

## Conceptual Framework

### Qualitative Characteristics 3: Relationships between Qualitative Characteristics

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## INTRODUCTION

1. This paper is the third considering issues related to qualitative characteristics. In May, the Boards considered the qualitative characteristics of relevance and reliability (faithful representation)<sup>1</sup>. In June the Boards considered qualitative characteristics other than relevance and faithful representation. This paper considers relationships between those qualitative characteristics identified in May and June.
2. The one cross-cutting issue addressed in this paper (it's a big issue) is as follows:  
  
QC12: Relationships between characteristics?
3. This paper starts by considering our overall approach to assessing the relationships between qualitative characteristics. It then proceeds to consider each of the qualitative characteristics and its relationship to the others, concluding with a request for the Boards to confirm that the overall approach should continue to be developed and refined. A summary of the staff recommendations is at the end of the paper. Appendix A provides a different perspective of the first part of the process. Appendix B is carried forward from May and June and illustrates the hierarchical approach portrayed at those meetings. Appendix C summarizes tentative decisions reached to date, and cross-cutting issues remaining to be considered, relating to qualitative characteristics, as a whole. Illustration 1, which appears

<sup>1</sup> The IASB and FASB tentatively agreed, in May 2005, to replace reliability with faithful representation. Faithful representation is, therefore, used in this paper in the manner tentatively agreed to in May – i.e., encompassing completeness, neutrality and verifiability.

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on page 3 and is referred to throughout the paper, is reproduced 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.

## OVERALL APPROACH

### Can we think in terms of a process, rather than “trade-offs” or “trumping”?

4. To date, Board members (and staff) have been discussing the relationships between qualitative characteristics in terms of “bargaining”—how much of one quality are we willing to “trade-off” to get more of another quality—and “hierarchy”—which qualities outrank and therefore “trump” other qualities. Bargaining or hierarchy has also been the thrust of earlier efforts to consider those relationships, for example, the discussion of trade-offs in paragraphs 42-45 of FASB Concepts Statement 2 and the hierarchical diagram in paragraph 32 (Figure 1) of that Statement (and deliberately omitted from the IASB *Framework*).<sup>2,3</sup> However, those discussions and efforts have been less than successful in helping Board members deal with situations in which different characteristics suggest different answers to financial reporting issues. The staff has concluded that neither bargaining nor hierarchy is the most productive approach to resolving such conflicts between qualitative characteristics.
5. Instead, with the benefit of some earlier thinking by scholars<sup>4</sup> and some recent comments by Board members, the staff has come to see consideration of the various qualitative characteristics as steps in a *process* that results in decision-useful financial reporting. The process can be visualized as a flow process (see Illustration 1), and much of this paper is a discussion of that flow process. The visualization, and the process, may well require further fine-tuning and refinement. However, the staff would like the Boards to consider whether this approach seems preferable to the previous “bargaining” or “hierarchical”

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<sup>2</sup> This is also the manner in which the qualitative characteristics had been portrayed in the May and June Board papers — carried forward as Illustration 3, for reference purposes.

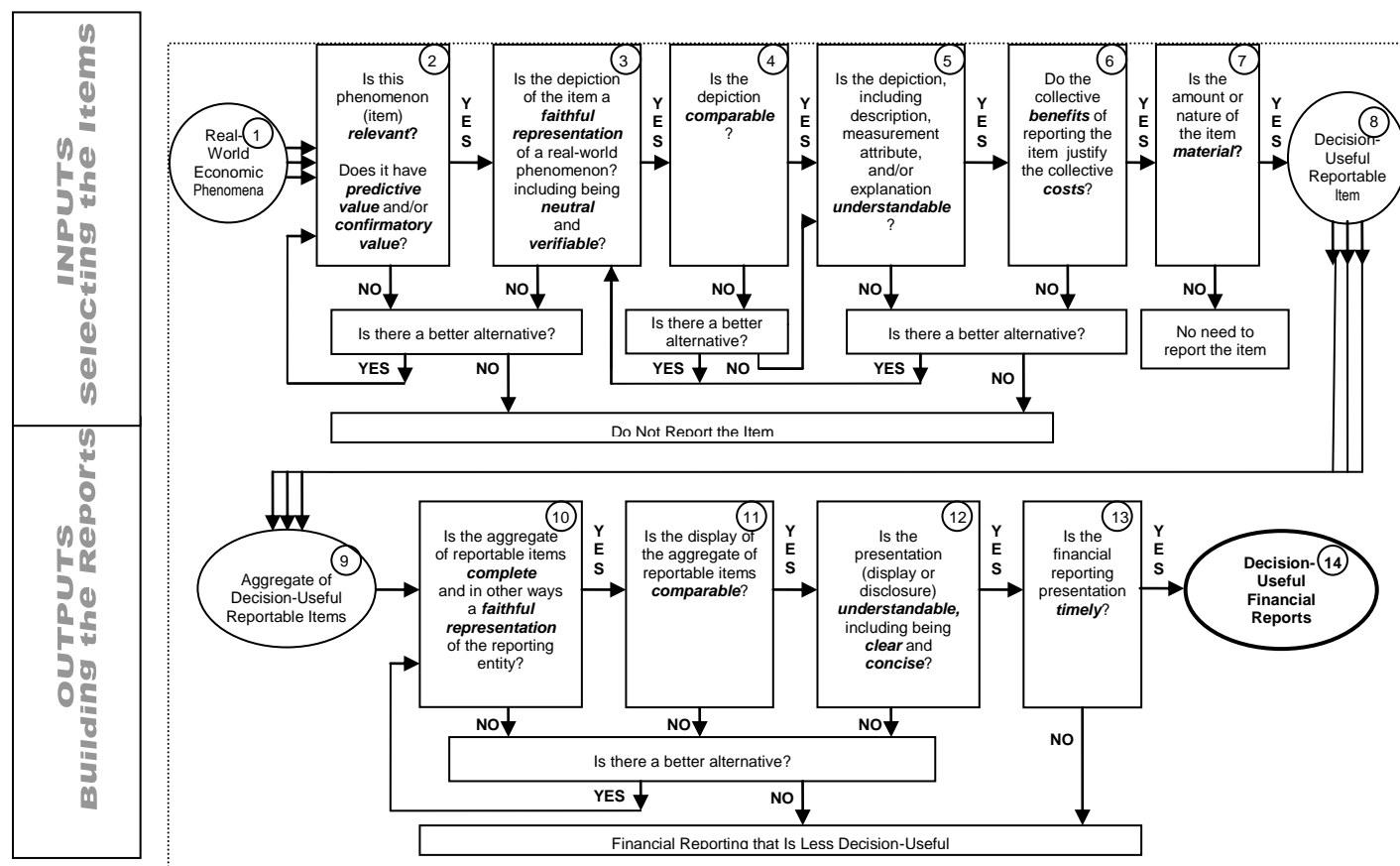
<sup>3</sup> The UK Statement of Principles and Japanese Concepts discussion paper also use hierarchical diagrams.

