Conceptual Framework

Qualitative Characteristics 1: Relevance and Reliability

Staff contacts:
IASB: Kimberley Crook, kcrook@iasb.org.uk Tel +44 (0) 20 7246 6434
FASB: Halsey Bullen, hgbullen@fasb.org Tel +1 203 956 8274
and Todd Johnson, ltjohnson@fasb.org Tel +1 203 956 5288
AcSB: Ian Hague, Ian.Hague@cica.ca Tel +1 416 204 3270

Introduction

1. This paper focuses on the 'cross-cutting issues' relating to relevance and reliability and their component characteristics that were identified during the series of meetings held in November and December 2004 with small groups of Board members and staff. To provide context and be complete, it also discusses some "non-issues"—other aspects of relevance and reliability and their components that, in the staff's view, need no changes beyond editorial convergence. The cross-cutting issues are as follows:

   QC.2 What do we mean by reliability? (a) Many equate reliability with verifiability, not representational faithfulness. (b) Can it be empirically measured?

   QC.3 Relevance versus reliability – does one always trump the other?

   QC.4 Different standards have different hurdles for what represents "reliable" measurement – is this because we are applying different meanings of reliable (eg depending on desired outcome)? Or is it because of different trade-offs between relevance and reliability? Or is it the influence of conservatism? Why is some information "sufficiently" reliable for balance sheet recognition but not for income statement (eg valuation changes recognised directly in equity)?

   QC.6 What is predictive value? (eg in statistics, persistence vs. mean reversion)

   QC.7 What is the role of conservatism? Does it conflict with neutrality? If not, why not? Why keep it?

2. The staff plans to discuss issues about qualitative characteristics other than relevance and reliability at meetings in June, and issues dealing with trade-offs between characteristics at meetings in July.

3. This paper first discusses issues and other matters relating to relevance and its sub-characteristics, and then considers reliability and its sub-characteristics. The cross-cutting issues are discussed as they arise in those contexts, rather than in numerical order. A summary of the issues and staff recommendations is at the end of the paper, followed by an Appendix that shows the relationships between the recommended characteristics in a diagram.

RELEVANCE

4. Relevance is a quality emphasized in every accounting framework. That is hardly new. For example, in 1966 the American Accounting Association's *A Statement of Basic Accounting Theory* ("ASOBAT") called it the primary standard. There is at least one cross-cutting issue about relevance, about the meaning of predictive value, which is discussed below after reviewing what the staff considers a non-issue: that relevance belongs among the qualitative characteristics and consists of predictive value, confirmatory value, and timeliness.

A non-issue: What does *relevance* mean, and of what does it consist? Predictive value, confirmatory or feedback value, materiality, timeliness?

5. The IASB *Framework for the Preparation and Presentation of Financial Statements* (IASB Framework) says in paragraph 26 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*, (FASB Concepts Statement 2) says in paragraph 47 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," and goes on to define *event* and *outcome*. Those definitions are quite similar. The italics added here emphasize the only real difference: whether information must influence decisions or only be capable of influencing decisions. The staff plans to use the latter formulation, reasoning that information has whatever qualities it has even if some or even all users fail to take advantage of it or already were aware of it.[1]

[1] That is consistent with the UK Statement of Principles, which defines information to be "relevant if it has the ability to influence the economic decisions of users" (paragraph 3.2), and the Canadian concepts, which say "can influence.' But it is not as clearly consistent with the Australian Concepts Statement 3, which says "for information to be relevant it must have value in terms of assisting users in making and evaluating decisions" (paragraph 9). It is somewhat consistent with a draft ASBJ discussion paper that defines *relevance to decision* partly by requiring that information "positively affects and contributes to the investors' decision making" but notes that "it is difficult to

