MINUTES

Financial Accounting Standards Board

To:	Board Members		
From:	Duke (ext. 297)		
Subject:	Minutes of the May 25, 2005 Board Meeting: Conceptual Framework—Qualitative Characteristics: Relevance and Relilability	**Date:**	June 1, 2005
cc:	Leisenring, Bielstein, Smith, Petrone, Mahoney, Polley, Lott, Gabriele, Thompson, Getz, Sutay, Project Team, FASB Intranet; Finden; Upton, Hickey		

The Board meeting minutes are provided for the information and convenience of constituents who want to follow the Board's deliberations. All of the conclusions reported are tentative and may be changed at future Board meetings. Decisions become final only after a formal written ballot to issue a final Statement or Interpretation.

<u>Topic</u>: Qualitative Characteristics: Relevance and Relilability

<u>Basis for Discussion</u>: Memorandum dated May 11, 2005 (Agenda paper 7)

<u>Length of Discussion</u>: 9:00 a.m. to 11:00 a.m.

<u>Attendance</u>:

Board members present: Herz, Batavick, Crooch, Schipper, Seidman, Trott, and Young

Board members absent: none

Staff in charge of topic: Bullen

Other staff at Board table: Bielstein, T. Johnson, McBeth, Bossio, Duke, and Varian

Outside participants: Leisenring (IASB)
by phone: Rees (IASB), Hague and Villman (AcSB), Willis

Summary of Decisions Reached:

The Board continued its deliberations on its joint IASB/FASB conceptual framework project. The Board discussed issues relating to some of the qualitative characteristics of accounting information and reached the following conclusions, which are generally consistent with the present frameworks except as noted:

1. *Relevance* is an essential qualitative characteristic. To be relevant, information must be capable of making a difference in the economic decisions of users by helping them evaluate the effect of past and present events on future net cash inflows (predictive value) or confirm or correct previous evaluations (confirmatory value), even if it is not now being used. Being "capable of making a difference," rather than now being used, is a change from the present IASB framework; "confirmatory" rather than "feedback" value is a change from the present FASB framework. Also, the information must be available when the users need it (timeliness).
2. Accounting information has *predictive value* if users use it, or could use it, to make predictions. Accounting information is not intended, in itself, as a prediction or as synonomous with statistical predictability or persistence.
3. *Faithful representation* of real-world economic phenomena is an essential qualitative characteristic, which includes capturing the substance of those economic phenomena. Faithful representation also includes the quality of *completeness*. The common conceptual framework will need to discuss thoroughly what faithful representation means and what it does not mean.
4. Financial information needs to be *neutral*—free from bias intended to influence a decision or outcome. To that end, the common conceptual framework should not include conservatism or prudence among the desirable qualitative characteristics of accounting information. However, the framework should note the continuing need to be careful in the face of uncertainty.
5. Financial information needs to be *verifiable* to provide assurance to users that the information faithfully represents what it purports to represent and that the information is free from material error, complete, and neutral. Descriptions and measures that can be directly verified through consensus among

observers are preferable to descriptions or measures that can only be indirectly verified.

6. Representations are faithful—there is correspondence or agreement between the accounting measures or descriptions in financial reports and the economic phenomena they purport to represent—when the measures and descriptions are verifiable, and the measuring or describing is done in a neutral manner. Therefore, faithful representation requires completeness, not subordinating substance to form, verifiability, and neutrality. Consequently, the common framework should drop the widely misinterpreted term *reliability* from the qualitative characteristics, replacing it with *faithful representation*. That replacement is a change from the current IASB and FASB frameworks.
7. Although empirical research may provide evidence useful in standard-setting decisions, for example, in assessing trade-offs between desirable qualities, the conceptual framework project should not seek to develop empirical measures of faithful representation or its component qualities.

<u>Objective of Meeting</u>:

The objective of the meeting was for the Board to reach conclusions on cross-cutting issues, namely, relevance and reliability.

<u>Matters Discussed and Decisions Reached</u>:

1. Mr. Bullen began the meeting by stating that the staff believed that relevance was a primary qualitative characteristic. "What does relevance mean," and "What does relevance consist of," are what the staff consider to be non-issues (that is, the IASB and FASB frameworks describe relevance and it's sub-characteristics similarly). Relevant information has predictive value, confirmatory or feedback value, and is material and timely. In order for information to be relevant, it 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. Information may still be relevant even if some or all of the users fail to take advantage of it or are already aware of it. Additionally, the staff plans to use *confirmatory* in

the converged framework instead of *feedback* because of the broader nature of *confirmatory*. The staff plans to discuss *materiality* at a future meeting. *Timeliness* will be classified with relevance, as it currently is in the FASB framework.

