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International
Accounting Standards
Board

INFORMATION FOR OBSERVERS

Board Meeting: **January 2009, London**

Project: **Conceptual Framework - phase A: Qualitative Characteristics and Constraints of Financial Reporting (Agenda paper 5)**

INTRODUCTION

1. This meeting, we commence redeliberations on Chapter 2 of the Exposure Draft, *An improved Conceptual Framework: Chapter 1: The Objective of Financial Reporting* and *Chapter 2: Qualitative Characteristics and Constraints of Decision-useful Financial Reporting Information* (ED). The boards will focus on key issues raised from the ED. This paper is outlined below:

    a. Should we have a distinction to classify the qualitative characteristics? If yes, are the classifications in the ED appropriate?

    b. Should we replace the term *reliability* with *faithful representation*?

2. In March 2009, the boards will discuss the issues arising from Chapter 1 and other issues that arose from the Preface to the ED. Until that time, the staff will assume that the qualitative characteristics (QCs) will apply to all aspects of general purpose financial reports.

3. Comments about QCs that were identified in the comment letter summary but are not discussed in this memo are deemed to be drafting issues rather than matters for decisions by the boards. Board members should notify the staff if there is another comment that you think should be discussed prior to drafting.

SHOULD WE HAVE A DISTINCTION TO CLASSIFY THE QCS?

What the ED Said

4. The ED described the following three types of things that affect usefulness of financial information:

   a. Fundamental QCs

      i. Relevance

      ii. Faithful representation

   b. Enhancing QCs

      i. Verifiability

      ii. Comparability

      iii. Timeliness

      iv. Understandability

   c. Pervasive constraints

      i. Costs

      ii. Materiality

5. The ED described the fundamental QCs as qualities that make financial reporting information useful[1]. The enhancing QCs improve the usefulness of financial information and should be maximised to the extent possible. However, the enhancing qualitative characteristics, either individually or in concert with each other, cannot make information useful for decisions if that information is irrelevant or not faithfully represented[2].

[1] ED Chapter 2 *Qualitative Characteristics and Constraints of decision-useful financial reporting information* paragraph QC14.
[2] Ibid paragraph QC25

6. The basis for conclusions in the ED explains why the boards proposed to classify the QCs. Relevant extracts are:

BC2.51 Both boards' existing frameworks discuss the need to exchange a degree of one desirable characteristic for an increased amount of another (trade-offs). …

BC2.54 In reviewing comments from respondents, the boards noted respondents' confusion about how the qualitative characteristics relate to each other. Therefore, the boards proposed that the qualitative characteristics should be distinguished as fundamental or enhancing, depending on how they affect the usefulness of information. Regardless of its classification, each qualitative characteristic contributes to the usefulness of financial reporting information.

Summary of Comments

7. The ED asked if the distinctions – fundamental and enhancing qualitative characteristics and pervasive constraints of financial reporting – are helpful. This issue received the most comments. A majority of respondents supported the boards' decisions. They also agreed that the distinctions are helpful in understanding how they are applied.

8. The most significant point made by those who disagreed with the proposed classification of QCs was that understandability and verifiability should be considered fundamental rather than enhancing. Those who disagreed also made the following points:

a. The distinctions are arbitrary, of little or no use, and not adequately justified.

b. All QCs are equally important. In particular, classifying verifiability as an enhancing QC seems to mean that it is not essential to producing decision-useful information. (Some comments implied that the respondent considered verifiability not just equal to but more important than the fundamental QC.)

c. The most important QCs vary depending on circumstances. Therefore, differentiating among QCs is not appropriate. The boards should make a general statement that professional judgement should be used when determining which qualitative characteristics are to be emphasized.

Staff Analysis and Recommendation

9. As noted in December 2008, most respondents to the ED agreed with our proposals in Chapter 2. We recommend no changes to the proposals in the ED, but we expect to expand on the explanation of some points when drafting the final chapter. We plan to move some of the explanations or portions of explanations from the basis for conclusions to the main body of the chapter. We may also add material from the existing frameworks.

1) Distinctions among QCs are Appropriate

10. The main body of the ED did not adequately explain the reasons for and the role of fundamental QCs and enhancing QCs. Most of the explanations were located in the basis for conclusions and some of it should be moved to the main body of chapter.

11. Contrary to the comments of some respondents, distinguishing between types of QCs is not arbitrary or new. FASB Concept Statement 2, *Qualitative Characteristics of Accounting Information*, describes relevance and reliability as primary qualities and other QCs as secondary and interactive.[3] Even though the IASB *Conceptual Framework* lists four QCs—relevance, reliability, understandability and comparability—without distinctions, other literature implicitly acknowledges a hierarchy of QCs. For example, IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*, requires an entity to provide information that is relevant and reliable[4] without mentioning the other QCs. Explicitly classifying the QCs would be more straightforward.

