they are relevant, faithful representations with due consideration given to comparability, understandability, and cost-benefit considerations. Those selected items are then aggregated as we move to the lower half of the Illustration in Step 10; in practice, that aggregation step is what an entity's financial accounting and reporting system accomplishes. The process then shifts to building the financial reports, applying the other qualitative characteristics, focusing particularly in step 11 on completeness, and in step 13 on being clear and concise. One final quality to be assessed in step 14 is timeliness.

Step 11: Assessing Faithful Representation in the Aggregate: Completeness and Materiality

31. Even though each item that makes it to step 9 has been assessed for faithful representation, that does not ensure that the aggregation of those items in step 10 results

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in a faithful representation of the reporting entity's overall financial position and activities.

32. One sub-quality of faithful representation, ***completeness***, is not really assessable on an individual item basis. Instead, completeness comes into play in assessing whether the aggregate of individually relevant, faithfully represented, comparable, understandable, and cost-beneficial items that survive the upper part of our flow process is, collectively, a faithful representation of the reporting entity. If the answer is no—if the process has left out something too important to leave out—that requires a search for an alternative that would avoid having to settle for financial reporting that is less decision-useful than it could be, and a return to step 10 to redo the aggregation.
33. ***Materiality***, which is a screen or filter rather than a qualitative characteristic of financial reporting information, comes into play in assessing completeness. If the process has left out something that is *not* too important to leave out, that does not matter because that item is not material. Information is material if its omission or misstatement could influence the economic decisions that users make on the basis of an entity's financial report. Materiality depends on the nature and amount of the item judged in the particular circumstances of its omission or misstatement, based on knowledge and understanding of the whole entity. That means that whether a particular item or set of items is not material can be judged only in context, that is, only in relation to the aggregate of reportable items.
34. In an earlier version of the process Illustration, materiality had a step of its own, the last step to be applied to an individual item before aggregation. Some disagreed with that placement, seeing materiality of an incorrect or missing item or items as something that can be judged only in relation to the financial report as a whole. Also, the Boards decided that materiality is not a qualitative characteristic but rather a screen or filter. That suggests de-emphasizing it in the refined Illustration, which is achieved by treating materiality as something that comes into play in assessing completeness and, as discussed in step 13, conciseness.⁶

⁶ It has also been suggested that, for standard-setters, materiality also concerns the importance of an issue, for example, in making an agenda decision. The staff view is that agenda decisions have a process and a set of criteria that are separate and distinct from the process being discussed here. In that process, the

*Process for Assessing Qualitative Characteristics***Step 12: Comparability, including Consistency**

35. Comparability, assessed item-by-item in step 6, also needs to be considered at the aggregate level. The focus is on the manner in which the aggregate of items is displayed, with the objective being to maximize comparability in the manner of display. In many cases, this will result in displaying items in a consistent manner – but consistency should not be applied blindly, to the detriment of improved relevance, faithful representation or understandability.
36. If the aggregation does not display matters in a comparable way, the process calls for consideration of alternative ways of aggregation. For example, if information about expenses aggregated by function (cost of sales, marketing, research, administration) is judged to impede comparability with other entities that aggregate differently, the alternative of aggregation by nature (purchased goods, purchased services, salaries and benefits, interest) might be considered. (The refined Illustration gets a bit complicated at this point: the Yes answer to whether alternatives are available crosses another path on its way back to step 10, while the No answer results in less decision-useful financial reports (as indicated by the dotted-line) but the process leads on to step 13.)

Step 13: Assessing Understandability, including Being Clear and Concise

37. The next step is to assess the understandability of the aggregated presentation, in particular, to evaluate whether the overall display and disclosure of the reportable item is clear and concise.
38. Being concise means narrowing down or condensing what is reported so that what really matters is not obscured by less important—immaterial—information. Standard setters and preparers need to keep in mind that the aggregation or condensing of information must be balanced with providing sufficient information such that the meaning of the information is conveyed. In some circumstances, more information rather than less will be needed; in other situations less information might be more understandable. As Kenneth E. Boulding famously stated: ". . . It is a very fundamental principle indeed that knowledge is always gained by the *orderly* loss of information,

“importance of the issue” is the rough equivalent to relevance and materiality. But the staff sees no need to include agenda decision criteria in our list of qualitative characteristics of financial reporting information.

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that is, by condensing and abstracting and indexing the great buzzing confusion of information that comes from the world around us into a form which we can appreciate and comprehend"(emphasis added).⁷

39. If information is not understandable because it is not clear, then consideration should be given as to whether there is a better way to present the information, e.g. use of a list or chart instead of a paragraph. Depictions written in plain language are generally more understandable to more users than those that include legal or industry-specific terminology. An alternative that is more clear and concise could result in a larger number of users comprehending the information or users comprehending a deeper understanding of the information. After an alternative is developed, then the process returns to step 10 to confirm the completeness, faithful representation and comparability of the new aggregation and/or display. As in step 7, to provide a non-understandable presentation is unacceptable. That would waste the users' time and possibly mislead them, and it is entirely avoidable by better standards and due care in executing those standards. Therefore, the process calls for enhancing the depiction until it *is* understandable.

40. As with much of this paper, while the process of assessing understandability is described from a preparer's point of view, it applies equally to standard setters. Steps 7 and 13 are where the understandability of the financial reporting required by a proposed standard should be questioned. Standard setters could check whether an alternative, which could be simpler and more cost effective, may result in more users understanding the item or a similar or higher level of users' comprehension of the item. For example, some criticize the overall understandability of how pension liabilities and expenses are determined in accordance with IAS 19 or FASB Statement 87 and the volume of additional disclosures that result; they suggest that a different accounting method that does not delay recognition of certain events, report cost net, and offset pension assets and liabilities might be more understandable.

Step 14: Timeliness

⁷ Kenneth E. Boulding, *Economics as a Science*, New York: McGraw-Hill Book Company, 1970, p. 2,

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41. Timeliness is making information available to decision makers before it loses its capacity to influence their decisions. If information becomes available only after the time that a decision must be made, it has no capacity to influence that decision and thus lacks relevance. Timeliness alone cannot make information relevant, but a lack of timeliness can rob information of relevance it might otherwise have had.
42. Some suggest that timeliness might mean whether the information was current or dated, for example, whether items are measured based on current or historical prices. However, in the staff's understanding that is part of a different aspect of relevance: how much predictive value or confirmatory value the information conveys. Many would say that information based on current prices has more predictive value and some would say it has more confirmatory value than information based on historical prices. Others are concerned that insistence on timeliness might exclude valuable but dated pieces of information that came to light belatedly, for example, discovery of an old claim. In the staff's view, that is not about timeliness, it just means that previous financial statements were not complete. Those are important considerations, but they do not fit the definition of timeliness in either existing framework and, in the staff's view, should not be included in timeliness in the converged framework.
43. Unlike other aspects of relevance, timeliness comes into play not in the item-by-item assessments shown in the top of the flow diagram in Illustration 1, but only at the end of the aggregation process that produces the financial report. If the process takes too long, the whole effort may be entirely wasted as the investment or credit decisions may already have been made without the benefit of the financial report. Timeliness is not an absolute, of course. Immediate reports of badly flawed information are likely to be less useful than somewhat delayed reports of information without such flaws. Conversely, in setting standards, a consideration may be whether the financial report might be delayed by the work needed to meet the requirements of the standard.

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See Next Page for “tear-off” version of Illustration

Illustration: Using the Qualitative Characteristics for Standard-Setting and to Build Decision-Useful Financial Reports

