JOINT CONCEPTUAL FRAMEWORK PROJECT

Financial Accounting Standards Advisory Council
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BACKGROUND

In February, the IASB and FASB approved plans to start work on the conceptual framework project by considering the objectives of financial reporting and the qualitative characteristics of accounting information. The Boards started discussing those topics in April and May, and will discuss them further in June and July. In the next phase, beginning later in 2005, the Boards plan to work on the concept of the reporting entity, along with work on the elements of financial statements and their definitions, recognition and derecognition, and defining the various measurement attributes, focusing on the "cross-cutting" issues that keep arising in standards-level projects. Work on selecting measurement attributes, presentation, disclosure, and scope will be undertaken later.

The FASB also decided that, rather than forming its own conceptual framework working group or task force, it plans to consult with this Council for advice on broad, strategic issues in the project. This meeting is one of those consultations.

Please see the appendix to this paper for a list of tentative decisions reached to date. Separately attached is a communications paper, "Revisiting the Concepts," describing the Board's project on the conceptual framework.

This paper focuses on two of the qualitative characteristics discussed by the Boards in May: neutrality and faithful representation.

NEUTRALITY, INCLUDING FREEDOM FROM BIAS, VERSUS CONSERVATISM

What the Frameworks Say Today

One qualitative characteristic identified in all existing frameworks is neutrality. The IASB and FASB unanimously decided in May to retain neutrality as a characteristic desired in financial reporting. The current 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 current 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 judgment in order to achieve a predetermined result or outcome." The IASB Framework lists prudence as a subquality of reliability, calling prudence "the inclusion of a degree of caution in the exercise of the judgments 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." FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*, discusses conservatism—meaning prudence—at length, 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."

The Boards' Discussion of Neutrality and Conservatism

The project staff suggested to the Boards that the clash of conservatism or prudence with neutrality 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 concepts statements' warning against "misguided conservatism" or Concepts Statement 2's recollection that "it also became evident that understated assets frequently led to overstated income in later periods." The Boards decided that conservatism or prudence should be discussed in the revised framework in a similar manner without including either as a separate qualitative characteristic. They also agreed that neutrality should be included as a qualitative characteristic.

The Consequences of Including Neutrality and Excluding Conservatism

While Americans sometimes have criticized traditional European accounting practices such as the German Imparitätsprinzip as overly conservative, much guidance within U.S. GAAP is also conservative rather than neutral: loss recognition is accelerated and gain recognition is deferred. For example, inventory is measured at the lower of cost or market. Similarly, long-lived assets are written down in response to impairment but not written up in response to appreciation. Furthermore, loss contingencies are recognized if probable and reasonably estimable, but gain contingencies are not. In those cases, the downside must be recognized whereas the upside is not recognized until some later confirming event. The Boards' concepts-level decision to exclude conservatism or prudence as a separate qualitative characteristic, coupled with their discussion of what problems may arise if conservatism or prudence is used, suggests that future standards may move away from such conservative practices.

No current standards projects are addressing inventory, asset impairments, or loss contingencies. But some current standards projects are reconsidering existing practices that may be overly conservative. For example, one current FASB project is addressing the accounting for servicing rights. FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, conservatively requires that servicing right assets be assessed for impairment at each reporting date and reported at the lower of amortized cost or fair value. Mortgage servicers complain that this standard is complicated, requiring stratification of servicing contracts. They also complain that this standard results in unbalanced accounting when they hedge the risks of these contracts, because while a hedging gain can be recognized at the same time as the countervailing servicing impairment loss it was intended to and did hedge, a hedging loss must be recognized immediately while the appreciation in the countervailing servicing gain is deferred until realized. In the current project, the Board has decided that measurement at lower of cost or fair value is not an optimal measurement attribute for servicing assets because it lacks evenhandedness, that is, is overly conservative rather than neutral.[1]

The Board and its predecessors may have set some standards incorporating conservatism to counteract a perceived overoptimistic implementation bias, in hopes of that the opposite biases will cancel each other out, resulting in neutral information. Also, as the Boards make incremental changes, they may weigh the qualitative characteristics differently, a topic the Boards plan to discuss in concept at the July Board meeting. However, the decision of both the FASB and IASB to exclude conservatism or prudence and include neutrality in the

[1] The Board decided that entities should be permitted, but not required, to subsequently measure servicing rights at fair value. This decision demonstrates the importance the Board places on setting standards that at least allow neutral reporting. However, entities will still be permitted to subsequently measure servicing rights at the lower of cost or fair value measurement.

qualitative characteristics of the framework, if carried out in the updated joint framework, seems likely to affect the development of future standards.

FAITHFUL REPRESENTATION, INCLUDING COMPLETENESS AND VERIFIABILITY, WHICH SUBSUMES SUBSTANCE OVER FORM

The Boards decided in May to retain the concept of *faithful representation* as a qualitative characteristic, and to elevate it to a primary characteristic, along with relevance. As discussed later in this paper, the Boards decided that faithful representation should take the place of the often-misunderstood term *reliability*. So, what does faithful representation mean, and of what does it consist?

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." 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." 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 representationally faithful of the number of dollars that is collectible. Faithful representation concerns descriptions as well as amounts. For example, it would not be representationally faithful to describe those receivables as "cash."

