Exposure Draft

ED 164
June 2008

An improved Conceptual Framework for Financial Reporting: The Objective of Financial Reporting and Qualitative Characteristics and Constraints of Decision-useful Financial Reporting Information

Prepared by the
Australian Accounting Standards Board

Australian Government

Australian Accounting Standards Board

Commenting on this Exposure Draft

Constituents are strongly encouraged to respond to the AASB and the IASB. The AASB is seeking comment by 25 August 2008. This will enable the AASB to consider Australian constituents' comments in the process of formulating its own comments to the IASB, which are due by 29 September 2008. Comments should be addressed to:

The Chairman
Australian Accounting Standards Board
PO Box 204
Collins Street West Victoria 8007
AUSTRALIA
E-mail: standard@aasb.gov.au

Sent electronically through the 'Open for Comment' page on the IASB website (www.iasb.org)

A copy of all non-confidential submissions to the AASB will be placed on public record on the AASB website: www.aasb.gov.au and forwarded to the IASB.

Obtaining a Copy of this Exposure Draft

This Exposure Draft is available on the AASB website: www.aasb.gov.au. Alternatively, printed copies of this Exposure Draft are available by contacting:

The Customer Service Officer
Australian Accounting Standards Board
Level 7
600 Bourke Street
Melbourne Victoria 3000
AUSTRALIA

Phone: (03) 9617 7637
Fax: (03) 9617 7608
E-mail: publications@aasb.gov.au
Postal address:
PO Box 204
Collins Street West Victoria 8007

Other Enquiries

Phone: (03) 9617 7600
Fax: (03) 9617 7608
E-mail:standard@aasb.gov.au

ISSN 1030-5882

CONTENTS

PREFACE

Background

Australian Accounting Standards

The Australian Accounting Standards Board (AASB) makes Australian Accounting Standards to be applied by:

(a) entities required by the *Corporations Act 2001* to prepare financial reports;

(b) governments in preparing financial statements for the whole of government and the General Government Sector (GGS); and

(c) entities in the private or public for-profit or not-for-profit sectors that are reporting entities or that prepare general purpose financial statements.

Australian Accounting Standards incorporate International Financial Reporting Standards (IFRSs), as issued by the International Accounting Standards Board (IASB), with the addition of paragraphs on the applicability of the Standard in the Australian environment.

Australian Accounting Standards also include requirements that are specific to Australian entities. These requirements may be located in Australian Accounting Standards that incorporate IFRSs or in other Australian Accounting Standards. These requirements are generally restricted to the not-for-profit or public sectors or include additional disclosures that address domestic, regulatory or other issues.

Exposure Drafts

The publication of an Exposure Draft is an essential part of the due process that the AASB follows before making a new or amending an existing Australian Accounting Standard. Similarly, it is an essential part of the due process that the AASB follows before amending its *Framework for the Preparation and Presentation of Financial Statements* ("the AASB *Framework*"). An Exposure Draft is designed to seek public comment on the AASB's proposals for a new Australian Accounting Standard or amendments to an existing Australian Accounting Standard or to the AASB *Framework*.

Introduction

The IASB has published an Exposure Draft on two significant aspects of a Conceptual Framework for Financial Reporting. The two aspects are (i) the objective of financial reporting and (ii) the qualitative characteristics and constraints of decision-useful financial reporting information. The Exposure Draft has been published for comment as part of a joint project, undertaken by the IASB and the Financial Accounting Standards Board (FASB), to develop a common framework that will replace the respective existing frameworks of the two Boards. The title of the IASB Exposure Draft is *An improved Conceptual Framework for Financial Reporting: The Objective of Financial Reporting and Qualitative Characteristics and Constraints of Decision-useful Financial Reporting Information* and the Exposure Draft was issued in May 2008.

Reasons for Issuing this Exposure Draft

The AASB has published this Exposure Draft to:

- facilitate Australian constituents providing comments on the IASB Exposure Draft;
- assist the AASB in formulating its response to the IASB; and

- assist the AASB in determining how to incorporate the proposed concepts, once finalised, into the AASB *Framework*.

The proposals in the Exposure Draft, if included in the IASB's revised *Framework*, would be reflected in the AASB *Framework* and potentially would profoundly affect the future direction of financial reporting in Australia.

If these proposals result in amendments to the AASB *Framework*, they are expected to be applicable to for-profit entities from the time that the IASB makes the amendments to the IASB *Framework* applicable. The implications for not-for-profit entities are considered later in this Preface.

