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International
Accounting Standards
Board

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These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting: 18 April 2007, London

Project: Conceptual Framework

Subject: **Phase A Redeliberations: Qualitative Characteristics of Decision-Useful Financial Reporting Information (Agenda Paper 5)**

INTRODUCTION

1. At the Boards' February meetings, the staff presented an analysis of comments received related to the Discussion Paper (DP), *Preliminary Views on an Improved Conceptual Framework for Financial Reporting: The Objective of Financial Reporting and Qualitative Characteristics of Decision-Useful Financial Reporting Information*. In this paper, the staff presents alternatives and make recommendations for addressing the concerns raised by respondents regarding the qualitative characteristics. A future paper will address the comments received regarding the objective of financial reporting.
2. In cases where the staff quotes a comment letter received, this memo does not identify the respondent and letter number in the text. Rather, endnotes are provided which list the applicable letter number and respondent identifying information so that Board members may conduct further research if desired.
[Sentences omitted from Observer Notes.]

REDELIBERATIONS RELATED TO THE QUALITATIVE CHARACTERISTICS

3. After analyzing the comments received, the staff identified several issues related to the qualitative characteristics for the Boards' consideration. Those issues are: faithful representation, understandability, the constraints on financial reporting, and conservatism as a potential additional qualitative characteristic. The staff thinks that these issues are the only issues raised by respondents that require decisions by the Boards. Those respondent comments which were identified by the staff in its analysis of comment letters but which are not discussed in this memo are deemed by the staff to be matters that can be handled in drafting or that do not require any Board action. For example, although some respondents commented on the qualitative characteristics of relevance and comparability, the staff did not identify any issues related to those qualitative characteristics that would require redeliberation. Board members should alert a member of the staff if there is a matter that the Board member thinks the staff has overlooked. In any case, additional matters may arise during the staff's work on drafting the exposure document that require Board action. Those issues will be brought to the Boards as needed.
4. There were comments related to the distinction between financial statements and financial reporting that discuss the applicability of the qualitative characteristics to different types of information. For example, some commented that verifiability may be an appropriate qualitative characteristic for financial statements but be inappropriate for some other types of financial reporting, such as management's discussion and analysis. This memo does not address those comments. They will be addressed in a future memo that focuses on Chapter 1 of the DP.

Comments Related to Faithful Representation

Issues Raised

5. Faithful representation was by far the most frequently cited qualitative characteristic in comment letters. 73% of respondents commented unfavorably on the DP's explanation of faithful representation and the components thereof.

Many objected to the Board's decision to replace reliability in the Boards' frameworks with faithful representation. Some rejected the Boards' assertion that *faithful representation* means essentially the same thing as *reliability*, as the latter term has been used in the existing frameworks. Finally, some respondents objected to the inclusion of verifiability as a component of faithful representation. Each issue is discussed in turn below.

6. Many respondents objected to the DP's description of the replacement of reliability in the existing frameworks with faithful representation in the DP. For example, a letter from a regulatorⁱ states:

[We believe] that IASB is wrong to describe replacing reliability with faithful representation as not being a change of substance. Faithful representation is a narrower notion than reliability...Bearing in mind that under existing Framework faithful representation is just one sub-characteristic of reliability, it follows that reliability must be a broader notion than faithful representation. It therefore must follow that, in replacing reliability with faithful representation, there is either a change of substance or a change in the meaning of the term faithful representation.

7. Some respondents took issue with the Boards' description of faithful representation. 12% of respondents noted that *substance over form* should be included as a component of faithful representation, rejecting the Boards' assertion that to do so would be redundant. A letter from a professional organizationⁱⁱ states:

Substance over form...should be identified as a component of faithful representation—in fact as the primary component, as it is in our view more important than verifiability, neutrality or completeness...The discussion paper states that “the quality of faithful representation is incompatible with representations that subordinate substance to form. Accordingly, the proposed framework does not identify *substance over form* as a component of faithful representation because to do so would be redundant” (BC2.18)...According to the discussion paper, the quality of faithful representation is also incompatible with the absence of the qualities of verifiability, neutrality and completeness. But this has not prevented the two Boards identifying them as components of faithful representation.

8. Some respondents suggested that verifiability should not be a component of faithful representation. Those constituents argued that certain useful information presented in financial reports can faithfully represent what it

purports to represent while not being verifiable. Those respondents expressed concern that including verifiability as a component of faithful representation will result in information being excluded from financial reporting that is useful for decision making. A comment from a preparerⁱⁱⁱ states:

Financial information is either verifiable or it is not; greater verifiability does not, in our view, equate with greater reliability/faithful representation, nor does it necessarily improve the usefulness of financial information...The emphasis on verifiability will result in future accounting standards that are rules-based rather than principles-based.

