

## STAFF PAPER

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## IASB Meeting

Project	Conceptual Framework		
Paper topic	Sweep issue: measurement uncertainty and the fundamental qualitative characteristics of useful financial information		
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**Purpose of paper**

1. On 26 July 2017, the staff issued for comment a pre-ballot draft of the *Conceptual Framework for Financial Reporting* (pre-ballot draft). Board members and a number of external reviewers provided their comments on the document.
2. This paper considers comments received on the discussion of measurement uncertainty included in the pre-ballot draft and related comments on the fundamental qualitative characteristics of useful financial information and proposes clarifications. It also provides relevant background information.

**Staff recommendation**

3. The staff recommend that Chapter 2—*Qualitative characteristics of useful financial information* of the revised *Conceptual Framework for Financial Reporting* (*Conceptual Framework*):
  - (a) clarifies that a trade-off may need to be made between relevance and faithful representation and specifically between relevance and measurement uncertainty; but
  - (b) does not discuss *how* such a trade-off is made.

4. Appendix A provides illustrative drafting of those clarifications. It is provided for information only. The staff do not plan to discuss detailed drafting points at the meeting.

## Next steps

5. The staff are working through the other comments received on the pre-ballot draft and plan to present any further sweep issues at the October 2017 IASB meeting. The staff aim to ballot the revised *Conceptual Framework* in Q4 2017 and to issue the revised *Conceptual Framework* in Q1 2018.

## Background

### **Existing Conceptual Framework**

6. The existing *Conceptual Framework* issued in 2010 identifies relevance and faithful representation as fundamental qualitative characteristics of useful financial information (paragraph QC5). It states that both characteristics must be present for financial information to be useful. It further states that neither a faithful representation of an irrelevant phenomenon nor an unfaithful representation of a relevant phenomenon helps users make good decisions (paragraph QC17).
7. However, in discussing measurement uncertainty, the existing *Conceptual Framework* implies that a trade-off may need to be made between relevance and faithful representation. Specifically, paragraph QC16 of the existing *Conceptual Framework* states that an 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.

8. Paragraph QC18 further describes a process that would usually be the most efficient and effective process for applying the fundamental qualitative characteristics:

[...] First, identify an economic phenomenon that has the potential to be useful to users of the reporting entity's financial information. Second, identify the type of information about that phenomenon that would be most relevant if it is available and can be faithfully represented. Third, determine whether that information is available and can be faithfully represented. If so, the process of satisfying the fundamental qualitative characteristics ends at that point. If not, the process is repeated with the next most relevant type of information.

### ***Proposals in the Exposure Draft***

9. In developing the proposals for the revised *Conceptual Framework*, the Board received feedback on the discussion of qualitative characteristics of useful financial information and measurement uncertainty. Specifically:

- (a) some interested parties argued that the existing *Conceptual Framework* implied that anything could be faithfully represented if sufficient disclosures were given. Consequently, in the view of those interested parties, faithful representation did not act as an effective filter for information that should be included in financial statements. In particular, they expressed concerns that the existing *Conceptual Framework* would allow recognition of items that could not be measured reliably and that recognising those items in such cases would not result in useful information.
- (b) some interested parties expressed a concern about the lack of discussion of the need for a trade-off between qualitative characteristics of useful financial information in the existing *Conceptual Framework*. They pointed out that the need for such a trade-off had been acknowledged in the 1989 *Framework for the Preparation and Presentation of Financial Statements*

(1989 *Framework*). Their main concern seemed to relate to the relationship between relevance of information and the acceptable level of measurement uncertainty.

10. To address those concerns, the Board proposed a number of changes designed to clarify the role of measurement uncertainty in financial reporting in the revised *Conceptual Framework*. In particular, the Board proposed to:
  - (a) describe measurement uncertainty as a factor that can make financial information less relevant;
  - (b) acknowledge that a trade-off may need to be made between the level of measurement uncertainty and other factors that make information relevant; and
  - (c) discuss the role of measurement uncertainty in measurement and recognition decisions.
  