2. Mr. Bullen stated that the meaning of *predictive value* was a cross-cutting issue. He stated that statisticians use *predictability* in a precise way and that they distinguish it from *persistence.* In the accounting frameworks, predictive value is used in a much more general way. Accounting information that has predictive value does not have to be a forecast and is not in and of itself a prediction. The staff believes that the current definition of predictive value is proper in context and does not recommend exploring a more precise or statistical meaning of predictive value.
3. Ms. Schipper stated that she believed there was little benefit to be gained and a high cost to be incurred if statistical concepts were to be introduced into the notion of predictive value. She stated that it was not the job of the standard setter to predict the ways users will use the accounting information and that the Board did not have a duty to determine if those uses are good or bad. She stated that the revised concepts should explain that information with predictive value is not information that predicts itself; that is, that by looking at one number in a series a user would not be able to predict the next number in the series.
4. Mr. Trott stated that the concepts should explain why being *capable* is operative in relevant information. Standard setters often are challenged by constituents to explain why new or more significant information is required to be disclosed. Those constituents want to know that it *will* be used and how. The framework should explain the difference between information that is capable of being used and information for which there is evidence of a present use; that is, information may be capable of making a difference in a resource allocation decision even if no one is currently using the information. Mr. Trott also suggested that the staff try to find a term other than *predictive value* because of possible confusion stemming from its different meanings outside of accounting.

5. Ms. Seidman stated that predictive value may be of concern because of the way information is displayed, specifically in regard to core and nonrecurring items; however, she did support its inclusion in the framework. She also agreed that the Board should not just aim to provide information that it knows is being used but that it also should determine what additional information its constituents need to make informed decisions and then require it.
6. Mr. Young stated that he had concerns with the definition of *user.* The relevance of the information should be determined from the user's perspective (and that perspective should focus on all users, such as individual investors, and not just professional investors or credit managers). He stated a concern that the framework was not focused enough on the less sophisticated user.
7. Mr. Bullen stated that the qualities of the user were briefly discussed at the April joint meeting. The existing framework identifies characteristics of users, such as being reasonably informed about business and diligent in studying the information provided. He stated that it is an area that may need to be developed further. Additionally, *understandability* of information may be related to Mr. Young's concern and will be discussed in a future meeting.
8. Mr. Batavick stated that the team should include in the framework the Board's expectation that preparers and users use *due care* in their work with the information and accounting standards. A certain level of education and diligence is expected in order to properly perform their duties. While due care is not a separate qualitative characteristic, it fits into the area of objectives and qualitative characteristics.
9. Mr. Herz stated that when thinking about being *capable*, the Board should consider whether the information is capable of making a difference in a decision in the context of the objectives of financial reporting.
10. Mr. Bullen stated that he understood that the Board agreed with the staff recommendations about relevance. He then introduced the topic of reliability. He stated that in FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information,* reliability is said to comprise representational faithfulness, verifiability, and neutrality. It is also overlayed with

completeness, freedom from bias, precision, and uncertainty. In the IASB framework, reliability is comprised of faithful representation, substance over form, neutrality, prudence, and completeness. He stated that many constituents equate reliability primarily with verifiability, not representational faithfulness. He said that those disparities suggest a need to clarify the terminology.

11. Mr. Bullen stated that accounting information has the quality of *faithful representation* when the data faithfully represents the real-world economic phenomenon it purports to represent. Faithful representation includes completeness and leaves no room for representations that subordinate substance over form. Mr. Bullen asked the Board if faithful representation is a key quality of accounting information and if the staff has described it well.

12. Mr. Crooch stated that he agreed with the staff proposal with regard to faithful representation, and that he understood that faithful representation encompasses all of the other characteristics that were previously sub-qualities of *reliability*. He stated that careful consideration should be given to the drafting in order to communicate why faithful representation encompasses the other qualities.

13. Mr. Trott stated that he supported replacing *reliability* with some other term, such as *faithful representation.* He stated that the revised framework should explain that *verifiability* does not mean not having to change a recorded accounting number (such as an estimate) when the ultimate outcome is determined or as economic conditions change.

