STAFF PAPER

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Project	**Conceptual Framework**		
Paper topic	Reliability, stewardship and prudence		

CONTACT(S)	Li Li Lian	llian@ifrs.org	+44 20 7246 6486
	Peter Clark	pclark@ifrs.org	+44 20 7246 6451

Purpose of the paper

1. The IASB completed Chapter 1 *Objective of Financial Reporting* and Chapter 3 *The Qualitative Characteristics of Useful Financial Information* in 2010. The IASB does not intend to fundamentally reconsider the content of these chapters because:

   (a) these chapters have been through extensive due process and, in the IASB's opinion, provide a sound foundation for the rest of the Conceptual Framework; and

   (b) the IASB has no reason to think that a fundamental reconsideration of Chapters 1 and 3 would lead to significant changes, or that any resulting changes would significantly affect the remaining chapters. A fundamental reconsideration of these chapters would be time consuming and might lead to unnecessary delays in the finalisation of the revised *Conceptual Framework*.

2. However, the IASB will make changes to those chapters if work on the rest of the *Conceptual Framework* highlights areas within those chapters that need clarifying or amending. However, we have heard concerns that some have raised with how these chapters deal with the issues of stewardship, reliability and prudence. Paragraphs 3-20 provide background information about these issues.

Questions

The CMAC members are asked to discuss:

(1) whether you agree with the IASB's approach to Chapters 1 and 3.

(2) if you disagree, what changes do you think the IASB should consider making to Chapters 1 and 3, and why? How would those changes affect the rest of the *Conceptual Framework*?

Stewardship

3. Before the publication of Chapter 1, the *Conceptual Framework* made explicit reference to stewardship:

> Financial statements also show the results of the stewardship of management, or the accountability of management for the resources entrusted to it. Those users who wish to assess the stewardship or accountability of management do so in order that they may make economic decisions; these decisions may include, for example, whether to hold or sell their investment in the entity or whether to reappoint or replace the management.[1]

4. In describing the objective of general purpose financial reporting, Chapter 1 does not use the word 'stewardship'. Some have interpreted this as meaning that the *Conceptual Framework* no longer treats information about stewardship as part of what is needed to meet the objective of financial reporting. Those with this view believe that, as a result, financial reporting may come to focus more on the needs of short-term investors, who may be viewed as likely to sell their holdings if the performance of an entity is poor, rather than on the needs of longer-term investors, who may be viewed as more likely to work with management to improve an entity's performance, or who may wish to change management.

5. Although Chapter 1 does not use the phrase stewardship, it was not the intention of the IASB to remove the concept of stewardship from the objective of financial

1 See paragraph 14 of the pre-2010 *Conceptual Framework*.

reporting. Chapter 1 states that users of financial statements need information about how effectively and efficiently the entity's management and governing body have discharged their responsibilities:

> To assess an entity's prospects for future net cash inflows, existing and potential investors, lenders and other creditors need information about the resources of the entity, claims against the entity, and how efficiently and effectively the entity's management and governing board have discharged their responsibilities to use the entity's resources. Examples of such responsibilities include protecting the entity's resources from unfavourable effects of economic factors such as price and technological changes and ensuring that the entity complies with applicable laws, regulations and contractual provisions. Information about management's discharge of its responsibilities is also useful for decisions by existing investors, lenders and other creditors who have the right to vote on or otherwise influence management's actions.[2]

6. Paragraph BC1.27 of the basis for conclusions on Chapter 1 states that information that can be used to assess future cash flow prospects and information about stewardship are both important for making decisions about providing resources to an entity. In addition, information about stewardship is important for resource providers who have the ability to vote on, or otherwise influence, management's actions.

7. The Basis for Conclusions goes on to explain that the IASB decided to describe what is meant by the term stewardship rather than using the term itself because there would be difficulties translating the term 'stewardship' into other languages.

Reliability

8. Before Chapter 3 was published in 2010, the Conceptual Framework stated that one of the qualitative characteristics of useful financial information was

[2] See paragraph OB4 of the existing *Conceptual Framework*.

reliability. In 2010, Chapter 3 replaced reliability with the qualitative characteristic of faithful representation—information is useful if it faithfully represents what it purports to represent.3

9. Paragraphs BC3.20–BC3.25 of Chapter 3 explain why the IASB replaced the term ‘reliability’ with the term ‘faithful representation’. The main reason for the change was a lack of a common understanding of the term reliability. In particular, many seemed to equate reliability with information being verifiable or free from material error.[4]

10. Some have objected to the replacement of the term ‘reliability’ with the term ‘faithful representation’ stating that:

    (a) the idea that users can rely on the financial statements is a key concept;

    (b) the concept of reliability is better understood and easier to explain than the concept of faithful representation; and

    (c) the concept of reliability is more likely to result in the use of measurements that are more verifiable and more likely to be free from error.