Structure of this Exposure Draft

This Exposure Draft:

(a) reproduces the IASB Exposure Draft without amendment as part of this Exposure Draft;

(b) identifies the proposals in this Preface; and

(c) seeks constituents' views on the proposals.

To assist constituents in their assessment of the proposed concepts, this Preface initially provides some background information to the conceptual framework project and other explanations.

Background to the IASB-FASB Conceptual Framework Project

As part of their commitment to achieving harmonisation of financial reporting standards, in October 2004, the IASB and FASB embarked on a joint project to develop an improved, common conceptual framework that, once finalised, is expected to replace the existing frameworks currently used by the two Boards. The Boards' objective is to produce principle-based financial reporting standards, and a common conceptual framework that is sound, comprehensive and internally consistent will help in this endeavour. Rather than undertake a fundamental re-think of the existing concepts, the project's aim is to build on the existing IASB and FASB frameworks by refining, updating, completing and converging them into a common framework.

The project is being conducted in eight phases. Initially, the Boards are focusing on developing concepts applying to business entities in the private sector. In a later phase of the project, the Boards will consider the applicability of those concepts to other types of entities, in particular, not-for-profit entities in the private sector.

This Exposure Draft is the result of work undertaken so far in Phase A of the project, on the objective of financial reporting and qualitative characteristics of decision-useful financial reporting information. In July 2006, the two Boards jointly issued a Discussion Paper for Phase A entitled *Preliminary Views on an improved Conceptual Framework for Financial Reporting: The Objective of Financial Reporting and Qualitative Characteristics of Decision-useful Financial Reporting Information*. The AASB's submission on that Discussion Paper can be accessed on the AASB website. This Exposure Draft is based on the Boards' re-deliberations following consideration of the issues raised in the responses to the Discussion Paper.

The following table shows the phases of the IASB-FASB conceptual framework project and those Boards' plan for the release of near-term due process documents, extracted from the IASB Work Plan as at 30 June 2008 (further information about each phase is available on the IASB website):

Phase	Last document issued	Estimated publication date					Estimated issuance of final document
		2008 Q3	2008 Q4	2009 H1	2009 H2	2010	
Phase A: Objectives and qualitative characteristics	ED			Final chapter			
Phase B: Elements and recognition					DP	ED	2011
Phase C: Measurement				DP		ED	2011
Phase D: Reporting entity	DP*				ED		To be determined
Phase E: Presentation and disclosure							
Phase F: Purpose and status							
Phase G: Application to not-for-profit entities							
Phase H: Remaining Issues							

Key to abbreviations:

DP - Discussion Paper
ED - Exposure Draft

* See AASB Invitation to Comment ITC 17 *Request for Comment on IASB Discussion Paper "Preliminary Views on an improved Conceptual Framework for Financial Reporting: The Reporting Entity"* (June 2008).

The Boards also have decided that each Board, within the context of its respective current GAAP hierarchy, will finalise the common framework as parts (chapters) are completed. However, later phases of the project may include consequential amendments to parts of the framework that were completed in earlier phases.

Implications for not-for-profit entities

The AASB *Framework* applies to all Australian entities that prepare general purpose financial reports. As noted above, the IASB has decided to consider the applicability to not-for-profit entities of the various amendments it makes to the IASB *Framework* as a later phase of its project to review and amend that *Framework*. Therefore, there are implications for the AASB *Framework* arising from the IASB's plan to finalise parts of its new framework before it has considered the applicability of any new or revised concepts to other types of entities.

The AASB, in conjunction with standard setting boards in Canada, NZ and the UK, has been monitoring the development of the IASB-FASB joint conceptual framework project from the perspective of private and public sector not-for-profit entities. The monitoring group consists of the Chairs and senior staff members of the above standard setters. A consultant was engaged by the group to monitor the IASB-FASB conceptual framework project. The group plans to issue a report highlighting the implications of applying the concepts proposed in the Exposure Draft to private sector and public sector not-for-profit entities.

The AASB plans to consider how to incorporate any amendments to the existing IASB *Framework* into the AASB *Framework*. The AASB's preliminary view is that, until such time as the IASB considers the applicability of any new or revised concepts to other types of entities, it may be necessary to limit the applicability of those new or revised concepts to for-profit entities only. In other words, if the IASB proceeds with replacing the relevant parts of the existing *Framework* when work on Phase A is completed, then the AASB will consider whether those amendments should apply only to Australian for-profit entities, with the existing AASB *Framework* retained for not-for-profit entities, as an interim measure. Any decision on this issue will be made by the AASB when the IASB finalises Chapter 1, and will be affected by:

- whether the IASB proceeds with its plan to replace parts of its existing *Framework* before considering the applicability of any new or revised concepts to other types of entities; and
- whether the revised parts of the IASB's *Framework* are substantially different from the relevant parts of its existing *Framework*, upon which the AASB *Framework* is based.