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. As to measures, either the historical cost or the fair value of a purchased asset are faithful representations of what they purport to measure. However, the cost of a purchased asset, net of sum-of-the-years-digits amortization, is not a faithful representation of any economic phenomenon, but instead the result of an accounting computation.

FASB Concepts Statement 2 illustrates faithful representation using an analogy to maps and mapmaking:

> 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]

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 using symbols to represent real-world phenomena that communicate a great deal of useful information to users who have learned to interpret the symbols.

Completeness

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.")[2]

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." The concept is the same, and the Boards agreed in May that completeness is a necessary subquality of faithful representation.

Verifiability

FASB Concepts Statement 2 identifies verifiability as one of its three subqualities of reliability. 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 of correspondence to economic things and events, and (3) direct verification versus indirect verification. It also explains how verifiability differs from accuracy or precision. 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.*" Some might say the italicized words imply the sort of verification provided by internal controls and auditing.

The Boards agreed in May that verifiability is an important quality of financial reporting information. The Board discussion emphasized that verifiability does

[2] A statistician might call the first mapping error discussed in 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.

not mean accuracy, nor does high verifiability mean a low likelihood of having to change a recorded accounting number (such as an estimate) when the ultimate outcome is determined or as economic conditions change.

Substance over Form

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." 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". The Boards agreed that substance over form should not be a separate qualitative characteristic.

What Do We Mean by *Reliability*?

Our accounting standards have different (inconsistent?) hurdles for sufficiently reliable measurement and different (inconsistent?) treatments for insufficiently reliable measurement. GAAP doesn't identify the different hurdles, but they certainly exist: trading stock versus held for investment, investment-grade versus junk bonds, exchange-traded versus principal-to-principal markets, tangible versus 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.

The staff suggested to the Boards that 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. Some constituents seem to equate reliability entirely with verifiability. Notwithstanding the discussion of this matter in the present frameworks, when we say “reliability,” we may well be talking past each other.

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? The staff suggested to the Boards that 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, but also verifiability and neutrality. For those reasons, the staff recommended 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. The Boards agreed with the staff recommendation.

QUESTIONS FOR DISCUSSION BY COUNCIL

1. Embracing neutrality as likely to produce information that is more decision-useful to investors and creditors, and rejecting a separate quality of conservatism or prudence, could have major implications. It points toward eventual shifts away from impairment, lower-of-cost-or-market, and other accounting procedures that recognize losses early and gains later. Are there conceptual reasons not to make such a shift? Are there practical reasons not to make such a shift and, if so, what are those reasons?

2. Will replacing *reliability* with *faithful representation,* a concept that includes not only completeness but also verifiability and neutrality, improve people’s

understanding of this essential qualitative characteristic of financial information?

3. The Boards decided that "substance over form" is not a quality in itself, but rather that faithful representation of economic phenomena leaves no room for representations that subordinate substance to form. Is anything more than that needed at the concepts level to keep standard-setters or practitioners from being led astray by form that is contrary to the economic phenomena purportedly being represented?

Appendix

TENTATIVE DECISIONS REACHED BY THE FASB AND IASB

The Boards deliberated issues relating to the objectives of financial reporting at the Boards' joint meeting in April. They reached the following tentative conclusions:

- Financial reports should be prepared from the entity's perspective and should aim to provide information to a wide range of users, rather than focusing on the information needs of existing common shareholders only. The framework should identify the primary users as present and potential investors and creditors (and their advisers). Later in the project, the Boards will consider whether financial reporting also should provide information to meet the information needs of particular types of users, such as different types of equity participants.
- The objective is to provide information about the entity that is useful to the external users who lack the power to prescribe the information they require and must therefore rely on the information provided by an entity's management. The entity's management also will be interested in that information. However, because management has the power to obtain the information it requires, any additional information needs of management are beyond the scope of the framework. Similarly, certain external users, for example, a credit rating agency or a bank lender, generally have the power to prescribe the information they require and their additional information needs may therefore be beyond the scope of the framework.
- As discussed in the two Boards' existing frameworks, the financial statements should provide information to help users to assess an entity's liquidity and solvency. However, that objective should be consistent with the overall objective of providing decision-useful information to a wide range of users. Therefore, the information provided in the financial statements should not be focused on meeting the information needs of particular types of users that primarily use the financial statements to help them assess an entity's liquidity and solvency.
- As with the existing frameworks, the Boards' converged framework should be concerned with *general purpose* financial reports, which focus on the common information needs of users. That does not preclude the Boards from concluding, in a standards-level project, that additional information should be provided to meet the information needs of particular types of users.

The Board continued its deliberations on its joint IASB/FASB conceptual framework project at its meeting on May 25, 2005. 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:

- *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).
- Accounting information has *predictive value* if users use it, or could use it, to make predictions. Accounting information is not intended, in itself, to be a prediction or to be synonymous with statistical predictability or persistence.
- *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.
- 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.
- 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.
- 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.
- 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.

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 potential 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 the discussion of user-specific characteristics need to be developed further.

The staff was directed to consider how to emphasize the following suggestions by Board members 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.
- Information can be capable of being used even if there is no evidence of a present use. In addition, whether information 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. That is, if information is not relevant, there is no need to consider whether it faithfully represents what it purports to represent.