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International
Accounting Standards
Board

This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.
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:	**December 2007, London**
Project:	**Conceptual Framework**
Subject:	**Consequential amendments to the framework: reliability of measurement (Agenda Paper 10)**

INTRODUCTION

1. At the October 2007 meeting, the Board decided that when Chapters 1 and 2 of the updated conceptual framework are finalised, there will be no consequential amendments to the IASB *Framework* (hereafter, the *Framework*), unless considered necessary. The Board also asked the staff to consider the implications for the Board and constituents when we merge the finalised new chapters with the existing *Framework*. This paper discusses the options available, particularly in relation to the replacement of the term 'reliability' with 'faithful representation' and its implications for the recognition criteria.

BACKGROUND INFORMATION

2. Pre-ballot draft I of the ED describes faithful representation as follows:

QC8 Financial information represents economic phenomena in words and numbers in financial reports. To be useful to capital providers, that information must be a faithful representation of the economic phenomena that it purports to represent. Faithful representation is attained when the substance of an economic phenomenon is depicted in a complete, accurate, and neutral manner.

…

(Subsequent paragraphs of the draft ED elaborate further on *substance of the economic phenomena*, *accuracy*, *neutrality* and *completeness* as aspects of faithful representation. Attachment A to this memo contains extracts of these paragraphs.) [These extracts have been omitted from the observer note].

3. The basis for conclusions in Chapter 2 explains that that reliability and faithful representation are essentially the same, and also explains why the Board proposed the new terminology. Paragraph BC2.29 in the DP says that:

BC2.29 To avoid confusion from using two terms to mean essentially the same thing, the remainder of this Basis for Conclusions uses the term faithful representation rather than reliability, even in referring to the existing frameworks that use the latter term.

4. Extracts from the existing *Framework* on reliability and reliability of measurement are as follows:

31 To be useful, information must also be reliable. Information has the quality of reliability when it is free from material errors and bias and can be depended upon by users to represent faithfully that which it either purports to represent or could reasonably be expected to represent.

….

[Subsequent paragraphs of the *Framework* (paragraphs 32–38) discuss *substance over form*, *neutrality*, *prudence*, and *completeness* as aspects of faithful representation. Attachment A contains extracts of these paragraphs.]

…

83 An item that meets the definition of an element should be recognised if:

(a) it is probable that any future economic benefit associated with the item will flow to or from the entity; and

(b) the item has a cost or value that can be measured with reliability.

Reliability of Measurement

86 The second criterion for the recognition of an item is that it possesses a cost or value that can be measured with reliability as discussed in paragraphs 31 to 38 of this *Framework*. In many cases, cost or value must be estimated; the use of reasonable estimates is an essential part of

the preparation of financial statements and does not undermine their reliability. When, however, a reasonable estimate cannot be made the item is not recognised in the balance sheet or income statement. For example, the expected proceeds from a lawsuit may meet the definitions of both an asset and income as well as the probability criterion for recognition; however, if it is not possible for the claim to be measured reliably, it should not be recognised as an asset or as income; the existence of the claim, however, would be disclosed in the notes, explanatory material or supplementary schedules.

STAFF ANALYSIS ON UPDATING THE *FRAMEWORK*

5. In updating the *Framework*, the staff envisages the following:

New framework =		
	New Chapters 1 and 2	
	Add	existing *Framework*
	Less	(paragraphs 9-21 + paragraphs 23-46)[1]
	Add	other necessary consequential amendments

6. Updating the *Framework* in some cases will be fairly easy. For example, paragraph 84 in the existing *Framework* can be updated as follows:

84 In assessing whether an item meets these criteria and therefore qualifies for recognition in the financial statements, regard needs to be given to the materiality considerations discussed in ~~paragraphs 29 and 30~~Chapter 2. The interrelationship between the elements means that an item that meets the definition and recognition criteria for a particular element, for example, an asset, automatically requires the recognition of another element, for example, income or a liability.

7. However in other places, it may not be as easy to solve the merger between the new chapters and the existing *Framework*. As noted previously, Chapter 2 of the new framework proposes to replace the term reliability with faithful representation. Withdrawing the term reliability in the *Framework* also means

[1] These are the paragraphs dealing with the objective of financial statements and the qualitative characteristics of financial statements

withdrawing supporting materials (including the definition in the Glossary) on what reliability means.

8. Constituents could refer to a dictionary on what reliability means. The Oxford English dictionary defines reliable as: something or someone that is reliable can be trusted or believed because they work or behave well in the way you expect. In contrast, reliability is defined in the *Framework* as follows: "information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully that which it purports to represent or could reasonably be expected to represent".