6. IASB *Framework* paragraph 27 says "the predictive and confirmatory roles of information are interrelated," illustrating that with an example about the utility, for both of those roles, of information about current asset holdings. FASB Concepts Statement 2 uses "feedback value" rather than confirmatory role, but paragraph 52 notes that "disclosure requirements almost always have the dual purpose of helping to predict and confirming or correcting earlier predictions," illustrating that with the examples of business segment information and interim reporting. The concept is the same. The staff plans to retain that discussion, using *confirmatory*, in the broad sense of "confirming or correcting," rather than FASB's admittedly "inelegant term" *feedback*.[2]

7. IASB *Framework* paragraphs 29 and 30 state that the relevance of information is affected by its nature and materiality, noting that materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic. FASB Concepts Statement 2 also characterizes materiality as a threshold but discusses materiality separately from relevance. The staff will discuss materiality, and its place among the qualitative characteristics, at the next meeting.

8. In IASB *Framework* paragraph 43, timeliness is cited as a necessary constraint lest information lose its relevance. In FASB Concepts Statement 2, paragraph 56, timeliness is considered "an ancillary aspect of relevance. If information is not available when it is needed or becomes available only so long after the reported events that it has no value for future action, it lacks relevance and is of little or no use." The concept is the same. The staff plans to classify timeliness with relevance, following the usage in the FASB concepts.[3]

QC.6 What is predictive value?

9. One cross-cutting issue about relevance was identified: what is predictive value?

10. Statisticians use *predictability* in a precise way and distinguish it from *persistence*. Predictability concerns the accuracy with which the next number in a series can be

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affirm in advance whether specific information will improve investors' behavior."

[2] That is consistent with other frameworks. The UK Statement of Principles and Australian Concepts Statement 3 make the same point, using the same words and examples as the IASB Framework. The Canadian Handbook section 1000.20 uses the same terminology as the FASB, noting that "information often has both predictive value and feedback value;" asdoes the New Zealand framework (paragraph 4.3). The ASBJ draft discusses only the effect on investors' predictions and behavior.

[3] That is consistent with some other frameworks. Canada lists timeliness as a sub-quality of relevance, as does New Zealand. The UK Statement of Principles does not make timeliness a formal quality, but does say in paragraph 3.2 that, to be relevant, information must be provided in time to influence decisions. However, the AASB follows the IASB in ranking timeliness as a constraint, and the ASBJ draft does not discuss timeliness.

foretold. Persistence concerns the tendency of a series to keep going as it has been going, for example, to continue a random walk rather than reverting to a mean.

11. Accounting concepts have used *predictive value* in a much more general way. IASB *Framework* paragraph 28 explains that information need not be an explicit forecast to have predictive value, and that the predictive value of information is enhanced by the manner of display, citing the example of separately disclosing unusual, abnormal and infrequent items of income or expense. FASB Concepts Statement 2, paragraph 53, similarly explains that "to say that accounting information has *predictive value* is not to say that it is itself a *prediction*," going on to analogize investors' pursuit of information with predictive value to the constantly improving information meteorologists use in forecasting weather. While the FASB discussion alludes to the role of financial statement information as inputs to econometric models, neither framework attempts any real tie-in with statistical techniques. Neither do any of the other frameworks.

12. The Board could ask the staff to look further into adopting statistical terminology in the discussion of predictive value. However, in the staff's view, the current concepts have got it right. Accounting information has predictive value if users use it, or could use it, in making their own predictions about the outcomes of past, present, or future events. That is, accountants supply the information, users make the predictions. *How* users make those predictions—whether they focus explicitly on predictability, assume persistence or mean-reversion, create sophisticated models using accounting data as inputs, or consult an oracle—is not the concern of those who prepare financial statements or set standards for them. Instead, the concern is *whether* users do use the information, or would use it if available, or (perhaps) should use it even though they don't. Therefore, the staff proposes not conducting further research in this area and not attempting to change the discussion of predictive value to incorporate statistical terminology.

RELIABILITY

QC.2 What do we mean by reliability?