9. Other respondents suggested that reliability should be retained as a qualitative characteristic because verifiability is a component of reliability but it is not a component of faithful representation. However, these constituents' descriptions of reliability varied greatly and in most cases differed substantively from the Boards' intended meaning of the term in their existing frameworks. For example, a letter from a Big Four accounting firm^{iv} states:

Reliability is an important component of faithful representation and consequently the Boards should include the role of reliability in the discussion of faithful representation. Reliability of measurement represents the extent to which measurement yields the same results when performed by different qualified parties and is closely associated with verifiability.

10. That description of *reliability* is very similar to the Boards' description of *verifiability* as a component of faithful representation. Paragraph QC23 of the DP states:

Verifiability implies that different knowledgeable and independent observers would reach general consensus, although not necessarily complete agreement, either:

1. that the information represents the economic phenomena that it purports to represent without material error or bias (by direct verification); or
2. that the chosen recognition or measurement method has been applied without material error or bias (by indirect verification).

11. Some constituents also responded unfavorably to the Boards' description of indirect verification in the DP. A letter from a Big Four accounting firm^v states:

We do not agree that information should be considered to be verified simply because knowledgeable and independent observers would reach general consensus that the chosen recognition or measurement *method* has been applied without material error or bias...[The Boards' definition of *verifiability*] requires only that the information has been arrived at by a method that has been applied correctly, not that the method itself is appropriate or reliable or that it has been applied to reliable data...Information should be considered to be verified when knowledgeable and independent observers would reach general consensus that the information both represents the economic phenomena that it purports to represent *and* that the chosen recognition or measurement method has been applied without material error or bias.

12. Paragraph QC26 of the DP states:

Indirect verification is generally based on the same method used to produce the amount being verified. Thus, even though different verifiers reach consensus, an indirectly verified amount may not faithfully represent the economic phenomena that it purports to represent because the method used may give rise to material error. Even though indirect verification does not guarantee the appropriateness of the method used, it does carry some assurance that the method used, whatever it was, was applied carefully and without error or personal bias on the part of the one applying it. [Emphasis added.]

Staff Analysis

13. The staff thinks that it is clear from the analysis of the comment letters that reliability is not a well-understood term. While many respondents indicated that reliability should be retained as a qualitative characteristic because it is well understood, each of those respondents described reliability in a very different way from the way it is described in the Boards' existing frameworks. In many cases, respondents' descriptions of reliability more closely resembled the Boards' notion of verifiability than the Boards' notion of reliability. As such, the staff thinks that the Boards' decision to replace reliability with faithful representation gives the document the best chance of being understood as the Boards intend it.
14. The staff thinks that there is validity to some of the respondents' concerns about the DP's description of faithful representation. The staff agrees with respondents that the DP could be improved by a more robust discussion of the relationship between faithful representation and the notion of substance over

form. The existing IASB framework notes that substance over form is a necessary condition of faithful representation. FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*, states that the quality of representational faithfulness leaves no room for accounting representations that subordinate substance to form. The DP cites both existing frameworks and concludes that inclusion of substance over form is unnecessary because faithful representation is incompatible with information that subordinates substance to form. However, the DP fails to demonstrate why the Boards have chosen to elaborate on verifiability, neutrality, and completeness when the same argument can be made for these components. For example, it is equally true to say that faithful representation is incompatible with information that is not neutral or complete.

15. While the DP specifically identifies some components of faithful representation that needed further elaboration (verifiability, neutrality, and completeness), those components by themselves do not fully encompass the meaning of the qualitative characteristic. Rather, the components are necessary but not sufficient to establish a faithful representation. (Whether verifiability is in fact a necessary condition is discussed in the next paragraph.) The component that is not explicitly described is the requirement that the information must be a good faith depiction of the economic substance of the underlying phenomenon. That component is embodied in the primary characteristic *faithful representation*. In other words, depiction of the economic substance of a particular phenomenon (regardless of whether the substance corresponds to the form) is not a component of faithful representation; it is a synonym for it.
16. The staff thinks there is some validity to respondent comments that indicated that verifiability should not be a component of faithful representation. While neutrality and completeness contribute to faithful representation, verifiability does not. A piece of information can be a good faith depiction of the economic phenomenon that it purports to represent, regardless of whether the information is verifiable. Conversely, if information lacks neutrality or completeness, then by definition it cannot be a faithful representation of the phenomenon it purports to represent. On the other hand, information which perfectly reflects the economic substance of the phenomenon that it purports to represent may not be

verifiable, and that fact does not diminish the extent to which it is a faithful representation. Take, for example, a piece of information that is influenced by management's opinion or management's intent. While management presumably knows what it thinks or what it intends at a given point in time, verification of that belief by another would not be possible. The fact that the information is unverifiable might render it less useful for decision making in the eyes of financial reporting users, but it does not diminish the extent to which the information is a faithful representation of management's opinion or intent. Accordingly, while verifiability has an undeniable place in the qualitative characteristics, it does not fit as a component of faithful representation.