11. The trade-off discussed in the Exposure Draft *Conceptual Framework for Financial Reporting* (Exposure Draft) was similar to the trade-off previously described in the 1989 *Framework* as a trade-off that may need to be made between relevance and reliability. In discussing that trade-off, the Exposure Draft built on the discussion of measurement uncertainty included in paragraph QC16 of the existing *Conceptual Framework* and reproduced in paragraph 7 of this Agenda Paper. In particular, it proposed that:
  - (a) for some estimates a high level of measurement uncertainty may outweigh other factors that make information relevant to such an extent that the resulting information may have little relevance; but
  - (b) a high level of measurement uncertainty does not prevent the use of an estimate if that estimate provides the most relevant information.
  
12. The Exposure Draft also proposed that an estimate can be faithfully represented 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 estimate is not relevant, the information provided will not be useful.

13. The enhanced discussion of measurement uncertainty proposed in the Exposure Draft would make paragraph QC16 of the existing *Conceptual Framework* largely redundant. Consequently, the Exposure Draft proposed to delete that paragraph.
14. Relevant extracts from the Exposure Draft are reproduced in Appendix B to this paper.

### ***Tentative decisions***

15. Respondents to the Exposure Draft generally welcomed the proposed enhanced discussion on measurement uncertainty. However, some respondents, many of them standard-setters, suggested that measurement uncertainty is a factor that affects faithful representation rather than relevance. They argued that information can be highly uncertain but still remain relevant. For example, in the insurance industry measurements can be highly uncertain yet relevant, and in many circumstances the presence of significant uncertainty can make information even more relevant. In contrast, a high level of measurement uncertainty affects whether and how a faithful representation can be achieved. For example, the information provided by a single amount could be misleading if that single amount is used to represent a wide range of possible outcomes. In such cases, it would be necessary to provide disclosures that explain the measurement technique selected, the inputs used and the uncertainties involved.
16. Respondents to the Exposure Draft also generally supported the idea that a trade-off may need to be made between factors that make information useful. Depending on their views on how measurement uncertainty affects the usefulness of information, some respondents agreed that a trade-off may need to be made between factors that affect relevance of financial information as proposed in the Exposure Draft. Other respondents instead suggested that a trade-off may need to be made between the qualitative characteristics of relevance and faithful representation. In particular, some argued that a single number might not faithfully represent the economic phenomena even if supported by appropriate disclosure.
17. The Board agreed with the view that measurement uncertainty is a factor that affects the qualitative characteristic of faithful representation instead of relevance. This is

because the qualitative characteristic of relevance is concerned with *what* information about an economic phenomenon is capable of being useful while the qualitative characteristic of faithful representation is concerned with *whether* and *how* that information can be provided in a way that faithfully represents that phenomenon.

18. Consistent with its tentative decision on measurement uncertainty, the Board also decided to clarify in the Basis for Conclusions on the revised *Conceptual Framework* that a trade-off may need to be made between the qualitative characteristics of relevance and faithful representation. In making that decision, the Board noted that the need for such a trade-off is already implicit in the existing *Conceptual Framework* (see discussion in paragraphs 6–7 of this Agenda Paper).