13. Reliability is said, in FASB Concepts Statement 2, to comprise representational faithfulness, verifiability, and neutrality, with an overlay of completeness, freedom from bias, precision, and uncertainty. It is said in the IASB Framework to comprise faithful representation, substance over form, neutrality, prudence, and completeness. The UK ASB Principles also include freedom from material error. The Japanese draft uses the three qualities cited by FASB, while Canada's concepts add conservatism. AASB Concepts

Statement 3 discusses almost all of those matters, without giving separate status to any of them. That is a lot of different sub-characteristics to fit under one label, possibly too many; for example, the staff has observed that many constituents seem to equate reliability with verifiability, not representational faithfulness. For purposes of discussion at this meeting, the staff plans to collect those sub-characteristics into three groups:

a. Faithful representation, including completeness and substance over form

b. Verifiability, including precision and uncertainty

c. Neutrality, including freedom from bias, prudence, and conservatism

Faithful representation, including completeness and substance over form

14. Concepts Statement 2 says that "representational faithfulness is correspondence or agreement between a measure or description and the phenomenon it purports to represent. In accounting, the phenomena to be represented are economic resources and obligations and the transactions and events that change those resources and obligations" (paragraph 63).

15. The IASB Framework says that "to be reliable, information must represent faithfully the transactions and other events it either purports to represent or could reasonably be expected to represent" (paragraph 33).

16. For example, the representation of receivables in a balance sheet at a specified dollar amount, net of any allowance for bad debts, purports that the stated number of dollars is collectible. However, if the allowance is too small and many more of the receivables are uncollectible, that depiction would not be reliable because it would not be representationally faithful of the number of dollars that is collectible. What sometimes is overlooked is the requirement that, to be representationally faithful, accounting measures or descriptions must reflect economic phenomena—economic resources and obligations and the transactions that change them—and not simply accounting notions. Consider, for example, so-called "deferred charges" or "deferred credits" sometimes seen in balance sheets. If deferred charges do not reflect economic resources that are assets, and if deferred credits do not reflect economic obligations that are liabilities, those depictions are not representationally faithful and, hence, not useful.

17. In a forthcoming book, former AICPA research director Paul Rosenfield argues for distinguishing *representativeness*—do the data purport to *represent* real-world phenomena?—from *faithfulness*—if so, do they represent the phenomena *faithfully*? For

example, reporting a deferred charge that does not reflect economic resources as an "asset" would not be representative, while reporting an allowance for bad debts that is too small would not be faithful.

18. FASB Concepts Statement 2 illustrates faithful representation using an analogy to maps and mapmaking. Notwithstanding a view expressed at the recent joint meeting, the staff continues to consider it helpful:

> A map represents the geographical features of the mapped area by using symbols bearing no resemblance to the actual countryside, yet they communicate a great deal of information about it. The captions and numbers in financial statements present a "picture of a business enterprise and many of its external and internal relationships more rigorously—more informatively, in fact—than a simple description of it. There are, admittedly important differences between geography and economic activity and, therefore, between maps and financial statements. But the similarities may, nevertheless, be illuminating. [paragraph 24]

19. There is nothing special about the relationship between maps and financial statements and the real-world geography and economic activity that the former abstractions purport to represent. An electrician's schematic diagram, a naval architect's set of lines, a composer's musical score, a physicist's equations, a manager's organization chart—all are abstractions that communicate a great deal of useful information, using symbols that bear little if any resemblance to the real world phenomenon they represent.

20. FASB Concepts Statement 2 notes that "reliability implies completeness of information, at least within the bounds of what is material and feasible, considering the cost. A map that is 99 percent reliable but fails to show a bridge across a river where one exists can do much harm" (paragraph 79). (So can the opposite error of showing a bridge where there is none: a recent television advertisement in America showed a young man watching his car being hauled out of a river, sheepishly commenting that "the map was a disappointment.")[4] The IASB framework reports completeness as one of five subqualities of reliability, saying that "the information in financial statements must be complete within the bounds of materiality and cost" (paragraph 38). To the staff, completeness is closely related to representational faithfulness, while materiality and cost considerations are bounds (or constraints, or thresholds) for all the other qualitative characteristics.

