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DISCUSSION PAPER

Preliminary Views on an improved Conceptual Framework for Financial Reporting:

The Objective of Financial Reporting and Qualitative Characteristics of Decision-useful Financial Reporting Information

Comments to be submitted by 3 November 2006



**International
Accounting Standards
Board®**

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Conceptual Framework for
Financial Reporting:**

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and

**Qualitative Characteristics of
Decision-useful Financial
Reporting Information**

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This Discussion Paper *Preliminary Views on an improved Conceptual Framework for Financial Reporting—The Objective of Financial Reporting and Qualitative Characteristics of Decision-useful Financial Reporting* is published by the International Accounting Standards Board (IASB) for comment only. The Discussion Paper has been prepared as part of a joint project by the US Financial Accounting Standards Board and the IASB, and it sets out the boards' preliminary views of the first two chapters of their proposed common framework. Those views may be modified in the light of comments received before being published as exposure drafts of the proposed chapters.

Comments on the contents of the Discussion Paper should be submitted in writing so as to be received by **3 November 2006**.

All responses will be put on the public record unless the respondent requests confidentiality. However, such requests will not normally be granted unless supported by good reason, such as commercial confidence. If commentators respond by fax or email, it would be helpful if they could also send a hard copy of their response by post. Comments should preferably be sent by email to: CommentLetters@iasb.org or addressed to:

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ALTERNATIVE VIEW

Preface

- P1 This Discussion Paper is the first in a series of publications being developed jointly by the US Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) (the boards) as part of a joint project to develop a common Conceptual Framework for Financial Reporting. The boards expect to publish other discussion papers that will seek comments on parts of what ultimately will be an improved conceptual framework for financial reporting that both will adopt to replace their separate frameworks.

Authoritative status of the framework

- P2 At present, the boards' existing frameworks differ in their authoritative status. For entities preparing financial statements under International Financial Reporting Standards (IFRSs)^{*} management is expressly required to consider the IASB's *Framework for the Preparation and Presentation of Financial Statements* if no standard or interpretation specifically applies or deals with a similar and related issue.[†] The FASB's Concepts Statements have a lower standing in the hierarchy of generally accepted accounting principles (GAAP) in the United States,[§] and entities are not required to consider those concepts in preparing financial statements. However, the GAAP hierarchy in the United States is under reconsideration.[°] The boards have deferred consideration of how to accommodate any differences in the authoritative standing of the conceptual framework in their jurisdictions until that reconsideration is complete.

^{*} IFRSs, as defined in Appendix A of IFRS 1 *First-time Adoption of International Financial Reporting Standards*, are 'Standards and Interpretations adopted by the International Accounting Standards Board (IASB). They comprise: (a) International Financial Reporting Standards; (b) International Accounting Standards; and (c) Interpretations originated by the International Financial Reporting Interpretations Committee (IFRIC) or the former Standing Interpretations Committee (SIC).'

[†] IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, paragraphs 10 and 11.

[§] AU Section 411 *The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles*, paragraphs .10 and .11.

[°] FASB Exposure Draft of a Proposed Statement of Financial Accounting Standards, *The Hierarchy of Generally Accepted Accounting Principles*, April 2005.

Why the boards are reconsidering their frameworks

- P3 A common goal of the boards—a goal shared by their constituents—is for their standards to be clearly based on consistent principles. To be consistent, principles must be rooted in fundamental concepts rather than being a collection of conventions. For the body of standards taken as a whole to result in coherent financial reporting, the fundamental concepts need to constitute a framework that is sound, comprehensive, and internally consistent.
- P4 The IASB's *Framework* and the FASB's Concepts Statements articulate concepts that go a long way towards being an adequate foundation for consistent standards, and the boards have used them for that purpose. For example, the bases for conclusions of most of the boards' standards discuss how their conclusions are consistent with the applicable concepts.
- P5 Another common goal of the boards is to bring their standards into convergence. The boards are aligning their agendas more closely to achieve convergence in future standards, but they will encounter difficulties in doing that if they base their decisions on different frameworks.
- P6 To provide the best foundation for developing principles-based and converged standards, the boards undertook a joint project to develop a common and improved conceptual framework. The goals for the project include updating and refining the existing concepts to reflect changes in markets, business practices, and the economic environment in the two or more decades since the concepts were developed. The boards also intend to improve some parts of the existing frameworks, such as recognition and measurement, as well as to fill some gaps in the frameworks. For example, neither framework includes a robust concept of a reporting entity. The FASB's Concepts Statements include no definition of a reporting entity or discussion of how to identify one. Paragraph 8 of the IASB's *Framework* defines a reporting entity as 'an entity for which there are users who rely on the financial statements as their major source of financial information about the entity.' But the *Framework* does not include a discussion of either why that definition is appropriate or how it should be applied.

Developing the common conceptual framework

- P7 The boards concluded that a comprehensive reconsideration of all concepts would not be an efficient use of their resources. Many aspects of their frameworks are consistent with each other and, pending comments on the preliminary views set out in this Discussion Paper, do not seem to need fundamental revision. Instead, the boards adopted an approach that focuses mainly on improving the framework, giving priority to issues that are likely to yield standard-setting benefits in the near term. When completed, the common framework will be a single document (like the IASB's *Framework*) rather than a series of Concepts Statements (like the FASB's conceptual framework).
- P8 The boards decided to focus initially on business entities in the private sector. Once concepts for those entities are developed, the boards will consider the applicability of those concepts to financial reporting by other entities, such as not-for-profit entities in the private sector and, in some jurisdictions, business entities in the public sector.
- P9 This Discussion Paper is the product of the boards' initial deliberations of the issues being addressed in the first phase of the project. The boards are simultaneously publishing common preliminary views to seek comments from their respective constituents on the first two draft chapters of the improved framework. The boards will consider those comments in their redeliberations of the issues in this first phase.
- P10 Three other phases of the conceptual framework project are also under way. In those phases, the boards are considering conceptual matters related to the definitions of elements of financial statements, recognition of elements of financial statements, initial and subsequent measurement of items in financial statements, and the definition and boundaries of a reporting entity. In a later phase, the boards will consider matters of financial statement presentation and disclosures, including the boundaries of general purpose external financial reporting and the role that standard-setters should play in improving the quality of management commentary that accompanies the financial statements.

Due process

- P11 As part of their due process, the boards plan to continue separately publishing common discussion papers, which may be in the form of preliminary views, to seek comments on each of the proposed chapters of the common and improved framework, followed by common exposure

drafts, which will also be separately published. They may also jointly or separately publish discussion papers to seek comments on particular issues before publishing preliminary views on those issues. The boards also expect to continue using other means of soliciting input from their constituents, which include discussions with the IASB's Standards Advisory Council, the FASB's Financial Accounting Standards Advisory Council, round-tables, and other meetings with constituents.

INVITATION TO COMMENT

Invitation to comment

The International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) invite comments on all matters in this Discussion Paper. Comments are most helpful if they:

- (a) indicate the specific paragraph or paragraphs to which the comments relate
- (b) contain a clear rationale
- (c) include any alternative the boards should consider.

Respondents should submit one comment letter to either the IASB or the FASB. The boards will share and consider jointly all comment letters received. Respondents must submit comments in writing by **3 November 2006**.

Summary

Introduction to the framework

- S1 The [draft] Conceptual Framework for Financial Reporting establishes the concepts that underlie financial reporting. The framework is a coherent system of concepts that flow from an objective. The objective identifies the purpose of financial reporting. The other concepts provide guidance on identifying the boundaries of financial reporting, selecting the transactions, other events, and circumstances to be represented, how they should be recognised and measured (or disclosed), and how they should be summarised and reported.

Chapter 1: The objective of financial reporting

Providing information useful in making investment and credit decisions

- S2 The objective of general purpose external financial reporting is to provide information that is useful to present and potential investors and creditors and others in making investment, credit, and similar resource allocation decisions.

Information useful in assessing cash flow prospects

- S3 To help achieve its objective, financial reporting should provide information to help present and potential investors and creditors and others to assess the amounts, timing, and uncertainty of the entity's future cash inflows and outflows (the entity's future cash flows). That information is essential in assessing an entity's ability to generate net cash inflows and thus to provide returns to investors and creditors.

Information about an entity's resources, claims to those resources, and changes in resources and claims

- S4 To help present and potential investors and creditors and others in assessing an entity's ability to generate net cash inflows, financial reporting should provide information about the economic resources of the entity (its assets) and the claims to those resources (its liabilities and

SUMMARY

equity). Information about the effects of transactions and other events and circumstances that change resources and claims to them is also essential.

Chapter 2: Qualitative characteristics of decision-useful financial reporting information

Users and preparers of financial information

- S5 In developing financial reporting standards, standard-setters presume that those who use the resulting information will have a reasonable knowledge of business and economic activities and be able to read a financial report. Standard-setters also presume that users of financial reporting information will review and analyse the information with reasonable diligence.
- S6 Standard-setters also presume that preparers of financial reports will exercise due care in implementing a financial reporting requirement. Exercising due care includes comprehending the reporting requirements for a transaction or other event and applying them properly, as well as presenting the resulting information clearly and concisely.

The qualitative characteristics

Relevance

- S7 To be useful in making investment, credit, and similar resource allocation decisions, information must be relevant to those decisions. *Relevant* information is capable of making a difference in the decisions of users by helping them to evaluate the potential effects of past, present, or future transactions or other events on future cash flows (*predictive value*) or to confirm or correct their previous evaluations (*confirmatory value*). *Timeliness*—making information available to decision makers before it loses its capacity to influence decisions—is another aspect of relevance.

Faithful representation

- S8 To be useful in making investment, credit, and similar resource allocation decisions, information must be a *faithful representation* of the real-world economic phenomena that it purports to represent. The phenomena represented in financial reports are economic resources and obligations and the transactions and other events and circumstances that change them. To be a faithful representation of those economic

phenomena, information must be *verifiable*, *neutral*, and *complete*. (The qualitative characteristic of *faithful representation* would replace the qualitative characteristic of *reliability* that appears in the boards' existing frameworks. Paragraphs BC2.26–BC2.28 explain the reasons for that proposed change.)

- S9 To assure users that information faithfully represents the economic phenomena that it purports to represent, the information must be verifiable. *Verifiability* implies that different knowledgeable and independent observers would reach general consensus, although not necessarily complete agreement, either:
- (a) that the information represents the economic phenomena that it purports to represent without material error or bias (by direct verification); or
 - (b) that the chosen recognition or measurement method has been applied without material error or bias (by indirect verification).

To be verifiable, information need not be a single point estimate. A range of possible amounts and the related probabilities can also be verified.

- S10 *Neutrality* is the absence of bias intended to attain a predetermined result or to induce a particular behaviour. Neutrality is an essential aspect of faithful representation because biased financial reporting information cannot faithfully represent economic phenomena.
- S11 *Completeness* means including in financial reporting all information that is necessary for faithful representation of the economic phenomena that the information purports to represent. Therefore, completeness, within the bounds of what is material and feasible, considering the cost, is an essential component of faithful representation.

Comparability (including consistency)

- S12 Comparability, including consistency, enhances the usefulness of financial reporting information in making investment, credit, and similar resource allocation decisions. *Comparability* is the quality of information that enables users to identify similarities in and differences between two sets of economic phenomena. *Consistency* refers to use of the same accounting policies and procedures, either from period to period within an entity or in a single period across entities. Comparability is the goal; consistency is a means to an end that helps in achieving that goal.

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Understandability

- S13 *Understandability* is the quality of information that enables users who have a reasonable knowledge of business and economic activities and financial accounting, and who study the information with reasonable diligence, to comprehend its meaning. Relevant information should not be excluded solely because it may be too complex or difficult for some users to understand. Understandability is enhanced when information is classified, characterised, and presented clearly and concisely.

Constraints on financial reporting

Materiality

- S14 Information is material if its omission or misstatement could influence the resource allocation decisions that users make on the basis of an entity's financial report. Materiality depends on the nature and amount of the item judged in the particular circumstances of its omission or misstatement. A financial report should include all information that is material in relation to a particular entity—information that is not material may, and probably should, be omitted. To clutter a financial report with immaterial information risks obscuring more important information, thus making the report less decision-useful.

Benefits and costs

- S15 The benefits of financial reporting information should justify the costs of providing and using it. The benefits of financial reporting information include better investment, credit, and similar resource allocation decisions, which in turn result in more efficient functioning of the capital markets and lower costs of capital for the economy as a whole. However, financial reporting and financial reporting standards impose direct and indirect costs on both preparers and users of financial reports, as well as on others such as auditors and regulators. Thus, standard-setters seek information from preparers, users, and other constituents about what they expect the nature and quantity of the benefits and costs of proposed standards to be and consider in their deliberations the information they obtain.

Introduction to the [draft] framework

- IN1 The [draft] Conceptual Framework for Financial Reporting (the framework) establishes the concepts that underlie financial reporting. The [draft] framework is a coherent system of concepts that flow from an objective. The objective identifies the purpose of financial reporting. The other concepts [in the completed framework] provide guidance on identifying the boundaries of financial reporting, selecting the transactions, other events, and circumstances to be represented, how they should be recognised and measured (or disclosed), and how they should be summarised and reported.
- IN2 The boards have concluded that they need a framework to provide direction and structure to their work in developing requirements for financial reporting. (That conclusion is shared by many other national standard-setters that have also developed conceptual frameworks to help guide their decisions on financial reporting issues.) Standard-setters cannot fulfil their missions without a sound and unified conceptual underpinning that guides and provides discipline to decisions about whether one solution to a financial reporting issue is better than other potential solutions.
- IN3 Without the guidance provided by an established framework, standard-setting would be based on the personal financial reporting frameworks developed by each member of the standard-setting body. Standard-setting based on such personal frameworks can produce agreement on specific standard-setting issues only if enough of those frameworks happen to intersect on those issues. Even those agreements might prove transitory because, as the membership of the standard-setting body changes over time, the mix of personal conceptual frameworks changes as well. As a result, a standard-setting body might reach quite different conclusions about similar (or even identical) issues from those reached before, with standards not being consistent with one another and past decisions not being indicative of future decisions.
- IN4 Standard-setting bodies such as the FASB and the IASB are likely to be the most direct beneficiaries of the [proposed] framework. However, knowledge of the concepts that standard-setting bodies use in developing standards of financial reporting should enable all interested parties to gain a better understanding of the reasons for standard-setters' conclusions. That understanding may enhance their ability both to participate effectively in the standard-setting process and to anticipate

INTRODUCTION TO THE [DRAFT] FRAMEWORK

the likely results of standard-setting for a specific issue. Knowledge of the framework should also help interested parties to understand the content and limitations of information provided by financial reporting, thereby furthering their ability to use that information effectively.

- IN5 The [draft] framework does not establish standards for particular financial reporting issues. Some existing standards may be inconsistent with the concepts set forth in this [draft] framework. The [draft] framework does not override those standards, nor does it constitute support for providing financial reports that do not comply with them. The boards may reconsider such standards in the future, depending on the extent to which the topics satisfy the criteria for adding a project to the respective board's agenda. In addition, financial reporting is not static; it evolves over time. Financial reporting standards developed in response to changes in business practices and the economic environment may help in continuing the development of the [proposed] framework.

[Draft] Conceptual Framework for Financial Reporting

Chapter 1: The objective of financial reporting

Introduction

- OB1 The first chapter of the [draft] conceptual framework establishes the objective of general purpose external financial reporting by business entities in the private sector. (Throughout the [draft] framework, the term *entities* (or *entity*) refers to *business entities* (or *a business entity*) in the private sector.) The objective of financial reporting is the foundation of the framework. Other aspects of the framework—qualitative characteristics, elements of financial statements, definition of a reporting entity, recognition and measurement, and presentation and disclosure—flow logically from the objective. Those aspects of the [draft] framework help ensure that financial reporting achieves its objective to the maximum extent feasible.