IPSASB Framework

In March 2006, the International Public Sector Accounting Standards Board (IPSASB) agreed to develop a public sector conceptual framework as a collaborative project with national standard setters and other authoritative bodies in various jurisdictions. The AASB has contributed to developing the draft IPSASB *Framework*. Later this year, the IPSASB intends to issue an omnibus Consultation Paper on the objectives and scope of financial reporting, the qualitative characteristics of financial information, and the concept of a reporting entity.

The AASB considers that it is important to engage in both the IASB-FASB and IPSASB conceptual framework projects.

Main Features of this Exposure Draft

The attached IASB Exposure Draft is composed of two draft chapters of the revised IASB *Framework*, related Bases for Conclusions and an Appendix explaining how those chapters would be incorporated into the IASB *Framework*.

In its draft chapter on The Objective of Financial Reporting, the IASB proposes that:

(a) the objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to present and potential equity investors, lenders and other creditors in making decisions in their capacity as capital providers;

(b) general purpose financial reporting is directed to the needs of a wide range of users; however, present and potential capital providers are the primary users of general purpose financial reports;

(c) when making decisions about a reporting entity, capital providers are interested in assessing that entity's ability to generate net cash inflows and the ability of that entity's management to protect and enhance the capital providers' investments;

(d) management's performance in discharging its stewardship responsibilities usually affects a reporting entity's ability to generate net cash inflows. Therefore, management's performance is of interest to capital providers; and

(e) general purpose financial reports reflect the perspective of the reporting entity rather than the perspective of that entity's equity investors or any particular group of that entity's equity investors or other capital providers. However, this does not preclude providing additional information in general purpose financial reports that is primarily directed to the needs of a reporting entity's equity investors or another group of its capital providers.

In its draft chapter on Qualitative Characteristics and Constraints of Decision-useful Financial Reporting Information, the IASB proposes that:

(a) the two fundamental qualitative characteristics of decision-useful financial reporting information are relevance and faithful representation;

(b) information is relevant if it is capable of making a difference in the decisions made by users of general purpose financial reports in their capacity as capital providers. Predictive value and confirmatory value are components of relevance;

(c) faithful representation is attained when the depiction of an economic phenomenon in a general purpose financial report is complete, neutral and free from material error. In the revised IASB *Framework*, faithful representation is proposed to replace the qualitative characteristic of reliability. Completeness, accuracy and neutrality are components of representational faithfulness, but verifiability is not;

(d) the qualitative characteristics that enhance those fundamental characteristics ('enhancing characteristics') are comparability, verifiability, timeliness and understandability; and

(e) two pervasive constraints that limit the information provided by general purpose financial reporting are materiality and cost. The benefits of general purpose financial reporting should justify the related costs.

Request for Comments

Comments are invited on any of the proposals in the Exposure Draft, including the questions on the proposals as listed in the Invitation to Comment section of the IASB Exposure Draft.

Constituents are strongly encouraged to respond to the AASB and the IASB. The AASB is seeking comment by 25 August 2008. This will enable the AASB to consider Australian constituents' comments in the process of formulating its own comments to the IASB, which are due by 29 September 2008. The AASB would prefer that respondents supplement their opinions with detailed comments, whether supportive or critical, on the major issues. The AASB regards both critical and supportive comments as essential to a balanced review and will consider all submissions, whether they address all specific matters, additional issues or only one issue.

Specific Matters for Comment

In addition, the AASB would value comments on:

(a) as indicated above, because the IASB-FASB joint conceptual framework project has an initial focus on for-profit entities in the private sector, the AASB plans to undertake additional consultation with constituents in relation to not-for-profit issues. In the meantime, in relation to the topics of 'objective' and 'qualitative characteristics' covered by the Exposure Draft, the AASB would welcome comments on the issues that would need to be considered if the proposed concepts were also to be applied in Australia to not-for-profit entities in the private and public sectors and for-profit entities in the public sector;

(b) whether the proposals would result in financial reports that are useful to users; and

(c) whether the proposals in the Exposure Draft are in the best interests of the Australian economy.