***Pre-ballot draft***

19. In accordance with the Board’s tentative decisions, the pre-ballot draft discussed measurement uncertainty as a factor affecting the qualitative characteristic of faithful representation. It stated that the use of reasonable estimates is an essential part of the preparation of financial information and even a high level of measurement uncertainty does not prevent an estimate from providing useful information. However, it acknowledged that in some cases the level of measurement uncertainty involved in making an estimate can be so high that it is necessary to consider whether other information about the economic phenomenon would be more useful than that highly uncertain estimate. In making that judgement, the qualitative characteristics of relevance and faithful representation are considered applying the process described in paragraph QC18 of the existing *Conceptual Framework* and reproduced in paragraph 7 of this Agenda Paper.
20. In accordance with the Board’s tentative decisions, the pre-ballot draft did not discuss a trade-off that may need to be made between the qualitative characteristics of relevance and faithful representation. In particular, it did not discuss a scenario where only one type of information about a particular economic phenomenon is relevant but that information is subject to a high degree of measurement uncertainty. However, the pre-ballot draft retained the discussion in paragraph QC17 of the existing *Conceptual Framework* that information must both be relevant and provide a faithful representation if it is to be useful. The pre-ballot draft also discussed how

measurement uncertainty is considered in making recognition and measurement decisions.

21. The pre-ballot draft of the Basis for Conclusions explained that even though the revised *Conceptual Framework* does not discuss a trade-off that may need to be made between qualitative characteristics it does refer to the need for both relevance and faithful representation. That is, applying the revised *Conceptual Framework*, if relevant information does not provide a faithful representation, that information is not useful. Similarly, if information provides a faithful representation but is not relevant, that information is not useful.
22. The Basis for Conclusions also emphasised that even if information is subject to a high level of measurement uncertainty, it can be relevant. For example, if there are significant risks and uncertainties associated with the economic phenomenon, it may be the case that a highly uncertain measure provides the only relevant information about that phenomenon. That discussion in the Basis for Conclusions was consistent with the discussion in paragraph QC16 of the existing *Conceptual Framework* that was replaced by the enhanced discussion proposed in the Exposure Draft (reproduced in paragraph 7 of this Agenda Paper).

### **Feedback on the pre-ballot draft**

23. A few commentators expressed concerns about the discussion of measurement uncertainty included in the pre-ballot draft. Their main concern seemed to relate to whether and how a trade-off could be made between relevance and faithful representation and in particular:
  - (a) whether a highly uncertain estimate could be regarded as providing useful information in situations where there is no other relevant measurement basis; and
  - (b) how that assessment would be made.
24. Some of the commentators who provided feedback on measurement uncertainty seemed to have interpreted the discussion in the pre-ballot draft in different ways. For example, one commentator interpreted the pre-ballot draft as suggesting that a level of

measurement uncertainty involved in making an estimate can be so high that the measure would not provide faithful representation of the economic phenomenon even if supported by appropriate disclosure. Applying the revised *Conceptual Framework*, that would necessitate identifying the next most relevant type of information about the economic phenomenon that is available and can be provided in a way that faithfully represents the phenomenon. However, that commentator stated that it is not clear what information would be provided if the highly uncertain estimate were the only relevant measure of the economic phenomenon.

25. The commentator argued that applying such an analysis to, for example, complex derivative financial instruments could result in either measuring them at cost or not recognising them in the financial statements. In that commentator's view, that outcome would result in less useful information than the highly uncertain estimate of fair value supported by appropriate disclosure.
26. In contrast, another commentator interpreted the pre-ballot draft as suggesting that an estimate can always be faithfully represented regardless of how uncertain it is. Consequently, in that commentator's view, it will never be necessary to identify the next most relevant type of information about the economic phenomenon applying the process described in QC18 of the existing *Conceptual Framework*. Accordingly, that commentator argued that the discussion of measurement uncertainty in the pre-ballot draft and the description of the process of applying the qualitative characteristics are in conflict with each other.
27. A few other commentators raised general questions about the process of applying the fundamental qualitative characteristics. For example, one commentator suggested it was not clear whether:
  - (a) information that is less relevant may be provided if it is a more faithful representation of the phenomenon, even when that may not be the most relevant information; or
  - (b) a trade-off between relevance and faithful representation would be permitted only when the most relevant information cannot be provided with sufficient representational faithfulness.