The objective of financial reporting—providing information useful in making investment and credit decisions

- OB2 The objective of general purpose external financial reporting is to provide information that is useful to present and potential investors and creditors and others in making investment, credit, and similar resource allocation decisions. (Paragraphs OB6–OB9 discuss the potential users of financial reporting information.)

Information useful in assessing cash flow prospects

- OB3 To help achieve its objective, financial reporting should provide information to help present and potential investors and creditors and others to assess the amounts, timing, and uncertainty of the entity's future cash inflows and outflows (the entity's future cash flows). That information is essential in assessing an entity's ability to generate net cash inflows and thus to provide returns to investors and creditors.
- OB4 An entity's investors and creditors (both present and potential) are directly interested in the amounts, timing, and uncertainty of their cash flows from dividends, interest, and the sale, redemption, or maturity of securities or loans. However, the prospects for those cash flows depend on the entity's present cash resources and, more importantly, on its

ability to generate enough cash to pay its employees and suppliers and satisfy its other operating needs, to meet its obligations when due, to reinvest in operations, and to distribute cash to owners (for example, to pay cash dividends). The judgements of capital market participants about the entity's ability to generate net cash inflows affect the values of debt or equity interests. Therefore, those judgements also may affect cash flows to investors and creditors through sale of their interests.

- OB5 In a cash-based exchange economy like those that generally exist in parts of the world in which financial reporting is important, cash (or its equivalent) is the medium of exchange, as well as the store of value. In such an economy, most goods and services have money prices, and cash (including currency, coins, and money on deposit in financial institutions) is prized because of what it can buy. Members of the society carry out their consumption, saving, and investment decisions by allocating their present and expected cash resources. Thus, discussion of the objective focuses on an entity's cash-generating ability and on cash returns to investors and creditors. However, an entity might provide a return in ways other than by distributing cash. One example is a *dividend-in-kind*, which is a dividend distributed to owners in the form of non-cash resources such as inventory. Investors and creditors may be indifferent about whether a return to them is in the form of cash, another asset that can be converted into the same amount of cash, or in some other form. The objective of financial reporting could have been stated in terms of *cash, cash equivalents, or other resources that can be converted to cash or the like*. The role of cash as a medium of exchange and store of value, and therefore the ultimate interest of investors and creditors in cash, makes it unnecessary to use such an unwieldy term.

Potential users of financial reports and their information needs

- OB6 Financial reporting is not an end in itself. It is a means of communicating to the users of financial reports information that is useful in making choices among alternative uses of scarce resources. Thus, the objective stems largely from the needs and interests of those users. Potential users of financial reports and their information needs include:
- (a) *Equity investors*. Equity investors in an entity are interested in the entity's ability to generate net cash inflows because their decisions relate to the amounts, timing, and uncertainties of those cash flows. To an equity investor, an entity is a source of cash in the form of dividends (or other cash distributions) and increases in the

prices of shares or other ownership interests. Equity investors are directly concerned with the ability of the entity to generate net cash inflows and also with how the perception of that ability affects the prices of its equity interests.

- (b) *Creditors.* Creditors, including purchasers of traded debt instruments, provide financial capital to an entity by lending cash (or other assets) to it. Like investors, creditors are interested in the amounts, timing, and uncertainty of an entity's future cash flows. To a creditor, an entity is a source of cash in the form of interest, repayments of borrowings, and increases in the prices of debt securities.
- (c) *Suppliers.* Suppliers provide goods or services rather than financial capital. They are interested in assessing the likelihood that amounts an entity owes them will be paid when due.
- (d) *Employees.* Employees provide services to an entity; employees and their representatives are interested in evaluating the stability, profitability, and growth of their employer. They are interested in information that helps them to assess the entity's continuing ability to pay salaries and wages and to provide incentive payments and retirement and other benefits.
- (e) *Customers.* To its customers, an entity is a source of goods or services. Customers are interested in assessing the entity's ability to continue to provide those goods or services, especially if they have a long-term involvement with, or are dependent on, the entity.
- (f) *Governments and their agencies and regulatory bodies.* Governments and their agencies and regulatory bodies are interested in the activities of an entity because they are in various ways responsible for seeing that economic resources are allocated efficiently. They also need information to help in regulating the activities of entities, determining and applying taxation policies, and preparing national income and similar statistics.
- (g) *Members of the public.* An entity may affect members of the public in a variety of ways. For example, an entity may make a substantial contribution to the local economy by providing employment opportunities, patronising local suppliers, paying taxes, and making charitable contributions. Financial reporting may assist members of the public and their representatives by providing information about the trends and recent developments in the

entity's prosperity and the range of its activities, as well as the entity's ability to continue to undertake those activities.

- OB7 As used in the [draft] framework, the term *investors* refers to equity investors and includes present and potential holders of equity securities, holders of partnership interests, and other owners; as well as their advisers. The term *creditors* as used in the [draft] framework includes present and potential institutional and individual lenders and their advisers. (Investors and creditors include both those who obtain their interests from the entity and those who obtain their interests from other holders of the entity's equity or debt instruments. In other words, a party may become an entity's investor or creditor either directly or indirectly.)
- OB8 Both investors and creditors generally provide cash to an entity with the expectation of receiving a return **on**, as well as a return **of**, the cash provided; in other words, they expect to receive more cash than they provided. Suppliers, employees, customers, governmental agencies, or others also often have claims to cash payment by the entity. For example, at a given date, a supplier might have a right to payment for goods delivered, a customer might have a right to a cash refund, or a governmental agency might have a right to payment for taxes due. However, claims by such parties are not included in the category *creditors* because those parties have dual roles in relation to an entity. For instance, customers' rights to receive goods or services may be more important to them than any right to receive a cash refund or other cash payment. Nevertheless, information that satisfies the needs of investors and creditors is likely to be useful to those parties as well.
- OB9 Management and the governing board of an entity are also interested in the entity's ability to generate net cash inflows because that is a significant part of management's responsibility and accountability to the entity's owners. However, management is responsible for preparing financial reports; management is not their intended recipient. In addition, management is able to prescribe the form and content of the information it needs in satisfying its responsibility to owners. (Paragraphs OB27 and OB28 discuss how the objective of financial reporting relates to assessing management's accountability for its stewardship responsibilities.)

General purpose external financial reporting

- OB10 The information provided by general purpose external financial reporting is directed to the needs of a wide range of users rather than only to the needs of a single group. (Throughout the [draft] framework, the terms *financial reports* or *financial reporting* refer to *general purpose external financial reports* or *reporting*.) Accordingly, financial reports reflect the perspective of the entity rather than only the perspective of the entity's owners (existing ordinary shareholders or ordinary shareholders of the parent entity in consolidated financial statements) or any other single group of users. However, adopting the entity perspective as the basic perspective underlying financial reporting does not preclude also including in financial reports information that is primarily directed to the entity's owners or to another group of users. For example, financial reports include *earnings per (ordinary) share*, which may be of interest largely to holders and potential purchasers of those shares. Financial statements generally also report separately the amount of *earnings*, which may be termed *comprehensive income*, *profit or loss*, or the like, attributable to holders of ordinary shares in the parent entity and the amount attributable to holders of non-controlling interests in subsidiaries. That information, however, is in addition to—not a replacement for—information prepared in accordance with the entity perspective.
- OB11 The objective of financial reporting stems from the information needs of external users who lack the ability to prescribe all the financial information they need from an entity and therefore must rely, at least partly, on the information provided in financial reports. Information needed to satisfy the specialised needs of management and other potential users, such as tax authorities or other governmental agencies that are able to prescribe the information they need from an entity, is beyond the scope of the [draft] framework.
- OB12 Investors and creditors (and their advisers) are the most prominent external groups who use the information provided by financial reporting and who generally lack the ability to prescribe all of the information they need. Investors' and creditors' decisions and their uses of information have been studied and described to a greater extent, and thus are better understood, than those of other external groups. In addition, information that meets the needs of investors and creditors is also likely to be useful to members of other groups who are interested in an entity's ability to generate net cash inflows. Thus, the primary users of general purpose financial reports are present and potential investors and

creditors (and their advisers). (Throughout the [draft] framework, the term *investors and creditors* refers to *investors and creditors and their advisers*.)

- OB13 Present and potential investors and creditors have a common interest in the ability of an entity to generate net cash inflows. Accordingly, information about that ability is the primary focus of financial reporting because it helps satisfy the needs of investors and creditors. Other potential users of financial reports discussed in paragraph OB6 also have either a direct interest or an indirect interest in an entity's ability to generate net cash inflows. For example, although an entity is not a direct source of cash flows to its customers, an entity can continue to provide goods or services to customers only by generating sufficient cash to pay for the resources it uses and to satisfy its other obligations. Thus, information that meets the needs of investors and creditors is also likely to be useful to members of other groups who are interested in an entity's ability to generate net cash inflows. By focusing primarily on the needs of present and potential investors and creditors, the objective of financial reporting encompasses the needs of a wide range of users.

Limitations and evolution of general purpose external financial reporting

- OB14 Financial reporting is but one source of information needed by those who make investment, credit and other resource allocation decisions. Users of financial reports also need to consider pertinent information from other sources, for example, information about general economic conditions or expectations, political events and political climate, or industry outlook.
- OB15 Users of financial reports also need to be aware of the characteristics and limitations of the information in them. To a significant extent, financial reporting information is based on estimates, rather than exact measures, of the financial effects on entities of transactions and other events and circumstances that have already happened or that already exist. The [draft] framework establishes the concepts that underlie those estimates and other aspects of financial reports. The concepts are the goal or ideal towards which standard-setters and preparers of financial reports should strive. Like most goals, the [draft] framework's vision of the ideal financial reporting is unlikely to be achieved in full, at least not in the short term, because of considerations of technical feasibility and cost. In some areas, users of financial reports (and standard-setters) may need to continue to accept estimates based more on accounting conventions than on the concepts in the framework. Nevertheless, establishing a goal towards which to strive is essential if financial reporting is to evolve in a common direction that improves the

information provided to investors, creditors, and others for use in making resource allocation decisions.

Financial statements and financial reporting

- OB16 Financial statements, including the accompanying notes, are a central feature of financial reporting. However, the objective pertains to all of financial reporting, not just financial statements, because some types of both financial and non-financial information may best be communicated by means other than traditional financial statements. Corporate annual reports, prospectuses, and annual reports filed with governmental agencies in some jurisdictions are common examples of reports that include financial statements, other financial information, and non-financial information. News releases, management's forecasts or other descriptions of its plans or expectations, and descriptions of an entity's social or environmental impact are examples of reports giving financial information other than financial statements or giving only non-financial information.
- OB17 Paragraphs OB18–OB26 describe the financial reporting information that has long been considered useful in assessing an entity's ability to generate net cash inflows and why the information is useful for that purpose. Discussion of that information does not imply that other information might not also be useful in achieving the objective of financial reporting.

Information about an entity's resources, claims to those resources, and changes in resources and claims

- OB18 To help present and potential investors and creditors and others in assessing an entity's ability to generate net cash inflows, financial reporting should provide information about the economic resources of the entity (its assets) and the claims on those resources (its liabilities and equity). Information about the effects of transactions and other events and circumstances that change resources and claims to them is also essential.
- OB19 Most of the information provided in financial statements about resources and claims and the changes in them results from the application of accrual accounting, although information about cash flows during a period is also important (paragraph OB24). Accrual accounting attempts to reflect the financial effects of transactions and other events and circumstances that have cash (or other) consequences for an entity's

resources and the claims to them in the periods in which they occur or arise. The buying, producing, selling, and other operations of an entity during a period, as well as other events that affect its economic resources and the claims to them, often do not coincide with the cash receipts and payments of the period. The accrual accounting information in financial reports about an entity's resources and claims and changes in resources and claims generally provides a better basis for assessing cash flow prospects than information solely about the entity's current cash receipts and payments. Without accrual accounting, important economic resources and claims on resources would be excluded from financial statements.

Economic resources and claims to them

- OB20 Information about an entity's economic resources and the claims on them—its financial position—can provide a user of the entity's financial reports with much insight into the amounts, timing, and uncertainty of its future cash flows. That information helps investors, creditors, and others to identify the entity's financial strengths and weaknesses and to assess its liquidity and solvency. Moreover, it indicates the cash flow potentials of some economic resources and the cash needed to satisfy most claims of creditors. Some of an entity's economic resources, such as accounts receivable or investments in debt instruments, are direct sources of future cash inflows. In addition, many creditors' claims, such as accounts payable or outstanding debt instruments, are direct causes of future cash outflows. However, many of the cash flows generated by an entity's operations result from combining several of its economic resources to produce or provide and market goods or services. Although those cash flows cannot be identified with individual economic resources (or claims), investors and creditors need to know the nature and quantity of the resources available for use in an entity's operations, which is provided by information about its financial position. That information is also likely to help those who wish to estimate the value of the entity, but financial reports are not designed to show the value of an entity. Estimating the value of an entity would require taking into account information in addition to that provided in financial reports, for example, general economic conditions in the industry in which the entity operates.

- OB21 Information about an entity's financial structure, as reflected in its financial position, helps users to assess its needs for additional borrowing or other financing and how successful it is likely to be in obtaining that financing. It also helps users to predict how future cash flows will be distributed among those with a claim on the entity's economic resources.

Changes in economic resources and claims to them

- OB22 Information about effects of transactions, other events, and circumstances that change an entity's economic resources and the claims on them also helps a user of the entity's financial reports to assess the amounts, timing, and uncertainty of its future cash flows. That information includes quantitative measures (and other information) about an entity's financial performance measured by accrual accounting, its cash flows during a period, and changes in economic resources and claims that do not directly affect cash.

Financial performance measured by accrual accounting

- OB23 Information about an entity's financial performance during a period measured by changes in its resources and the claims on them other than claims resulting from transactions with owners as owners, as well as the components of the total change, is critical in assessing the entity's ability to generate net cash inflows. Therefore, information about financial performance measured by accrual accounting rather than only by the entity's cash transactions during the period is essential to users of financial reports (paragraph OB19). That information indicates the extent to which the entity has increased its available economic resources, and thus its capacity for generating net cash inflows, through its operations rather than by obtaining additional financing from investors or creditors. An entity's financial performance provides information about the return it has produced on the economic resources it controls. In the long run, an entity must produce a positive return on its economic resources if it is to generate net cash inflows and thus provide a return to its investors and creditors. The variability of that return is also important, especially in assessing the uncertainty of future cash flows, as is information about the components of that return. Investors and creditors usually find information about an entity's past financial performance helpful in predicting the entity's future returns on its resources, which will be its future financial performance.

Financial performance measured by cash flows during a period

- OB24 Information about an entity's cash flows during a period is another aspect of its financial performance that helps users to assess the entity's ability to generate future net cash inflows. Information about an entity's cash flows during a period indicates how it obtains and spends cash, including information about its borrowing and repayment of borrowing, its capital transactions, including cash dividends or other distributions to owners, and other factors that may affect the entity's liquidity or solvency. Investors, creditors, and others use information about cash flows to help them understand an entity's business model and operations, evaluate its financing and investing activities, assess its liquidity or solvency, or interpret information provided about financial performance. Cash flow information provides a perspective on the entity's economic activities that is different from the one provided by accrual accounting—a perspective that is largely free from the measurement and related issues inherent in accrual accounting.

Changes in resources and claims that do not affect cash

- OB25 Financial reporting should also provide information about changes in an entity's economic resources and claims on them that do not affect cash. Examples include acquiring economic resources in exchange for creditors' claims, settling creditors' claims by transfers of non-cash resources, and converting creditors' claims into ownership claims. Investors, creditors, and others need that information to understand fully information about an entity's financial position and financial performance. It also helps users understand the information provided about cash flows during a period.