[4] A statistician might call the first mapping error discussed in FASB Concepts Statement 2 "Type I error", rejecting the hypothesis that the bridge was there when the mapmaker should have accepted it. In our terminology, that map lacked completeness, as does a financial statement that leaves out a valuable asset. In contrast, the second mapping error that dampened the sheepish young man's day is "Type II error," accepting the hypothesis that the bridge was there when the mapmaker should have rejected it. That map lacked representational faithfulness, as does a financial statement that reports a deferred charge with no future economic benefit as an asset.

21. The IASB Framework includes *substance over form* among the subqualities of reliability, including an example of a transaction with documentation that purports to pass legal ownership but where side agreements "ensure that the enterprise continues to enjoy the future economic benefits embodied in the asset" (paragraph 35).[5] FASB Concepts Statement 2 did 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. Substance over form is, in any case, a rather vague idea that defies precise definition" (paragraph 160). The staff finds it difficult to disagree with the FASB's main point, though not all staff members agree that the idea is vague.

22. The staff recommends that faithful representation continue to be identified as a key quality (or subquality) of accounting information, a quality that includes completeness and leaves no room for representations that subordinate substance to form.

Verifiability, including precision and uncertainty

23. The IASB Framework does not include verifiability among its qualities. However, it does say that "information has the quality of reliability *when it is free from material error* and bias *and can be depended upon by users*" (paragraph 31). Some might say the italicized words imply the sort of verification provided by internal controls and auditing.[6] FASB Concepts Statement 2, identifies verifiability as one of its three subqualities of reliability.[7]

24. The FASB framework defines verifiability as "the ability through consensus among measurers to ensure that information represents what it purports to represent or that the chosen method of measurement has been used without error or bias." It goes on to discuss verifiability, identifying three key aspects: (1) consensus among observers, (2) assurance

[5] The UK Statement of Principles (paragraph 3.13] and AASB Concepts Statement 3 (paragraph 24) include that same example, but as an illustration of the need for) faithful representation (UK) or of both relevance and reliability (Australia) rather than making substance over form a separate quality. The Canadian concepts also discuss differences between substance and form as part of the discussion of representational faithfulness. (paragraph .21a)

[6] The UK ASB's Statement of Principles also excludes verifiability, but it formally lists freedom from material error as a subquality of reliability (paragraphs 3.16 and 3.17).

[7] The Canadian concepts say, in paragraph .21, that information "is verifiable if knowledgeable and independent observers would concur that it is in agreement with the actual underlying transaction or event with a reasonable degree of precision," and point out that "verifiability focuses on the correct application of a basis of measurement rather than its appropriateness." The New Zealand concepts (paragraph 4.11) and draft ASBJ discussion paper A2 (paragraph 10) also include verifiability as an explicit subquality of reliability. AASB's Concepts Statement 3 includes freedom from undue error and discusses the role of independent auditors in, among other things, ensuring that the contents of general purpose financial statements are verifiable (paragraphs 22 and 23). Verifiability is another concept with a long history: ASOBAT, in 1966, included verifiability among its four basic standards, requiring "that essential similar measures or conclusions would be reached if two or more qualified persons examined the same data."

of correspondence to economic things and events, and (3) direct verification versus indirect verification. Because this is a point of difference between the FASB and IASB frameworks, the following paragraphs discuss those aspects of verifiability at some length.

25. Verifiability implies consensus among observers. Accounting measures that are determined by one measurer should be capable of being confirmed or substantiated by other measurers. For cash balances, that may be relatively straightforward. For receivables, different observers' measures (net of the allowance for bad debts) are more likely to vary, in part because of differences in views about the collectibility of those receivables. Consensus among observers cannot be assessed in isolation. Rather, it must be assessed in the context of both correspondence to economic things and events and direct verification versus indirect verification.

26. Concepts Statement 2 states that "the *purpose of verification* is to provide a significant degree of assurance that accounting measures represent what they purport to represent" (paragraph 81, *emphasis* added), that is, real-world economic phenomena. Accounting information may not correspond to economic things and events because of measurer bias, measurement bias, or both. *Measurer bias* may be unintentional (for example, because of lack of skill) or intentional (for example, because of lack of integrity), which may be evidenced by misapplication of the measurement method. *Measurement bias* results from using a measurement method that is unlikely to produce a result that represents what it purports to represent, such as a method that consistently produces results that understate or overstate the item in question.