## Staff analysis and proposed clarifications

28. The staff do not think that the proposals in the Exposure Draft and the Board’s subsequent tentative decisions were meant to amend the process of applying the fundamental qualitative characteristics of useful financial information described in the existing *Conceptual Framework*. Rather, those proposals and tentative decisions were meant to clarify and enhance the visibility of the role of measurement uncertainty in deciding what information about an economic phenomenon should be provided in the financial statements.
29. As discussed in paragraphs 6–8 of this Agenda Paper, the existing *Conceptual Framework*:
- (a) states that in order to be useful information must both be relevant and provide a faithful representation of what it purports to represent (paragraphs QC4, QC5 and QC17);
  - (b) implies that a trade-off may need to be made between relevance and faithful representation (paragraph QC16); and
  - (c) describes a process that would usually be the most efficient and effective process of applying the fundamental qualitative characteristics (paragraph QC18).
30. Comments and concerns about measurement uncertainty raised by the commentators on the pre-ballot draft tend to revolve around the trade-off that may need to be made between relevance and faithful representation and, in particular, between relevance and measurement uncertainty, with measurement uncertainty being a factor that affects faithful representation. Further, most of those comments and concerns focus on:
- (a) whether the revised *Conceptual Framework* would allow a trade-off to be made between relevance and faithful representation, or relevance and measurement uncertainty; and
  - (b) if so, what factors would be considered in making such a trade-off.
31. In the light of those comments and concerns, the staff recommend that:

- (a) the Board should clarify that a trade-off may need to be made between relevance and faithful representation and specifically between relevance and measurement uncertainty; and
  - (b) such clarifications should be included in the revised *Conceptual Framework*, not just in the Basis for Conclusions.
32. The staff think that such a clarification would be consistent both with the logic in the existing *Conceptual Framework* and the Board’s tentative decisions made in developing the revised *Conceptual Framework*.
33. The staff think that such a clarification should:
- (a) build on the discussion of measurement uncertainty both in paragraph QC16 of the existing *Conceptual Framework* (reproduced in paragraph 7 of this Agenda Paper) and paragraph 2.20 of the Exposure Draft (reproduced in Appendix B); and
  - (b) be included within the discussion of applying the fundamental qualitative characteristics in Chapter 2 of the revised *Conceptual Framework*.
34. However, the staff do **not** recommend that the revised *Conceptual Framework* should go further than acknowledging that a trade-off made need to be made between qualitative characteristics and provide guidance on how such a trade-off could be made, including in the situations where only one measurement basis is deemed relevant for a particular economic phenomenon. This is because applying such a trade-off would require consideration of the specific transaction or other event and exercise of judgement.
35. For example, the Board might conclude that a higher level of measurement uncertainty, supported by appropriate disclosure, is acceptable for a financial instrument measured at current value than for a unique internally generated intangible asset or for a law suit to which an entity is a party. This is because a financial instrument is a contract and its measurement is based on cash flows specified by the terms of the contract and generally reflects market inputs, statistical data and other, often observable, inputs. In contrast, measurement of a unique intangible asset or of a law suit could involve a set of assumptions about cash flows that are not contractually specified and that depend on variables that are not observable; that measurement

could be further complicated by uncertainty about whether an asset or a liability even exists.

36. Accordingly, the staff think that the Board should consider how to apply the trade-off in setting Standards and should not prescribe this in the revised *Conceptual Framework*. However, the Basis for Conclusions could explain why the need for the trade-off is acknowledged but not discussed in detail in the revised *Conceptual Framework*. In explaining that, it could also provide an example similar to the example discussed in paragraph 35 of this Agenda Paper.
37. Appendix A provides illustrative drafting on measurement uncertainty and the related discussion of fundamental qualitative characteristics for Chapter 2 of the revised *Conceptual Framework*. The discussion in Chapter 5—*Recognition and derecognition* and Chapter 6—*Measurement* of the revised *Conceptual Framework* would be updated to align it with the discussion in Chapter 2.
38. As noted in paragraph 4, Appendix A is provided for illustration only and the staff do not plan to discuss detailed drafting points at the meeting.