Management's explanations

- OB26 Financial reporting should include management's explanations and other information needed to enable users to understand the information provided. The usefulness of financial reports to investors, creditors, and others in forming expectations about an entity is enhanced by management's explanations of the information in them. Management knows more about the entity and its affairs than external users do and can often increase the usefulness of financial reports by identifying particular transactions and other events and circumstances that have affected the entity or may affect it in the future and by explaining their financial effects on the entity. In addition, financial reporting often provides information that depends on, or is affected by, management's

estimates and judgements. Investors, creditors, and others are aided in evaluating estimates and judgemental information by explanations of underlying assumptions or methods used, including disclosure of significant uncertainties about principal underlying assumptions or estimates.

The objective of financial reporting and assessing management's stewardship

- OB27 Management of an entity is accountable to owners (shareholders) for the custody and safekeeping of the entity's economic resources and for their efficient and profitable use. Management's stewardship responsibilities include protecting the entity's economic resources, to the extent possible, from unfavourable economic effects of factors in the economy such as inflation or deflation and technological and social changes. Management is also accountable for ensuring that the entity complies with applicable laws, regulations, and contractual provisions. Because management's performance in discharging its stewardship responsibilities significantly affects an entity's ability to generate net cash inflows, management's stewardship is of significant interest to users of financial reports who are interested in making resource allocation decisions.
- OB28 Users of financial reports who wish to assess how well management has discharged its stewardship responsibilities are generally interested in making resource allocation decisions, which include, but are not limited to, whether to buy, sell, or hold the entity's securities or whether to lend money to the entity. Decisions about whether to replace or reappoint management, how to remunerate management, and how to vote on shareholder proposals about management's policies and other matters are also potential considerations in making resource allocation decisions in the broad sense in which that term is used in the framework. Thus, the objective of financial reporting stated in paragraph OB2 encompasses providing information useful in assessing management's stewardship. In addition, the information discussed in paragraphs OB18–OB26 is useful in assessing how well management has discharged its stewardship responsibilities because management is responsible for the entity's resources and related claims and changes in resources and claims.

Basis for Conclusions on draft Chapter 1

Introduction

BC1.1 This Basis for Conclusions summarises considerations that board members thought significant in reaching the conclusions in this chapter of the draft conceptual framework. It includes reasons for accepting some alternatives and rejecting others. Individual board members gave greater weight to some factors than to others.

The objective of financial reporting

Introduction

BC1.2 The boards identified several issues, including some issues of convergence, pertaining to the objective of financial reporting. Those issues and the reasons for the boards' conclusions on them are discussed in paragraphs BC1.3–BC1.43.

Should the objective focus on financial statements or on financial reporting?

BC1.3 FASB Concepts Statement No. 1 *Objectives of Financial Reporting by Business Enterprises* focuses on financial reporting, and the IASB's *Framework* focuses only on financial statements. That difference is not as significant as it might first appear because the primary focus of the FASB's conceptual framework is on financial statements. Initial plans for the FASB's conceptual framework contemplated development of concepts to establish the boundaries of financial reporting and to distinguish between information that should be provided in financial statements and information to be provided in financial reporting outside financial statements. Work on those concepts was begun but never completed.

BC1.4 The boards concluded that the objective should be broad enough to encompass information that might eventually be provided by financial reporting outside financial statements. Thus, the proposed objective pertains to financial reporting as a whole, not just to financial statements. However, financial statements are a central feature of financial reporting, and most of the issues that need to be resolved to enable the boards to make progress on standards projects involve financial statements. Therefore, the boards also concluded that

consideration of specific issues concerning the boundaries of financial reporting and distinctions between financial statements and other parts of financial reporting should be deferred to a later phase of the conceptual framework project.

- BC1.5 The boards do not expect that resolution of issues in that later phase will significantly change the proposed objective of financial reporting stated in the draft framework. However, reaching conclusions on the boundaries of financial reporting might result in adding information to that discussed in paragraphs OB18–OB26 as helpful in achieving the objective. For example, whether financial reporting should include prospective information or forecasts and, if so, how that information should be provided, has long been the subject of debate. The boards' eventual consideration of those matters might result in a conclusion that adding a discussion of forecasts to the framework would be consistent with the focus on users' interest in the amounts, timing, and uncertainty of an entity's future cash flows (paragraph OB3).
- BC1.6 Whatever additions might be made to the information discussed in paragraphs OB18–OB26 to help achieve the objective, the boards concluded that information about an entity's economic resources and claims on them, and changes in resources and claims, will continue to be needed. The boards decided to defer consideration of issues such as whether to include cash flow forecasts in financial reports to a later phase of the conceptual framework project.
- BC1.7 In addition, questions have arisen about whether financial reporting should include environmental or social information. An example is information about what an entity is doing to ensure that its operations do not harm the sustainability of the environment, perhaps including, but not necessarily limited to, its compliance with environmental regulations. The boards deferred consideration of that issue to the later phase of the project that will deal with the boundaries of financial reporting.

Should the objective be to provide information to a wide range of users or only to existing shareholders?

- BC1.8 Both the FASB's and the IASB's existing frameworks discuss the objective of financial reporting in terms of information that is useful to a wide range of users in making economic decisions. Both frameworks list a variety of present and potential users including, among others, investors, creditors, employees, suppliers, customers, and governmental agencies.

- BC1.9 Questions continue to be raised in standards-level projects about whether financial reporting should be directed to, or reflect the perspective of, existing ordinary shareholders only. Many, though not all, of those questions involve the effects of adopting the *proprietary perspective* or the *entity perspective*. (See paragraphs BC1.14–BC1.17 for a discussion of designating a primary user group.) The two perspectives are important primarily for consolidated financial statements and for determining the distinction between liabilities and equity. They affect whether the effects of transactions and other events are viewed from the perspective of the entire consolidated group or solely from the perspective of the parent entity.
- BC1.10 The boards decided to retain the focus on a wide range of users because it is more consistent with the objective of providing information that is useful for resource allocation decisions by investors, creditors, and other users than a narrower focus on existing ordinary shareholders would be. Although existing ordinary shareholders are important users of financial reports, many other groups need financial information about the entity that they cannot require management to provide and therefore must rely on the information in financial reports. Examples of those groups are potential ordinary shareholders as well as present and potential holders of other types of equity shares, bonds, or options. An example of a situation in which an entity's financial report is directed primarily to potential shareholders and other users, such as present and potential creditors, is in an initial public offering. Moreover, the boards expect that information needed by existing shareholders generally would also be pertinent to decisions by potential shareholders and vice versa. Furthermore, many who are not investors or creditors, such as suppliers, customers, employees, their advisers, and the general public, frequently use financial reports.
- BC1.11 The boards also concluded that the entity perspective is consistent with the focus on a wide range of users because it views the effects of transactions and other events from the perspective of the entire entity rather than only a part of it (in consolidated financial statements, that part would be the parent entity). The proprietary perspective, in contrast, would reflect in financial statements the effects of transactions and other events from only the parent entity's perspective. However, adopting the entity perspective as the main perspective underlying financial reports does not mean that the information needs of existing ordinary shareholders (such as existing ordinary shareholders of the parent entity

in consolidated financial statements) should be neglected. On the contrary, adopting that perspective is intended to help ensure that financial reports meet the needs of existing shareholders and other user groups.

- BC1.12 Although the boards adopted the entity perspective as the basic perspective underlying financial reports, including in financial reports some information that is primarily directed to ordinary shareholders, existing or potential (that is, information consistent with the proprietary perspective), is appropriate. The boards observed that adopting the entity perspective does not preclude also deciding in future standards projects to include in financial statements more information that might be viewed as consistent with a proprietary perspective.
- BC1.13 The boards observed that a broader focus on the needs of a range of users is appropriate both in jurisdictions with a corporate governance model defined in the context of shareholders and in those with a corporate governance model that focuses on stakeholders, which is a broader group than shareholders.

Should the objective designate a primary group of users?

- BC1.14 Both the FASB's and the IASB's existing frameworks identify a particular group of primary users. Information that satisfies the needs of that particular group of users is likely to meet most of the needs of other users. The IASB's *Framework*, paragraph 10, says:

As investors are providers of risk capital to the entity, the provision of financial statements that meet their needs will also meet most of the needs of other users that financial statements can satisfy.

The FASB's Concepts Statement 1 focuses on information for investment and credit decisions, which means that present and potential *investors and creditors* (and their advisers) are the primary users on which the objective focuses.

- BC1.15 The boards concluded that identifying a group of primary users of financial reports, as the existing frameworks do, provides an important focus for the objective and the other parts of the conceptual framework. Without a defined group of primary users, the framework would risk becoming unduly abstract or vague.

- BC1.16 Present and potential investors and creditors are the most prominent external users of financial reports. They are interested in an entity's ability to generate future net cash inflows, which significantly affects the entity's ability to distribute cash to them in the form of dividends or other types of distributions to owners, interest, and repayment of borrowing. Other potential users of financial reports, for example, employees, suppliers, and customers, also have either a direct or an indirect interest in an entity's ability to generate future net cash inflows. Because present and potential investors and creditors clearly represent users of financial reports who are interested in an entity's ability to generate net cash inflows, the boards decided to designate them as the primary users of financial reporting information.
- BC1.17 Some constituents suggested designating existing ordinary shareholders as the primary users of financial reports. For the reasons discussed in paragraph BC1.16, the boards decided to designate a somewhat broader group than existing ordinary shareholders, including potential investors and present and potential creditors, as the primary users. The boards observed that to designate existing ordinary shareholders as the primary users might imply that standard-setters need not take into account the needs of creditors and others with an interest in the entity's ability to generate net cash inflows, which could effectively negate the focus on a wide range of users. However, designating a primary user group that includes both investors and creditors, present and potential, does not imply that standard-setters, and financial reports, may neglect the information needs of existing ordinary shareholders (paragraph BC1.12). Rather, it means that standard-setters should strive to meet the information needs of all members of the primary user group. The boards expect that the needs of those other members generally will be essentially the same as the needs of existing ordinary shareholders (paragraph BC1.16). However, some standards issues, such as particular disclosures, may be of more significance to the resource allocation needs of creditors than to those of investors, or existing ordinary shareholders. In that situation, designating existing ordinary shareholders as the primary users of financial reporting information could imply an inadequate focus on creditors' needs.

Should the objective focus on general purpose financial reports or on different reports for different users?

- BC1.18 Some of the boards' constituents have suggested that the focus on a single set of financial statements intended to meet the needs of a wide range of users may no longer be appropriate. They think that advances in technology may make general purpose financial reporting obsolete. New technologies may make it practicable for entities either to prepare or to make available the information necessary for different users to assemble different financial reports.
- BC1.19 Providing different reports for different users has some appeal. For example, entities might provide a list of revenues and expenses (or even debits and credits, such as a trial balance), with explanatory notes, and leave it to users to assemble their own performance statements. Alternatively, rather than producing a single performance statement, entities might provide different performance statements for different types of users, for example, different classes of equity investors. Even with such approaches, however, accounting standards would continue to be needed. For example, standard-setters would need to provide guidance on what amounts should be included in the list of revenues and expenses (or debits and credits), and when they should be included, to ensure that users have comparable information across entities.
- BC1.20 To provide different reports for different users or to make available the information that users need to assemble their own reports would make potentially unreasonable demands on many users of financial reporting information. For example, to make informed choices about which of several financial reports to select or which information to select to assemble their own reports or perhaps a single financial statement, many users would need to have a greater understanding of accounting than they have now. Many users of financial reports are not accounting experts and may not wish to acquire such expertise.
- BC1.21 Providing different reports for different users also raises cost-benefit concerns. Requiring entities to provide either a variety of different reporting packages or the information sufficient for users to assemble their own reporting packages would greatly expand the amount of information that entities must make available. That would increase both the costs of providing financial reports and the costs of using them in exchange for benefits that seem questionable, especially if users continue to want a general purpose financial report.

BC1.22 The boards concluded that, at least for the time being, users' information needs continue to be best served by general purpose financial reports. Moreover, because users of financial reports have a common interest in an entity's ability to generate net cash inflows, a financial report that focuses on information that is helpful in assessing that ability is likely to continue to be needed regardless of how much additional financial data is made available to users.

Does the objective of general purpose external financial reporting differ for different types of entities?

BC1.23 The boards also considered whether the objective of general purpose external financial reporting should differ for different types of entities. Possibilities include:

- (a) smaller entities versus larger entities
- (b) entities with listed (publicly traded) financial instruments versus those without such instruments (sometimes referred to as non-public or private entities)
- (c) closely held entities versus those with widely dispersed ownership.

BC1.24 The boards concluded that the objective of general purpose external financial reporting should be the same for all entities that issue such reports. That conclusion is consistent with the IASB *Framework* and FASB Concepts Statement 1, as well as the frameworks of other national standard-setters. The boards observed that the users of some entities' financial reports, for example, smaller, closely held entities, may be able to specify and receive the information they need. Such entities may have little need to issue general purpose external financial reports. However, for entities that do have external users of their financial reports, the objective of the reports issued to them is the same because the information needs of investors, creditors, and others who need to make resource allocation decisions about the entity generally are the same.

BC1.25 Although the objective of financial reporting is the same for all entities, cost-benefit constraints may sometimes lead standard-setters to provide exemptions from specific requirements or require other differences in reporting requirements for some types of entities. In those situations, standard-setters have concluded that the objective can be achieved by financial reports prepared in accordance with such requirements—not that different requirements are needed because the objective is different. (The cost-benefit constraint is discussed in Chapter 2 of the draft framework.)

Is the purpose of the statement of financial position to help particular users to assess solvency?

- BC1.26 In response to suggestions by constituents, the boards considered whether the main purpose of the statement of financial position should be to provide information that helps particular groups of users, such as creditors or regulators, to assess the entity's solvency. The boards note that similar questions could be asked about whether other individual financial statements should be directed to the needs of particular users.
- BC1.27 The question is not whether information provided in the financial statements should be helpful in assessing solvency—clearly it should. Assessing solvency is one part of making investment and credit (and other) decisions, and the overriding objective of general purpose external financial reporting is to provide information that is helpful in making resource allocation decisions. However, some have suggested that the statement of financial position should be directed towards the needs of creditors and regulators, possibly to the exclusion of other users. But to do so would be inconsistent with the objective of providing information to a wide range of users that is helpful in making a variety of resource allocation decisions. Therefore, the boards rejected the notion of directing the statement of financial position (or any other individual financial statement) towards the needs of particular groups of users. Nevertheless, in a standards project, the boards might require disclosure of information that is particularly relevant to creditors (or some other group of users, such as regulators).

The significance of information about financial performance as measured by changes in resources and claims

- BC1.28 Another issue concerning the objective of financial reporting is the relative importance of information about an entity's financial performance provided by measures of comprehensive income and its components.¹ FASB Concepts Statement 1 (paragraph 43) says:

The primary focus of financial reporting is information about an enterprise's performance provided by measures of [comprehensive income] and its components. Investors, creditors, and others who are concerned with

¹ Concepts Statement 1 refers to 'earnings and its components.' However, FASB Concepts Statement No. 6 *Elements of Financial Statements* substitutes the term *comprehensive income* for the term *earnings*. The latter term is reserved for a component of comprehensive income.

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assessing the prospects for enterprise net cash inflows are especially interested in that information.

In contrast, the IASB *Framework* does not elevate the importance of information about performance above that of other financial reporting information.