9. Constituents could also deduce by analogy the meaning of reliability or reliable. For example, they could refer to IAS 39—paragraphs AG80 and AG81 explain the circumstances when it is not possible to reasonably measure a financial instrument at fair value. Another example is paragraph 25 in IAS 37 notes that an entity will be able to determine a reliable measure of a liability, except in extremely rare cases. Attachment B shows where IFRSs provide guidance on the meaning of reliable or reliability and possible implications when constituents apply by analogy what reliable or reliability means. [These implications have been omitted from the observer note].

10. Constituents could also infer from the basis for conclusions to the new framework that reliability and faithful representation are essentially the same[2]. Paragraph 3 of this paper shows the relevant extract. However, it is not ideal to rely on the basis to tell constituents that reliability is replaced with faithful representation.

11. The rest of this paper focuses on how to deal with paragraph 86 in the existing *Framework*, ie the reliability of measurement aspect of the recognition criteria because it is the area for which the staff faced the most difficulty in trying to amend the existing *Framework*.

OPTIONS FOR THE BOARD

12. There are 3 options in addressing the issue of reliability of measurement:

    A) Delete references to paragraphs that are withdrawn.

[2] The ED will also explain that having two terms in one document will be temporary until the Board has updated the entire new framework.

B) Include a rubric to tell constituents that we have withdrawn some paragraphs in the existing *Framework* and replaced these with new chapters. To also include, by way of footnote, the existing definition of reliability the first time *reliability* appears in the new framework.

C) Update the recognition criteria to reflect the change in terminology.

Option A: Delete references to paragraphs that are withdrawn

13. In the new framework, paragraph 86 could be updated as follows:

86 The second criterion for the recognition of an item is that it possesses a cost or value that can be measured with reliability ~~as discussed in paragraphs 31 to 38 of this *Framework*~~. In many cases …..

14. The key features of Option A are:

a. The new framework does not provide a definition of reliability. Constituents can refer to a dictionary or deduce by analogy from IFRSs the meaning of reliability.

b. The new framework contains two terms: reliability and faithful representation.

c. Constituents must rely on the basis for conclusions to be informed that reliability and faithful representation are essentially the same.

Option B: Include a rubric to tell constituents that we have withdrawn some paragraphs of the existing *Framework* and replaced them with the new chapters, and include the definition of reliability as a footnote

15. The staff visualises that we can place this rubric in front of the new framework. The rubric could read as below:

Chapters 1 (the objective of financial reporting) and 2 (the qualitative characteristics of financial reporting) supersede paragraphs 9-21 and 23-46 of the *Framework for the Preparation and Presentation of Financial Statements*, which are consequently withdrawn. Where there is reference in the *Framework* to the withdrawn paragraphs, please refer to these new Chapters for guidance.

16. In addition, paragraph 86 could be updated as below:

86 The second criterion for the recognition of an item is that it possesses a cost or value that can be measured with reliability[1] ~~as discussed in paragraphs 31 to 38 of this *Framework*~~. In many cases, …

Footnote 1: Information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully that which it either purports to represent or could reasonably be expected to represent. [this is from the current definition of reliability in the *Framework*]

17. The key features of Option B are:

a. The new framework contains two terms: reliability and faithful representation.

b. Constituents must rely on the basis for conclusions to be informed that reliability and faithful representation are essentially the same.

c. The new framework contains a definition of reliability, which can be transferred to the Glossary.

Option C: Update the recognition criteria

18. Theoretically this option would provide the most elegant solution because it would remove the term reliability from the entire *Framework* and we could use only one term going forward. However, it is not possible to simply 'cut and paste' the changed terminology, which means that updating the wording of paragraph 86 (see below) is not straight forward. This update is the best that the staff could draft within a short period. In view of the fact that the majority of the board members are not in favour of redrafting the recognition criteria, the staff does not propose that we should spend extensive time updating this paragraph.

86 The second criterion for the recognition of an item is that it is possible to develop a measurement that is a faithful representation of the item's ~~possesses a~~ cost or ~~value that can be measured with reliability as discussed in paragraphs 31 to 38 of this *Framework*~~. In many cases, cost or value must be estimated; the use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their ability to provide a ~~reliability~~faithful representation.

When, however, a reasonable estimate cannot be made the item is not recognised in the ~~balance sheet or income~~financial statement. For example, the expected proceeds from a lawsuit may meet the definitions of both an asset and income as well as the probability criterion for recognition; however, if it is not possible to obtain a faithful representation of the cost or value of ~~measure~~ the claim ~~reliably~~, it should not be recognised as an asset or as income; the existence of the claim, however, would be disclosed in the notes, explanatory material or supplementary schedules.