<sup>4</sup> In particular, Sterling, Robert R., *An Essay on Recognition*, University of Sydney (Sydney: 1985), paragraph 2.2.2.3 and Figure 2, pp.30-35

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approaches and, if so, to consider whether they agree with the process as illustrated and discussed in this paper.

**Illustration 1: 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)

**An overview of the process**

- 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, and 7 to make it to step 8 are decision-useful items, information about which should be included in financial reports. Then, in the lower half of the process diagram, after the decision-useful reportable items are aggregated (step 9), they

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are built into decision-useful financial reports—the outputs of the process—by applying the other qualitative characteristics in steps 10, 11, 12, and 13.

7. The inputs into the process (step 1 in the flow chart — Illustration 1) are *all* real-world economic phenomena—resources, obligations, changes in resources or obligations, purchase prices, sale prices, fair values, interest rates, downside risks, upside potentials, physical dimensions, and many more. Each real-world economic phenomenon is then evaluated by reference to the qualitative characteristics of decision-useful financial reporting to assess, first, whether it constitutes a decision-useful item for the reporting entity in question; and then, if so, whether the aggregate of decision-useful reportable items is presented in the most decision-useful manner in the output of the process, the financial reports. 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 not the phenomena which the process is intended to capture and portray.

**RELEVANCE AND FAITHFUL REPRESENTATION**

8. 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 irrelevant, either because they do not pertain to the reporting entity (for example, retail sales of hand-crafted kites in Tibet) or because they are not useful in making investment and credit decisions about the entity (for example, employees' shoeshine expenditures). The step 2 process is iterative (the search for a better alternative will uncover, for example, retail sales of the entity's products in Tibet and employees' salaries, which *are* relevant) and repetitive (all other economic phenomena need to be considered too.) The process also is prioritized, rather than random (for example, the search starts with an entity's transactions, assets, and liabilities, and focuses first on the aspects of those things that seem most relevant). If a phenomenon is not relevant to the reporting entity and there is no better alternative, that's

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the end of the process—there is no point in reporting irrelevancies to investors and creditors.

9. 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 a brief description and measure for recognition in a financial statement, or it might be a description and/or a quantification for disclosure in notes to a set of financial statements, in MD&A, or in some other way of reporting financial information to users. Step 3 of the flow process then considers whether that depiction is a faithful representation of the relevant phenomenon, including being neutral and verifiable. This process is also iterative—a depiction found not to be a faithful representation triggers a search for a better alternative, which might be the same phenomenon depicted differently or a different relevant phenomenon. If no faithful representation can be developed, that is the end of the process—there is no point in reporting information, even about a relevant phenomenon, if that information is a false representation, is biased, or is merely an assertion.
10. The flow process continues step by step through the other qualities. But first, this paper considers the relationship between relevance and representational faithfulness in more detail.

**Relevance versus faithful representation**

11. In May, the Boards decided that *relevance* is an essential qualitative characteristic. To be relevant, information must be capable of making a difference in the economic decisions of users by helping them evaluate the effect of past and present events on future net cash inflows (predictive value) or confirm or correct previous evaluations (confirmatory value), even if the information is not now being used. (Also, the information must be available when the users need it (timeliness), a sub-quality that this paper will discuss later — see paragraphs 56-58.)
12. In May, the Boards also decided that *faithful representation* of real-world economic phenomena is an essential qualitative characteristic. Representations are faithful—there is correspondence or agreement between the accounting descriptions and measures in

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financial reports and the economic phenomena they purport to represent—only if the descriptions and measures are verifiable and the describing or measuring is done in a neutral manner. Therefore, faithful representation also requires completeness, not subordinating substance to form, verifiability, and neutrality, and should replace *reliability* in our set of qualities. (This paper discusses the sub-quality of *completeness* later — see paragraph 19.)

13. Both relevance and faithful representation are essential characteristics. Both are necessary conditions for requiring an item to be included in financial reports, as the Boards decided in May. But what if both are present but they point in different directions? Such conflicts might be resolved in at least four distinct ways. Three of those ways can be illustrated by the familiar situation in which we must choose only one measurement attribute for a recognized asset or liability.
14. One kind of resolution arises if a phenomenon that is relevant cannot be faithfully represented and another phenomenon related to the same item can be faithfully represented but is not relevant. An example might be internally developed intangible assets. The FASB (before it had a framework) concluded that such assets were important but should not be recognized. Restating that reasoning in our current conceptual terminology, the FASB came to that decision because one possible measurement attribute—the fair value of the asset that resulted from the research and development efforts—would be relevant (would pass step 2) but was not verifiable and so could not be faithfully represented (failing in step 3), while the other possible measurement attribute that seemed a possible better alternative—costs of research and development that led to the asset—could perhaps be faithfully represented but had neither predictive nor confirmatory value and so was not relevant (would fail the second iteration of step 2.) Leaving for another day (and another project) the issue of whether that decision might be out-of-date today in light of new facts, that kind of decision process would still be valid in the flow process under the framework we are now developing.
15. Another kind of resolution arises if a phenomenon is relevant but the candidate representations of it, while somewhat faithful, are not as faithful as might be preferred.