27. With *direct* (or *separate*) *verification,* the accounting measure itself is verified, such as by counting cash or observing quoted prices for marketable securities. Another example of direct verification is counting inventories to verify their *quantity.* With *indirect verification,* the accounting measure is verified by checking the inputs and recalculating the outputs, using the same accounting methodology. An example is the carrying amount of inventory, which is indirectly verified by verifying the inputs (quantities and costs) and recalculating the ending inventory using the same cost flow assumption (that is, LIFO, FIFO, etc.). Consensus among measurers with indirect verification is unlikely unless the measurers include the same inputs (costs) and use the same accounting methodology and assumptions, because otherwise there likely will be a wide dispersion in their results. Direct verification tends to minimize both measurer bias and measurement bias. In contrast, indirect verification tends to minimize only measurer bias and not any measurement bias from the selection of accounting or allocation methods. Thus, even

though there is consensus among measurers, an indirectly verified measurement may not be reliable if the accounting method results in a measure that does not correspond to the economic phenomena that it purports to represent.

28. The staff finds itself agreeing with the IASB *Framework* on the need for financial information to be free from material error in order that it can be relied on by users. The staff also finds itself agreeing with the FASB Concepts Statements and others that the way—the established way, and perhaps the only way—to assure users that they can rely on the information is for it to be verifiable, preferably by direct verification. The staff therefore recommends that verifiability be included as a quality or subquality, with an explanation that emphasizes that being verifiable is necessary to provide assurance to users that the information is free from material error, as well as representationally faithful, complete, and neutral.

Neutrality, including freedom from bias, prudence, and conservatism

29. The FASB framework defines neutrality as "the absence in reported information of bias intended to attain a predetermined result or to induce a particular mode of behavior." The IASB Framework equates neutrality to freedom from bias and says "financial statements are not neutral if, by the selection or presentation of information, they influence the making of a decision or judgement in order to achieve a predetermined result or outcome" (paragraph 36). So far, so good.[8] The staff considers the inclusion of neutrality a non-issue. However, differences arise in relating that "non-issue," the concept of neutrality, to the accounting traditions of prudence and conservatism. (You might detect some lack of neutrality in the staff's choice of words in that last sentence, which of course is intended to influence your decision on the next cross-cutting issue in order to achieve a recommended, though not predetermined, result! That heavy-handed humor is actually intended to remind you of the need for and value of neutrality in financial reporting standards.)

QC.7 What is the role of conservatism (or prudence)? Does it conflict with neutrality? If not, why not? Why keep it?

30. The IASB Framework lists prudence as a subquality of reliability, calling prudence "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" (paragraph 37). FASB Concepts

[8] The AASB, UK, Canadian, New Zealand, and ASBJ frameworks all also say much the same thing, with slightly different emphases. For example, the ASBJ discussion paper says "information must not be biased toward the interest of a particular constituency."

Statement 2 discusses conservatism—meaning prudence—at length in paragraphs 91–97, defining it as "a prudent reaction to uncertainty to try to ensure that uncertainty and risks inherent in business situations are adequately considered," but pointedly leaves it out of its table of qualitative characteristics. The IASB does go on to say that "the exercise of prudence does not allow, for example, the creation of hidden reserves or excessive provisions, the deliberate understatement of assets or income, or the deliberate overstatement of liabilities or expenses, because the financial statement would not be neutral and, therefore, not have the quality of reliability." [9]

31. The staff is reluctant to continue to include conservatism or prudence in a list of qualitative characteristics of accounting information right there next to neutrality. The clash of concepts is as glaring as putting orange next to pink. Remembering that the first objective of financial reporting is to provide information useful to present and potential investors and creditors, is it truly helping present investors to understate the net assets of an entity whose securities they now own, possibly inducing them to sell what they might better keep? Is it truly helping potential investors to understate the net income of an entity they might invest in, possibly discouraging them from an investment they might better make? It has been suggested that conservatism is a characteristic of accountants, a counterweight to the exuberance of other kinds of business people, rather than a necessary characteristic of accounting information. Perhaps so. But that suggests, rather than making prudence or conservatism a separate qualitative characteristic, instead having a discussion under neutrality along the lines of the Australian warning against "misguided conservatism" or the FASB Concepts Statement 2's recollection that "it also became evident that understated assets frequently led to overstated income in later periods." That is what the staff recommends.

