

STAFF PAPER

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Project	Conceptual Framework		
Paper topic	Reliability		
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Purpose of paper

1. The purpose of this paper is to discuss whether to include reference to ‘reliability’ in Chapter 3 *Qualitative Characteristics of Useful Financial Information* of the *Conceptual Framework*.

Summary of staff recommendation

2. The staff do **not** recommend:
 - (a) replacing the qualitative characteristic of faithful representation with reliability;
 - (b) including reference to reliability as either an additional qualitative characteristic or an aspect of either relevance or faithful representation.

Structure of paper

3. This paper is structured as follows:
 - (a) background (paragraphs 4-9);
 - (b) feedback (paragraphs 10-18);
 - (c) analysis and staff recommendations (paragraphs 19-27);

- (d) question for the IASB.

Background

4. Before Chapter 3 was published in 2010, the *Framework for the Preparation and Presentation of Financial Statements* (the ‘pre-2010 Framework’) stated that one of the qualitative characteristics of useful financial information was 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.¹
5. 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.²
6. The term ‘reliability’ was in fact intended to describe more than just verifiability and freedom from material error. The following table compares the description of reliability in the pre-2010 *Framework* and the description of faithful representation in Chapter 3.

Reliability (pre-2010)	Faithful representation
Free from material error or bias	Free from error and neutral
Can be depended on by users to faithfully represent what it purports to represent	Information is useful if it faithfully represents what it purports to represent

¹ See paragraph QC12 of the existing *Conceptual Framework*.

² ‘Verifiability’ is described in Chapter 3 as an enhancing qualitative characteristic of useful financial information.

Reliability (pre-2010)	Faithful representation
Neutral	Neutral
Complete	Complete
Substance over form	Not included but BC3.26 states that accounting in accordance with form rather than substance could not result in a faithful representation
Prudence	Not included

7. As can be seen from the table, 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 *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:
- (a) AP 10I – *Prudence* discusses whether and, if so, how to reintroduce prudence in the *Conceptual Framework*.
 - (b) Paragraph BC3.26 of the Basis for Conclusions on 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. AP 10J – *Chapters 1 & 3 – Other possible changes* proposes making this explanation explicit in Chapter 3.

8. The International Public Sector Accounting Standards Board's *Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities* issued in 2013 also describes faithful representation rather than reliability as a qualitative characteristic of useful financial information. Their reasons for adopting this approach (as explained in their basis for conclusions) are similar to those stated by the IASB in the Basis for Conclusions on Chapter 3.
9. Reliability was discussed in Section 9 of the IASB's Discussion Paper *A Review of the Conceptual Framework for Financial Reporting* (the 'Discussion Paper'). However, we did not ask an explicit question on the issue. Instead we asked whether respondents agreed with the IASB's proposal not to fundamentally reconsider Chapters 1 and 3.

Feedback

10. Although we did not ask an explicit question on reliability, many respondents commented on the issue.
11. Some respondents expressed the view that the IASB should not reconsider its decision to replace reliability with faithful representation. Reasons cited included:
 - (a) The term faithful representation captures better than 'reliability' the features that make financial information useful. The term reliability is equated by many with verifiability and certainty to the exclusion of other features of a faithful representation.
 - (b) Because of the similarity between reliability and faithful representation, it is unclear what effect changing back to the term reliability would have on financial statements.
 - (c) Reliability is incorrectly equated by some with financial statements that show only financial performance that is sustainable over time.
12. However, many respondents expressed the view that reliability should be reinstated in the *Conceptual Framework*. Reasons cited included:

- (a) The pre-2010 *Framework* acknowledged a trade-off between the qualitative characteristics of relevance and reliability. The most relevant information may not be capable of being portrayed reliably, and the most reliable information might not be relevant. Some respondents believe that this trade-off is missing in the existing *Conceptual Framework*.
 - (b) The existing *Conceptual Framework* implies that anything can be faithfully represented if sufficient disclosures are given. Consequently, the qualitative characteristic of faithful representation does not act as an effective filter to identify the types of information that should be included in financial statements.
 - (c) The idea that financial statements should be credible (that is, that they provide reliable information that users can depend on) is a key concept that should be acknowledged in the *Conceptual Framework*.
 - (d) The term reliability is clearer and better understood than the term faithful representation.
 - (e) Omitting reference to reliability from the *Conceptual Framework* allows items that cannot be measured reliably to be recognised.
 - (f) The term ‘freedom from material error’, which is a component of a faithful representation, does not adequately capture what was meant previously by the term ‘reliability’.
13. Many of the respondents who believe changes should be made to Chapter 3 suggested that reliability should replace faithful representation as a fundamental qualitative characteristic. However, some suggested that reliability should be included in the *Conceptual Framework* as an enhancing qualitative characteristic. Others suggested that it should be treated as a feature of a faithful representation.
14. Some respondents suggested that the IASB could address some of the concerns over the term ‘faithful representation’ by giving more prominence to the enhancing qualitative characteristic of verifiability. Some suggested that

verifiability should be elevated by treating it as part of a faithful representation. Others suggested that verifiability should be treated as a fundamental qualitative characteristic.

15. A few respondents stated that the concepts of prudence and reliability were closely linked; that is, if financial statements were required to be prudent they would be more reliable.
16. The Accounting Standards Advisory Forum (ASAF) discussed reliability at their meeting in December 2013.
17. Some ASAF members supported reintroducing reliability as a fundamental qualitative characteristic because they thought that:
 - (a) not having reliability as a fundamental qualitative characteristic could result in the recognition of assets or liabilities with highly uncertain measurements. Some saw this as a particularly significant concern in emerging economies, where there may be a lack of observable inputs to use in some measurements;
 - (b) not having reliability as a fundamental qualitative characteristic could lead to the recognition of more intangible assets. Recognising more intangible assets does not have benefits that exceed the costs, because they believe that many users ignore the measurements attributed in financial statements to intangible assets; and
 - (c) reinstating reliability would emphasise the need for the IASB to consider the trade-off between relevant and reliable information.
18. Other ASAF members supported retaining faithful representation as a fundamental qualitative characteristic, instead of reinstating reliability. This is because they thought that:
 - (a) although the notion of faithful representation does not differ significantly from the notion of reliability, as it was defined in the pre-2010 *Framework*, many commentators used the term reliability in a

different sense. For example, commentators often used the term reliability to refer to the degree of certainty about the ultimate outcome of a transaction, rather than to the degree of certainty about the measurement of the transaction;

- (b) if information gives a faithful representation of the economic phenomena, then users can rely on that information;
- (c) the *Conceptual Framework* already implies that if the level of uncertainty in an estimate is too large, that estimate may not be particularly relevant. Consequently, there was no need to discuss a trade-off between relevance and reliability. However some ASAF members suggested that it may be useful to better explain this relationship to minimise confusion among the stakeholders; and
- (d) it would not be productive to reopen the debate on this issue, which has already gone through extensive due process.

Analysis and staff recommendations

19. The staff believe that the IASB have used the notion of reliability in two different ways:
 - (a) The word reliable is often used in our Standards to mean that there is an acceptable level of measurement uncertainty associated with an amount. This use of the word flows from the recognition criteria in the existing *Conceptual Framework* (an item that meets the definition of an element is only recognised if it is probable there will be a flow of economic benefits and it has a cost or value that can be measured with reliability³).