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One recent example is IAS 41, *Agriculture*, in which the IASC considered whether biological assets should be measured at fair value or historical cost. The IASC noted that while fair values can be difficult to verify (perhaps leading to uncertainty about faithful representation) —especially for partially mature products in the absence of active markets, costs of many biological assets are also difficult to verify because joint products and joint costs can result in ill-defined relationships between inputs and outputs. The Board resolved this dilemma between less-than-ideally faithful representations by generally requiring fair value, describing it as more relevant, comparable, and understandable, but allowing a verifiability (reliability) exception if market-determined prices or values are not available and alternative estimates of fair value are determined to be clearly unreliable.<sup>5</sup>

16. Another kind of difficulty arises if we must choose only one of two (or more) relevant phenomena, one of which is *more* relevant and the other can be represented *more* faithfully. A recent example is one decision made by the FASB in its revision of Statement 123. The issue was measurement of liability instruments awarded as stock-based compensation. Re-expressing the Board’s reasoning in terms of the concepts we have been developing, that decision could be analyzed as follows: the Board agreed that fair value was more relevant than the alternative, “intrinsic value” which disregards the value that results from the volatility of the underlying shares. The Board also agreed that fair value could be measured with adequate verifiability—faithfully represented—by public companies but perhaps not by nonpublic companies. Therefore, the Board allowed nonpublic companies to elect to use the less relevant but more verifiable—more faithfully representational— intrinsic value to measure those liabilities. That analysis is not the way the Board expressed its reasoning—the Statement cites pragmatic reasons and a sole purpose of lowering implementation costs<sup>6</sup>—but that analysis would be a valid line of reasoning based on the qualitative characteristics.
17. Yet another kind of difficulty arises if we are asked to choose only one of two phenomena, both relevant in different ways, and both of which can be faithfully represented. A classic example (not involving the choice of measurement attribute, for a change of pace) is

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<sup>5</sup> IAS 41, *Agriculture*, paragraphs B13-B21.

<sup>6</sup> FASB Statement 123 (Revised), *Share-Based Compensation*, paragraphs B140-143.

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whether to group an entity's expenses by "natural" classifications—salaries and benefits, supplies, rents, interest—or by "functional" classification—manufacturing, marketing, research, administration. That kind of difficulty ought perhaps to be resolved based on judgment about which is more relevant<sup>7</sup>, perhaps based on assessments of the needs of the majority of users, or in this example possibly even by reporting both kinds of information.

18. As the examples indicate, seeing the application of the qualitative characteristics as a process can be an aid to resolving some conflicts between relevance and faithful representation or their components, but is by no means an automatic answer machine. Judgment, by standard-setters and by practitioners, will still be needed to resolve some conflicts between qualities.
19. One sub-quality of faithful representation, completeness, is not really assessable on an individual item basis. Instead, in step 10 of our flow process, completeness comes into play in assessing whether the aggregate of individually relevant, faithfully represented, comparable, understandable, cost-beneficial and material items that survive the upper part of our flow process is, *in toto*, 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 a better alternative to avoid having to settle for financial reporting that is less decision-useful than it could be.
20. Recommendations:
  - (a) The process of standard-setting, and accounting in the absence of standards, should begin with assessment of the relevance of various real-world economic phenomena. [see paragraph 8]
  - (b) The next step is to consider whether relevant items can be depicted in a faithful representation. If so, they should proceed to assessment of other qualities in subsequent steps in the process. If not, other relevant aspects or other representations should be considered before deciding not to report the item. [see paragraph 9]

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<sup>7</sup> The UK Statement of Principles expressly states that "if a choice exists between relevant and reliable approaches that are mutually exclusive, the approach chosen needs to be the one that results in the relevance of the information provided being maximised." (Chapter 3 Principles, page 32)



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- (c) While sequencing standard-setting or accounting decisions in that manner will help resolve conflicts, resolving some conflicts between relevance and faithful representation will still require judgment by standard-setters and practitioners. [see paragraph 18]

**COMPARABILITY (including consistency)**

- 21. Once we have dealt with relevance and faithful representation, the next item for consideration in the process flow of Illustration 1 is whether the depiction of the item is consistent and comparable (step 4).
- 22. In June, the Boards concluded that:
  - (a) comparability is an important characteristic of decision-useful financial information and should be included in the converged conceptual framework;
  - (b) comparability — which enables users to identify similarities in and differences between economic phenomena — should be distinguished from consistency — the consistent use of accounting methods;
  - (c) concerns about comparability or consistency should not preclude reporting information that is of greater relevance or that more faithfully represents the economic phenomena it purports to represent; and
  - (d) if such concerns arise, disclosures can help to compensate for lessened comparability or consistency.
- 23. As noted in paragraph 22(b), above, comparability and consistency are to be distinguished. The staff does not intend to further explore that distinction at the July meeting. However, while comparability and consistency describe distinguishable characteristics, they are closely related.<sup>8</sup> The purpose of consistency is to achieve comparability; that is

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<sup>8</sup> That is because *consistency* (the quality of information that results from the use of the same accounting method or presentation format over time or across entities) is thought to improve *comparability* (the quality of information that enables users to identify similarities in and differences between economic phenomena). However, that is not always the case, as the consistent application of some accounting methods may mask important differences between economic phenomena. For example, applying a method that delays the recognition of revenue on contracts until the final obligation under the contract is extinguished may mask significance differences between a 10-year contract and a one-day contract.

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consistency is a means to an end, whereas comparability is the desired end. Accordingly, we refer only to comparability in the remainder of this discussion.

24. Comparability, while a desirable quality, is not essential (in contrast to relevance and faithful representation). Making progress in improving financial reporting may sometimes necessitate sacrificing 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 the across-entity comparability of such information, 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, others are also precluded from doing so on grounds of lack of comparability.
25. We conclude that 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. These should be eliminated first. As noted by Sterling,<sup>9</sup> “Comparability alone cannot make information relevant ...”
26. Comparability becomes important in making choices between items that have an appropriate degree of relevance and faithful representation to be considered candidates for decision-useful information (i.e., that has passed through steps 2 and 3 in Illustration 1), but that are not the most relevant and most faithful representation<sup>10</sup>. Once these steps are passed, greater comparability results in more decision-useful financial information, all else being equal. Like the process for considering relevance and faithful representation, this process is also iterative — a depiction found not to be comparable triggers a search for a better alternative, which might be the same phenomenon depicted differently or a different

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<sup>9</sup> Sterling, Robert, R (1985), “An Essay on Recognition”, paragraph 2.2.2.1.3.