May 2008

EXPOSURE DRAFT OF

An improved Conceptual Framework for Financial Reporting:

Chapter 1: The Objective of Financial Reporting
Chapter 2: Qualitative Characteristics and Constraints of Decision-useful Financial Reporting Information

Comments to be submitted by 29 September 2008

International
Accounting Standards
Board®

Exposure Draft

AN IMPROVED CONCEPTUAL FRAMEWORK FOR FINANCIAL REPORTING:

Chapter 1 The Objective of Financial Reporting

Chapter 2 Qualitative Characteristics and Constraints of Decision-useful Financial Reporting Information

Comments to be received by 29 September 2008

This exposure draft of two chapters of an improved Conceptual Framework for Financial Reporting: Chapter 1 *The Objective of Financial Reporting* and Chapter 2 *Qualitative Characteristics and Constraints of Decision-useful Financial Reporting Information* is published by the International Accounting Standards Board (IASB) for comment only. The exposure draft has been prepared as part of a joint project by the IASB and the US Financial Accounting Standards Board and it sets out the boards' proposals for two chapters of their proposed common framework. The proposals may be modified in the light of the comments received before being issued in final form. Comments on the exposure draft and the Basis for Conclusions on the proposals should be submitted in writing so as to be received by **29 September 2008**. Respondents are asked to send their comments electronically to the IASB Website (www.iasb.org), using the 'Open to Comment' page.

All responses will be put on the public record unless the respondent requests confidentiality. However, such requests will not normally be granted unless supported by good reason, such as commercial confidence.

ISBN: 978-1-905590-65-0

ISBN for complete publication (two parts including a discussion paper *Preliminary Views on an improved Conceptual Framework for Financial Reporting: The Reporting Entity*): 978-1-905590-67-4

International
Accounting Standards
Board®

CONTENTS

CHAPTER 2: QUALITATIVE CHARACTERISTICS AND CONSTRAINTS OF DECISION-USEFUL FINANCIAL REPORTING INFORMATION

Invitation to comment

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

(a) indicate the specific paragraph or paragraphs to which the comments relate

(b) contain a clear rationale

(c) include any alternative the boards should consider.

Respondents should submit one comment letter to either the IASB or the FASB. The boards will share and consider jointly all comment letters received.

Respondents must submit comments in writing by 29 September 2008.

Respondents are also invited to comment on the following questions.

Chapter 1 *The objective of financial reporting*

Chapter 1 describes the objective of financial reporting, the primary user group to which financial reporting is directed, the types of decisions made by that group and the financial information useful to that group in making those decisions.

1 The boards decided that an entity's financial reporting should be prepared from the perspective of the entity (entity perspective) rather than the perspective of its owners or a particular class of owners (proprietary perspective). (See paragraphs OB5–OB8 and paragraphs BC1.11–BC1.17.) Do you agree with the boards' conclusion and the basis for it? If not, why?

2 The boards decided to identify present and potential capital providers as the primary user group for general purpose financial reporting. (See paragraphs OB5–OB8 and paragraphs BC1.18–BC1.24.) Do you agree with the boards' conclusion and the basis for it? If not, why?

3 The boards decided that the objective should be broad enough to encompass all the decisions that equity investors, lenders and other creditors make in their capacity as capital providers, including resource allocation decisions as well as decisions made to protect and enhance

their investments. (See paragraphs OB9–OB12 and paragraphs BC1.24–BC1.30.) Do you agree with that objective and the boards' basis for it? If not, why? Please provide any alternative objective that you think the boards should consider.

Chapter 2 *Qualitative characteristics and constraints of decision-useful financial reporting information*

Chapter 2 describes the qualitative characteristics that make financial information useful. The qualitative characteristics are complementary concepts but can be distinguished as fundamental and enhancing based on how they affect the usefulness of information. Providing financial reporting information is also subject to two pervasive constraints—materiality and cost. Are the distinctions—fundamental and enhancing qualitative characteristics and pervasive constraints of financial reporting—helpful in understanding how the qualitative characteristics interact and how they are applied in obtaining useful financial reporting information? If not, why?

1 Do you agree that:

(a) *relevance* and *faithful representation* are fundamental qualitative characteristics? (See paragraphs QC2–QC15 and BC2.3–BC2.24.) If not, why?

(b) *comparability*, *verifiability*, *timeliness* and *understandability* are enhancing qualitative characteristics? (See paragraphs QC17–QC35 and BC2.25–BC2.35.) If not, why?