12. The final QC chapter should better explain the relationship between fundamental QCs and enhancing QCs. Fundamental QCs must be considered first and in some cases balanced against each other. Enhancing QCs may affect that balancing or they may affect the way the information is presented.

3 Concept Statement 2, *Qualitative Characteristics of Accounting Information*, paragraph 33
4 IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*, paragraph 10

2) Relevance and Faithful Representation are Fundamental QCs

13. No respondents objected to including relevance and faithful representation as fundamental QCs. Most respondents also agreed that financial reporting information that has predictive value or confirmatory value is relevant. The explanations in the ED were clear and persuasive and should not be significantly changed.

14. Most respondents also agreed that faithful representation should be complete, neutral and free from material error. Some respondents also asked for more clarification on how to apply these components:

    a. Some viewed that it would be virtually impossible to achieve neutrality and completeness because they viewed these concepts as absolutes. This is in contrast to *free from material error*. On the other hand, some viewed that the term *material* in free from material error is redundant should be removed. Therefore, we recommend that we rename the component *free from material error* to *free from error* and clarify that these components are not absolutes.

    b. Some respondents also noted that because financial reporting is used as a tool to influence decision-making, the nature of financial reporting cannot be neutral. The staff disagrees with them. We think these respondents were confusing the objective (or purpose) of financial reports, the qualities that financial information should have and how users behave. We recommend reinstating what was in the DP/PV, "Financial reporting information influences behaviour, as do the results of elections, school examinations and lotteries. Elections, examinations are not unfair – do not lack neutrality – merely because some people win and others lose. So it is with neutrality in financial reporting. …. The consequences of a new financial reporting standard may indeed be bad for some interests in either the short or long term. But the dissemination of potentially misleading information is, in the long run, bad for all interests. …. The consequences of a new financial reporting standard may indeed be bad for some interests in either the short or long term. But the dissemination of potentially misleading information is, in the long run, bad for all interests. The

> responsibility of standard-setters is to the integrity of the financial reporting system—a responsibility that could not be fulfilled if a standard-setter changed direction with every change in the political wind. Politically motivated standards would quickly lose their credibility.[5]."

15. A discussion of respondents' comments about the use of the term faithful representation instead of reliability begins in paragraph 31.

3a) Comparability and Understandability are Enhancing QCs

16. Comparability and understandability considerations are related to the way information is presented, including reporting any changes in the type of information to be presented.

17. The ED defines understandability as the quality of information that enables users to comprehend its meaning[6]. Although presenting information clearly and concisely helps users to comprehend it, the actual comprehension or understanding of financial information depends largely on the users of financial report[7].

18. If understandability considerations were fundamental, that would suggest that it might appropriate to avoid reporting information about very complicated things even if the information is relevant and represented in a faithful manner. Classifying it as an enhancing characteristic means that information that might be hard to understand should be presented and explained as clearly as possible.

3b) Verifiability and Timeliness are Enhancing QCs

19. The ED defines verifiability as the quality of information that helps assure users that information faithfully represents the economic phenomena that it purports to represent. Verifiability implies that different knowledgeable and independent observers could reach general consensus, although not necessarily complete agreement. To be verifiable, information need not be a single point estimate[8].

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5 DP Chapter 2 *Qualitative Characteristics of Decision-useful Financial Reporting Information* paragraphs QC 29- QC31

6 ED Chapter 2 *Qualitative Characteristics and Constraints of decision-useful financial reporting information* paragraph QC14 paragraph QC23.

7 Ibid paragraph QC24.

8 Ibid paragraph QC20.

20. Timeliness and verifiability help in choosing between different information that might be reported and may, at times, point in opposite directions. For example, waiting to report information about an uncertain future payment (such as an insurance liability) until the outcome is known would make the information more faithfully represented and verifiable. However, timeliness weighs heavily against that type of reporting because given a choice, users of financial information would likely demand that the best available information be reported sooner.

21. In summary, one should logically apply the fundamental QCs first, and then consider a balance of the enhancing QCs to get better information in financial reports. Lastly, one would apply the pervasive constraints. This process clarifies how to “trade-off” QCs.

4) Materiality and Costs are Constraints of financial reporting

22. *Costs:* Most respondents agreed that cost is a pervasive constraint of financial reporting. Therefore, we do not think we shall significantly change the text in the ED.

23. *Materiality:* Some respondents stated that materiality is a component of relevance rather than a constraint on financial reporting. In other words, they disagreed that materiality is pertinent to all other QCs.

24. The ED explains that information is relevant if it is capable of making a difference in the decisions made by users in their capacity as capital providers.