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[9] The UK Statement of Principles discusses prudence in similar terms to the IASB, going further to say that under conditions of uncertainty, it requires more confirmatory evidence about the existence of, and a greater reliability of measurement for, assets and gains that is required for liabilities and losses; it does, however, echo the IASB's rejection of hidden reserves, excessive provisions, and deliberate over- or under-statements.
The Canadian concepts say that using "conservatism in making judgements under conditions of uncertainty affects neutrality in an acceptable manner", attempting "to ensure that assets, revenues and gains are not overstated and, conversely, that liabilities, expenses and losses are not understated," but rejects "deliberate under- or overstatements.
AASB Concepts Statement 3 avoids using conservatism, noting that, if it means deliberate bias, it is at odds with many of the desirable characteristics, including reliability.
The ASBJ discussion paper, interestingly, does not discuss conservatism or prudence.
The German accounting tradition, as Hans-Georg reminded us at the April meeting, has its prudence or Vorsichtsprinzip, comprising the Imparitätsprinzip and the Realisationsprinzip, explicitly codifying in law what in many other jurisdictions was implicit in practice. The FEE Comparative Study on Conceptual Accounting Frameworks in Europe (May 1997) discusses the roots of that concept of prudence in Austrian, Czech, German, Luxembourgian and Swiss laws and explains that prudence was brought into the EU's Fourth Directive "with a view to protecting the interests of creditors in accordance with the objective of the Directive but also to protect management" (paragraph 10.1).

QC.2 (b) Can reliability be empirically measured?

32. In brief, this issue asks whether it is possible to measure empirically what some people mean by reliability, rather than what our current frameworks mean by reliability. The question has two aspects: can the quality of reliability be quantified, and can empirical techniques measure that quantity?

33. Statisticians use *reliability* much more narrowly than it is used in current concepts frameworks. One definition is "the proportion of variance that is caused by systematic variation in the population." Statistical estimates are commonly presented in terms of precision and reliability, for example, a test using a statistical sample might be said to provide 95 percent assurance (reliability) that estimation error is less than 3 percent, that is, that the mean of some attribute of the actual population is within plus or minus 3 percent (precision) of the sample mean. While that more narrow usage has found its place in auditing standards, it is absent from our accounting concepts.

34. Among accountants, usage varies. Many seem to equate reliability with verifiability, not representational faithfulness, a problem considered in the next section. But the staff is unaware of much usage that points to quantification.

35. If we seek out aspects of reliability that might be quantifiable, possibilities include *freedom from material error*, an aspect of verifiability now discussed in the auditing literature, and perhaps the *faithfulness* that Paul Rosenfield distinguishes from representativeness. It is not clear to the staff how neutrality (freedom from bias) or representativeness could be quantified in an objective way. Perhaps neutrality or representativeness could be quantified by calculating closeness to an ideal (for example, total reported assets as a percentage of total ideally recognized and measured assets) but the ideal would be so subjective, so controversial, that the calculation seems likely to be a waste of energy.

36. 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 price changes. Some studies provide evidence that a particular accounting principle results in the reporting of information that the market considers sufficiently relevant and reliable, while other studies provide evidence that some other accounting principle results in the reporting of information that the market rejects as not sufficiently relevant and reliable. Some of those studies have influenced Board decisions, for example, about the amortization of goodwill. But that may or may not help in

weighing the importance of relevance vis à vis reliability. The IASB recently concluded that it had sufficient evidence, from both empirical research and comments from users, to support its conclusion that it is possible to make an estimate of the fair value of employee share options with sufficient reliability, [10] perhaps because the information was so relevant. On the other hand, one research-minded Board member recently reported no progress after six years' personal pondering about how statistical accounting research techniques might be used to separate relevance from reliability.