(c) *materiality* and *cost* are pervasive constraints? (See QC29–QC32 and BC2.60–2.66.) If not, why? Is the importance of the pervasive constraints relative to the qualitative characteristics appropriately represented in Chapter 2?

2 The boards have identified two fundamental qualitative characteristics—*relevance* and *faithful representation*:

(a) Financial reporting information that has *predictive value* or *confirmatory value* is relevant.

(b) Financial reporting information that is *complete*, *free from material error* and *neutral* is said to be a faithful representation of an economic phenomenon.

(i) Are the fundamental qualitative characteristics appropriately identified and sufficiently defined for them to be consistently understood? If not, why?

(ii) Are the components of the fundamental qualitative characteristics appropriately identified and sufficiently defined for them to be consistently understood? If not, why?

3 Are the enhancing qualitative characteristics (*comparability*, *verifiability*, *timeliness* and *understandability*) appropriately identified and sufficiently defined for them to be consistently understood and useful? If not, why?

4 Are the pervasive constraints (*materiality* and *cost*) appropriately identified and sufficiently defined for them to be consistently understood and useful? If not, why?

Preface

P1 In July 2006 the US Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) jointly published a discussion paper *Preliminary Views on an improved Conceptual Framework for Financial Reporting: The Objective of Financial Reporting and Qualitative Characteristics of Decision-useful Financial Reporting Information*. That paper was the first in a series of publications jointly developed by the boards as part of a project to develop a common conceptual framework for financial reporting.

P2 The boards received 179 responses related to that discussion paper. At their meetings in 2007 the boards considered the issues raised by respondents. This exposure draft is the product of the boards' redeliberations of the issues being addressed in the first phase of the project and consideration of responses to the discussion paper.

P3 Both the FASB and the IASB have published this common exposure draft for public comment. It relates to one part of the boards' broader conceptual framework. The boards expect to publish other discussion papers and exposure drafts to seek comments on other parts of what will ultimately be an improved conceptual framework for financial reporting. The boards share the ultimate goal of adopting the improved framework as a replacement of their existing frameworks.

Why the boards are reconsidering their frameworks

P4 A common goal of the boards—a goal shared by their constituents—is for their standards to be clearly based on consistent principles. To be consistent, principles must be rooted in fundamental concepts rather than a collection of conventions. To consistently achieve useful financial reporting, the body of standards taken as a whole and the application of those standards should be based on a framework that is sound, comprehensive and internally consistent.

P5 The IASB's *Framework for the Preparation and Presentation of Financial Statements* and the FASB's Concepts Statements articulate concepts that go a long way towards being an adequate foundation for consistent standards, and the boards have used them for that purpose. For example, the bases for conclusions on most of the boards' standards discuss how their conclusions are derived from the applicable concepts.

P6 Another common goal of the boards is the convergence of their standards. The boards are more closely aligning their agendas to achieve convergence in future standards, but they will encounter difficulties in doing that if they base their decisions on different frameworks.

P7 To provide the best foundation for developing principle-based common standards, the boards have undertaken a joint project to develop a common and improved conceptual framework. The goals for the project include updating and refining the existing concepts to reflect changes in markets, business practices and the economic environment that occurred in the two or more decades since the concepts were developed. The boards also intend to improve some parts of the existing frameworks, such as recognition and measurement, as well as to fill some gaps in the frameworks. For example, neither framework includes a robust concept of a reporting entity.

Developing the common conceptual framework

P8 The boards concluded that a comprehensive reconsideration of all concepts would not be an efficient use of their resources. Many aspects of their frameworks are consistent with each other and do not seem to need fundamental revision. Instead, the boards adopted an approach that focuses mainly on improving their existing frameworks and achieving their convergence, giving priority to issues that are likely to yield standard-setting benefits in the near term. When completed, the common framework will be a single document (like the IASB's *Framework*) rather than a series of Concepts Statements (like the FASB's conceptual framework).

P9 The boards decided to focus initially on concepts applicable to business entities in the private sector. Once concepts for those entities are developed, the boards will consider the applicability of those concepts to financial reporting by other entities, such as not-for-profit entities in the private sector and, in some jurisdictions, business entities in the public (governmental) sector.

P10 Four phases of the conceptual framework project are currently active. In this phase, the boards are considering conceptual matters relating to the objective of financial reporting and the qualitative characteristics of financial reporting information. Other active phases are considering many conceptual matters, such as:

(a) definitions of elements of financial statements

(b) the unit of account

(c) recognition and derecognition of elements of financial statements

(d) initial and subsequent measurement of elements in financial statements

(e) the concept of a reporting entity.