14. Ms. Schipper stated that she supported the staff's recommendation but that she is concerned that the disagreements over the term *reliability* may be transferred to the new term. For example, both the best estimate of the ultimate outcome and the best estimate based on the dispersion of possible outcomes given today's information can be verified, but there is a conflict about what the phenomena being represented is. She also stated that she starts with *relevance* before thinking about faithful representation because if the information is not relevant, it does not matter how faithfully it represents the economic phenomenon it purports to represent.

15. Mr. Leisenring stated that he agreed with the staff's recommendation (see paragraph 24) to replace reliability with faithful representation but that he does not believe it will solve the most contentious issue of what is being represented. The issue is that both historical cost and fair value can be faithfully represented, but they are completely different. He also stated that the IASB agreed with the staff's recommendation that neither relevance nor reliability trump the other; however, that may mask the issue that some faithfully represented information could be irrelevant.
16. Mr. Bullen stated that there may be instances in which two or more measures faithfully represent an economic phenomenon. In those cases, the Board will need to determine which one is more relevant or to decide which subquality of reliability (such as verifiability) to focus on. The Board will need to determine how it wants to evaluate the alternatives, and the staff plans to ask the Board for guidance in this area at a future meeting.
17. Ms. Seidman stated that she believed the staff's recommendation would elevate the discussion to a point other than just defaulting to verifiability or reliability. The recommendation would help the Board and constituents consider which alternative is most relevant and represents most faithfully the accounting objective. Relevance and faithful representation are essential and co-equals, but relevance may be used as a filter in the thought process before faithful representation.
18. Mr. Bullen stated that he understood that the Board agreed with the staff recommendations concerning faithful representation and verifiabilility but that further work needs to be done to incorporate the Board's inputs.
19. Mr. Bullen then introduced the topic of *neutrality.* He stated that neutrality is not an issue that the staff feels is in debate. That is, accounting information needs to be neutral. The issue here is *conservatism* or *prudence* and whether they conflict with the characteristic of neutrality. He stated that the staff recommended including a discussion of conservatism and prudence in the revised framework but not including either one as a qualitative characteristic.

20. Ms. Schipper stated that she had observed that U.S. GAAP was conservative in the sense that loss recognition is accelerated and gain recognition is deferred. She stated that some standards have incorporated conservatism to counteract a perceived implementation bias in hopes of obtaining neutral information.
21. Ms. Seidman stated that she agreed with the staff recommendation; however, she further stated that when standard setters make incremental changes, they may weigh the qualitative characteristics differently.
22. Mr. Crooch stated that neutrality should be the concept, and even if the Board seemingly steps away from it in a standard, the goal is the same. When neutrality is subverted, it should be explained.
23. Mr. Herz said that the Board had agreed with the staff recommendation.
24. Mr. Bullen then asked whether the framework should discuss the possibility of measuring empirically what some people mean by reliability, rather than what the current frameworks mean by reliability. The question has two aspects: can the quality of reliability be quantified, and can empirical techniques measure that quantity. The staff considers it unlikely that the project can develop useful quantification of the characteristics of reliability. Additionally, different standards have different hurdles for what represents reliable measurement. Several factors, including applying different meanings depending on the desired outcome, trade-offs between reliability and relevance, and the influence of conservatism play a role in determining what is sufficiently reliable information. He said that the staff recommends replacing the umbrella term *reliability* with *faithful representation.*
25. Mr. Bullen stated that under the staff's recommendation, reliability will be discussed in the concepts statement but not identified as a qualitative characteristic.
26. The Board supported the staff's recommendation.

Follow-up Items:

The staff was directed by Board members to address the following at a subsequent meeting:

- Possibly using another term for the concept of predictive value to avoid possible confusion stemming from its different meanings outside of accounting.
- The notion of the need to exercise due care in the preparation of financial information.
- Whether user-specific characteristics need to be developed further.

The staff was directed by Board members to consider the following in drafting:

- Information with *predictive value* is not information that predicts itself; that is, that by looking at one number in a series, a user would not be able to predict the next number in the series.
- The difference between information that is capable of being used and information for which there is evidence of a present use. In addition, information that is capable of making a difference in a decision should be thought of in the context of the objectives of financial reporting.
- Why *faithful representation* encompasses the other qualities previously considered subqualities of reliability.
- *Verifiability* does not mean not having to change a recorded accounting number (such as an estimate) when the ultimate outcome is determined or as economic conditions change.
- *Relevance* and *faithful representation* are both essential qualitative characteristics, but relevance may be used as a filter in the thought process before faithful representation.

<u>General Announcements</u>:

None.