37. The staff considers it unlikely that this project can develop useful quantification of the qualitative characteristic of reliability or of its components. However, some but not all staff members think that our converged concepts statement should perhaps discuss the potential utility of empirical research in helping the Boards assess the combined relevance and reliability, or perhaps the overall quality, of information that would be provided by a potential accounting standard.

QC.4 Different standards have different hurdles for what represents "reliable" measurement – is this because we are applying different meanings of reliable (eg depending on desired outcome)? Or is it because of different trade-offs between relevance and reliability? Or is it the influence of conservatism? Why is some information "sufficiently" reliable for balance sheet recognition but not for income statement (eg valuation changes recognised directly in equity)?

38. That cross-cutting issue offers a wide range of possible answers to a rather sweeping question. This paper begins by analyzing the question, then considers possible answers.

39. The question observes that our accounting standards have different (inconsistent?) hurdles for sufficiently reliable measurement and different (inconsistent?) treatments for insufficiently reliable measurement. It doesn't identify the different hurdles, but they certainly exist: trading stock vs held for investment, investment-grade vs. junk bonds, exchange-traded vs. principal-to-principal markets, tangible vs intangible assets. As to different treatments, some items are not recognized at all, others are measured only by the often more easily verified measure of historical cost or proceeds, still others are measured at current values but with (some) unrealized changes excluded from net income.

40. The sweeping question is "why do we standard-setters do that?" As to the suggested answers, well, yes perhaps we sometimes choose a different meaning of reliability to fit a desired outcome (thereby violating precept 2—by using inductive rather than deductive

[10] IFRS 2, paragraph BC307

reasoning—and precept 8—by peeking.) And, yes, different trade-offs between relevance and reliability may have been applied; the issue of trade-offs between qualitative characteristics will be the subject of a later Board meeting. And yes, sometimes it is because we choose conservatively even though that conflicts with neutrality.

41. But, in the staff's view, one of the biggest reasons for different (inconsistent?) treatment in applying reliability is that different Board members mean different things when they say "reliability." For many, the meaning seems to be verifiability, for some it is precision, for some it may be faithful representation, for a few perhaps all of those plus neutrality. Among constituents, the differences in meaning are if anything much greater. Just take a look at the comment letters on almost any contentious exposure draft. Opponents criticize the proposed standard as requiring accounting that is unreliable. Proponents support the same proposal as improving the reliability of financial statements. Notwithstanding the discussion of this matter in the present frameworks, when we say "reliability," we may well be talking past each other.

42. In the staff view, leaving the umbrella term *reliability* in place with the present explanations would be violating precept 11—papering over real differences. We have options. We can either (1) retain the umbrella term reliability but do a better job of explaining that it includes all those subqualities, (2) find a better umbrella term to replace reliability, or (3) establish representational faithfulness, verifiability, and neutrality as separate, equally important qualitative characteristics.

43. After many, many well-crafted but ultimately unsuccessful attempts by Board members, staff, and well-meaning constituents to explain what reliability means, and what it does not mean, the staff is of the view that (1) cannot be achieved.

44. As to (3), the question is whether we should give up the umbrella term. The staff notes that the very definition of reliability (for example, FASB's "the quality of information that assures that information is reasonably free from error and bias and faithfully represents what it purports to represent") is essentially a laundry list of distinct qualities with no unifying idea[11]. The causes of error, bias, and unfaithful or mis-representation differ, and the processes and controls needed to avoid those ills also differ. It is tempting to let those qualities remain distinct by establishing faithful representation, verifiability, and neutrality

[11] The UK Statement of Principles definition of *reliability* literally is a five-point numbered list (paragraph 3.8). In contrast, for relevance, the definitions begin with a unifying idea: FASB Concepts Statement 2 definition begins "The capacity of information to make a difference in a decision. . . ." The IASB *Framework* begins saying information is relevant "when it influences the economic decisions of users . . ."

as separate, equally essential qualitative characteristics of accounting information. But that would make for a longer list, perhaps too long, and might overemphasize some arguably subordinate qualities.