- BC1.29 The boards concluded that it is important for the proposed framework to explain clearly that to assess an entity's ability to generate net cash inflows, users need information about the entity's *financial performance measured by accrual accounting* (paragraph BC1.30). However, to designate one type of information as the primary focus of financial reporting would be inappropriate.
- BC1.30 The net change during a period in economic resources and the claims on them, other than those resulting from transactions with owners as owners, or components of that net change, may go by a variety of terms, such as *comprehensive income, net income, or profit or loss*. The boards concluded that none of the terms communicate the critical idea that in measuring performance, an entity first identifies and measures its economic resources and the claims on them in accordance with the applicable recognition and measurement guidance. In the process, the entity separates claims by owners from claims by other parties. The entity then calculates the net change in economic resources and claims other than changes resulting from transactions with owners as owners, as well as the net change in claims by owners. (The draft framework refers to the result of that calculation as *financial performance measured by accrual accounting*.) Displays of those changes in economic resources and displays of the list of economic resources and claims are equally important.
- BC1.31 Information about actual cash flows during a period is also important in assessing an entity's financial performance (paragraph OB24). However, financial performance measured by accrual accounting more closely tracks the occurrence of transactions and other events that will have cash consequences for an entity. In addition, financial reports based on accrual accounting include much information about an entity's existing economic resources and the claims on them that would be omitted if only cash flows were reported. Thus, the boards concluded that information about an entity's economic resources and claims on them and the changes in resources measured by accrual accounting is essential to assessing the entity's ability to generate net cash inflows.

Does stewardship have a role in the objective?

- BC1.32 The existing frameworks of both the IASB and the FASB focus on providing information that is useful in making resource allocation decisions as the fundamental objective of financial reporting. (Those frameworks use the term *economic decisions*. The term *resource allocation decisions* used in this draft framework is consistent with, although more specific than, the term used in those frameworks.) As part of that objective, both frameworks also discuss providing information that is helpful in assessing how management has fulfilled its stewardship responsibility. Those frameworks note that the reason why users of financial reports wish to assess how management has discharged its stewardship responsibilities is to help in making resource allocation decisions.
- BC1.33 Differing views continue to exist on whether providing information useful in assessing management's stewardship should be a stated objective of financial reporting, either in addition to the objective of providing information that is useful in making resource allocation decisions or in place of that objective. Views about the meaning and implications of a stewardship objective differ, and supporters of such an objective do not necessarily view the implications of a separate objective focusing on stewardship in the same way that opponents do.
- BC1.34 Some contend that the role of information useful in assessing stewardship should be elevated. They think that assessing how management has fulfilled its stewardship responsibilities may require information that would not necessarily be provided to achieve the objective stated in paragraph OB2. Accordingly, they are concerned about the potential implications of subsuming stewardship within a broad objective focusing on usefulness in making resource allocation decisions.
- BC1.35 Others consider a separate stewardship objective to be unnecessary because it is encompassed in the decision-usefulness objective in paragraph OB2. They say that the information about economic resources and claims, and changes in them, that is needed for making resource allocation decisions is the same information needed for assessing management's stewardship and accountability. Therefore, they think that to include a discussion of providing information that is helpful in assessing stewardship would add nothing substantive to the objective. They also think that to make stewardship a separate objective might risk implying that financial reporting can and should separate management performance from entity performance. Some who hold those views

would eliminate any discussion of stewardship from Chapter 1 of the draft framework.

- BC1.36 On balance, the boards concluded that providing information useful in assessing how management has fulfilled its stewardship responsibility should remain as part of the overall objective of providing information useful in making resource allocation decisions. As noted in paragraph OB28, users of financial reports who wish to assess how well management has discharged its stewardship responsibilities generally are interested in making resource allocation decisions. The boards also concluded that eliminating any discussion of stewardship, even with an explanation of why such a discussion is unnecessary, could erroneously imply that the boards do not think that financial reports should provide information that is useful in assessing stewardship.
- BC1.37 The boards also agreed with the view stated in paragraph BC1.35 that adding a separate objective for stewardship might imply that financial reporting should attempt to separate the effects of management's performance from the effects of events and circumstances that are beyond the control of management. Examples are general economic conditions and the supply and demand characteristics of an entity's inputs and outputs. Management may be able to affect the extent to which the entity benefits or suffers from such events and circumstances. However, the boards concluded that separating the effects of an event or circumstance on the entity from the possibly related effects of management's performance (for example, changes in the nature and amount of various types of assets held or liabilities owed because management anticipates a change in interest rates) is not feasible in financial reporting. Financial reporting provides information about an entity during a period when it was under the direction of a particular management, but it does not directly provide information about that management's performance. To make stewardship a separate objective might exaggerate what is feasible for financial reporting to accomplish.
- BC1.38 Moreover, the boards observed that those who consider providing information useful in assessing management's stewardship to be a broader objective than decision-usefulness may be mixing financial reporting and corporate governance issues. Sound financial reporting information may often be helpful in assessing matters pertaining to corporate governance. However, assessing corporate governance may require information beyond that appropriately provided by financial reporting. Even if it were feasible to separate the effects of management performance from entity performance, the former type of information would not necessarily be an appropriate part of financial reporting.

- BC1.39 The frequent use of financial reports as the basis for contractual agreements and the stewardship issue are related because both may involve situations in which one party acts on behalf of another. Because general purpose financial reports are prepared in accordance with a generally accepted set of financial reporting standards and often are audited, the parties to an agreement may consider them useful as the basis for contractual agreements. However, the parties to an agreement are generally able to specify how financial reporting standards are applied for the purpose of that agreement, including which information in a financial report is used and how it is used. For example, a restrictive covenant may be stated in terms of a particular line item or subtotal on a financial statement, prepared in accordance with financial reporting standards in effect at a specified date. Therefore, reports prepared solely as the basis for contractual agreements are specialised reports, rather than general purpose financial reports that are the subject of this draft framework. (See paragraphs OB10–OB13.)
- BC1.40 The relationship of an entity's management and its owners is essentially the same as that of an agent (management) that acts on behalf of a principal (shareholders or other owners). The economic interests of management may not always be the same as those of shareholders. Members of management may have the ability to take advantage of their position in various ways, for example, to enrich themselves unjustifiably (that is, beyond agreed-upon remuneration) at the expense of owners.
- BC1.41 Some of the concern about stewardship seems to stem from the potential tension between the interests of management and those of shareholders. The boards acknowledge that those are important issues that standard-setters need to keep in mind. Financial reports generally are useful to those with the responsibility for making decisions about management remuneration and monitoring management's dealings with an entity's owners because financial reports include the effects of all transactions engaged in by management on behalf of owners, as well as transactions between the entity and members of its management. But providing information for the specific purpose of helping to decide what constitutes *excessive remuneration* or *unjust enrichment* is not the purpose of financial reporting.

What should be the interaction between financial reporting and management's perspective?

- BC1.42 Another issue involves the interaction between general purpose external financial reporting and management's perspective. The draft framework makes it clear (as do both boards' existing frameworks) that general purpose external financial reporting is directed to the needs of users who lack the ability to specify all of the information that an entity provides to them. An entity's management is not in that category—management has the ability to obtain whatever information it needs. Thus, general purpose external financial reporting is not explicitly directed to the information needs of management. However, as noted in paragraph OB9, an entity's management and its governing board are also interested in the entity's ability to generate net cash inflows because that is a significant part of management's responsibility and accountability to the entity's owners. Thus, financial reporting information is likely to be useful to them as well as to external users of the entity's financial reports.
- BC1.43 Three additional potential aspects of the management perspective pertain to later phases of the conceptual framework project. First, whether management's perspective or intent should affect recognition or measurement will be considered in the phase of the project that deals with measurement concepts. Second, the extent to which, and how, financial reports should include management commentary will be addressed in the phase dealing with presentation and display of financial reporting information. The third issue is whether some information in financial reports should be presented in a way that is consistent with how management views the business. Segment information prepared in accordance with FASB Statement No. 131 *Disclosures about Segments of an Enterprise and Related Information* and financial risk management information prepared in accordance with IFRS 7 *Financial Instruments: Disclosures* are examples of that type of management perspective. That issue also will be considered in the phase dealing with presentation and display of financial reporting information.

Alternative view

- AV1.1 Two IASB members disagree with the proposal for subsuming stewardship within a decision-usefulness objective (paragraphs OB27, OB28 and BC1.36). They would prefer stewardship to be identified as a separate objective of financial reporting.
- AV1.2 The objective in the preliminary views set out in this Discussion Paper of providing information relevant to ‘investment, credit and similar resource allocation decisions’ (paragraph OB2) leads to a view that ‘the ability of an entity to generate future net cash flows’ is ‘the primary focus of financial reporting’ (paragraph OB13). This emphasis on the ability to forecast the future does not fully capture the requirements of stewardship, which is concerned with monitoring past transactions and events.
- AV1.3 Stewardship is concerned with the accountability of the directors, or management board, of a business entity to its proprietors or owners. This is at the heart of the financial reporting process in many jurisdictions, where the financial statements are presented to the shareholders at an annual general meeting, which approves the financial statements, elects directors, approves dividends, and conducts other important business. The financial statements provide input into these decisions, by providing an account of past transactions and events and the current financial position of the business. These decisions concern not only the competence of the stewards of the entity (which is clearly an important consideration in resource allocation) but also their integrity.
- AV1.4 It is accepted that information relevant to predicting future flows of economic benefit is relevant to this stewardship process, but it will not provide a complete set of information for stewardship purposes. For example, stewardship may require more emphasis on related party transactions, and generally on past rather than future transactions and events, than would be required by the primary focus on future cash flows. Thus, stewardship and decision-usefulness for investors are parallel objectives which do not necessarily conflict, but which have different emphases. They should therefore be defined as separate objectives.
- AV1.5 The two IASB members do not agree that stewardship requires management performance to be separated from entity performance (paragraphs BC1.35, BC1.37 and BC1.38). The stewardship responsibility of the management board extends to all of the activities of the entity. Even if some risks are out of the control of management, the decision to

be exposed to those risks (by the choice of activities, investments and hedging and insurance strategies) is within management control.

- AV1.6 Paragraph BC1.41 states that 'providing information for the specific purpose of helping to decide what constitutes *excessive remuneration* or *unjust enrichment* is not the purpose of financial reporting.' The two IASB members agree that this type of information is not a specific purpose of financial reporting. However, the stewardship objective requires that information relevant to these purposes should be supplied insofar as it is material and meets the cost-benefit requirement. Of course, such information is unlikely to be complete for the purposes of stewardship, but financial reports are unlikely to provide complete information for any specific purpose, including the prediction of future cash flows.
- AV1.7 Paragraph BC1.41 also states that 'Financial reports generally are useful to those with the responsibility for making decisions about management remuneration and monitoring management's dealings with an entity's owners because financial reports include the effects of all transactions engaged in by management on behalf of owners, as well as transactions between the entity and members of its management.' Although this statement is correct, the two IASB members believe that, as described in paragraph BC1.34, such information, produced as a by-product of the decision-usefulness objective, may be inadequate to meet the objective of stewardship. In order to meet that objective, a greater amount of disaggregation of information may be required. In particular, the level of materiality for reporting dealings with management should, for stewardship purposes, be determined by reference to the individual rather than the entity. A payment that may appear to have little significance in relation to the entity as a whole may assume much greater significance when viewed as a transaction with an individual manager.

Chapter 2: Qualitative characteristics of decision-useful financial reporting information

Introduction

- QC1 The objective of financial reporting is to provide information that is useful to present and potential investors and creditors and others in making investment, credit, and similar resource allocation decisions (paragraph OB2). To achieve that objective, financial reporting should provide information to help those users in assessing the amounts, timing, and uncertainty of an entity's future cash flows (paragraph OB3). Because the qualitative characteristics discussed in this chapter distinguish **more useful** information from **less useful** information, they are the qualities to be sought in making decisions about financial reporting.
- QC2 The qualitative characteristics of decision-useful financial reporting information, together with two constraints on providing that information, are discussed in paragraphs QC7–QC59, following a discussion of standard-setters' expectations of users and preparers of that information.

Users and preparers of financial information

- QC3 Financial reporting information is directed to meeting the needs of a wide range of users, with present and potential investors and creditors being the primary users. Those users, especially investors, may have widely differing degrees of knowledge about the business and economic environment, business activities, securities markets, and related matters.
- QC4 In developing financial reporting standards, standard-setters presume that those who use the resulting information will have a reasonable knowledge of business and economic activities and be able to read a financial report. Standard-setters also presume that users of financial reporting information will review and analyse the information with reasonable diligence. Financial reporting is a means of communicating information and, like most other types of information, cannot be of much direct help to those who are unable or unwilling to use it or who misuse it. One does not need to be a cartographer to use a map to get to an unfamiliar location. But it is necessary to know how to read a map, including understanding the concepts and symbols used in preparing it, and one must study the map carefully to get to the desired location. Likewise, one does not need to be an accountant or a professional investor

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to use financial reporting information, but it is necessary to learn how to read a financial report. And users need to study the information with the degree of care consistent with both the underlying transactions and other events and the related financial reporting to make a well-informed investment or credit decision. (Paragraphs QC39–QC41 discuss the qualitative characteristic of *understandability*.)

- QC5 Standard-setters also presume that preparers of financial reports will exercise due care in implementing a financial reporting requirement. Exercising due care includes comprehending the reporting requirements for a transaction or other event and applying them properly, as well as presenting the resulting information clearly and concisely.
- QC6 Standard-setters, of course, also bear responsibilities to exercise due care in developing financial reporting standards, including communicating requirements in a manner that preparers can be expected to comprehend and implement without undue effort. However, the qualitative characteristics (and the framework as a whole) pertain to the information that results from the process of establishing standards and implementing them—not to the characteristics of the standards themselves.

The qualitative characteristics

- QC7 The qualities of decision-useful financial reporting information are *relevance*, *faithful representation*, *comparability*, and *understandability*. The qualities are subject to two pervasive constraints: *materiality* and *benefits that justify costs*.

Relevance

- QC8 To be useful in making investment, credit, and similar resource allocation decisions, information must be relevant to those decisions. *Relevant* information is capable of making a difference in the decisions of users by helping them to evaluate the potential effects of past, present, or future transactions or other events on future cash flows (*predictive value*) or to confirm or correct their previous evaluations (*confirmatory value*). *Timeliness*—making information available to decision makers before it loses its capacity to influence decisions—is another aspect of relevance.
- QC9 The phrase *capable of making a difference* is important. In the past, some participants in the standard-setting process have claimed that information lacks relevance if it is not possible to demonstrate either that it has been or will be used or that it has affected or will affect a particular decision. But information may be capable of making a difference in a

decision—and thus be relevant—even if some users choose not to take advantage of it or are already aware of it. Different users may use different types of information or may use the same information differently. Also, many users may incorporate the available financial reporting information into their decision processes and may not be aware of other pertinent information that financial reports could include. Those users may not be able to determine how, or even whether, such additional information would affect their decisions until the information becomes available and they have had the opportunity to incorporate it into their decision-making processes. Also, some users may have easier access to sources of information outside general purpose financial reports than do others. Accordingly, standard-setters cannot rely entirely on users to request or identify all of the information that is capable of making a difference in a decision.

Predictive value and confirmatory value

- QC10 To say that an item of financial reporting information has predictive value means that it has value as an input to a predictive process. It does not mean that the information itself is a prediction or forecast. Investors, creditors, and others often use information about the past to help in forming their own expectations about the future. Without knowledge of the past, users generally will have no basis for a prediction. For example, information about past or current financial position and performance, generally considered in conjunction with other information, is often used in predicting future financial position and performance and other matters, such as future dividend, interest, or wage payments and the entity's ability to meet its commitments as they become due.
- QC11 The focus on predictive value as one aspect of relevance does not mean that relevant information is, in effect, designed to predict itself. Information that has predictive value need not be—and usually is not—part of a series in which the next number in the series can be accurately predicted on the basis of the previous numbers in the series. For example, investors and other users of financial reporting information often wish to predict revenue for the next reporting period. Reported revenue for the most recent reporting period is likely to have value as an input to whatever process a particular user employs to predict future revenue. But current revenue does not, by itself, predict future revenue. (Some types of predictions may be necessary to estimate financial reporting amounts, for example, the predicted useful life of a long-lived asset is used in determining depreciation amounts, and the expected return on a financial instrument is used in estimating its fair value.)

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Those types of predictions necessary to make estimates are not what the framework means by *predictive value*.)