P11 The boards will consider in later phases matters of financial statement presentation and disclosure and, as discussed above, the applicability of the concepts in earlier phases to other types of entities.

Due process

P12 As part of their due process, the boards plan to consult interested parties by publishing common discussion papers and exposure drafts on each of the proposed chapters of the common and improved framework. The boards may also consult by publishing other due process documents to seek views on particular issues before developing preliminary views on those issues. The boards also expect to continue to consult in other ways, such as through discussions with the IASB's Standards Advisory Council and the FASB's Financial Accounting Standards Advisory Council, and in round-table and other meetings with interested parties.

Authoritative status of the framework

P13 At present, an entity preparing financial statements under International Financial Reporting Standards (IFRSs) is required to consider the IASB *Framework* when there is no standard or interpretation that specifically applies to a transaction, other event or condition or that deals with a similar and related issue.[*] There is no similar requirement for entities preparing financial statements in accordance with existing US generally accepted accounting principles (GAAP). The FASB's Concepts Statements have the same authoritative status as accounting textbooks, handbooks and articles, and a lower authoritative status than practices that are widely recognised and prevalent either generally or in the industry.[†]

---

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

† FASB Statement No. 162 *The Hierachy of Generally Accepted Accounting Principles*, paragraphs 4 and 5. Statement 162 is not yet effective as of publication of this exposure draft but is expected to be effective before the final version of this Conceptual Framework for Financial Reporting.

P14 The boards have not reached a common conclusion on the authoritative status of the common conceptual framework; however, both have decided that the common conceptual framework will not have the same status as financial reporting standards. In particular, the common framework will not override those standards. Some existing standards may be inconsistent with the common framework. The boards will reconsider those standards to the extent that the discrepancies meet the criteria for adding a project to their agendas.

P15 The boards have also decided that each board, within the context of its respective current hierarchy, will finalise the common framework as parts (chapters) are completed. However, later phases of the project may include consequential amendments to parts of the framework that were completed in earlier phases. Furthermore, the boards note that their decision on how to finalise the common conceptual framework may need to be readdressed when they discuss the placement of the framework within their respective hierarchies.

P16 The FASB has decided that the authoritative status of the framework within the US GAAP hierarchy should be considered once the framework is closer to being substantially complete. However, for the purposes of providing comments on this exposure draft, and on other discussion papers and exposure drafts published by the boards during their joint conceptual framework project, respondents should assume that the framework's authoritative status will be elevated in the US GAAP hierarchy to be comparable to the status of the *Framework* in IFRSs.

Summary

Introduction to the Framework

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

Chapter 1 The objective of financial reporting

S2 The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to present and potential equity investors, lenders and other creditors in making decisions in their capacity as capital providers. Capital providers are the primary users of financial reporting. To accomplish the objective, financial reports should communicate information about an entity's economic resources, claims on those resources, and the transactions and other events and circumstances that change them. The degree to which that financial information is useful will depend on its qualitative characteristics.

Chapter 2 Qualitative characteristics and constraints of decision-useful financial reporting information

S3 Qualitative characteristics are the attributes that make financial reporting information useful. The qualitative characteristics are complementary concepts that each contribute to the usefulness of financial reporting information. However, for analysis purposes it is helpful to distinguish the qualitative characteristics as either fundamental or enhancing, depending on how they affect the usefulness of information. Providing useful financial reporting information is limited by two pervasive constraints on financial reporting—materiality and cost.

S4 Fundamental qualitative characteristics distinguish useful financial reporting information from information that is not useful or is misleading. For financial information to be useful, it must possess the two fundamental qualitative characteristics—relevance and faithful representation. Relevant information is capable of making a difference in decision making by virtue of its predictive or confirmatory value. Financial reporting information is a faithful representation if it depicts the substance of an economic phenomenon completely, neutrally and without material error.

S5 Financial reporting information may have varying degrees of usefulness to different capital providers. Enhancing qualitative characteristics distinguish more useful information from less useful information. They enhance the decision-usefulness of financial reporting information that is relevant and faithfully represented. Enhancing qualitative characteristics (comparability, verifiability, timeliness and understandability) should be maximised to the extent possible. However, the enhancing qualitative characteristics, either individually or in concert with each other, cannot make information useful for decisions if that information is irrelevant or not faithfully represented.