³ Paragraph 4.38, existing *Conceptual Framework*

- (b) The pre-2010 *Framework* defined reliability much more broadly (as described in paragraph 6). This broader definition of reliability is used much less frequently in the Standards⁴.
- 20. The decision to change from reliability to faithful representation was made to avoid confusion between these two different meanings of the word. The responses to the Discussion Paper seem, if anything, to reinforce the idea that many of our constituents equate the word reliability with an acceptable level of measurement uncertainty rather than the broader notion described in the pre-2010 *Framework*. Consequently, the staff do not recommend replacing the qualitative characteristic of faithful representation with reliability.
- 21. Other reasons not to replace the qualitative characteristic of faithful representation with reliability include the following:
 - (a) As discussed in paragraph 7, the description of reliability in the pre-2010 *Framework* and the description of faithful representation in Chapter 3 have much in common. Consequently, it is unclear to the staff what effect changing back to reliability would have in practice;
 - (b) Chapter 3 has been through extensive due process; and
 - (c) Because Chapter 3 was developed together with the FASB, it is converged with US GAAP.
- 22. Rather than replacing the qualitative characteristic of faithful representation with reliability, the IASB could instead include reliability (defined as an acceptable level of measurement uncertainty) as either an additional qualitative characteristic or as an aspect of either relevance or faithful representation. This would address the calls to reintroduce reliability into the *Conceptual Framework* and would provide a basis for the requirement in many of our Standards that measurements must be reliable.

⁴ Examples of this broader use of the word reliability include: IAS 1 – *Presentation of Financial Statements*, IAS 8 – *Accounting Policies, Changes in Accounting Estimates and Errors* and IFRS 4 – *Insurance Contracts*.

23. However, the staff do not believe it is necessary to include a reference to reliability in Chapter 3 because QC16 already captures the idea that if the level of uncertainty in an estimate is very large then the estimate might not provide relevant information (the appendix to this paper includes the text of QC16). This aspect of relevance appears to have been overlooked by many of those calling for the reintroduction of reliability. Consequently, the staff will consider during drafting whether including this idea in a separate paragraph would increase its prominence. AP 10B – *Recognition* discusses how this notion might be used in the recognition criteria for assets and liabilities. Future papers on measurement will discuss the implications of this notion for the selection of a measurement.
24. In addition, the staff note that sometimes a measurement with a high degree of uncertainty provides the only relevant information about an item. For example, this may be the case with many non-traded derivative financial instruments. Including reliability as a separate qualitative characteristic might be interpreted as restricting the IASB’s ability to use such a measure in cases when it would provide relevant information.

Trade-off between relevance and reliability

25. As noted in paragraph 12(a), the pre-2010 *Framework* referred to a trade-off between the qualitative characteristics:

Balance between qualitative characteristics

In practice, a balancing, or trade-off, between qualitative characteristics is often necessary. Generally the aim is to achieve an appropriate balance among the characteristics in order to meet the objective of financial statements. The relative importance of the characteristics in different cases is a matter of professional judgement⁵.

⁵ Paragraph 45, pre-2010 *Framework*

26. Some respondents to the Discussion Paper believe that this trade-off (and in particular the trade-off between relevance and reliability) was lost when reliability was replaced with faithful representation.
27. However, the staff note that Chapter 3 states that:
- (a) useful information must be both relevant and faithfully represented (QC17);
 - (b) a faithful representation, by itself, does not necessarily result in useful information (QC16);
 - (c) if the level of uncertainty in an estimate is sufficiently large, that estimate may not be particularly useful (relevant) (QC16);
 - (d) in some cases the most relevant information may not be capable of being faithfully represented (QC18).

Consequently, the staff do not agree with the idea that the need to balance the qualitative characteristics has been lost.

Question for the IASB

Question 1

The staff do *not* recommend:

- (a) replacing the qualitative characteristic of faithful representation with reliability;
- (b) including reference to reliability as either an additional qualitative characteristic or as an aspect of either of relevance or faithful representation.

Do you agree?

Appendix – Extract from Chapter 3

A1. The following quote is from QC16 of Chapter 3:

A faithful representation, by itself, does not necessarily result in useful information. For example, a reporting entity may receive property, plant and equipment through a government grant. Obviously, reporting that an entity acquired an asset at no cost would faithfully represent its cost, but that information would probably not be very useful. A slightly more subtle example is an estimate of the amount by which an asset's carrying amount should be adjusted to reflect an impairment in the asset's value. That estimate can be a faithful representation if the reporting entity has properly applied an appropriate process, properly described the estimate and explained any uncertainties that significantly affect the estimate. However, if the level of uncertainty in such an estimate is sufficiently large, that estimate will not be particularly useful. In other words, the relevance of the asset being faithfully represented is questionable. If there is no alternative representation that is more faithful, that estimate may provide the best available information.