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Getting a Better Framework
RELIABILITY OF FINANCIAL INFORMATION
Bulletin

Published bulletins:

- Prudence
- Reliability of financial information
- Uncertainty

The publication of Bulletins is part of the project partners' strategy to stimulate debate within Europe, and keep European Constituents informed, as the IASB develops its Conceptual Framework. Any views expressed are tentative: the issuing bodies will develop their final views after considering responses to this Bulletin and other developments in the debate.

Further information about the work of the project partners, including regular newsletters, is available on the partners' websites.

We welcome views on any of the points addressed in this Bulletin. Specific questions are given at the end of the document. These comments should be sent by email to commentletters@efrag.org or by post to

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So as to arrive no later than 5 July 2013.

All comments will be placed on the public record unless confidentiality is requested.

Introduction

1   This Bulletin addresses the issue of reliability of financial information. Until the Conceptual Framework was revised in September 2010, the IASB (and FASB) acknowledged that relevance and reliability were qualitative characteristics that could conflict, in which case financial reporting should aim at achieving an appropriate balance among them. This was known as the trade-off between relevance and reliability.

2   In the 2010 revision of the Framework, the IASB (and FASB) replaced 'reliability' by 'faithful representation', and eliminated all references to a potential trade-off between these two qualitative characteristics.

3   This Bulletin considers whether the replacement of reliability with faithful representation and the loss of the idea of the trade-off between relevance and reliability is appropriate or whether there is an ongoing need for such ideas in the Framework. This matters because a clear understanding and consensus on the extent to which amounts in financial statements can be regarded as reliable is vital to their use.

4   The Bulletin tentatively concludes that reliability (including the idea of verifiability) needs to be reinstated as a fundamental characteristic of information in financial statements and should continue to be a recognition criterion, with further discussion on how reliability should be assessed, and what level of reliability is needed for information to be useful.

Background

6   The pre-2010 Framework discussed four principal qualitative characteristics for financial information: understandability, relevance, reliability and comparability. Relevant information was information that influenced the economic decisions of users of financial statements. Reliable information was free from material error and bias and could be depended upon by users to represent faithfully that which it represents. The Framework noted that in practice a balancing, or trade-off, between qualitative characteristics was often necessary and that the relative importance of the characteristics in different cases was a matter of professional judgment.

7   The 2010 revision of the Framework replaced those qualitative characteristics with two fundamental qualitative characteristics: relevance and faithful representation.[1] Relevant financial information is capable of making a difference in the decisions made by users. To be a perfectly faithful representation of a phenomenon, a depiction would be complete, neutral and free from error. The Framework notes that perfection is seldom, if ever, achievable, but that the three qualities should be maximised to the extent possible. On the relationship between relevance and faithful representation, the Framework states that both are necessary for financial information to be useful and that they should be applied as follows. First, identify an economic phenomenon that has the potential to be useful to users of the reporting entity's financial information. Second, identify the type of information about that phenomenon that would be the most relevant if it is available and can be faithfully represented. Third, determine whether that information is available and can be faithfully represented. If so, the process of satisfying the fundamental characteristics ends at that point. If not, the process is repeated with the next most relevant type of information.

8   This Bulletin explores whether the replacement of reliability with faithful representation and the lack of discussion of a trade-off between the two removes a necessary part of the assessment of whether financial information is useful.

[1] There are also four enhancing qualitative characteristics: comparability, verifiability, timeliness and understandability.

VIEW 1: NOTHING HAS BEEN LOST

9 The Basis for Conclusions to the revised Framework explains that many had misunderstood the term 'reliability'. The term faithful representation encompasses the main characteristics that the previous Framework included as reliability and more clearly conveys the intended meaning. In substance there has been no change in the characteristics that are required.

10 In terms of a trade-off between relevance and faithful representation/reliability, there is none, because both characteristics are necessary. Only relevant and reliable information is useful. The Framework is clear that, although relevance is considered first, faithful representation also needs to be achieved before the information is included in the financial statement. Both characteristics must be present.

11 This can be illustrated by looking at the use of fair values. Some argue that using fair value accounting enhances the relevance of financial reporting whilst at the same time detracting from the reliability of financial reporting. However, this is a misunderstanding of what reliable meant under the previous Framework. Fair values can be reliable in the sense of being a faithful representation, as long as there is sufficient disclosure of how the fair value has been determined. To be useful information, fair value must be relevant and also be supported by sufficient disclosure to give a faithful representation.

VIEW 2: AN IMPORTANT STEP HAS BEEN LOST

12   As noted above, the IASB described the change in terminology from reliability to faithful representation as essentially a matter of semantics. However, if this is the case, the question arises as to why an issue of substance such as a potential trade-off between qualitative characteristics that was addressed in the previous Framework has been eliminated.

13   The trade-off between relevance and reliability is not simply a one-off comment in the previous IASB Framework. The importance that was previously attributed to this trade-off is illustrated by the following references to US documents. In its predecessor to the revised Framework, Statements of Concepts 2, the FASB acknowledged that "… reliability may suffer when an accounting method is changed to gain relevance, and vice versa"[2]. In October 2002 the FASB acknowledged that the "FASB Statement of Concepts N° 2 does not provide conceptual guidance <u>necessary</u> (emphasis added) for making trade-offs in accounting standards focusing on, among other things, the primary characteristics of relevance and reliability…"[3]. In July 2003 the U.S. SEC stated: "Thus, <u>a key responsibility</u> (emphasis added) of the standard setters is to make the determination as to the trade-offs among the qualitative characteristics of accounting information… In practice, making these trade-offs in setting standards is closely intertwined … with the use of the asset-liability view to standard-setting"[4].