**Question for the Board**

Does the Board agree with the staff recommendation set out in paragraph 3 that Chapter 2 of the revised *Conceptual Framework*:

- (a) clarifies that a trade-off may need to be made between relevance and faithful representation and specifically between relevance and measurement uncertainty; but
- (b) does not discuss *how* such a trade-off is made?

## Appendix A—Illustrative drafting on measurement uncertainty and the fundamental qualitative characteristics

Note: Chapter 2 will be carried forward from Chapter 3 of the existing *Conceptual Framework* with only limited changes. For this appendix, paragraph numbers are based on the existing *Conceptual Framework*, new text is underlined and deleted text is struck through.

QC15 Faithful representation does not mean accurate in all respects. Free from error means there are no errors or omissions in the description of the phenomenon, and the process used to produce the reported information has been selected and applied with no errors in the process. In this context, free from error does not mean perfectly accurate in all respects. For example, an estimate of an unobservable price or value cannot be determined to be accurate or inaccurate. However, a representation of that estimate can be faithful if the amount is described clearly and accurately as being an estimate, the nature and limitations of the estimating process are explained, and no errors have been made in selecting and applying an appropriate process for developing the estimate.

~~QC16 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.~~

QC16AWhen monetary amounts in financial reports cannot be observed directly and must instead be estimated, measurement uncertainty arises. The use of reasonable estimates is an essential part of the preparation of financial information and does not necessarily undermine the usefulness of the information if the estimates are clearly and accurately described and explained. Even a high level of measurement uncertainty does not prevent such an estimate from providing useful information (see paragraph QC20).

*Applying the fundamental qualitative characteristics*

QC17 Information must be both be relevant and provide a faithfully represented representation if it is to be useful. Neither a faithful representation of an irrelevant phenomenon nor an unfaithful representation of a relevant phenomenon helps users make good decisions.

QC18 The most efficient and effective process for applying the fundamental qualitative characteristics would usually be as follows (subject to the effects of enhancing characteristics and the cost constraint, which are not considered in this example). First, identify an economic phenomenon about which information that has the potential to be is capable of being useful to users of the reporting entity's financial information. Second, identify the type of information about that phenomenon that would be most relevant if it is available and if it can be faithfully represented provided in a way that faithfully represents the economic phenomenon. Third, determine whether that information is available and whether it can be faithfully represented provided in a way that faithfully represents the economic phenomenon. If so, the process of satisfying the fundamental qualitative characteristics ends at that point. If not, the process is repeated with the next most relevant type of information.

QC18AIn some cases, a trade-off between the fundamental qualitative characteristics may need to be made in order to provide the most useful information about an economic phenomenon. For example, the most relevant information about a phenomenon may be a highly uncertain estimate. In some cases, the level of measurement uncertainty involved in making the estimate may be so high that it may be questionable whether the estimate would provide a sufficiently faithful representation of that phenomenon even if the representation includes a description of the estimate and an explanation of

the uncertainties that affect it. In some such cases, the most useful information may be the highly uncertain estimate, accompanied by that description and explanation. In other such cases, the most useful information may be an estimate of another amount that provides a different type of information about the phenomenon that is slightly less relevant but subject to lower measurement uncertainty. In limited circumstances, there may be no estimate that provides useful information. In those limited circumstances, it may be necessary to provide information that does not rely on an estimate.