17. Some constituents commented that indirect verification should require use of an appropriate method in addition to requiring that the method be applied correctly, as an inappropriate method would not result in faithfully represented information. The staff thinks that this argument derives from the fact that verifiability is included as a component of faithful representation. In this context, some respondents are confused about how the Board can argue that indirect verification of information may not contribute evidence that the information is faithfully represented. On the other hand, if verifiability was not a component of faithful representation, the assertion is easier to understand. Just as a faithfully represented item may not be relevant, it also may not be verifiable.

Staff Recommendation

18. The staff has the following recommendations regarding faithful representation that it thinks will address many respondents' concerns:
 - a. Retain faithful representation as a primary qualitative characteristic.
 - b. Separate verifiability from faithful representation and describe it as a primary qualitative characteristic.
 - c. Clarify the description of faithful representation to make clear that faithful representation requires depiction of the economic substance of the underlying phenomenon regardless of its form and that neutrality and

completeness are necessary but not sufficient to achieve faithful representation.

Retain faithful representation

19. The staff thinks that it is clear that the Boards' descriptions of reliability in their existing frameworks are not understood or accepted by their constituencies. The staff thinks that the Boards' decision to replace the term rather than make further efforts to clarify its description was a good one. Accordingly, the staff recommends that the Board retain the replacement characteristic of faithful representation and attempt to clarify that characteristic in order to address the remaining concerns raised by respondents.

Separate verifiability from faithful representation

20. The staff recommends that verifiability be described as an enhancing qualitative characteristic rather than a component. The staff recommends that the DP section titled "How the Qualitative Characteristics Relate to the Objective of Financial Reporting and to Each Other" be modified to accommodate the change in status of verifiability. The staff thinks that verifiability should fall in logical order after comparability and understandability. Extending the logic in the DP, one first determines if a particular phenomenon is relevant, and then one determines the best way to faithfully represent that phenomenon. Once that step is complete, one should determine the extent to which the information is comparable, understandable, and verifiable. Presumably, verifiability will be more important to decision usefulness for some types of information than others. In the same way that relevance and faithful representation are complementary, verifiability also works in concert with the other qualitative characteristics.
21. The staff thinks that the Boards should retain their description of indirect verification in the DP, as long as verifiability is a separate characteristic from faithful representation. If verifiability is not a component of faithful representation, then the Boards can explain in the Exposure Draft that indirectly verified information may not faithfully represent the economic phenomenon; however, it is important to maximize all qualitative characteristics in determining the appropriate accounting for a transaction (and thus achieving faithful representation is still necessary).

22. Some staff members are concerned that identifying verifiability as a qualitative characteristic will overemphasize the importance of verifiability to decision usefulness. They are concerned that constituents might view the identification of what was formerly a component of a qualitative characteristic as a stand-alone qualitative characteristic elevates its importance for decision usefulness. Other staff members think that identifying verifiability as an enhancing qualitative characteristic, thus placing it on the same plane as comparability and understandability, actually establishes an appropriate level of importance. Those staff members think that the DP overemphasizes the importance of verifiability by including it as a component of a necessary qualitative characteristic (faithful representation).

Clarify description of faithful representation

23. The staff recommends that the DP include a more robust discussion of the relationship between faithful representation and the concept of substance over form. The Boards acknowledged in paragraph BC2.18, “The Boards concluded that the qualitative characteristic of faithful representation encompasses ensuring that financial reports represent the substance of an economic phenomenon (such as a particular transaction) rather than solely its legal form.” The staff recommends that discussion be included in the chapter itself rather than basis for conclusions. The staff also thinks that it is important to clarify in the Exposure Draft that the explicitly identified components of faithful representation (neutrality and completeness) are necessary for a faithful representation but they are not in and of themselves sufficient for a faithful representation. Depiction of the economic substance of the phenomenon is also necessary.