11. The term ‘reliability’ was in fact intended to describe more than just verifiability and freedom from material error. Table 1 below compares the description of reliability in the pre-2010 *Conceptual Framework* and the description of faithful representation in Chapter 3.

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[3] See paragraph QC12 of the existing *Conceptual Framework*.

[4] ‘Verifiability’ is described in Chapter 3 as an enhancing qualitative characteristic of useful financial information.

Table 1: description of reliability in the pre-2010 *Conceptual Framework* and the description of faithful representation in Chapter 3

Pre-2010 *Conceptual Framework*	**Chapter 3**
To be useful, information must be reliable. Information is reliable when it: • is free from material error and bias; and • can be depended upon by users of financial statements to represent faithfully what it purports to represent. Other aspects of reliability: • substance over form; • neutrality; • prudence; and • completeness.	To be useful, information must faithfully represent what it purports to represent. A perfectly faithful representation would be: • complete; • neutral; and • free from error.

12. As can be seen from Table 1, the concepts of reliability and faithful representation have much in common. Both concepts require neutrality, completeness and freedom from error. Faithful representation is described in the pre-2010 *Conceptual Framework* as an aspect of reliability (that is, information is reliable if it can be depended upon to represent faithfully what it purports to represent). The main difference between the two concepts is that Chapter 3 does not refer to prudence or substance over form. The concept of prudence is discussed in paragraphs 13–20. Paragraph BC3.26 of Chapter 3 explains that substance over form is not considered a separate component of faithful representation because it would be redundant. Accounting for something in accordance with its legal form rather than its economic substance could not result in a faithful representation.

Prudence

13. Both paragraph QC12 of Chapter 3 and paragraph 36 of the pre-2010 *Conceptual Framework* state that financial statements should be neutral, that is, free from bias. However, the pre-2010 Conceptual Framework went on to describe the concept of prudence. Chapter 3 does not include any reference to prudence.

14. Paragraph 37 of the pre-2010 Conceptual Framework describes prudence as follows:

> 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.

15. Hence, the pre-2010 Conceptual Framework expressed the view that the exercise of prudence need not be inconsistent with neutrality.

16. In developing Chapter 3 of the *Conceptual Framework*, the IASB removed reference to the concept of prudence. The Basis for Conclusions on Chapter 3 explains that prudence was not included as an aspect of faithful representation because:

    (a) including a reference to prudence would be inconsistent with neutrality. Even with the prohibitions against deliberate misstatement that appear in the pre-2010 *Conceptual Framework*, a requirement to be prudent would lead to bias in the preparation of financial statements.

    (b) deliberately understating assets or overstating liabilities in one period often leads to overstating financial performance in later periods.

17. Many continue to object to the removal of the reference to prudence from the *Conceptual Framework*, stating that:

    (a) deliberately reflecting conservative estimates in the financial statements may be desirable to counteract the effect of over-optimistic management estimates.

    (b) such a removal could result in the recognition of assets and gains whose existence is uncertain and the non-recognition of some possible liabilities and possible losses.

(c) such a removal may increase the use of current value measurements (including fair value), which some view as inherently unverifiable and prone to error.

18. Few would disagree with the idea expressed in the pre-2010 *Conceptual Framework* that a preparer should exercise caution when making estimates and judgements under conditions of uncertainty. This idea is reflected in many of the decisions that the IASB makes when setting Standards.

19. However, it is unclear whether some who call for the reintroduction of references to prudence would agree with the description of prudence as the exercise of caution when making estimates and judgements under conditions of uncertainty. Some would prefer financial statements to show a bias towards conservatism and reject the notion of neutrality.

20. As noted in paragraph 19, some have expressed a fear that removing prudence will lead to a much more widespread use of current value measurements than at present. Section 6 on measurement indicates the factors that the IASB believes it will need to consider when determining which measurement to adopt when developing or revising particular Standards. It is not clear that including prudence as an additional factor to consider would result in a significantly different outcome.