S6 Comparable information enables users to identify similarities in and differences between two sets of economic phenomena. Verifiable information lends credibility to the assertion that financial reporting information represents the economic phenomena that it purports to represent. Timeliness provides information to decision makers when it has the capacity to influence decisions. Understandability is the quality of information that enables users to comprehend its meaning.

S7 Providing useful financial reporting information is limited by two pervasive constraints, *materiality* and *cost*. Information is material if its omission or misstatement could influence the decisions that users make on the basis of an entity's financial information. The benefits of providing financial reporting information should justify the costs of providing that information.

[Draft] Conceptual Framework for Financial Reporting

Chapter 1 The objective of financial reporting

Introduction

OB1 The first chapter of the conceptual framework establishes the objective of general purpose financial reporting by business entities in the private sector.* The objective of financial reporting is the foundation of the framework. Other aspects of the framework–qualitative characteristics, elements of financial statements, definition of a reporting entity, recognition and measurement, and presentation and disclosure–flow logically from the objective. Those aspects of the framework help to ensure that financial reporting achieves its objective.

Objective of general purpose financial reporting

OB2 The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to present and potential equity investors, lenders and other creditors in making decisions in their capacity as capital providers. Information that is decision-useful to capital providers may also be useful to other users of financial reporting who are not capital providers.

General purpose financial reporting

OB3 The boards' mandate is to assist in the efficient functioning of economies and the efficient allocation of resources in capital markets by developing high quality financial reporting standards. The objective pertains to financial reporting, which includes but is not limited to financial statements, and thereby provides a more complete basis on which to achieve these outcomes.

OB4 General purpose financial reporting is directed to the needs of a wide range of users rather than only to the needs of a single group. General purpose financial reporting stems from the information needs of users who lack the ability to prescribe all the financial information they need from an entity and must therefore rely, at least partly, on the information

* Throughout the framework, the terms *financial reports* and *financial reporting* refer to *general purpose financial reports* and *reporting*, and the term *entities* (or *entity*) refers to *business entities* (or *entity*).

provided in financial reports. Information needed to satisfy the specialised needs of some users may be beyond the scope of general purpose financial reporting. The boards intend to consider the boundaries of general purpose financial reporting in a later phase of the conceptual framework project.

Capital providers and the entity perspective

OB5 The information provided by general purpose financial reporting focuses on the needs of all capital providers (those with a claim on the entity's resources), not just the needs of a particular group. Financial reports reflect the perspective of the entity rather than the perspective of the entity's equity investors, a particular group of its equity investors or any other group of capital providers. Adopting the entity perspective does not preclude the inclusion in financial reports of additional information that is primarily directed to the needs of an entity's equity investors or to another group of capital providers. For example, financial reports often include quantitative measures such as earnings per share, which may be of particular interest to holders and potential purchasers of those shares.

OB6 An entity obtains economic resources from capital providers in exchange for claims on those resources. By virtue of those claims, capital providers have the most critical and immediate need for general purpose financial information about the economic resources of an entity. Accordingly, financial reporting should provide information about the economic resources of an entity (its assets) and the claims on those resources (its liabilities and equity). Capital providers include equity investors, lenders and other creditors, who have common information needs.

(a) *Equity investors*. Equity investors include holders of equity securities, holders of partnership interests, and other equity owners. Equity investors generally invest economic resources (usually cash) in an entity with the expectation of receiving a return **on**, as well as a return **of**, the cash provided; in other words, they expect to receive more cash than they provided in the form of cash distributions and increases in the prices of shares or other ownership interests. Therefore, equity investors are directly interested in the amount, timing and uncertainty of an entity's future cash flows and also in how the perception of an entity's ability to generate those cash flows affects the prices of their equity interests. Equity investors often have the right to vote on management actions and therefore are interested in how well the directors and management of the entity have discharged their responsibility to make efficient and profitable use of the assets entrusted to them.

(b) *Lenders*. Lenders, including purchasers of traded debt instruments, provide financial capital to an entity by lending it economic resources (usually cash). Lenders generally expect to receive a return in the form of interest, repayments of borrowings and increases in the prices of debt securities. Like equity investors, lenders are interested in the amount, timing and uncertainty of an entity's future cash flows and in how the perception of an entity's ability to generate those cash flows affects the prices of its debt securities. Lenders may also have the right to influence or approve some management actions and therefore may also be interested in how well management has discharged its responsibilities.