- QC12 In addition, financial information may be highly predictable without being relevant to users' assessments of the amounts, timing, and uncertainty of an entity's future cash flows. An example is straight-line depreciation of the original (historical) cost of a piece of equipment. Reported depreciation expense for one year exactly predicts depreciation expense for the next year in the life of the equipment. Historical cost depreciation reflects the using up or consumption of an asset, which is a real-world economic phenomenon. (See paragraph QC18.) But the amounts allocated to each year and the resulting carrying amount may not faithfully represent the decline in the asset's value or its current condition in financial terms unless the value of the asset declines rateably over its estimated useful life. In such circumstances, historical cost depreciation may not be very helpful in assessing an entity's ability to generate net cash inflows.
- QC13 Information that has confirmatory value may confirm past (or present) expectations based on previous evaluations or it may change (correct) them. Information that confirms past expectations decreases the uncertainty (increases the likelihood) that the results will be as previously expected. If the information changes expectations, it changes the perceived probabilities of the range of possible outcomes or their amounts. In other words, the information changes the degree of confidence in past expectations. Either way, it is capable of making a difference in users' decisions.
- QC14 The predictive and confirmatory roles of information are interrelated; information that has predictive value usually also has confirmatory value. For example, information about the current level and structure of assets and liabilities helps users to predict an entity's ability to take advantage of opportunities and to react to adverse situations. The same information helps to confirm or correct users' past predictions about that ability.

Timeliness

- QC15 Timeliness, which is an ancillary aspect of relevance, means having information available to decision makers before it loses its capacity to influence decisions. If information becomes available only after the time that a decision must be made, it has no capacity to influence that decision and thus lacks relevance. Timeliness alone cannot make information relevant. But having relevant information available sooner can enhance

its capacity to influence decisions, and a lack of timeliness can rob information of relevance it might otherwise have had. To sacrifice some degree of precision for increased timeliness sometimes may be desirable because an approximation produced quickly may be more useful than precise information that takes longer to produce. However, some information may continue to be timely long after the end of a reporting period because some users may continue to need to consider that information in making decisions. For example, users may need to assess trends in various items of financial reporting information in making investment or credit decisions.

Faithful representation

- QC16 To be useful in making investment, credit, and similar resource allocation decisions, information must be a *faithful representation* of the real-world economic phenomena that it purports to represent. The phenomena represented in financial reports are economic resources and obligations and the transactions and other events and circumstances that change them. To be a faithful representation of those economic phenomena, information must be *verifiable, neutral, and complete*.
- QC17 Information cannot be a faithful representation of an economic phenomenon unless it depicts the economic substance of the underlying transaction or other event, which is often, but not always, the same as its legal form. Thus, to include what has often been termed *substance over form* as a separate qualitative characteristic is unnecessary because faithful representation is incompatible with information that subordinates substance to form.
- QC18 The phrase *real-world economic phenomena* deserves emphasis because its implications have often been overlooked. The phenomena depicted in financial reports are *real-world* because they exist now or have already occurred. For example, a stamping machine exists in the real world. In contrast, an accounting construct such as a 'deferred charge' (that is not an economic resource) or a 'deferred credit' (that is not an economic obligation) is a creation of accountants. Because such deferred charges and deferred credits do not exist in the real world outside financial reporting, they cannot be faithfully represented as the term is used in the framework. The phenomena to be represented in financial reports are *economic* because they are 'relating to the production and distribution of material wealth.'² The machine qualifies as an economic phenomenon, and a photograph may be one way to faithfully represent it. However, a

² Oxford English Dictionary Online, s.v. 'Economic' (accessed 10 January 2006).

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photograph is not sufficient for financial reporting. Inclusion of information about the machine in an entity's financial reports, especially in its financial statements, requires that the machine be depicted in words and numbers. Determining how best to depict in financial terms the machine as it currently exists in the real world is the role of faithful representation. The machine's original cost is a real-world economic phenomenon, and reporting that amount would be one way to faithfully represent the machine. However, if the machine is three years old, reporting it at original cost would not be a faithful representation of the machine as it now exists. In that situation, reporting the machine at an amount based on allocating its original cost over its useful life (amortised or depreciated cost) rather than at its original cost would better represent the machine as it currently exists. Another method, such as reporting the machine at an amount based on what it would cost to replace it in its current condition (replacement cost) might provide an even better representation of the machine as it now exists in the real world. Another method of representing the machine in its current condition would be to report the amount that would be received for the machine in a current exchange between a willing buyer and willing seller (fair value). Whether one of those methods would provide both a more relevant and more representationally faithful depiction of the machine is an issue for standard-setters to resolve.

- QC19 The meaning of the phrase *what it purports to represent* has also sometimes been misunderstood. For example, the number 1,000 is the result of multiplying 100 by 10. If the result of that calculation is all that the information purports to represent, 1,000 might be said to be a faithful representation. But *faithful representation* applies only to real-world economic phenomena (paragraph QC18). Multiplying 100 by 10 might be part of faithfully representing a real-world economic phenomenon, such as the total cost of 100 items acquired for 10 each. But the result of the calculation, by itself, is not a real-world economic phenomenon. Therefore, the cost of 100 items, not the result of the underlying calculation, would be what the information *purports to represent* as the framework uses that term.

Certainty, precision, and faithful representation

- QC20 An entity's financial report, especially its financial statements, can be thought of as a financial model of the entity—a model that represents the entity's economic resources and obligations and changes in them, including the financial flows into, out of, and within the entity. Like all models, it must abstract from much that goes on in the real world.

No model can show everything that happens within a complex entity—to do so, the model would virtually have to reproduce the original. However, the mere fact that a model works—that when it receives inputs it produces outputs—gives no assurance that it faithfully represents the original. Just as an inexpensive sound system may fail to reproduce faithfully the sounds that went into the microphone, so a poor financial model fails to represent faithfully the real-world economic phenomena that it models. The question that standard-setters must face continually is how much precision is necessary and feasible in the financial reporting model. A perfect sound reproduction system would be too expensive for most people, and the cost of a perfect financial reporting model, even if technically feasible, would make it equally impractical.

- QC21 Economic activities take place under conditions of uncertainty, and most financial reporting measures involve estimates of various types, some of which incorporate management judgement. With the possible exception of the amount of cash that an entity controls, it rarely is possible to develop a measure of an economic phenomenon that does not involve some degree of uncertainty. For instance, an entity's receivables could be represented as the sum of the legal claims embodied in the receivables. However, a more relevant representation would be the estimated amount of cash inflows that will result from the receivable, which requires reflecting the effects of uncertainty about whether the receivables are collectible. An estimate of receivables that are collectible at a point in time may be a faithful representation even though the amount that is eventually collected differs from the previous estimate. To faithfully represent an economic phenomenon, an estimate must be based on the appropriate inputs, and each input must reflect the best available information. Accuracy of estimates is desirable, of course, and some minimum level of accuracy (precision) is necessary for an estimate to be a faithful representation of an economic phenomenon. However, faithful representation implies neither absolute precision in the estimate nor certainty about the outcome. To imply a degree of precision or certainty of information that it does not possess would diminish the extent to which the information faithfully represents the economic phenomena that it purports to represent.
- QC22 Some financial reporting measures that are often thought of as precise, or at least more precise than the alternatives, prove to be not necessarily so precise upon closer inspection. For example, measures based on original cost have long been regarded as highly precise representations of economic phenomena, and it is true that the cost of acquiring assets can often be determined unambiguously. However, if a collection of assets is bought for a specified amount, the cost of each individual item may be

impossible to ascertain. The problem of determining cost becomes more difficult if assets are fungible. If an entity has made several purchases at different prices and a number of disposals at different dates, only by the adoption of some convention (such as first-in, first-out (FIFO)) can a cost be allocated to the assets on hand at a particular date. The result is that what is shown as the assets' cost is only one of several alternatives, and it is difficult to verify that the chosen amount faithfully represents the economic phenomenon in question, that is, the purchase price of the assets.

Components of faithful representation

Verifiability

QC23 To assure users that information faithfully represents the economic phenomena that it purports to represent, the information must be verifiable. *Verifiability* implies that different knowledgeable and independent observers would reach general consensus, although not necessarily complete agreement, either:

- (a) that the information represents the economic phenomena that it purports to represent without material error or bias (by direct verification); or
- (b) that the chosen recognition or measurement method has been applied without material error or bias (by indirect verification).

To be verifiable, information need not be a single point estimate. A range of possible amounts and the related probabilities can also be verified.

QC24 Financial reporting information may not faithfully represent economic phenomena because of errors of either *method* or *application* or both. Errors of *method* result from using a recognition or measurement method that is unlikely to produce a result that faithfully represents the economic phenomena that it purports to represent. For example, the method may consistently omit, misdescribe, or misstate the amount of particular economic phenomena, such as a method that consistently produces results that understate the item in question (an example of bias). Errors of *application* result from misapplying a recognition or measurement method. Application errors may be either unintentional (for example, because of lack of skill) or intentional (for example, because of lack of integrity). Intentional errors, whether by use of an inappropriate method or by inappropriate application of a method, are likely to lead to bias which in turn results in information that is not neutral (paragraphs QC27–QC31).

- QC25 Verification may be either direct or indirect. With *direct verification*, an amount or other representation itself is verified, such as by counting cash or observing marketable securities and the quoted prices for them. With *indirect verification*, the amount or other representation is verified by checking the inputs and recalculating the outputs, using the same accounting convention or methodology. An example is verifying the carrying amount of inventory by checking the inputs (quantities and costs) and recalculating the ending inventory using the same cost flow assumption (for example, average cost or FIFO).
- QC26 Direct verification is more helpful in assuring that information faithfully represents the economic phenomena that it purports to represent because direct verification tends to minimise both error and bias in method and application. In contrast, indirect verification tends to minimise only application bias. Indirect verification is generally based on the same method used to produce the amount being verified. Thus, even though different verifiers reach consensus, an indirectly verified amount may not faithfully represent the economic phenomena that it purports to represent because the method used may give rise to material error. Even though indirect verification does not guarantee the appropriateness of the method used, it does carry some assurance that the method used, whatever it was, was applied carefully and without error or personal bias on the part of the one applying it. In many situations, knowledgeable and independent observers may need to apply both direct and indirect verification.

Neutrality

- QC27 *Neutrality* is the absence of bias intended to attain a predetermined result or to induce a particular behaviour. Neutrality is an essential aspect of faithful representation because biased financial reporting information cannot faithfully represent economic phenomena.
- QC28 Neutrality is incompatible with conservatism, which implies a bias in financial reporting information. Neutral information does not colour the image it communicates to influence behaviour in a particular direction. For example, cars might be produced with speedometers that indicate a higher speed than the car actually is travelling at to influence drivers to obey the speed limit. But those 'conservative' speedometers would be unacceptable to drivers who expect them to faithfully represent the speed of the car. Conservative or otherwise biased financial reporting information is equally unacceptable.

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- QC29 However, to say that financial reporting information should be neutral does not mean that it should be without purpose or that it should not influence behaviour. On the contrary, relevant financial reporting information, by definition, is capable of influencing users' decisions. Financial reporting information influences behaviour, as do the results of elections, school examinations, and lotteries. Elections, examinations, and lotteries are not unfair—do not lack neutrality—merely because some people win and others lose. So it is with neutrality in financial reporting.
- QC30 For example, some constituents told standard-setters that requiring recognition of the cost of all employee share options would have a greater effect on some entities than on others. Therefore, some entities might **win** while others **lose** in terms of the effect on their relative cost of capital. Others said that a requirement to recognise the cost of all employee share options would cause some entities either to cease granting share options or to change the nature of the options they grant. None of those potential effects imply that the information resulting from recognising the cost of employee share options would lack neutrality. On the contrary, the information would lack neutrality if standard-setters had designed the requirements to eliminate the potential effect on particular types of entities, to encourage entities to award particular types of options, or otherwise to favour—in effect, to grant an accounting subsidy to—particular entities or particular types of remuneration.
- QC31 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 unreliable and 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. They would also cast doubt on the credibility of all standards, including those that provide decision-useful financial reporting information as judged by the qualitative characteristics.

Completeness

- QC32 *Completeness* means including in financial reporting all information that is necessary for faithful representation of the economic phenomena that the information purports to represent. Therefore, completeness, within the bounds of what is material and feasible, considering the cost, is an essential component of faithful representation.

- QC33 The importance of completeness is clear in the context of a line item on a financial statement. For example, to omit some revenues during the period from the item *revenues* on a statement of income (or profit or loss) would faithfully represent neither that item nor subsequent subtotals and totals. Completeness is also important in developing estimates of economic phenomena, such as in estimating fair value using a valuation technique. For example, estimating the fair value of a financial instrument using a pricing model must take into account all of the economic factors that are valid inputs to the model used. Thus, to omit dividends expected to be paid on the underlying shares over the term of a call or put option on those shares would not faithfully represent the fair value of the option.
- QC34 Ideally, an entity's financial report should include everything about the entity that is necessary to understand the effects of all economic phenomena that are pertinent to users' investment, credit, and similar resource allocation decisions. Completeness, however, is relative because financial reports cannot show everything. To try to include in financial reports everything that any potential user might want would not be cost-beneficial (paragraphs QC53–QC59) and might conflict with other desirable characteristics, such as understandability (paragraphs QC39–QC41). In addition, as discussed in paragraph OB14, those who use financial reports in making resource allocation decisions must also take into account information from other sources, for example, industry information about general supply and demand factors for an entity's products and potential technological innovations.

Comparability (including consistency)

- QC35 Comparability, including consistency, enhances the usefulness of financial reporting information in making investment, credit, and similar resource allocation decisions. *Comparability* is the quality of information that enables users to identify similarities in and differences between two sets of economic phenomena. *Consistency* refers to use of the same accounting policies and procedures, either from period to period within an entity or in a single period across entities. Comparability is the goal; consistency is a means to an end that helps in achieving that goal.
- QC36 The essence of investment, credit, and similar resource allocation decisions is choosing between alternatives, such as whether to buy shares in Entity A or in Entity B. Thus, information about an entity gains greatly in usefulness if it can be compared with similar information about other entities and with similar information about the same entity for some other period or some other point in time. Comparability is not a quality

of an individual item of information, but rather a quality of the relationship between two or more items of information.

- QC37 Comparability has sometimes been confused with uniformity. For information to be comparable, like things must look alike and different things must look different. An overemphasis on uniformity, for example, requiring all entities to use the same assumptions on economic factors such as the expected future dividend rate on their shares as inputs to a valuation model, may reduce comparability by making unlike things look alike. Comparability of financial reporting information is not enhanced by making unlike things look alike any more than it is by making like things look different.
- QC38 Permitting alternative accounting methods for the same transactions or other events (real-world economic phenomena) is undesirable because to do so diminishes comparability and may diminish other desirable qualities as well, for example, faithful representation and understandability. Regardless of its importance, however, comparability alone cannot make information useful for decision-making. Standard-setters may conclude that a temporary reduction in comparability is worthwhile to improve relevance or faithful representation (or both) in the longer term. For example, a temporary reduction in period-to-period consistency, and thus in comparability, occurs when a new financial reporting standard requires a change to a method that improves relevance or faithful representation. Such a change in reporting often also effectively trades a temporary reduction in period-to-period consistency for greater comparability in the future. In that situation, appropriate disclosures can help to compensate for the temporary reduction in comparability.

Understandability

- QC39 *Understandability* is the quality of information that enables users who have a reasonable knowledge of business and economic activities and financial reporting, and who study the information with reasonable diligence, to comprehend its meaning. (Paragraphs QC3 and QC4 discuss standard-setters' expectations of users of financial reporting information. The quality of understandability is defined in relation to users who satisfy those expectations.) Relevant information should not be excluded solely because it may be too complex or difficult for some users to understand. Understandability is enhanced when information is classified, characterised, and presented clearly and concisely. Comparability also enhances understandability.