Understandability

Issues Raised

24. Some respondents commented that there is incongruence between the primary user group identified in the DP and the discussion of understandability as a qualitative characteristic. Those who commented on the discrepancy requested that the Boards align the primary user group with the group for whom financial

reports should be understandable. A letter from an investor/analyst/creditor^{vi} stated:

Paragraph S13 of the Preliminary Views document suggests that users of financial reports will have “a reasonable knowledge of business and economic activities, and **financial accounting...**” (Emphasis added.) We maintain, however, that many of the primary users of financial reports actually have very little knowledge of financial accounting requirements.

Staff Analysis

25. Paragraph S5 of the DP states, “Standard-setters presume that those who use the resulting information will have a reasonable knowledge of business and economic activities and be able to read a financial report.” Furthermore, paragraph QC39 states, “*Understandability* is the quality of information that enables users who have a reasonable knowledge of business and economic activities and financial reporting, and who study the information with reasonable diligence, to comprehend its meaning.” The above sentences make it clear that the Boards’ intention is to make financial reports understandable to people who have a degree of financial knowledge. However, paragraph OB12 states, “Investors and creditors (and their advisers) are the most prominent external groups who use the information provided by financial reporting and who generally lack the ability to prescribe all of the information they need...the primary users of general purpose financial reports are present and potential investors and creditors (and their advisers).” This sentence implies that advisors themselves are users of financial information, rather than merely advisors to the primary users.
26. The staff thinks that it is crucial for the framework to draw a clear link between the objective of financial reporting and the rest of the framework. If the objective drives the framework, the framework drives the standards, and the standards drive financial reporting, then the staff can expect that the objective will be met by the financial reporting. In the case of understandability, the staff thinks that the DP should be more explicit in linking the qualitative characteristic to the objective, specifically the primary user group identified in the objective. While the Chapter 2 discussion of understandability discusses

users generally, it does not discuss the primary user group of present and potential investors, creditors, and their advisors. It should also be noted that the Boards received many comments from respondents addressing the Boards' identification of a primary user group in Chapter 1 of the DP. The staff will present its analysis of those comments at a future meeting and may make recommendations regarding who constitutes the primary users at that time.

Staff Recommendation

27. The staff thinks that it is crucial to align the descriptions of the primary user group with the discussion of understandability. Understandability as a qualitative characteristic is useless in application unless the Boards have a clear idea of who should be able to understand the information. The discussion in the DP is focused on the requisite knowledge that the Boards expect a user to possess, but there is no discussion in Chapter 2 of the primary user group identified in Chapter 1 and whether that user group can be expected to possess that requisite level of knowledge.
28. The staff also notes that the Board has included advisors to investors and creditors in its primary user group but has not indicated whether this decision means that investors and creditors are expected to require advisors to understand financial reporting information. The staff recommends that the discussion in the DP be expanded to address the role of advisors in the financial reporting system, including whether the Boards' expect that the primary user group should or should not be expected to be able to comprehend financial reporting information without the assistance of a professional advisor.
29. Because the discussion of understandability is inextricable from the Chapter 1 discussion of the primary user group, the staff expects that the recommendations on understandability could continue to evolve as respondent comments on Chapter 1 continue to be analyzed. Based on analysis to date, the staff is recommending only that the discussion in the DP be expanded to more clearly link it to the primary user group and to clarify the role of advisors.

Constraints on Financial Reporting

Issues Raised

30. Some constituents commented that materiality and timeliness affect many of the qualitative characteristics in the same manner, and as such, it is illogical to consider timeliness to be a component of relevance while materiality is considered a pervasive constraint. For example, a letter from a standard-setter states^{vii}, “Timeliness is just like materiality—it affects several qualitative characteristics, including faithful representation and reliability.”

Staff Analysis

31. The staff thinks that timeliness differs from the other components of relevance (predictive value and confirmatory value). Information has relevance as a consequence of the predictive value or confirmatory value that the information contains. The more useful that information is for predicting cash flows or for confirming expectations, the more relevant that information is by definition. On the other hand, some information can be reported in a timely manner and have no relevance at all, and other types of information can be delayed in reporting and remain quite relevant. Timeliness does not support relevance; both are important features of decision-useful financial reporting, but the two concepts are distinct. Thus, the staff thinks that timeliness can be viewed as similar to materiality in that “each concerns why some information is included in financial reports and other information, or the same type of information in different circumstances, is not” (paragraph QC48).
32. Paragraph QC50 states that timeliness is also similar to materiality in that “it is not a matter to be considered by standard setters.” Timeliness and materiality are similar in that both are more applicable to preparers than they are to standard setters, though there have been instances in which standard setters have used both.