<sup>10</sup> If the phenomena and depiction providing the most relevant and most faithful representation were always to be selected by all entities, this would automatically be comparable. No further consideration would be necessary.

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relevant phenomenon. For example, information depicted in the same currency is likely to be more comparable than information expressed in several different currencies, and standardized presentations or disclosures might enhance comparability.

27. Of course, all else is not always equal. Therefore, the assessment of comparability must also take into account other factors. The process flow (Illustration 1) goes on to consider understandability and costs. One might conclude that certain information, while comparable, is nonetheless not understandable, or that the costs exceed the benefits, in which case the iterative process means that alternatives would be considered – perhaps resulting in lesser comparability, but greater understandability or benefits that more greatly exceed the collective costs. Only if the information has an appropriate degree of comparability and understandability and the benefits of reporting justify the collective costs will it be decision useful and reportable.
28. The result is that maximum comparability is not always achieved. Some comparability might be sacrificed for greater relevance or faithful representation (as noted in paragraph 24, above), or for greater understandability or when costs exceed benefits. Nonetheless, information that does not maximize comparability can be decision useful. This is portrayed in Illustration 1 by what results if there is no better alternative that enhances comparability: one proceeds to steps 5, 6, and 7, rather than concluding that one should not report the item. The lack of comparability might be compensated for by disclosures. An example is the recent decisions made by both the IASB and FASB to allow a fair value measurement option for certain financial instruments. Allowing the option reduces comparability, but nonetheless information provided about the use of the option is more decision useful than would otherwise be the case. The lessened comparability is compensated for by additional disclosures.
29. In June, some suggested that comparability should be considered equally important to relevance and faithful representation. Concern was expressed that to suggest that comparability is less important would allow significant room for accounting alternatives – perhaps because entities would make choices based on other characteristics, such as lower costs, rather than the degree of comparability. The staff does not think so. Lesser

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comparability would only be appropriate when compensated for by greater relevance, more faithful representation, or greater understandability.

30. 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 4), but also in considering the aggregate of decision-useful reportable items (e.g., the use of comparable presentation as outputs) (step 11). In the latter case, 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, as noted earlier, consistency should not be applied blindly, to the detriment of improved relevance, faithful representation or understandability.
31. Recommendations:
- (a) Comparability should be considered after an initial assessment of relevance and faithful representation. [see paragraph 25]
  - (b) When comparability is not achieved, consideration should be given as to whether there is an alternative phenomenon that also has an appropriate degree of relevance and faithful representation, but enhances comparability. [see paragraph 26]
  - (c) When comparability cannot be achieved, but information is nonetheless relevant, depicts real-world economic phenomena, is understandable, the benefits justify the costs and the item is material, it should be reported, perhaps with disclosures to compensate for the lessened comparability. [see paragraph 28]

**UNDERSTANDABILITY**

32. Once we have dealt with comparability, the next item for consideration in the process flow of Illustration 1 is whether the depiction is understandable (step 5).
33. In June, the Boards agreed that:
- (a) understandability is an essential characteristic of decision-useful financial information and should be included in the converged conceptual framework;

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- (b) information is made more understandable by aggregating, classifying, characterizing and presenting it clearly and concisely;
  - (c) whether reported information is sufficiently understandable depends on who is using it;
  - (d) the information in general-purpose external financial reports should be understandable to users who have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information with reasonable diligence; and
  - (e) relevant information should not be excluded because it is too complex or difficult for certain users to understand.
34. The definition of understandability is considered separately in Agenda Paper 7B (FASB Memorandum 9).
35. The IASB, Canadian, New Zealand and UK frameworks rank understandability equally with relevance and faithful representation as an essential characteristic. The FASB Concepts Statement No. 2 positions understandability as a link between the characteristics of users and the decision-useful qualities of information. The Australian framework lists understandability as a characteristic of financial statement preparation and in paragraph 37 states that, “Preparers should present information in the most understandable manner without sacrificing relevance or reliability”.<sup>11</sup>
36. These frameworks consider understandability an essential qualitative characteristic, as it reflects the comprehension by users of information that is relevant and faithfully represents what it purports to represent to assist users in making economic decisions.
- Understandability complements the qualitative characteristics of relevance and faithful representation, and links the actions of the preparers with the users of decision-useful financial reporting. When preparing decision-useful financial reporting, one needs to

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<sup>11</sup> The Japanese Discussion Paper, “Qualitative Characteristics of Accounting Information,” does not include or rank understandability as a qualitative characteristic as it “might contradict with the assumption of sophisticated investors,” it is self-evident and it was not clear how it would guide the development of standards in the future (see paragraph 21).

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assess how information is to be conveyed, such as which words to select to describe an item or the style of how information is presented. In the flow process of Illustration 1, understandability of the information is considered at two levels – in the assessment of inputs (step 5) and in the assessment of outputs (step 12).

37. Step 5 assesses whether the depiction of a real-world economic phenomena, such as the label of an asset on the balance sheet is understandable. Judgment will need to be used in assessing the understandability of the item's depiction.
38. When there is no understandable alternative available, the flowchart, in the "no" box, below step 5, acknowledges the possibility that information might not be reported.
39. Understandability also needs to be considered in relation to the aggregate of reportable items — the outputs of the process. Continuing the example from paragraph 37, upon aggregation of long-term debt, one includes debentures, senior discount notes, bank facilities and long-term leases, (step 9), one then develops, assesses and confirms that the aggregation is complete and a faithful representation (step 10) and that its display — a detailed breakdown and description of when the debt payments are due by year, terms including the security provided — is consistent and comparable (step 11). Next, one assesses the understandability of its aggregated presentation (step 12) to evaluate whether the overall display and disclosure of the reportable item is clear and concise.
40. 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, 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).<sup>12</sup>

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<sup>12</sup> Kenneth E. Boulding, *Economics as a Science*, New York: McGraw-Hill Book Company, 1970, p. 2,