- QC40 Information cannot influence a particular user's decision unless it is presented in a manner that the user can understand. However, information may be relevant to a situation even though some people who confront the situation cannot understand it—at least not without help. For example, a traveller in a foreign country may have trouble ordering from a menu printed in an unfamiliar language. The listing of items on the menu is relevant to the decision, but the traveller may not be able to use that information unless it is translated into a language that the traveller understands. Thus, information may not be useful to a particular user even though it is relevant to the situation the user faces.
- QC41 Similar situations arise frequently in financial reporting. For example, investors or creditors unfamiliar with actions an entity might take to hedge its exposure to financial risks might have difficulty understanding a note to the financial statements that explains its hedging activities and how those activities are reflected in its financial report. That information, however, is relevant to decisions about the entity and should be understandable to users who have a reasonable knowledge of hedging activities and who read and consider the information with reasonable diligence. The understandability of information about hedging activities and related hedge accounting might be improved by a standard-setter requiring, or an entity voluntarily providing, tabular or graphic formats (or both), as well as narrative explanations. However, conciseness is essential because to overwhelm users with unnecessarily lengthy narratives or unnecessary information can rob even relevant and representationally faithful information of its decision-usefulness. Standard-setters, together with those who prepare financial reports, should take whatever steps are necessary and feasible to improve the clarity and conciseness of financial reporting information so that the intended users (paragraph QC4) can understand it.

How the qualitative characteristics relate to the objective of financial reporting and to each other

- QC42 The objective of financial reporting is to provide information that is useful to present and potential investors and creditors and others in making investment, credit, and similar resource allocation decisions. Each qualitative characteristic discussed in this chapter makes its own distinct contribution to the decision-usefulness of financial reporting information. The discussion in paragraphs QC43–QC47 considers both the contributions of, and the relationships among, the qualitative characteristics of financial reporting information. The discussion takes as its starting point that investors, creditors, and other users of financial

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reports wish to understand economic phenomena that are pertinent to their decisions.

- QC43 The qualitative characteristic of *relevance* is concerned with the connection of economic phenomena to the decisions of investors, creditors, and other users of financial reporting information—the pertinence of the phenomena to those decisions. Application of the qualitative characteristic of relevance will identify **which** economic phenomena should be depicted in financial reports, with the intent of providing decision-useful information about those phenomena. Economic phenomena about which information is useful for making those decisions are relevant, and phenomena about which information is **not** useful are irrelevant. Logically, then, relevance must be considered before the other qualitative characteristics because relevance determines which economic phenomena should be depicted in financial reports.
- QC44 In logical order, the next qualitative characteristic to be applied is *faithful representation*. Once relevance is applied to determine which economic phenomena are pertinent to the decisions to be made, faithful representation is applied to determine which depictions of those phenomena provide the best correspondence of relevant phenomena with their representations. (Considering faithful representation after relevance does not mean that faithful representation is secondary to relevance. Rather, relevance is considered first because it would be illogical to consider how to faithfully represent a phenomenon that is not pertinent—information about it is not relevant—to the decisions of users of financial reports.) Application of the faithful representation characteristic determines whether a proposed depiction in words and numbers is faithful (or unfaithful) to the economic phenomena being depicted. Faithful depictions of relevant phenomena can be decision-useful; unfaithful depictions will be either useless for making decisions or misleading.
- QC45 The qualitative characteristics of relevance and representational faithfulness contribute to decision-usefulness in different ways. Thus, they work in concert with one another. Both relevance and faithful representation are necessary because a depiction is decision-useful only if it faithfully represents an economic phenomenon that is relevant to investment and credit decisions. A depiction that is a faithful representation of an irrelevant phenomenon is not decision-useful, just as a depiction that is an unfaithful representation of a relevant phenomenon is not decision-useful. Thus, **either** irrelevance (the economic phenomenon is not connected to the decision to be made)

or unfaithful representation (the depiction is not connected to the phenomena) results in information that is not decision-useful. Together, relevance and faithful representation make financial reporting information decision-useful.

- QC46 The next qualitative characteristics in logical order after faithful representation are *comparability* and *understandability*. They **enhance** the decision-usefulness of financial reporting information that is relevant and representationally faithful. For example, comparability can enhance the decision-usefulness of information because comparable information helps users to detect similarities and differences in the underlying economic phenomena. Understandability can enhance the decision-usefulness of information because it helps users to better comprehend the meaning of that information. However, comparability and understandability cannot, either individually or in concert with each other, make information decision-useful if it is irrelevant or not faithfully represented.
- QC47 The qualitative characteristics are complementary concepts in achieving decision-useful financial reporting information; their application, in concert, should maximise the usefulness of financial reports. However, standard-setters sometimes may need to compromise on one or more of those characteristics because of cost-benefit considerations or technical feasibility issues. Cost-benefit considerations may, for example, cause standard-setters to adopt a less relevant or less representationally faithful depiction to reduce the costs of preparing financial reporting information. (See paragraphs QC53–QC59.) Nevertheless, the purpose of the qualitative characteristics (and the rest of the conceptual framework) is to identify the ideals towards which to strive.

Constraints on financial reporting

- QC48 In addition to the qualitative characteristics of relevance, faithful representation, comparability, and understandability, decision-useful financial reporting is subject to two pervasive constraints: *materiality* and *benefits that justify costs*. The two constraints are linked because each concerns why some information is included in financial reports and other information, or the same type of information in different circumstances, is not.

Materiality

- QC49 Information is material if its omission or misstatement could influence the resource allocation decisions that users make on the basis of an entity's financial report. Materiality depends on the nature and amount of the item judged in the particular circumstances of its omission or misstatement. A financial report should include all information that is material in relation to a particular entity—information that is not material may, and probably should, be omitted. To clutter a financial report with immaterial information risks obscuring more important information, thus making the report less decision-useful.
- QC50 Materiality is considered in the context of the other qualitative characteristics, especially relevance and faithful representation. For example, whether information faithfully represents what it purports to represent should take into account the materiality of any potential misstatement. Thus, materiality is a pervasive constraint on the information to be included in an entity's financial report rather than a qualitative characteristic of decision-useful financial reporting information. Materiality also differs from both the qualitative characteristics and the constraint of benefits that justify costs in that materiality is not a matter to be considered by standard-setters.
- QC51 It is not feasible to specify a uniform quantitative threshold at which a particular type of information becomes material. Materiality judgements are made in the context of the **nature** and the **amount** of an item, as well as the entity's situation. For example:
- (a) Disclosure of the effects of an accounting change in circumstances that put an entity in danger of being in breach of covenant regarding its financial condition, or that help to avoid such a breach of covenant, may justify a lower materiality threshold than if the entity's position were stronger.
 - (b) A misclassification of an asset as equipment that should have been classified as plant may not be material because it does not affect classification on the statement of financial position; the line item 'plant and equipment' is the same regardless of the misclassification. However, a misclassification of the same amount might be material if it changed the classification of an asset from plant or equipment to inventory.
 - (c) An error of 10,000 in the amount of uncollectible receivables is more likely to be material if the total amount of receivables is 100,000 than if it is 1,000,000. Similarly, the materiality of such an

error also may depend on the significance of receivables to an entity's total assets and of uncollectible receivables to an entity's reported financial performance.

- (d) Amounts too small to warrant disclosure or correction in normal circumstances may be considered material if they arise from abnormal or unusual transactions or events or if they involve related parties. Similarly, the amount of a misstatement that would be immaterial if it results from an unintentional error might be considered material if it results from an intentional misstatement.

QC52 In addition, the amount of deviation that is considered immaterial may increase as the attainable degree of precision decreases. For example, the amount of accounts payable usually can be determined from supplier invoices more accurately than can liabilities arising from litigation that must be estimated, and a deviation considered material for the first item may be immaterial for the second.

Benefits and costs

QC53 The benefits of financial reporting information should justify the costs of providing and using it. The benefits of financial reporting information include better investment, credit, and similar resource allocation decisions, which in turn result in more efficient functioning of the capital markets and lower costs of capital for the economy as a whole. However, financial reporting and financial reporting standards impose direct and indirect costs on both preparers and users of financial reports, as well as on others such as auditors or regulators. Thus, standard-setters seek information from preparers, users, and other constituents about what they expect the nature and quantity of the benefits and costs of proposed standards to be and consider in their deliberations the information they obtain.

QC54 The economy and society as a whole are the ultimate beneficiaries of financial reporting that exhibits the qualitative characteristics to the maximum extent feasible. The benefits of financial reporting information include more efficient functioning of the capital markets, which may result in better availability and pricing for consumers, and in better opportunities and remuneration for employees and other suppliers of services or goods. Preparers of decision-useful financial reporting information enjoy other benefits also, including improved access to capital markets, favourable impact on public relations, and perhaps lower costs of capital. The benefits may also include better

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management decisions because financial information used internally is often based at least partly on information prepared for external reporting purposes.

- QC55 The direct costs of providing information include costs of collecting and processing the information, costs of having others verify it, and costs of disseminating it. Direct costs necessitated by changes in financial reporting include revising collection and processing systems and educating preparers, managers, and investors and creditors. Indirect costs may arise from litigation or from revealing secrets to trade competitors or trade unions (with a consequent effect on wage demands).
- QC56 The costs that users incur directly are mainly the costs of analysis and interpretation, including revision of analytical tools necessitated by changes in financial reporting requirements. Users' costs may also include costs of separating decision-useful information from other information that is less useful or redundant. However, not requiring decision-useful information also imposes costs, including the costs that users incur to obtain or attempt to estimate needed information using incomplete data in the financial report or data available elsewhere.
- QC57 Preparers incur the direct (and most of the indirect) costs of providing financial information, but investors and, to a lesser extent, other providers of capital ultimately bear those costs in the form of reduced returns to them. Preparers may also be able to pass some of those costs along to customers. Initially at least, the benefits of new financial reporting information may be enjoyed by parties other than those who bear most of the costs. Ultimately, however, both the costs and the benefits of financial information are diffused widely throughout the economy.
- QC58 In assessing whether the benefits of a proposed standard are likely to justify the costs it imposes, standard-setters generally consider the practicability of implementing it and whether some degree of precision might be sacrificed for greater simplicity and lower cost, in addition to other factors. Standard-setters' assessment of whether the benefits of providing information justify the related costs usually will be more qualitative than quantitative. Even the qualitative information that standard-setters can obtain about benefits, in particular, and costs often will be incomplete. Nevertheless, standard-setters should do what they can to assure that benefits and costs are appropriately balanced.

QC59 Constituents sometimes express concern that the availability of newly required financial reporting information will lead to economic consequences that are adverse to them or to others. Whether the perceived economic consequences of improved financial reporting information may be detrimental (or beneficial) to particular entities or groups of entities are not costs (or benefits) that standard-setters can appropriately consider. To do so would result in information that fails the test of neutrality (paragraphs QC27–QC31). Such consequences, if they occur, result from the availability of financial reporting information that is more useful for making resource allocation decisions than the information previously available.

Basis for Conclusions on draft Chapter 2

Introduction

BC2.1 This Basis for Conclusions summarises considerations that board members thought significant in reaching the conclusions in this chapter of the draft conceptual framework. It includes reasons for accepting some alternatives and rejecting others. Individual board members gave greater weight to some factors than to others.

Qualitative characteristics of financial reporting information

Introduction

BC2.2 The boards considered various issues related to the qualitative characteristics of financial reporting. Paragraphs BC2.3–BC2.72 discuss those issues and the outcome of the boards' consideration of them, beginning with issues about *relevance*.

Relevance

BC2.3 Whether relevance is a desirable qualitative characteristic that belongs in the conceptual framework is not at issue. Both the FASB's and the IASB's existing frameworks discuss relevance as a qualitative characteristic of financial reporting information, as do all other frameworks that the boards reviewed. However, the two frameworks define relevance and identify its components somewhat differently, and the boards determined that the meaning of *predictive value* needed attention.

Capable of making a difference in decisions

BC2.4 The FASB's and the IASB's definitions of relevance are similar, with one potentially significant exception. The IASB *Framework* (paragraph 26) says that information is relevant 'when it influences the economic decisions of users by helping them evaluate past, present or future events or confirming, or correcting, their past evaluations.' FASB Concepts Statement No. 2 *Qualitative Characteristics of Accounting Information*, paragraph 47, says that, to be relevant, '...accounting information must be capable of making a difference in a decision by helping users to form predictions about the outcomes of past, present, and future events or to confirm or correct expectations.' Thus, the definitions differ in whether

information must actually **make a difference** in a decision or **be capable of making a difference** in a decision.

- BC2.5 The boards concluded that information must be **capable of making a difference** in a decision to be relevant. (The other qualitative characteristics and the pervasive constraints on financial reporting help to determine how much of the information that may be capable of making a difference can and should be provided in financial reports.) Users consider many individual items of financial reporting information, together with other types of information from many other sources, in making their investment, credit, and similar resource allocation decisions. The decision a particular user reaches is a joint result of all the information considered. The extent to which users' decisions are affected by a particular item of financial reporting information often would be difficult to determine, even after the information has become available. To determine during the standard-setting process whether and how information that is not yet available would affect users' decisions would be even more difficult, perhaps impossible.
- BC2.6 Whether or not it is possible to demonstrate conclusively that a particular item of information will affect (or has affected) users' decisions, standard-setters can and should take steps to understand how investors and creditors use financial reporting information and how financial reports might better serve their needs. For example, the boards actively solicit written comments on proposed standards from investors and creditors and their representative organisations. The boards also meet frequently with users and user organisations to discuss not only the potential benefits and costs of particular proposed standards but also potential agenda decisions and other matters. Such steps provide standard-setters with knowledge about the types of information that are capable of affecting users' resource allocation decisions.
- BC2.7 In addition, standard-setters assess relevance in relation to a decision—not in relation to particular decision makers. (See paragraphs QC8 and QC9.) For various reasons, some users may choose not to take advantage of a particular item of information. For example, the information in a map that shows where a traveller can find a bridge over a river is relevant to—is capable of making a difference in—a decision about which road to take to cross the river. A person who has travelled that route before may know where the bridge is and have no need to consult the map. That may make the information in the map less valuable to that particular decision maker, but it does not make it less relevant to a decision about which road to take to cross the river. Similarly, some users may have been obtaining an item of information from a source other than financial

reporting, or users may have been estimating the amount of an item that financial reporting does not provide using other items that are provided. That does not mean that the item will not be relevant if a standard-setter requires entities to include that information in their financial reporting. On the contrary, the fact that users have been expending the effort to obtain the information elsewhere may emphasise the relevance of the information to their decisions.

What are the components of relevance?

- BC2.8 The boards identified no significant issues that relate to identifying the components of relevance. Therefore, they made only minor changes in that area, one of which affects terminology. The IASB *Framework* identifies *predictive value* and *confirmatory value* as components of relevance, and the FASB's Concepts Statement 2 refers to *predictive value* and *feedback value*. The boards concluded that confirmatory value and feedback value have the same meaning. In the interest of convergence of terminology, the boards decided to use *confirmatory value* in the broad sense of either confirming the accuracy of prior predictions or correcting them.
- BC2.9 In addition to predictive value and confirmatory value, the IASB *Framework* includes materiality as a component of relevance. However, it observes that materiality is not a qualitative characteristic of information; instead, materiality provides a threshold or cut-off point for deciding what information to report. The IASB *Framework* discusses timeliness separately, as a constraint that could rob information of relevance. Concepts Statement 2 includes timeliness as an ancillary aspect of relevance and discusses materiality separately. The substance of the concepts as discussed in the two frameworks is essentially the same, however. The boards concluded that timeliness pertains only to relevance. In contrast, materiality is pertinent to faithful representation and the other qualities as well as to relevance. For example, a depiction may faithfully represent a relevant, real-world economic phenomenon in all material respects. Thus, the proposed framework separates materiality from relevance. (See paragraphs BC2.66 and BC2.67 for discussion of materiality as a pervasive constraint on financial reporting information.)

What does predictive value mean?