Staff Recommendation

33. The staff recommends that timeliness be separated from relevance and identified instead as a pervasive constraint. The staff thinks timeliness is much more

closely related to materiality than it is to the components of relevance with which it has been associated in the DP. Both materiality and timeliness affect the qualitative characteristics in similar ways. An item which would otherwise be a relevant piece of information becomes less relevant as it becomes less material. By the same token, an item may become less comparable as the reporting of a particular piece of information becomes less timely. On the other hand, faithful representation may be improved as reporting of information is delayed because some uncertainties may be resolved as time passes. For example, a fair value estimate which is reported in a timely manner may represent what it purports to represent less effectively. The current tax provision reported in March purports to represent the taxes due in September. If a company waited until September to report the current tax provision for the first quarter, it would be more faithfully represented but less timely.

34. An alternative approach preferred by some staff members would be to describe timeliness not as a constraint or as a component of a qualitative characteristic, but rather to identify timeliness as a property of information that enhances relevance and potentially other qualitative characteristics. Similarly, materiality can be viewed as a property of information that enhances relevance and understandability and potentially other qualitative characteristics. Ultimately, the staff decided against this recommendation because there was a concern that introducing another term in addition to the terms *qualitative characteristic* (necessary or enhancing), *component*, and *constraint* would confuse the discussion of how the qualitative characteristics relate to each other.

Prudence/Conservatism

Issues Raised

35. Many constituents argued that prudence, or conservatism, should be included as a qualitative characteristic or as component of the qualitative characteristic of faithful representation. Some respondents acknowledged that there is a tension between conservatism and neutrality, but argued that similar tensions exist between other characteristics such as relevance and faithful representation. Thus, the fact that a tension exists is not a compelling argument for excluding conservatism. Some respondents argued that it will be difficult to apply the

concept of neutrality to determine the appropriate fair value measurement for an asset that does not have a readily determinable fair value. Constituents suggested that it would be appropriate to use the concept of conservatism in such a circumstance, because when there is considerable uncertainty in measurement, the consequences of misstatement in one direction may be more severe than the consequences of a misstatement in the other direction. A letter from a professional body^{viii} states:

The Board's treatment [of prudence] seems to stem from a misunderstanding of the concept of prudence; this concept does not allow for deliberate understatement of assets or income or overstatement of liabilities or expenses. Prudence is a concept providing for the inclusion of a degree of caution in the exercise of the judgments needed in making the estimates required under conditions of uncertainty.

Staff Analysis

36. It is not surprising that some respondents objected to the DP's assertion that neutrality is incompatible with conservatism. Concepts Statement No. 2, paragraphs 91-110, discusses conservatism and neutrality at length. The tension between the two is acknowledged, but incompatibility is not asserted. Paragraph 95 states, "Conservatism is a prudent reaction to uncertainty to try to ensure that uncertainties and risks inherent in business situations are adequately considered."
37. The DP basis for conclusions, in paragraphs BC2.19-BC2.22, discusses what the Boards now think to be an inherent conflict between conservatism and neutrality. The DP clarifies that there are many acceptable responses to uncertainty in financial reporting that do not introduce a conservative bias at the cost of decreasing faithful representation. The staff does not think that respondents raised any points related to conservatism or prudence that were not addressed adequately by the Boards during deliberations and documented clearly in the resulting basis for conclusions.

Staff Recommendation

38. The staff recommends the Boards affirm their decision that conservatism is incompatible with neutrality and therefore is not included in the qualitative characteristics of accounting information.

SUMMARY OF QUESTIONS FOR THE BOARDS

39. The staff seeks decisions from the Boards at this meeting on the following questions. Do the Boards agree with the staff's recommendations:
1. To retain faithful representation as a qualitative characteristic?
 2. To separate verifiability from faithful representation, elevate it to an enhancing qualitative characteristic, and place it in logical order after understandability and comparability?
 3. To clarify the description of faithful representation as indicated?
 4. To expand the discussion of understandability in the DP to link it more clearly to the identified primary user group and to clarify the role of advisors in understanding financial information?
 5. To separate timeliness from relevance and present it instead as a pervasive constraint similar to materiality?
 6. To affirm the Boards' decision that conservatism is incompatible with neutrality and should not be included among the qualitative characteristics?

ⁱ Letter 179 from EFRAG

ⁱⁱ Letter 163 from the Institute of Chartered Accountants in England and Wales

ⁱⁱⁱ Letter 92 from Shell International

^{iv} Letter 97 from KPMG

^v Letter 127 from Ernst & Young

^{vi} Letter 40 from Mind the GAAP

^{vii} Letter 55 from the Austrian Financial Reporting and Auditing Committee

^{viii} Letter 33 from Institut der Wirtschaftsprüfer