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41. If information is not understandable, then consideration should be given as to whether there is a better way to present the information, e.g. use of a chart instead of in paragraph form. 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 and/or a more faithful representation of the item it purports to represent could result in a larger number of users comprehending the information or users comprehending a deeper understanding of the information. If an alternative is considered, then one returns to step 10 to confirm the completeness, faithful representation and comparability of the new aggregation and/or display. If a better alternative is not identified, then the original depiction is provided – even though that might have limited decision-useful qualities. Again, judgment is necessary to decide which is the better alternative.
42. For standard setters, steps 5 and 12 are also 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, consider the overall understandability of how pension liabilities are determined and the volume of additional disclosures that required.
43. Recommendation:
- Understandability should be positioned as a complementary attribute to relevance, faithful representation and comparability, that needs to be considered at both the input level — in evaluating the depiction of individual real world economic phenomena (step 5) and at the output level — in evaluating the depiction of the aggregate of decision-useful reportable items (step 12). [see paragraph 36]

**COSTS AND BENEFITS**

44. In June, the Boards 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.

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45. The staff has not yet developed additional information about costs and criteria on how to take particular types of costs into account and consider whether the benefits of particular accounting standards changes justify incurring the related costs. That will be a topic for the Boards' September meeting, including particularly consideration of whether the costs and benefits weigh differently for small or private companies than for large, public companies.
46. The staff notes that it is not even clear whether the focus should continue to be on costs to preparers and benefits to users. For example, the potential decrease in the cost of capital to reporting entities that provide particular information in accordance with a proposed standard could be viewed as either a benefit of or a cost reduction from that standard.<sup>13</sup> In other words, the costs of providing a particular item of information could be weighed against the costs of not providing it. Nonetheless, it does seem clear that considering costs, and perhaps benefits, is a necessary step in selecting items to be included in financial reports. An assessment as to whether the collective benefits of reporting the item justify the collective costs is, therefore, included as step 6 in the evaluation of inputs.
47. Recommendations:
- None at this time.

**MATERIALITY**

48. Once we have dealt with costs, the next item for consideration in the process flow of Illustration 1 is whether the amount or nature of the item is material (step 7).
49. In June, the Boards agreed that materiality:
- (a) relates not only to relevance, but also to faithful representation; and
  - (b) should be included in the converged framework as a screen or filter to determine whether information is sufficiently significant to influence the decisions of users in

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<sup>13</sup> Some suggest that users' costs and benefits do not even need to be considered: American professors Paul Miller and Paul Bahnson have suggested in a series of columns in *Accounting Today* that voluntarily adopting better accounting practices—they propose a list of such practices—would be cost-beneficial to the companies doing that, because the savings from the lower cost of capital resulting from reducing risk premiums investors charge because of their doubts about the trustworthiness of financial information would far outweigh the costs of adopting those practices.



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the context of the entity, rather than as a qualitative characteristic of decision useful financial information.

50. The definition of materiality is considered separately in Agenda Paper 7B (FASB Memorandum 9).
51. Though not a qualitative characteristic, the materiality of information needs to be considered in order to produce decision-useful financial information. Immaterial information is information that is not relevant to users and/or is not a faithful representation of economic phenomena it purports to represent. For example, consider the common practice of not capitalizing furniture and office fixtures purchases that cost less than, say, \$1,000. Users of large entity's financial statements are not likely to be interested in knowing the dollar value not capitalized to property, plant and equipment during the year to replace office chairs. Compared to a significant purchase of land or productive assets, not classifying the purchases of less than a few thousand dollars as assets, instead classifying them as expenses, would not likely affect the economic decisions that financial statement users will make. This classification error is immaterial and is not decision-useful. For a smaller entity, recognition of such capital purchases as expenses might affect users' analyses of profitability and return on capital, which would likely affect their decisions to buy or sell their investments in entities. Information that is considered immaterial is not decision useful.
52. As outlined in the above example, materiality must be assessed based on knowledge and understanding of the whole entity. Step 7 of the process flowchart (Illustration 1) involves considering whether the omission or misstatement of the item in the context of the whole entity or financial statements could affect users' decisions when relied upon. If it could not affect users' decisions, then the omission or misstatement of the information is immaterial, and the information should not be reported. If it could affect users' decisions, then the information is material and is a decision useful, reportable item (step 8). One would then move on to step 9.

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53. Recommendations:

- (a) There is no need to report immaterial information as it is not decision useful. [see paragraph 51]
- (b) Materiality of an item is considered once a relevant, faithfully represented item is considered comparable, understandable and the benefits exceed the costs. [see paragraph 52]

**BUILDING THE FINANCIAL REPORT**

54. 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 8, they are relevant, faithful representations with due consideration given to comparability, understandability, cost-benefit considerations, and materiality. Those selected items are then aggregated as we move to the lower half of the Illustration in Step 9; 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 steps 10, 11, and 12 on completeness (as already discussed above in paragraph 19), comparability (paragraph 30), and being clear and concise (paragraph 39). One final quality to be assessed in step 13 is timeliness.

55. Recommendation:

Once items have been selected for reporting, the process shifts to building the financial reports, applying the other qualitative characteristics focusing particularly on completeness, comparability, and being clear and concise.

**TIMELINESS**

56. One sub-quality of relevance not yet discussed in this paper, and discussed only briefly at the Boards' May meetings, is timeliness. The paper for that meeting noted that in the IASB *Framework*, timeliness is cited as a necessary constraint lest information lose its relevance, while in FASB Concepts Statement 2, timeliness is considered an ancillary aspect of relevance. If information is not available when it is needed or becomes available only so

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long after the reported events that it has no value for future action, it lacks relevance and is of little or no use. The Boards decided in May that one aspect of relevance is that information must be available when the users need it (timeliness).

57. 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 in step 13 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. 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.

58. Recommendation:

Timeliness is necessary for relevance and can be assessed only at the end of the process that produces the financial report.

**SUMMARY RECOMMENDATION**

59. The flow process (depicted in Illustration 1) is preferable to the previous “bargaining” or “hierarchical” approaches to dealing with relationships between qualitative characteristics, and work should continue to further refine this approach.