- BC2.10 The boards identified the meaning of *predictive value* as an issue needing attention, more specifically, whether the framework should define predictive value in statistical terms. That is an issue largely because it is easy to confuse *predictive value* as used in financial reporting concepts with *predictability* and related terms used in statistics.
- BC2.11 For the purposes of the proposed framework, information has predictive value if users use it, or could use it, in making their own predictions about the eventual outcomes of past, present, or future events and their effects on future cash flows (paragraphs QC8 and QC9). In contrast, statisticians use *predictability* in a precise way and distinguish it from *persistence*. *Predictability* refers to the accuracy with which it is possible to foretell the next number in a series. *Persistence* refers to the tendency of a series of numbers to continue as it has been going, for example, to continue a random walk rather than reverting to a mean.
- BC2.12 The boards concluded that adopting statistical notions and terminology in the framework would be inappropriate. To do so would imply that relevant financial reporting information must, in itself, predict the future. Although financial reporting might include forward-looking information, the boards noted that information need not be forward-looking to have predictive value. Rather, information that has predictive value is valuable as an input to the processes that investors, creditors, or others use to develop their own predictions. In other words, financial reports supply the information; investors, creditors, and other users make the predictions. Standard-setters cannot, and do not try to, dictate how an individual user makes those predictions—whether by focusing explicitly on predictability, assuming persistence or mean reversion, creating sophisticated models that use accounting data as inputs, or using other methods.

What does *reliability* mean and how can standard-setters best convey its meaning?

- BC2.13 Both Concepts Statement 2 and the IASB *Framework* include *reliability* as an essential qualitative characteristic of decision-useful financial reporting information, as do other conceptual frameworks the boards reviewed. However, the boards identified several cross-cutting issues about reliability and its components. The boards also noted that neither board's existing framework conveys the meaning of reliability clearly enough to avoid misunderstandings.

What are the components of reliability?

BC2.14 In Concepts Statement 2, the components of reliability are *representational faithfulness*, *verifiability*, and *neutrality*, and its discussion of representational faithfulness also encompasses *completeness* and *freedom from bias*. The IASB Framework (paragraph 31) says:

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.

Subsequent paragraphs of the IASB Framework (paragraphs 33–38) discuss *substance over form*, *neutrality*, *prudence*, and *completeness* as aspects of faithful representation.

BC2.15 The boards concluded that both *faithful representation*—the quality of faithfully representing what information purports to represent—and *neutrality*—the absence of bias intended to attain a predetermined result or to induce a particular behaviour—play an essential role in decision-useful information. Their role as desirable qualitative characteristics is not controversial, and both boards' existing frameworks include them.

BC2.16 The boards also concluded that verifiability is an important aspect of reliability. Furthermore, the boards noted that their existing frameworks are not as different with respect to verifiability as it might appear. The IASB Framework does not include verifiability as an explicit aspect or component of reliability, and Concepts Statement 2 does. But the phrase *and can be depended upon by users* in paragraph 31 of the IASB Framework implies the need for a means of assuring users that they can depend on the information. In their joint deliberations, the boards concluded that information needs to be verifiable to assure users that it is free from material error and bias and thus can be depended on to represent what it purports to represent.

Faithful representation and substance over form

BC2.17 The IASB Framework includes *substance over form* among the components of reliability. Paragraph 35 includes the following example:

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...

In contrast, Concepts Statement 2 does not include substance over form ‘because it would be redundant. The quality of reliability and, in particular, of representational faithfulness leaves no room for accounting representations that subordinate substance to form’ (paragraph 160).

- BC2.18 The boards concluded that the qualitative characteristic of *faithful representation* encompasses ensuring that financial reports represent the substance of an economic phenomenon (such as a particular transaction) rather than solely its legal form. To represent legal form that differs from the economic substance of the underlying economic phenomenon could not result in a faithful representation. Therefore, the quality of faithful representation is incompatible with representations that subordinate substance to form. Accordingly, the proposed framework does not identify *substance over form* as a component of faithful representation because to do so would be redundant.

Neutrality and conservatism

- BC2.19 Both boards’ existing frameworks include neutrality as an essential component of faithful representation, and both define it similarly. The boards identified one issue related to neutrality, which involves the role of *conservatism*.
- BC2.20 The FASB’s and the IASB’s existing frameworks discuss the role of conservatism or prudence. For example, the following is from paragraph 92 of Concepts Statement 2. (The phrase in quotation marks is from paragraph 171 of APB Statement No. 4 *Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises*.)

There is a place for a convention such as conservatism—meaning prudence—in financial accounting and reporting, because business and economic activities are surrounded by uncertainty, but it needs to be applied with care. Since a preference “that possible errors in measurement be in the direction of understatement rather than overstatement of net income and net assets” introduces a bias into financial reporting, conservatism tends to conflict with significant qualitative characteristics, such as representational faithfulness, neutrality, and comparability (including consistency).

The next paragraph indicates that:

Conservatism in financial reporting should no longer connote deliberate, consistent understatement of net assets and profits. The Board emphasizes that point because conservatism has long been identified with the idea that deliberate understatement is a virtue.

- BC2.21 Paragraph 37 of the IASB *Framework* says that the exercise of prudence is an appropriate response to the uncertainties inherent in preparing financial statements. It defines prudence as ‘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.’ But that paragraph also notes that the exercise of prudence does not allow for deliberate understatement of assets or income or overstatement of liabilities or expenses.
- BC2.22 It almost goes without saying that accountants should be careful in the presence of uncertainty. In a particular situation, that care might include searching for additional information to reduce uncertainty, reflecting the uncertainty of a range of potential amounts in making an estimate, or selecting an amount from the midpoint of a range if a point estimate is required. Going beyond care in the presence of uncertainty to reflect conservative estimates of income and equity sometimes has been considered desirable to ensure that financial reports do not reflect excessive optimism, that is, bias, on the part of management. However, the boards concluded that describing *prudence* or *conservatism* as a desirable quality or response to uncertainty would conflict with the quality of *neutrality*. Even with the proscriptions of deliberate misstatement that appear in the existing frameworks, an admonition to be prudent is likely to lead to a bias in reported financial position and financial performance. Moreover, understating assets (or overstating liabilities) in one period frequently leads to overstating financial performance in later periods—a result that cannot be described as prudent. Neither result is consistent with the desirable quality of neutrality, which encompasses freedom from bias. Accordingly, the proposed framework does not include *prudence* or *conservatism* as desirable qualities of financial reporting information.

Can reliability be empirically measured?

- BC2.23 Another issue involving reliability is whether financial reporting concepts should (or could) attempt to develop empirical measures of the quality of reliability. The boards considered whether at least some aspects of reliability might be quantifiable and noted that a possibility is the degree to which a measure is *free from material misstatement*. That is an aspect of verifiability now discussed in the auditing literature. But how (or whether) financial reporting concepts could objectively quantify neutrality (freedom from bias) or the overall degree of representational faithfulness is far from clear. Conceivably, the concepts might attempt to

quantify neutrality (and representational faithfulness) by calculating closeness to an ideal (for example, total reported assets as a percentage of total ideally recognised and measured assets). But the so-called ideal would be so subjective, so controversial, that the attempt at quantification likely would be a waste of energy and resources.

- BC2.24 On a larger scale, empirical accounting research techniques, for example, value-relevance and experimental market studies, have accumulated considerable evidence supporting the measurability of the **combined** relevance and reliability of accounting information by correlation to market prices and changes in them. Some studies provide evidence that a particular financial reporting requirement results in information that the market regards as sufficiently relevant and reliable to be decision-useful. Other studies provide evidence that a particular requirement results in information that the market rejects as not sufficiently relevant and reliable. Some of those studies have influenced board decisions, for example, about the amortisation of goodwill. However, such studies have not so far provided help in empirically measuring reliability apart from relevance.
- BC2.25 Both boards' existing frameworks note the desirability in some circumstances of providing statistical information about the reliability (or unreliability) of financial reporting measures. For example, paragraph 72 of Concepts Statement 2 says:

...an indication of the probabilities attaching to different values of an attribute may be the best way of giving information reliably about the measure of the attribute and the uncertainty that surrounds it.

Paragraph 34 of the IASB *Framework* includes a similar statement. Other statistical notions are also sometimes reflected in financial reports. For example, some entities disclose their *value at risk* from derivative financial instruments and similar positions, which is a measure of expected loss under specified circumstances. The boards expect that the use of statistical concepts for financial reporting in specified situations will continue to be important. However, the boards are unaware of useful means of quantifying either the overall quality of reliability or its components and concluded that they should not attempt to develop such means in the proposed framework. In reaching that conclusion, the Boards noted that an inability to **quantify** characteristics identified as **qualitative** is not surprising. A complicating factor is that the meaning of *reliability* in econometrics and statistics is narrower than the way in which the existing frameworks use the term. Any attempt to quantify reliability presumably would require reconciling the use of the term in financial reporting concepts with its use in statistical analysis. Moreover,

exploring the question of whether reliability can be empirically measured emphasised the differing notions of *reliability* held by different standard-setters, as well as different preparers, auditors, and users of financial reporting information. The proposed framework needs to convey a clearer idea of that qualitative characteristic.

How can the framework best convey what reliability means?

- BC2.26 In considering the issues related to the qualitative characteristic of *reliability*, as well as standard-setters' experience with assessing reliability, the boards observed the existence of a variety of notions of what the concept means. For example, some constituents focus on *verifiability* to the virtual exclusion of the *faithful representation* aspect of reliability. Others focus more on faithful representation, perhaps combined with neutrality. And to some, reliability apparently refers primarily to *precision*. The comments on almost any controversial proposal by a standard-setting body also indicate the lack of a common notion of reliability. Sometimes, one group of respondents criticises the proposal as likely to reduce the reliability of the resulting financial reporting; another group supports the same proposal as likely to improve reliability. Generally, neither group explains clearly what it means by *reliability*, and the groups seem to have in mind different notions. Those considerations led the boards to consider how they could better convey what the proposed framework means by reliability.
- BC2.27 Given the nature and extent of the longstanding problems with the qualitative characteristic of *reliability*, as well as previous efforts to address them, the boards concluded that the term itself needed reconsideration. Because further efforts to explain what *reliability* means did not seem likely to be productive, the boards sought a term that would more clearly convey the intended meaning.
- BC2.28 The boards concluded that at least some of the problems seem to be related to presenting *faithful representation* as only one component of reliability. Faithful representation—correspondence or agreement between the accounting measures or descriptions in financial reports and the economic phenomena they purport to represent—is essential if information is to be decision-useful. To faithfully represent real-world economic phenomena, accounting representations must be complete and neutral. In addition, verifiability is needed to assure that the measures or descriptions are free from material error and bias and can be depended on to represent what they purport to represent. Accordingly, the boards concluded that faithful representation encompasses all of the qualities that the previous frameworks included as aspects of reliability.

In addition, elevating faithful representation helps to emphasise that the goal of financial reporting is to faithfully represent real-world economic phenomena and changes in them—whatever they may be. For example, representations of fair values should change when the values change, and the changes should reflect the degree of volatility in those changes. To depict a lack of volatility if the values are, in fact, volatile would not faithfully represent the economic phenomenon.

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.

How does comparability relate to relevance and faithful representation?

BC2.30 Whether comparability is a desirable qualitative characteristic of decision-useful financial reporting information is not controversial. The essence of all investment, credit, and similar resource allocation decisions is choice from among alternatives. Comparable information about the alternatives improves users' ability to make those choices, as does information about a given alternative that is consistent from period to period and across entities within a period. However, the boards identified the role of comparability relative to relevance and faithful representation as an issue needing attention.

BC2.31 The IASB *Framework* discusses comparability as a qualitative characteristic of decision-useful information on a par with relevance and faithful representation. Concepts Statement 2 describes comparability as a quality of the relationship between two or more pieces of information that, although important, is secondary to relevance and faithful representation. Both frameworks, however, indicate that comparability should not be overemphasised at the expense of improved relevance or faithful representation. For example, paragraph 41 of the IASB *Framework* says:

The need for comparability should not be confused with mere uniformity and should not be allowed to become an impediment to the introduction of improved accounting standards. It is not appropriate for an entity to continue accounting in the same manner for a transaction or other event if the policy adopted is not in keeping with the qualitative characteristics of relevance and reliability [faithful representation]. It is also inappropriate for an entity to leave its accounting policies unchanged when more relevant and reliable alternatives exist.

- BC2.32 The boards concluded that comparability logically follows both relevance and faithful representation. As noted in paragraph QC46, comparability alone cannot make information useful for decision making. Regardless of how comparable information may be, it will not be useful if it is irrelevant to users' decisions or does not faithfully represent the economic phenomena it purports to represent. Thus, relevance and faithful representation must be assessed before comparability.
- BC2.33 However, standard-setters sometimes must temporarily sacrifice some consistency to achieve improved relevance or faithful representation (or both) of the information in financial reports. For example, an entity's adoption of a new method of accounting or reporting will temporarily reduce the consistency of its financial reporting, thereby temporarily decreasing comparability. Appropriate disclosures can help to compensate for the resulting temporary decrease in consistency.

What does understandability mean?

- BC2.34 Both the IASB *Framework* and Concepts Statement 2 include *understandability* as an essential characteristic of decision-useful financial reporting information. Concepts Statement 2 (Glossary of Terms) defines understandability as 'the quality of information that enables users to perceive its significance.' The IASB *Framework* does not define the term.
- BC2.35 Both existing frameworks describe in a similar manner the users to whom financial reporting information should be understandable. For example, the IASB *Framework* (paragraph 25) says that users 'are assumed to have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information with reasonable diligence.'
- BC2.36 Despite those discussions of understandability and the descriptions of the users to whom financial reporting is directed, misunderstandings persist. For example, respondents other than users sometimes comment that a proposed financial reporting standard would result in information that users would not understand. Those respondents generally do not explain why they think users would not understand the information, nor is it apparent that they acknowledge the responsibility of users to study the information with reasonable diligence or of preparers to enhance its understandability. In some circumstances, constituents seem to consider understandability to be more important than relevance. They imply that a standard-setter should not require a new accounting method that would enhance the relevance of financial reports because some users might not understand it.

- BC2.37 The boards concluded that the proposed framework needed to clarify both the qualitative characteristic of understandability and the characteristics and responsibilities of users of financial reports. The revised discussion of understandability (paragraphs QC39–QC41) attempts to do that, in part by incorporating into the definition of understandability the responsibility of users to study information with reasonable diligence rather than only being willing to do so. That discussion also brings together important ideas related to understandability that either are absent from, or are not clearly associated with understandability in, the existing frameworks.
- BC2.38 The understandability of information is enhanced by presenting it clearly and concisely. The boards noted that some users have complained that financial reports sometimes obscure important information by using convoluted terminology or by an excessively detailed presentation. Accordingly, paragraph QC41 describes the role of clarity and conciseness and provides examples of how alternative formats might enhance understandability.
- BC2.39 The boards also concluded that the proposed framework should describe an entity's responsibility to use due care in preparing financial reporting information and to enhance its understandability. Paragraph QC5 discusses the responsibilities of entities in preparing financial reporting information.

Understandability in the context of particular types of entities

- BC2.40 As discussed in the Basis for Conclusions on Chapter 1 (paragraphs BC1.23–BC1.25), the boards concluded that the objective of financial reporting is the same for all types of entities. They also concluded that the qualitative characteristics of decision-useful information are the same for all types of entities. The boards observed, however, that financial reports should be understandable by both sophisticated and relatively unsophisticated users. The overall financial sophistication of users of an entity's financial reports may affect the extent to which those users understand potentially complex financial reporting. It follows that some types of entities, for example, entities with a significant number of relatively unsophisticated equity holders, may need to be especially careful to ensure that those users can understand the entity's financial reports. However, all entities need to consider the understandability of their financial reports and should enhance understandability in whatever ways are feasible.

Should additional qualitative characteristics be added?