19. The key features of Option C are:

    a. The new framework contains only one term: faithful representation.

    b. Constituents must rely on the basis for conclusions to be informed that reliability and faithful representation are essentially the same.

    c. The new framework does not provide a definition of reliability. Constituents can refer to a dictionary or deduce by analogy from IFRSs the meaning of reliability.

STAFF RECOMMENDATION

20. The staff thinks that option B is the best solution. It is the simplest option and contains guidance (although by way of a footnote) on what we *meant* by reliability.

21. The staff thinks that removing the term reliability from our literature, particularly reliability of measurement, should be done when we address the recognition criteria (ie in phase B) and when we update IFRSs.

Question for the Board:
22. Which option do you prefer?

ATTACHMENT A: RELEVANT EXTRACTS

Extract from the Pre-ballot Draft I of Chapter 2 on Faithful Representation

[Extract has been omitted from the observer note].

Extract from the existing *Framework* on reliability and reliability of measurement

Reliability

31 To be useful, information must also be reliable. Information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully that which it either purports to represent or could reasonably be expected to represent.

32 Information may be relevant but so unreliable in nature or representation that its recognition may be potentially misleading. For example, if the validity and amount of a claim for damages under a legal action are disputed, it may be inappropriate for the entity to recognise the full amount of the claim in the balance sheet, although it may be appropriate to disclose the amount and circumstances of the claim.

Faithful representation

33 To be reliable, information must represent faithfully the transactions and other events it either purports to represent or could reasonably be expected to represent. Thus, for example, a balance sheet should represent faithfully the transactions and other events that result in assets, liabilities and equity of the entity at the reporting date which meet the recognition criteria.

34 Most financial information is subject to some risk of being less than a faithful representation of that which it purports to portray. This is not due to bias, but rather to inherent difficulties either in identifying the transactions and other events to be measured or in devising and applying measurement and presentation techniques that can convey messages that correspond with those transactions and events. In certain cases, the measurement of the financial effects of items could be so uncertain that entities generally would not recognise them in the financial statements; for example, although most entities generate goodwill internally over time, it is usually difficult to identify or measure that goodwill reliably. In other cases, however, it may be relevant to recognise items and to disclose the risk of error surrounding their recognition and measurement.

Substance over form

35 If information is to represent faithfully the transactions and other events that it purports to represent, it is necessary that they are accounted for and presented in accordance with their substance and economic reality and not merely their legal form. The substance of transactions or other events is not always consistent with that which is apparent from their legal or contrived form. For example, an entity may dispose of an asset to another party in such a way that the documentation

purports to pass legal ownership to that party; nevertheless, agreements may exist that ensure that the entity continues to enjoy the future economic benefits embodied in the asset. In such circumstances, the reporting of a sale would not represent faithfully the transaction entered into (if indeed there was a transaction).

Neutrality

36 To be reliable, the information contained in financial statements must be neutral, that is, free from bias. Financial statements are not neutral if, by the selection or presentation of information, they influence the making of a decision or judgement in order to achieve a predetermined result or outcome.

Prudence

37 The preparers of financial statements do, however, have to contend with the uncertainties that inevitably surround many events and circumstances, such as the collectability of doubtful receivables, the probable useful life of plant and equipment and the number of warranty claims that may occur. Such uncertainties are recognised by the disclosure of their nature and extent and by the exercise of prudence in the preparation of the financial statements. Prudence is the inclusion of a degree of caution in the exercise of the judgements needed in making the estimates required under conditions of uncertainty, such that assets or income are not overstated and liabilities or expenses are not understated. However, the exercise of prudence does not allow, for example, the creation of hidden reserves or excessive provisions, the deliberate understatement of assets or income, or the deliberate overstatement of liabilities or expenses, because the financial statements would not be neutral and, therefore, not have the quality of reliability.

Completeness

38 To be reliable, the information in financial statements must be complete within the bounds of materiality and cost. An omission can cause information to be false or misleading and thus unreliable and deficient in terms of its relevance.

…

Recognition of the elements of financial statements

83 An item that meets the definition of an element should be recognised if:

(a) it is probable that any future economic benefit associated with the item will flow to or from the entity; and

(b) the item has a cost or value that can be measured with reliability.

<u>Reliability of Measurement</u>

86 The second criterion for the recognition of an item is that it possesses a cost or value that can be measured with reliability as discussed in paragraphs 31 to 38 of this *Framework*. In many cases, cost or value must be estimated; the use of

reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability. When, however, a reasonable estimate cannot be made the item is not recognised in the balance sheet or income statement. For example, the expected proceeds from a lawsuit may meet the definitions of both an asset and income as well as the probability criterion for recognition; however, if it is not possible for the claim to be measured reliably, it should not be recognised as an asset or as income; the existence of the claim, however, would be disclosed in the notes, explanatory material or supplementary schedules.