14   It is not clear what has occurred since 2003 to make the issue of a trade-off between relevance and reliability irrelevant.

15   In fact, rather than just being a change in terminology, an important aspect of reliability as described in the pre-2010 Framework has been diluted in the move to faithful representation: measurement uncertainty. The pre-2010 Framework stated clearly that 'in certain cases, the measurement of the financial effects of items could be so uncertain that entities generally would not recognise them in financial statements', giving internally-generated goodwill as an example. This discussion of measurement uncertainty leads directly to the recognition criterion that elements should be recognised only if they have a cost or value that can be measured with reliability. The 2010 Framework notes that 'if the level of uncertainty in an estimate is sufficiently large, that estimate will not be particularly useful'. However, it also states that 'a representation of [an] estimate can be faithful if the amount is described clearly and accurately as being an estimate, the nature and limitations of the estimating process are explained, and no errors have been made in selecting and applying an appropriate process for developing the estimate' and that 'if there is no alternative representation that is more faithful, that estimate may provide the best available information'.

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[2] FASB Statement of Concepts N° 2, paragraph 90. Although the IASB Framework does not include the same statement, it is consistent with the idea of the trade-off described in paragraph 5 above.
[3] FASB Proposal: Principles-Based Approach to U.S. Standards Setting. October 21, 2002.
[4] Study Pursuant to Section 108 (d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-based Accounting System. U.S. SEC. July 25, 2003, page 23.

16   The view that a reliable measurement base – be it cost or fair value – is always available is also reflected in standards. Despite the emphasis put in the Framework on reliability as a recognition criterion, individual Standards have been issued with no or little regard for reliability of measurement. Although Standards often repeat recognition criterion, over the years the Standards have concluded that by and large reliability is a non-issue. For example:

(a)   Of all the standards that include reliability of measurement as a recognition criterion (IAS 16, IAS 36, IAS 37, IAS 38, IAS 39, IAS 40, IAS 41, IFRS 2, IFRS 7, IFRS 9) only IAS 38 concludes that the measurement of some items (internally-generated goodwill and internally-generated research) may not be sufficiently reliable to permit recognition.[5]

(b)   IFRS 13 raises only once the question of the reliability of fair value, and it is not to cast doubt on the reliability of the measurement of fair value in certain cases, but it is to conclude that quoted prices in active markets provide the most reliable evidence of fair value.[6]

(c)   The IASB particularly in IFRS 13 views the reliability of measurement as a matter for disclosure, not a matter for recognition. The IASB makes the presumption that numbers should be reported in the primary financial statements and that concerns with the reliability of these numbers are better addressed in the notes to the financial statements.

17   Related to this lack of concern over reliability is the relegation in the 2010 Framework of verifiability to an enhancing, rather than fundamental, characteristic.[7] Some also worry that the meaning of verifiability has also been weakened in that it requires only a consensus between different knowledgeable and independent observers, rather than a reasonable level of certainty over the measurement of the financial effects of the item. A crucial aspect of the context in which financial information is used is that financial statements are audited. Information in financial statements therefore has to be capable of some level of verification.

18   There is substantial academic literature that supports the view that reliability is an important and desirable characteristic of financial information. This view was also illustrated in the IASB Discussion Paper on extractive activities, which explained that users do not find fair value information about oil reserves useful because of the lack of reliability in their measurement. Further, there is academic evidence that supports the view that information disclosed in the notes to the financial statements does not have the same predictive value as that which is reported in the primary financial statements.

19   The replacement of reliability with faithful representation significantly weakens the importance attached to linked ideas of measurement uncertainty and verifiability. In doing so the revised Framework ignores important aspects of the role of financial statements.

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[5] IAS 37 includes an acknowledgment that a liability should not be recognised when no reliable estimate can be made but states that this will only be in extremely rare cases.
[6] IFRS13, BC168.
[7] As explained in the Basis of Conclusions to the 2010 Framework, the previous Framework (1989) did not explicitly include verifiability as an aspect of reliability, but [FASB] Concepts Statement 2 did. However, the two frameworks are not as different as it might appear because the definition of reliability in the Framework (1989) contained the phrase 'and can be depended upon by users', which implies that users need assurance on the information.'

20   The revisions to the Framework are more than a clarification of terms. Rather they reflect assumptions that (i) relevance is more pertinent than reliability, (ii) every measurement base is sufficiently reliable to warrant recognising an element in the primary financial statements, and (iii) reliability is essentially a matter for disclosure, i.e. becomes a question of faithful representation.

21   All of these assumptions are open to question. Academic literature suggests that reliability is at least equally important as relevance, and that disclosure of the process and inputs into an estimate cannot always compensate for measurement uncertainty.

22   Hence, reliability (including the idea of verifiability) needs to be reinstated as a fundamental characteristic of information in financial statements. The pre-2010 Framework made it clear that sometimes measurement uncertainty is so great that recognition is not appropriate because of the inherent difficulties in devising and applying measurement and presentation techniques that can convey messages that correspond with the transaction or event being measured. Reinstating this view of reliability would provide the necessary support for continuing to use reliable measurement as a recognition criterion for assets and liabilities. Further discussion should also be added to the Framework on how reliability should be assessed, and what level of reliability is needed for information to be useful, so that the reliable measurement criterion has substance and can be applied in standards. For example, it may be that a higher threshold of verifiability is needed for information about assets and gains to be regarded as useful than for liabilities or losses.

Questions

We would welcome your views on any aspect of this Bulletin. In particular we are interested in your views on the following questions:

(i)   Are there any arguments for either of the views set out in the Bulletin that we have not discussed?

(ii) Which view do you support? Why?

Comments should be addressed to: commentletters@efrag.org, so as to be received before 5 July 2013.