- BC2.41 The boards considered whether additional qualitative characteristics should be added. They evaluated potential candidates in the context of the purpose of the qualitative characteristics, which is to help ensure that financial reporting information achieves its objective to the maximum extent feasible by distinguishing **more** useful information from **less** useful information (paragraph QC1).

Transparency

- BC2.42 In recent years, standard-setters, regulators, and others have used the terms *transparent* and *transparency* with increasing frequency in describing high quality financial reporting. For example, the FASB's mission statement says that 'accounting standards are essential to the efficient functioning of the economy because decisions about the allocation of resources rely heavily on credible, concise, **transparent** and understandable financial information' (emphasis added). The recently revised Constitution of the International Accounting Standards Committee Foundation, the governing body of the IASB, uses the term in a similar way in describing its purpose. That raises the question of whether *transparency* should be a qualitative characteristic of decision-useful information.
- BC2.43 Accountants, regulators, and others have used *transparency* in different ways. To some, transparency is a quality of financial reporting information. The FASB and the IASB use the term in that sense (paragraph BC2.42). Others have used the term to refer to a quality of accounting standards. For example, the chairman of the US Securities and Exchange Commission, Christopher Cox, said in a speech to the American Institute of Certified Public Accountants,

...we're looking for recommendations on how to make the rules and their application much more clear, straightforward and transparent. From an investor protection standpoint, the need for greater clarity and transparency is obvious.³

³ Christopher Cox, Speech by SEC Chairman: *Remarks Before the 2005 AICPA National Conference on Current SEC and PCAOB Developments*, Washington DC, 5 December 2005.

- BC2.44 Regardless of exactly what it is that accountants or others think should be transparent, they seem to use the term to mean *clear, candid, or easily seen through*, which is consistent with the term's meaning in general use. For example, the *Oxford English Dictionary Online* gives several definitions of *transparent*; the pertinent ones are 'easily seen through, recognized, understood, or detected; manifest, evident, obvious, clear' and 'frank, open, candid, ingenuous.'⁴
- BC2.45 The boards concluded that *transparency* should not be added as a qualitative characteristic of decision-useful financial reporting information because to do so would be redundant. Rather, *transparent* information results from applying several qualitative characteristics that the draft framework already incorporates, including *faithful representation* (paragraph QC16) and its components of *neutrality* (paragraph QC27) and *completeness* (paragraph QC32). Enhancing *understandability* (paragraph QC39) also improves transparency.

True and fair view

- BC2.46 Some discussions of accounting concepts or principles refer to a *true and fair view* or *fair presentation*. For example, the UK *Statement of Principles for Financial Reporting* says:
- The concept of a true and fair view lies at the heart of financial reporting in the UK and the Republic of Ireland. It is the ultimate test for financial statements and, as such, has a powerful, direct effect on accounting practice. No matter how skilled the standard-setters and law-makers are, it is the need to show a true and fair view that puts their requirements in perspective.⁵
- BC2.47 The Companies Act 1947 introduced the notion of a *true and fair view* into law in the United Kingdom, and the European Union's Fourth Directive (Article 2) also uses the term. Other countries have used similar terminology in their legislation regulating business entities. However, none of that legislation defines *true and fair view*. The use of the term in legislation generally is in the context of providing an exception if compliance with accounting standards would not result in a *true and fair view*. However, the issue here is whether the boards should add *true and fair view* as a qualitative characteristic of financial reporting information—not whether the authoritative literature should provide an exception to the application of accounting standards in some circumstances.

⁴ *Oxford English Dictionary Online*, s.v. 'Transparent' (accessed 10 January 2006).

⁵ Accounting Standards Board, *Statement of Principles for Financial Reporting*, December 1999, paragraph 10.

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BC2.48 The IASB *Framework* (paragraph 46) discusses *true and fair view* in the following way:

Financial statements are frequently described as showing a true and fair view of, or as presenting fairly, the financial position, performance and changes in financial position of an entity. Although this *Framework* does not deal directly with such concepts, the application of the principal qualitative characteristics and of appropriate accounting standards normally results in financial statements that convey what is generally understood as a true and fair view of, or as presenting fairly such information.

BC2.49 The boards concluded that *true and fair view* or *present fairly* is not a qualitative characteristic. Instead, a true and fair view should result from applying the qualitative characteristics. (That is the same as the conclusion in the IASB *Framework*.) The boards also observed that for financial reports to *present fairly* or to *present a true and fair view* is much the same as for a financial report to *faithfully represent*, which already is a qualitative characteristic.

Credibility

BC2.50 *Credibility*, which is another term that standard-setters or their constituents sometimes cite as a desirable attribute of financial reporting information, might be considered an additional qualitative characteristic. For example, the sentence from the FASB's mission statement quoted in paragraph BC2.42 refers to *credible* financial information.

BC2.51 Among the several definitions of *credible* in the *Oxford English Dictionary Online*, the most pertinent one is 'worthy of belief or confidence; trustworthy, reliable.'⁶ Clearly, information will not be of much help in making investment, credit, and similar resource allocation decisions if users do not consider it to be worthy of belief. The need for *credibility* is the reason that *verifiability* is one component of faithful representation. However, the boards concluded that *credibility* is not itself a characteristic of decision-useful financial information. Instead, *credibility* is a desired result of the process by which that information is developed. Whether users consider the information in an entity's financial report to be credible will depend heavily on their view of the trustworthiness of the entity's management and auditors, as well as on their view of the relevance of the information in the report and the degree to which it faithfully represents the underlying economic phenomenon.

⁶ *Oxford English Dictionary Online*, s.v. 'Credible' (accessed 16 January 2006).

Internal consistency

BC2.52 Another potential candidate for an additional qualitative characteristic is *internal consistency*. The Japanese Discussion Paper *Qualitative Characteristics of Accounting Information* (paragraph 16) discusses internal consistency as follows:

Internal consistency in this Discussion Paper is different from the term “consistency” that is referred to in conceptual frameworks issued overseas. While the latter requires a particular accounting procedure to be applied (for interim reporting and annual reporting) every period continuously, the former requires that any individual standard adopted should be consistent with the existing system of standards.⁷

BC2.53 Thus, the Japanese Discussion Paper focuses on internal consistency of financial reporting standards rather than of financial reporting information. The Accounting Standards Board of Japan (ASBJ) provided further explanation of internal consistency in preparation for the FASB’s and the IASB’s meetings of June 2005. The ASBJ said that, in developing financial reporting standards, *internal consistency* is needed to infer *relevance*, which usually can be demonstrated only after the information resulting from a proposed standard has actually improved users’ decisions, especially if the standard pertains to new types of transactions or other events. Therefore, if the economic environment has not changed radically, a standard-setter may infer that a proposed standard that is internally consistent with the existing system of standards that result in information accepted as relevant should also provide information that is relevant and useful for decision making.

BC2.54 The boards observed that internal consistency of accounting standards is desirable and that it should naturally result from developing standards that are consistent with the same conceptual framework. In addition, if an existing standard is generally considered to provide relevant information, it is helpful for standard-setters to be able to infer that a new standard that is consistent with the existing standard will do the same. However, the boards concluded that *internal consistency* should not be added as a qualitative characteristic of decision-useful financial reporting information. To do so could impede evolution in the body of financial reporting standards to improve the relevance, faithful representation, comparability, or understandability of financial reports on the grounds that adopting new standards would not result in internal consistency.

⁷ Discussion Paper in a series titled *Conceptual Framework of Financial Accounting*, written by a Working Group on Fundamental Concepts of the Accounting Standards Board of Japan, September 2004.

High quality

- BC2.55 In its report, *International Standard Setting: A Vision for the Future*,⁸ the FASB considered *high quality* as a desirable characteristic of both financial reporting information and financial reporting standards. That report indicates that application of objectives and qualitative characteristics should lead to high quality accounting standards, which in turn should lead to high quality financial reporting information that is useful for making decisions. That is, *quality* is defined by the objectives and qualitative characteristics.
- BC2.56 The boards concluded that *high quality* is achieved by adherence to the objectives and qualitative characteristics. *High quality* information is the goal to which financial reporting and standard-setters aspire. Therefore, the boards did not add *high quality* as a qualitative characteristic.

Other decision criteria sometimes suggested

- BC2.57 Constituents have sometimes suggested other criteria for standard-setting decisions, and the boards have at times cited some of those criteria as part of the rationale for some decisions. Those criteria include:
- (a) simplicity
 - (b) preciseness
 - (c) operationality
 - (d) practicability or practicality
 - (e) acceptability.
- BC2.58 To the extent that criteria such as those listed are appropriate matters for standard-setters to take into account, the boards concluded that they generally are part of the overall weighing of benefits and costs. For example, a simpler method may be less costly to apply than a more complex method. In some circumstances, a simpler method may result in information that is essentially the same as, but somewhat less precise than, a more complex method. In that situation, a standard-setter would include the decrease in precision and the decrease in implementation cost in weighing benefits against costs.

⁸ Report of the FASB *International Accounting Standard Setting: A Vision for the Future* (Norwalk, CT: FASB, 1999).

How the qualitative characteristics relate to the objective of financial reporting and to each other

BC2.59 Both boards' existing frameworks discuss the frequent need to exchange some of one desirable characteristic for an increased amount of another (trade-offs). For example, the IASB *Framework* (paragraph 45) says:

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 judgement.

Concepts Statement 2 discusses necessary trade-offs at greater length, but the essence of that discussion is the same—that applying judgement is necessary to achieve an appropriate balance of the qualitative characteristics.

BC2.60 Concepts Statement 2 also includes a chart of the relationships between the characteristics (together with the pervasive constraints). That chart is labelled 'A Hierarchy of Accounting Qualities'. Concepts Statement 2 acknowledges that the chart is 'a limited device ... for showing certain relationships among the qualities that make accounting information useful' (paragraph 33), and adds that 'the hierarchy should be seen as no more than an explanatory device, the purpose of which is to clarify certain relationships ...' (paragraph 34). Nonetheless, proving the adage that a picture is worth a thousand words, that chart has been reproduced in numerous accounting publications in the United States, including many accounting textbooks at the college and university level.

BC2.61 The boards acknowledged the chart's power as a means of communication. However, they also acknowledged its limitations, and they decided to search for a better way of explaining the relationships among the characteristics than the chart in Concepts Statement 2 provides. The boards considered a chart that would illustrate how standard-setters might apply the qualitative characteristics in making decisions about financial reporting issues. However, they concluded that a chart that illustrated the standard-setting process would necessarily involve matters that the boards had not yet addressed in the conceptual framework project, including recognition, measurement, presentation (display), and disclosure. For that reason, the boards concluded that to include such a chart in a chapter focusing solely on qualitative characteristics would be premature. Instead, they decided that the chapter should explain the relationship of the qualitative characteristics to the objective of financial reporting and to each other.

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- BC2.62 The boards concluded that relevance is the quality that should be considered first. If information about a particular real-world economic phenomenon is not pertinent to investment or credit decisions, none of the other qualitative characteristics matter. Accordingly, it would be inefficient to consider faithful representation, comparability, or understandability for irrelevant items.
- BC2.63 The boards then concluded that faithful representation is the quality that should be considered next. If the depiction of information about a relevant phenomenon is a faithful representation of what it purports to represent, the information will be decision-useful. However, if the depiction is not a faithful representation, it will not result in decision-useful information regardless of how comparable and understandable the depiction may be.
- BC2.64 The boards observed that both relevance and faithful representation are necessary for information to be decision-useful (paragraph QC45). A depiction that is a faithful representation of an irrelevant phenomenon is not decision-useful, nor is a depiction that is an unfaithful representation of a relevant phenomenon. Relevance and faithful representation work together to make financial reporting information useful in making investment, credit, and similar resource allocation decisions.
- BC2.65 Next in the logical progression are the qualitative characteristics of comparability and understandability. Because comparability enhances understandability, the boards concluded that comparability logically precedes understandability. Relevant information that is depicted faithfully may also be comparable and understandable. However, those qualitative characteristics need to be explicitly considered to enhance the decision-usefulness of relevant and faithfully represented information.

Pervasive constraints on financial reporting

Is materiality a qualitative characteristic or a constraint on financial reporting?

- BC2.66 Both Concepts Statement 2 and the IASB *Framework* discuss *materiality*, and both define it similarly. However, Concepts Statement 2 describes materiality as a constraint on financial reporting that can only be considered together with the qualitative characteristics, especially relevance and faithful representation. The IASB *Framework*, on the other hand, discusses materiality as an aspect of relevance and does not

indicate that materiality has a role in relation to the other qualitative characteristics.

- BC2.67 The boards concluded that materiality is a pervasive constraint on financial reporting because it is pertinent to all of the other qualitative characteristics—not just to relevance. The boards also concluded that materiality is not a consideration for standard-setters because whether something (for example, an item misstated or omitted) is material can be assessed only in relation to an individual reporting entity's situation. Accordingly, assessing materiality is a matter for individual entities and their auditors—not for standard-setters.

How should standard-setters evaluate the benefits and costs of financial reporting requirements?

- BC2.68 Both boards' existing frameworks describe the need to balance the benefits of financial reporting information with the costs of providing it as a pervasive constraint on financial reporting that standard-setters, as well as preparers and users of financial reports, should keep in mind. However, the discussion of benefits and costs in both frameworks focuses primarily on the difficulty of conducting cost-benefit analyses for financial reporting requirements.
- BC2.69 The boards concluded that the balance between the benefits of financial reporting information and the costs of providing and using it is a pervasive constraint on financial reporting rather than a qualitative characteristic of decision-useful financial reporting information. In the light of the increased emphasis on the need for cost-benefit assessments in other areas since the existing frameworks were developed, the boards also considered whether standard-setters should conduct more rigorous cost-benefit analyses, perhaps on a quantitative basis.
- BC2.70 Standard-setting bodies have long acknowledged the need to do what they can to ensure that the benefits of financial reporting information justify its costs. In recent years, both the FASB and the IASB have attempted to develop more structured methods of obtaining information about the perceived benefits and costs of proposed standards. The methods used generally have been in the form of requests—some more formal than others—to constituents to submit information about the nature and amount of the benefits and costs they expect to result from a specific proposal. Those requests generally have resulted in helpful information and in some situations led directly to changes to proposed requirements intended to reduce the costs of compliance without significantly reducing the related benefits.

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- BC2.71 The boards observed that, given the current state of the art of cost-benefit analysis, standard-setters are not able to conduct the sort of rigorous, quantitative analyses that could conclusively prove that the expected benefits of a particular reporting requirement would justify the related costs. The major problem in conducting rigorous cost-benefit analyses in financial reporting is the inability to quantify the benefits of a particular reporting requirement, or even to identify all of them. However, obtaining complete, objective quantitative information about the initial and ongoing costs of a requirement, or the failure to impose that requirement, would also be extremely difficult.
- BC2.72 Regardless of the difficulty, standard-setters must take into account both the benefits and the costs of proposed financial reporting requirements. The boards concluded that the proposed framework should commit standard-setters to seek information from constituents about their expectations of the nature and quantity of the benefits and costs of proposed standards and to consider that information in their deliberations. In other words, the boards concluded that the improved framework should go further in the area of assessing benefits and costs than the existing frameworks do. But the draft framework stops short of committing standard-setters to demonstrate that the benefits of a proposed requirement would justify the related costs. To suggest in the proposed framework that standard-setters should attempt to conduct rigorous, quantitative cost-benefit analyses would raise expectations beyond what is feasible and might make it more difficult for standard-setters to improve financial reporting.

Alternative view

- AV2.1 One IASB member believes that the description of verifiability in paragraph QC23 should additionally specify that the consensus between knowledgeable and independent observers should be based on reliable evidence. Consensus that is not based on reliable evidence does not constitute verification.
- AV2.2 The same IASB member believes that the description of indirect verification in paragraph QC23 should include a requirement that the method used should be one that may be expected to yield an estimate of the economic phenomenon that is free from material error or bias. Establishing that an inappropriate method has been applied without material error or bias does not constitute verification of the resulting estimate.