## Appendix B—Extracts from the Exposure Draft

### Extracts from Chapter 2

#### Measurement uncertainty

- 2.12 One factor affecting the relevance of financial information is the level of measurement uncertainty. Measurement uncertainty arises when a measure for an asset or a liability cannot be observed directly and must instead be estimated. The use of estimates is an essential part of the preparation of financial information and does not necessarily undermine its relevance, but the estimate needs to be properly described and disclosed (see paragraph 2.20).
- 2.13 An estimate can provide relevant information, even if the estimate is subject to a high level of measurement uncertainty. Nevertheless, if measurement uncertainty is high, an estimate is less relevant than it would be if it were subject to low measurement uncertainty. Thus, there is a trade-off between the level of measurement uncertainty and other factors that make information relevant. For example, for some estimates, a high level of measurement uncertainty may outweigh those other factors to such an extent that the resulting information may have little relevance. On the other hand, a high level of measurement uncertainty does not prevent the use of an estimate if that estimate provides the most relevant information.

[...]

#### **Applying the fundamental qualitative characteristics**

- 2.20 Information must be both relevant and faithfully represented if it is to be useful. Neither a faithful representation of an irrelevant phenomenon nor an unfaithful representation of a relevant phenomenon helps users make good decisions. For example, an estimate can be faithfully represented 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 estimate is not relevant, the information provided will not be useful.
- 2.21 The most efficient and effective process for applying the fundamental qualitative characteristics would usually be as follows (subject to the effects of enhancing characteristics and the cost constraint, which are not considered in this example). First, identify an economic phenomenon that ~~has the potential to be~~ is capable of being useful to users of the reporting entity's financial information. Second, identify the type of information about that phenomenon that would be most relevant if it is available and can be faithfully represented. Third, determine whether that information is available and can be faithfully represented. If so, the process of satisfying the fundamental qualitative characteristics ends at that point. If not, the process is repeated with the next most relevant type of information.

### Extracts from Chapter 5

- 5.20 To be recognised, an asset or a liability must be measured. In many cases, measurements must be estimated and are subject to uncertainty. The use of reasonable

estimates is an essential part of the preparation of financial statements and does not necessarily undermine their usefulness. A faithful representation is achieved if amounts that are estimates are described as such, and the nature and level of uncertainties, if material, are disclosed in the notes to the financial statements.

- 5.21 As noted in paragraph 2.13, for some estimates, a high level of measurement uncertainty may contribute to the resulting information having little relevance, even if the estimate is properly described and disclosed. For example, a measurement may not provide relevant information if:
- (a) the range of possible outcomes is extremely wide and the likelihood of each outcome is exceptionally difficult to estimate. In such cases, the most relevant information for users of financial statements may relate to the range of outcomes and the factors affecting their likelihoods. When that information is relevant (and can be provided at a cost that does not exceed the benefits), disclosure of that information in the notes to the financial statements may be appropriate, regardless of whether the entity also recognises the asset or the liability. However, in some cases, trying to capture that information in a single number may not provide any further relevant information. In such cases, if no relevant measure is available, or can be obtained, recognition would not provide relevant information.
  - (b) measuring the resource or obligation requires unusually difficult or exceptionally subjective allocations of cash flows that do not relate solely to the item being measured.

### **Extracts from Chapter 6**

- 6.55 One factor affecting the relevance of the information provided by a measurement basis is the level of measurement uncertainty in estimates of that information (see paragraphs 2.12–2.13). A high level of measurement uncertainty does not prevent the use of an estimate that provides the most relevant information. However, in some cases, the level of measurement uncertainty is so high that a different measurement basis may provide more relevant information. Moreover, if no measurement basis for an asset or a liability would provide relevant information, it is not appropriate to recognise the asset or the liability (see paragraph 5.13).
- 6.56 Measurement uncertainty is not the same thing as outcome uncertainty. For example, if the fair value of an asset is observable in an active market, no uncertainty is associated with the measurement of that fair value, even though it is uncertain how much cash the asset will ultimately produce. Nevertheless, outcome uncertainty may sometimes contribute to measurement uncertainty. For example, there may be a high level of uncertainty about the cash flows that a unique asset will produce (outcome uncertainty) and estimating a current value of that asset may depend on a model whose validity is untested and that requires inputs that are difficult to verify.