**SUMMARY OF STAFF RECOMMENDATIONS**

**Relevance and faithful representation**

- (a) The process of standard-setting, and accounting in the absence of standards, should begin with assessment of the relevance of various real-world economic phenomena.  
[see paragraph 8]
- (b) The next step is to consider whether relevant items can be depicted in a faithful representation. If so, one should proceed to assessment of other qualities in

*Relationships between Qualitative Characteristics*

subsequent steps in the process. If not, other relevant aspects or other representations should be considered before deciding not to report the item. [see paragraph 9]

- (c) While sequencing standard-setting or accounting decisions in that manner will help resolve conflicts, resolving some conflicts between relevance and faithful representation will still require judgment by standard-setters and practitioners. [see paragraph 18]

**Comparability (including consistency)**

- (d) Comparability should be considered after an initial assessment of relevance and faithful representation. [see paragraph 25]
- (e) When comparability is not achieved, consideration should be given as to whether there is an alternative phenomenon that also has an appropriate degree of relevance and faithful representation, but enhances comparability. [see paragraph 26]
- (f) When comparability cannot be achieved, but information is nonetheless relevant, depicts real world economic phenomena, is understandable, the benefits justify the costs and the item is material, it should be reported, perhaps with disclosures to compensate for the lessened comparability. [see paragraph 27]

**Understandability**

- (g) Understandability should be positioned as a complementary attribute to relevance, faithful representation and comparability, that needs to be considered at both the input level — in evaluating the depiction of individual real world economic phenomena and at the output level — in evaluating the depiction of the aggregate of decision-useful reportable items. [see paragraph 36]

**Costs and benefits**

- (h) No recommendations are made at this time. [see paragraph 47]

**Materiality**

- (i) There is no need to report immaterial information as it is not decision useful. [see paragraph 51]

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- (j) Materiality of an item is considered once a relevant, faithfully represented item is considered comparable, understandable and the benefits exceed the costs. [see paragraph 52]

**Building the report**

- (k) Once items have been selected for reporting, the process shifts to building the financial reports, applying the other qualitative characteristics focusing particularly on completeness, comparability, and being clear and concise. [see paragraph 55]

**Timeliness**

- (l) Timeliness is necessary for relevance and can be assessed only at the end of the process that produces the financial report [see paragraph 58]

**Summary recommendation**

- (m) The flow process (depicted in Illustration 1) is preferable to the previous “bargaining” or “hierarchical” approaches to dealing with relationships between qualitative characteristics, and work should continue to further refine this approach.

## **Appendix A: A different perspective on the first part of the process**

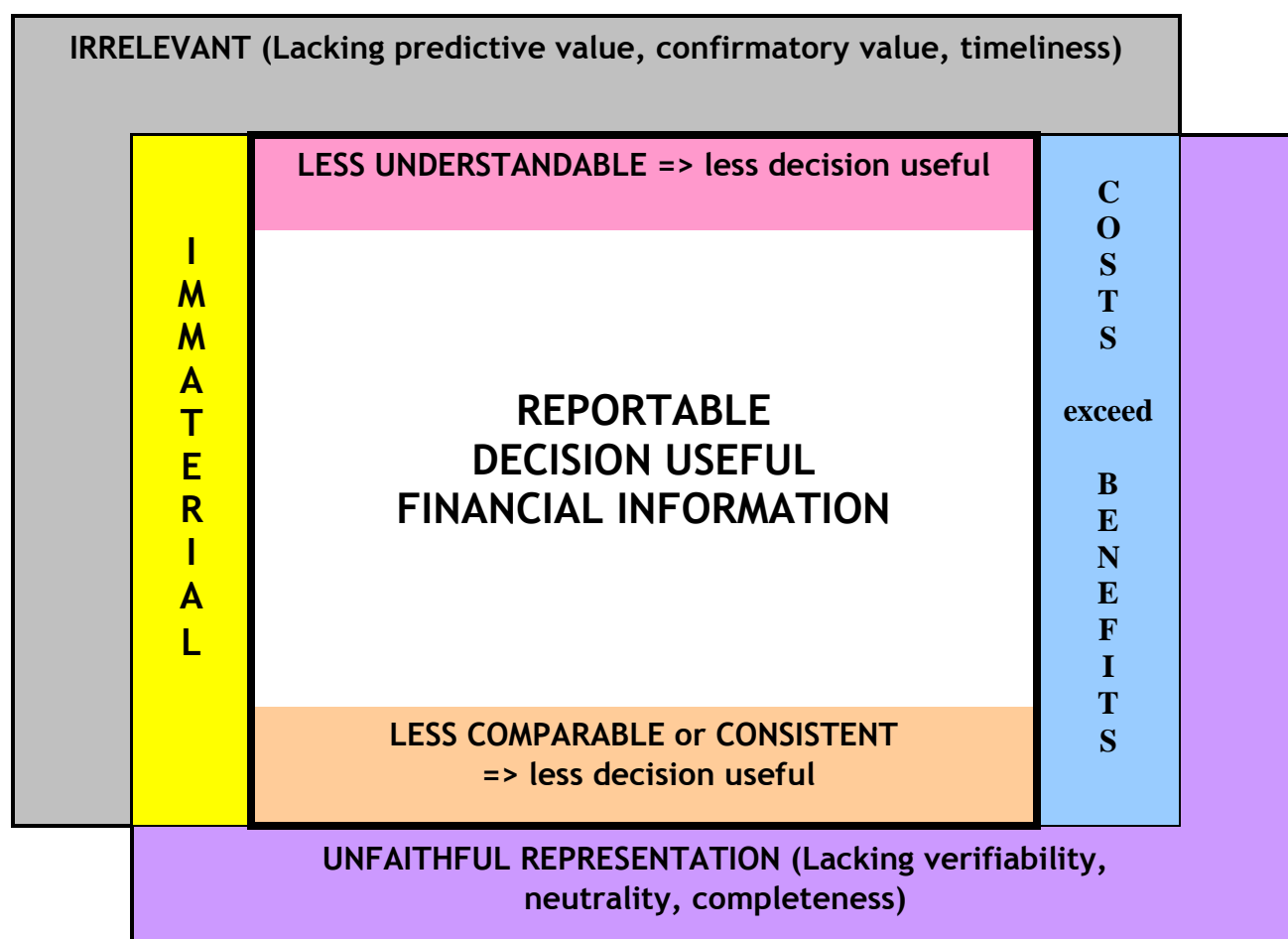
- A1. A different way of viewing the results of the input selection process discussed so far in this paper is depicted in Illustration 2. This visualizes the process as a selective exclusion or “weeding” process.
- A2. Like the process in Illustration 1, the weeding process in Illustration 2 starts with real-world economic phenomena. It “weeds-out” those phenomena that do not sufficiently satisfy the qualitative characteristics — pushing them to the sides — leaving those phenomena that meet the qualitative characteristics of decision-useful financial reporting at the centre. (Picture a beautifully manicured garden in the bold centre box, with all the weeds having been discarded to the sides.) Unlike the flow process in Illustration 1, the weeding process does not place as much emphasis on the order in which phenomena are weeded-out and retains some measure of “bargaining” to assess which phenomena best satisfies the objective of decision-useful financial reporting.
- A3. The weeding process first pushes to one side, and rejects irrelevant economic phenomena and economic phenomena for which there is no faithful representation. This is similar to steps 2 and 3 of the flow chart.
- A4. The weeding process also sets aside immaterial items (equivalent to step 7 of the flow chart) and items for which the collective benefits of reporting the item do not justify the collective costs (equivalent to step 6 of the flow chart). All other items remain in the bold centre box as candidates for reportable decision useful financial information. The best of this would be at the centre (the prized rose bushes) — those items that maximize relevance and faithful representation, with no need for any reduction in comparability or understandability. However, the reality is that the perfect solution will not be available in all cases. Therefore, one might find oneself moving away from the centre of the illustration, sacrificing one or another quality, but enhancing an alternative quality. As long as one remains within the bounds of the bold central box, the information remains decision useful, even though it might be less understandable or less comparable (the surrounding lawns and shrubbery also contribute to the garden).