25. Paragraph QC 28 says:

Information is material if its omission or misstatement could influence the decisions that users make on the basis of an entity’s financial information. Because materiality depends on the nature and amount of the item judged in the particular circumstances of its omission or misstatement, it is not possible to specify a uniform quantitative threshold at which a particular type of information becomes material. When considering whether financial information is a faithful representation of what it purports to represent, it is important to take into account materiality because material omissions or misstatements will result in information that is incomplete, biased or not free from error.

26. We think that materiality is related to relevance (because immaterial information is by definition incapable of making a difference in users' decisions) and cost (because any cost of reporting information that is not useful is too high). However, we think that as materiality has always been considered a separate constraint by most people, including standard-setters, and that we do not think that board members will change the way standards are considered, the staff proposes that materiality should continue to be a separate constraint of financial reporting.

> Questions to the boards:
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> 27. Should we distinguish the QCs as fundamental and enhancing?
>
> 28. Are the fundamental QCs relevance and faithful representation?
>
> 29. Are the enhancing QCs verifiability, timeliness, understandability and comparability?
>
> 30. Are the constraints of financial reporting materiality and costs?

FAITHFUL REPRESENTATION OR RELIABILITY?

What the ED Said

31. The ED proposed to replace the term *reliability* with the term *faithful representation*[9]. Faithful representation is attained when the depiction of an economic phenomenon is complete, neutral and free from material error[10].

32. The basis for conclusions explained that the change was proposed because many of constituents interpreted the term *reliability* in many ways, even though it has been defined in the frameworks. For example, some focus solely on *verifiability* or *free from material error* to the virtual exclusion of the *faithful representation* aspect of reliability. Some also refer reliability as precision[11].

[9] Ibid paragraph BC2.15
[10] Ibid paragraph QC7
[11] Ibid paragraph BC2.13

Summary of Comments

33. Many respondents to the ED noted that, in their view, the boards have not adequately justified replacing of the term *reliability* with the term *faithful representation*. Some suggested that if the boards thought the problem with reliability is the lack of common understanding, they should or could make the definition of reliability clearer.

34. Many respondents also commented on the difference in meanings between faithful representation, as proposed, and reliability. For example:

   a. A respondent noted that:

      "By withdrawing reliability as a characteristic and elevating the concept of representational faithfulness, the Exposure Draft seems to be rejecting reliability in the statistical sense and replacing it with a concern that the 'underlying economic phenomenon' is represented. This is a more demanding criterion than statistical reliability and implies that it is possible to identify some fundamental truth, rather than simply representing 'that which it purports to represent'. Thus, a strong critic of historical cost might argue that historical cost does not represent an 'underlying economic phenomenon' at balance sheet date and should therefore be rejected as not representationally faithful, even if a precise statistical measure of historical cost could be made[12]".

   b. A key feature of reliable information is that it can be "depended upon" (or defined as *verifiable* in the ED), which is now not reflected as a feature of faithful representation. While faithful representation also has an element of freedom from material error, verifiability is considered broader because it considers the appropriate recognition and measurement method. For example, a respondent noted:

      "… concerned that what is lost by the change in terms is any notion that numbers should only be included in the financial statement if they are worthy of use. It is possible for a calculation to be verifiable and for the financial statement to provide adequate disclosure about how the number

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has been determined and how and in what circumstances it could be different, but at some point the uncertainty becomes so great that the use of the number becomes at worst misleading and at best a waste of users' time in trying to understand the overall f/s including the number."

Staff Analysis and Recommendation

35. The major reason why the ED proposed to change the term *reliability* is because constituents seldom used the term *reliability* as defined in the frameworks. Rather, many respondents to due process documents produced by the boards always used the term *reliability* to mean whatever they chose. (It does not help that one can interpret the recognition criteria in both frameworks to refer to reliability of measurement as verifiability of measurement[13].) The boards have been unsuccessful or not persuasive in explaining the meaning of reliability in bases for conclusions of due process documents. Therefore, the boards proposed to replace that word with something less familiar– faithful representation. This could encourage constituents to look up the definition, rather than assume they know what it means.

36. As evident in the comments received, many respondents still believe *reliability* should have a different meaning from the one intended by the boards. For example, they equate *reliability* to mean whether an item can be measured accurately or estimated precisely. In contrast, *faithful representation* is not necessarily focused on measurement – measurement is only one aspect of representing an economic phenomenon.

37. Therefore, we recommend retaining the term *faithful representation* and that it be supported by an explanation in the text of the Chapter, rather than in the basis.

[13] FASB Concept Statement No 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, paragraph 65 says that: "The asset, liability, or change in equity must have a relevant attribute that can be quantified in monetary units with sufficient reliability." Paragraph 63 notes that *reliability* means that the information is representationally faithful, verifiable, and neutral.
IASB *Framework* in paragraph 83 says that an item should be recognised if the item has a cost or value that can be measured with reliability.

Question to the boards:

38. Do you confirm that we should replace the term reliability with faithful representation?