87 An item that, at a particular point in time, fails to meet the recognition criteria in paragraph 83 may qualify for recognition at a later date as a result of subsequent circumstances or events.

88 An item that possesses the essential characteristics of an element but fails to meet the criteria for recognition may nonetheless warrant disclosure in the notes, explanatory material or in supplementary schedules. This is appropriate when knowledge of the item is considered to be relevant to the evaluation of the financial position, performance and changes in financial position of an entity by the users of financial statements.

ATTACHMENT B: GUIDANCE IN IFRSs

The table below shows where existing IFRSs provide guidance on reliability or reliable, and when something is not reliable. The staff has also provided possible implications when an entity chooses to deduce by analogy when an item is not reliable. [These have been omitted from the observer note.] This table is not an exhaustive search because it does not include guidance from Implementation Guidance or basis for conclusions. When the terms: reliable, unreliable and reliability appear in IFRSs, they are underlined.

IFRSs	Extracts of what reliable/reliability means	Possible implications if applying by analogy [Discussion in this column has been omitted from the observer note].
IFRS 3 para 27	The published price at the date of exchange of a quoted equity instrument provides the best evidence of the instrument's fair value and shall be used, except in rare circumstances. … The published price at the date of exchange is an <u>unreliable</u> indicator only when it has been affected by the thinness of the market. …	
IAS 8 para 10	In the absence of a Standard or an Interpretation that specifically applies to a transaction, other event or condition, management shall use its judgement in developing and applying an accounting policy that results in information that is: (a) relevant to the economic decision-making needs of users; and (b) <u>reliable</u>, in that the financial statements: (i) represent faithfully the financial position, financial performance and cash flows of the entity; (ii) reflect the economic substance of transactions, other events and	

IFRSs	Extracts of what reliable/reliability means	Possible implications if applying by analogy [Discussion in this column has been omitted from the observer note].
	conditions, and not merely the legal form; (iii) are neutral, ie free from bias; (iv) are prudent; and (v) are complete in all material respects.	
IAS 11 para 29	An entity is generally able to make reliable estimates after it has agreed to a contract which establishes: (a) each party's enforceable rights regarding the asset to be constructed; (b) the consideration to be exchanged; and (c) the manner and terms of settlement. ….	
IAS 18 para 23	An entity is generally able to make reliable estimates after it has agreed to the following with the other parties to the transaction: (a) each party's enforceable rights regarding the service to be provided and received by the parties; (b) the consideration to be exchanged; and (c) the manner and terms of settlement.	

IFRSs	Extracts of what reliable/reliability means	Possible implications if applying by analogy [Discussion in this column has been omitted from the observer note].
IAS 19 para 20	An entity can make a reliable estimate of its legal or constructive obligation under a profit-sharing or bonus plan when, and only when: (a) the formal terms of the plan contain a formula for determining the amount of the benefit; (b) the entity determines the amounts to be paid before the financial statements are authorised for issue; or (c) past practice gives clear evidence of the amount of the entity's constructive obligation.	
IAS 37 para 25	… Except in extremely rare cases, an entity will be able to determine a range of possible outcomes and can therefore make an estimate of the obligation that is sufficiently reliable to use in recognising a provision.	
IAS 39 AG 80 and AG81	AG80 The fair value of investments in equity instruments that do not have a quoted market price in an active market and derivatives that are linked to and must be settled by delivery of such an unquoted equity instrument (see paragraphs 46(c) and 47) is reliably measurable if (a) the variability in the range of reasonable fair value estimates is not significant for that instrument or (b) the probabilities of the various estimates within the range can be reasonably assessed and used in estimating fair value. AG81 There are many situations in which the variability in the range of reasonable	

IFRSs	Extracts of what reliable/reliability means	**Possible implications if applying by analogy** [Discussion in this column has been omitted from the observer note].
	fair value estimates of investments in equity instruments that do not have a quoted market price and derivatives that are linked to and must be settled by delivery of such an unquoted equity instrument (see paragraphs 46(c) and 47) is likely not to be significant. Normally it is possible to estimate the fair value of a financial asset that an entity has acquired from an outside party. However, if the range of reasonable fair value estimates is significant and the probabilities of the various estimates cannot be reasonably assessed, an entity is precluded from measuring the instrument at fair value.	
IAS 40 para 53	There is a rebuttable presumption that an entity can reliably determine the fair value of an investment property on a continuing basis. However, in exceptional cases, there is clear evidence when an entity first acquires an investment property (or when an existing property first becomes investment property following the completion of construction or development, or after a change in use) that the fair value of the investment property is not reliably determinable on a continuing basis. This arises when, and only when, comparable market transactions are infrequent and alternative reliable estimates of fair value (for example, based on discounted cash flow projections) are not available. …	