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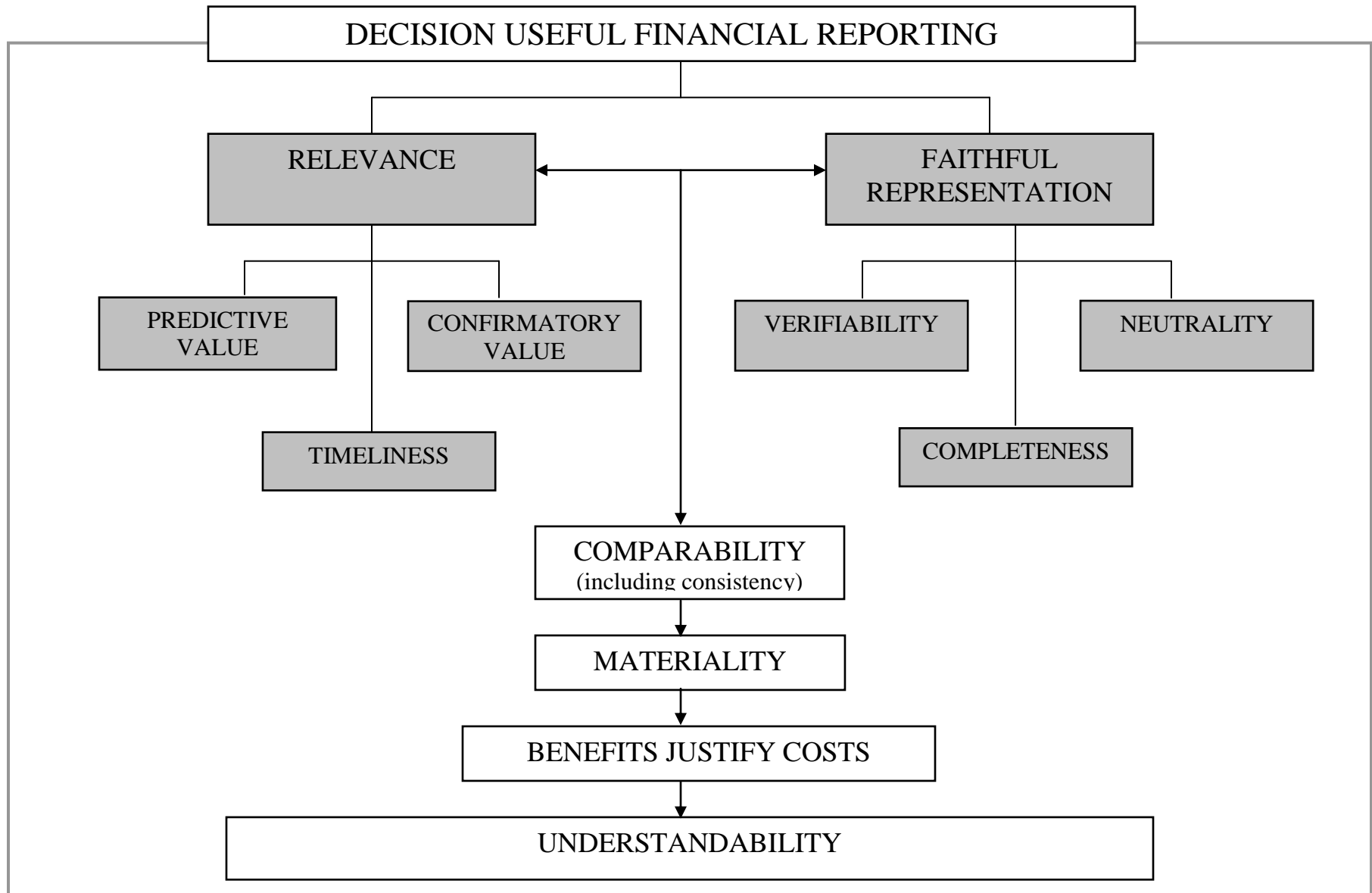
- A5. Choices must also be made in determining which information to report. That which is more decision-useful would be reported in preference to that which is less decision useful (just as certain flowers might be chosen for the garden whose colour or height fits with those of the rose bushes, while other flowers are rejected). Professional judgment must be used to select the most decision-useful information for financial statement users.

**Illustration 2: Decision Useful Financial Information**

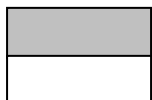
This Illustration portrays what comprises reportable decision useful financial information. Financial information that is irrelevant, is an unfaithful representation, is immaterial or for which the costs exceed the benefits is pushed to the sides — it is not reportable. Reportable decision-useful financial information is in the centre. Financial reporting might include information that is less understandable or less comparable or consistent, but which is nonetheless still decision useful.