45. So, how about (2), a better umbrella term to replace reliability? It turns out that we may already have the necessary term available. That may have occurred to you, as it did to several staff members, as you read the preceding paragraphs. Here is the key question: How can representations be faithful—how can there be correspondence or agreement between the accounting measures or descriptions in financial reports and the economic phenomena they purport to represent—unless the measures and descriptions are verifiable, and unless the measuring or describing is done in a neutral manner? In the staff's view, they cannot be. A purportedly faithful representation that cannot be verified is no more than an assertion. A purportedly faithful representation that is not neutral is a contradiction in terms. In other words, *faithful* representation requires not only completeness and not subordinating substance to form, as proposed in paragraph 22, but also verifiability and neutrality. For those reasons, the staff recommends replacing *reliability* with *faithful representation.* That uses two words instead of one, and isn't as alliterative, but it is a term that better conveys the second essential quality of accounting information that needs to accompany relevance.

QC.3 Relevance versus reliability – does one always trump the other?

46. This final cross-cutting issue for this meeting asks how do we deal with situations in which relevance points one way and reliability points the other way. That is part of the broader issue of trade-offs between different qualitative characteristics, which is to be the subject of a later meeting, planned for July. But the discussion in this memorandum leads the staff to the preliminary position that no, neither relevance or reliability (whatever we may call it) always trumps the other. Either can trump the other. Both qualities are necessary for information to be useful to present and prospective investors and creditors. Irrelevant information, however reliable, is of little if any use. Unreliable information—information that misrepresents what it purports to represent, however relevant the subject might be, is also of little if any use.

Summary of Staff Recommendations

47. The following list indicates the issue, the recommendation, and the paragraph in which the recommendation is made.

Non-issue: What does *relevance* mean, and of what does it consist?

Accounting information must be *capable of making a difference* in a decision
It consists of predictive value, confirmatory value, and timeliness. (paragraphs 5,6,and 8).

QC.6 What is predictive value?

The meaning in the present frameworks is appropriate, and the Boards should not conduct further research into attempting to change the discussion of predictive value to incorporate statistical terminology. (paragraph 12).

QC.2 What do we mean by reliability?

Faithful representation, which includes completeness, verifiability, and neutrality (paragraphs 22, 28, and 29)
But not, as a distinct characteristic, substance over form (paragraph 21)
And it is not something empirically quantifiable, although empirical research might be helpful to the Boards. (paragraph37).

QC.7 What is the role of conservatism? Does it conflict with neutrality? Why keep it?

Conservatism/prudence is not a separate qualitative characteristic, and does clash with neutrality, but it needs to be discussed in the Framework (paragraph 31).

QC.4 Different standards have different hurdles for what represents "reliable" measurement – Why is that?

The underlying problem is that different Board members mean different things when they say "reliability." (paragraph 41)
The recommendation is to replace *reliability* with *representational faithfulness*, of which verifiability and neutrality are sub-characteristics..(paragraph 45).

QC.3 Relevance versus reliability – does one always trump the other?

No (paragraph 46).

APPENDIX – Diagram of Recommended Qualitative Characteristics

Below is a partial diagram of qualitative characteristics, showing how the staff recommendations in this memorandum might be depicted graphically. The many potential qualitative characteristics not discussed in this memorandum are not shown. This diagram is provided only to aid Board members in visualising the staff recommendations, not as a recommendation to include such an illustration in the Framework.

Notice the difference in the two sides of the diagram. The different arrangement of the connecting lines is intended to signify a different relationship. Relevance *consists entirely of* predictive value, comfirmatory value, and timeliness. Faithful representation *includes* verifiability, neutrality, and completeness, as well as its own distinct qualities (perhaps separable into representativeness and faithfulness?).