## Appendix B: Hierarchy of Qualitative Characteristics (as discussed in May and June)



### Legend



Characteristics of financial information agreed upon at the May 2005 Board Meetings

Characteristics of financial information discussed at the June 2005 Board Meetings



## APPENDIX C

### QUALITATIVE CHARACTERISTICS - SUMMARY

#### Summary of tentative decisions made in prior meetings

#### Sources: FASB Action Alert and IASB Update

- QC1 In FASB Concepts Statement No. 2, “Qualitative Characteristics of Accounting Information” (CON2), should comparability be elevated to the same level as relevance and reliability (faithful representation)? (NB: also convergence issue) [June 2005]

*Comparability* is an important characteristic of decision-useful financial information and should be included in the converged conceptual framework. Comparability – which enables users to identify similarities in and differences between economic phenomena – should be distinguished from consistency – the consistent use of accounting methods. Concerns about comparability or consistency should not preclude reporting information that is of greater relevance, or that more faithfully represents the economic phenomena it purports to represent. If such concerns arise, disclosures can help to compensate for lessened comparability or consistency.

- QC.2 What do we mean by reliability? (a) Many equate reliability with verifiability, not representational faithfulness. (b) Can it be empirically measured? [May 2005]

- (a) Financial information needs to be *verifiable* to provide assurance to users that the information faithfully represents what it purports to represent and that the information is free from material error, complete, and neutral. Descriptions and measures that can be directly verified through consensus among observers are preferable to descriptions or measures that can only be indirectly verified.

*Faithful representation* of real-world economic phenomena is an essential qualitative characteristic, which includes capturing the substance of those economic phenomena. Faithful representation also includes the quality of *completeness*. The common conceptual framework will need to discuss thoroughly what faithful representation means, and what it does not mean.

- (b) Although empirical research may provide evidence useful in standard-setting decisions, for example, in assessing trade-offs between desirable qualities, the conceptual framework project should not seek to develop empirical measures of faithful representation or its component qualities.

- QC.3 Relevance versus reliability – does one always trump the other? [May 2005]

*Relevance* is an essential qualitative characteristic. To be relevant, information must be capable of making a difference in the economic decisions of users by helping them evaluate the effect of past and present events on future net cash inflows (predictive value)

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or confirm or correct previous evaluations (confirmatory value), even if it is not now being used. Being capable of making a difference, rather than now being used, is a change from the present IASB framework; confirmatory rather than feedback value is a change from the present FASB framework. Also, the information must be available when the users need it (timeliness).

- QC.4 Different standards have different hurdles for what represents “reliable” measurement – is this because we are applying different meanings of reliable (e.g., depending on desired outcome)? Or is it because of different trade-offs between relevance and reliability? Or is it the influence of conservatism? Why is some information “sufficiently” reliable for balance sheet recognition but not for income statement (e.g., valuation changes recognized directly in equity)? [May 2005]

Representations are faithful - there is correspondence or agreement between the accounting measures or descriptions in financial reports and the economic phenomena they purport to represent when the measures and descriptions are verifiable and the measuring or describing is done in a neutral manner. Therefore, faithful representation requires completeness, not subordinating substance to form, verifiability, and neutrality. Consequently, the common framework should drop the widely misinterpreted term *reliability* from the qualitative characteristics, replacing it with *faithful representation*. That replacement is a change from the current IASB and FASB frameworks.

- QC5 Is transparency a qualitative characteristic and what does it mean? Is it the sum of all qualitative characteristics? (E.g., IASCF Constitution: objective is to develop accounting standards that require “high quality, transparent, and comparable information...” ) [June 2005]

*Transparency*, often cited recently as a desirable characteristic of financial information, seems to be difficult to define. In current usage, it appears to encompass some of the qualitative characteristics already included in the frameworks. Because it would be redundant, transparency should not be added to the converged framework as a separate qualitative characteristic of decision useful financial information.

- QC.6 What is predictive value? (e.g., in statistics, persistence vs. mean reversion). [May 2005]

Accounting information has *predictive value* if users use it, or could use it, to make predictions. Accounting information is not intended in itself as a prediction, nor as synonymous with statistical predictability or persistence.

- QC.7 What is the role of conservatism? Does it conflict with neutrality? If not, why not? Why keep it? [May 2005]

Financial information needs to be *neutral* - free from bias intended to influence a decision or outcome. To that end, the common conceptual framework should not include conservatism or prudence among the desirable qualitative characteristics of accounting information. However, the framework should note the continuing need to be careful in the face of uncertainty.

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QC8 Is 'true & fair' a qualitative characteristic? Is it just faithful representation? [June 2005]

Other possible characteristics considered do not describe attributes of decision useful financial information that are distinct from other qualitative characteristics and should not be added as qualitative characteristics in the converged framework.

QC9 Is materiality a QC or just a filter (e.g., to determine if information relevant in the context of the entity)? [June 2005]

*Materiality* relates not only to relevance, but also to faithful representation. Materiality should be included in the converged framework as a screen or filter to determine whether information is sufficiently significant to influence the decisions of users in the context of the entity, rather than as a qualitative characteristic of decision useful financial information.

QC10 What do we mean by understandability? [June 2005]

*Understandability* also is an essential characteristic of decision-useful financial information and should be included in the converged conceptual framework. Information is made more understandable by aggregating, classifying, characterizing, and presenting it clearly and concisely. Whether reported information is sufficiently understandable depends on who is using it. The information in general-purpose external financial reports should be understandable by financial statement users who have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information with reasonable diligence. Relevant information should not be excluded because it is too complex or difficult for certain users to understand.

The converged framework should include presumptions not only about the capabilities of financial statement users but also about the capabilities of financial statement preparers and auditors.

QC11 Other candidates for qualitative characteristics? [June 2005]

Other possible characteristics considered, including credibility, high quality and internal consistency, do not describe attributes of decision useful financial information that are distinct from other qualitative characteristics. Thus, they should not be added as separate qualitative characteristics in the converged framework.

**Cross-cutting issues remaining to be addressed**

QC13 Cost/benefit - do the qualitative characteristics, especially the cost/benefit balance, differ for different entities, e.g., large/small, listed/unlisted, widely dispersed ownership vs. closely held? [scheduled for September 2005]

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.



# Illustration 1: Using the Qualitative Characteristics for Standard-Setting and to Build Decision-Useful Financial Reports