(c) *Other creditors*. Other groups provide resources as a consequence of their relationship with an entity, even though the relationship is not primarily that of a capital provider. For example, employees provide human capital in exchange for a salary or other remuneration, some of which may be deferred for many years. Suppliers may extend credit to facilitate a sale. A customer may prepay for goods or services to be provided by the entity. To the extent that employees, suppliers, customers or other groups make decisions relating to providing capital to the entity in the form of credit, they are capital providers.

OB7 The primary user group includes both present and potential equity investors, lenders and other creditors, regardless of how they obtained, or will obtain, their interests. In the framework, the terms *capital providers* and *claimants* are used interchangeably to refer to the primary user group.

OB8 Managers and the governing board of an entity (herein collectively referred to as management) are also interested in financial information about the entity. However, management's primary relationship with the entity is not that of a capital provider. Management is responsible for preparing financial reports; management is not their intended recipient. Other users who have specialised needs, such as suppliers, customers and employees (when not acting as capital providers), as well as governments and their agencies and members of the public, may also find useful the information that meets the needs of capital providers; however, financial reporting is not primarily directed to these other groups because capital providers have more direct and immediate needs.

Decision-usefulness

OB9 Capital providers are interested in financial reporting because it provides information that is useful for making decisions. The decisions that capital providers make include whether and how to allocate their resources to a particular entity (ie whether and how to provide capital) and whether and how to protect or enhance their investments. When making those decisions, capital providers are interested in assessing the entity's ability to generate net cash inflows and management's ability to protect and enhance the capital providers' investments.

Usefulness of financial reporting in assessing cash flow prospects

OB10 An entity's capital providers are directly interested in the amount, timing and uncertainty of cash flows from dividends, interest, and the sale, redemption or maturity of securities or loans. However, the prospects for those cash flows depend on the entity's existing cash resources and, of more importance, on its ability to generate enough cash to pay its employees and suppliers and satisfy its other operating needs, to meet its obligations when due, and to reinvest in operations. The judgements of capital market participants about the entity's ability to generate net cash inflows affect the values of debt or equity interests. Therefore, those judgements may also affect cash flows to the entity's capital providers through sale of their interests.

OB11 Other users of financial reports also have either a direct interest or an indirect interest in an entity's ability to generate net cash inflows. For example, although an entity is not a direct source of cash flows to its customers, an entity can provide goods or services to customers only by generating sufficient cash to pay for the resources it uses and to satisfy its other obligations. Thus, information that meets the needs of capital providers is also likely to be useful to members of other groups who are interested in financial information about an entity.

Usefulness of financial reporting in assessing stewardship

OB12 Management is accountable to the entity's capital providers for the custody and safekeeping of the entity's economic resources and for their efficient and profitable use. Management's responsibilities include, to the extent possible, protecting the entity's economic resources from unfavourable effects of economic factors such as price changes and technological and social changes. Management is also accountable for ensuring that the entity complies with applicable laws, regulations and contractual provisions. Management's performance in discharging its responsibilities, often referred to as stewardship responsibilities, is particularly important to existing equity investors when making decisions in their capacity as owners about whether to replace or reappoint management, how to remunerate management, and how to vote on shareholder proposals about management's policies and other matters. Because management's performance in discharging its stewardship responsibilities usually affects an entity's ability to generate net cash inflows, management's performance is also of interest to potential capital providers who are interested in providing capital to the entity.

Limitations of general purpose financial reporting

OB13 Financial reporting by a particular entity is but one source of information needed by capital providers. Those users of financial reports also need to consider pertinent information from other sources, for example, information about general economic conditions or expectations, political events and political climate, and industry and company outlooks. Users also need to be aware of the characteristics and limitations of the information provided by financial reports.

OB14 To a significant extent, financial reporting information is based on estimates, judgements and models of the financial effects on an entity of transactions and other events and circumstances that have happened or that exist, rather than on exact depictions of those effects. The framework establishes the concepts that underlie those estimates, judgements and models and other aspects of financial reports. The concepts are the goal or ideal towards which standard-setters and preparers of financial reports should strive. As with most goals, the framework's vision of ideal financial reporting is unlikely to be achieved in full, at least not in the short term, because of technical infeasibility and cost. In some areas, standard-setters and users of financial reports may need to accept estimates, judgements and models based more on accounting conventions than on the concepts in the framework. Nevertheless, establishing a goal towards which to strive is essential if financial reporting is to evolve so as to improve the information provided to capital providers and others for use in making decisions.

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

OB15 Financial reporting should provide information about the economic resources of the entity (its assets) and the claims on those resources (its liabilities and equity). Financial reporting should also provide information about the effects of transactions and other events and circumstances that change an entity's economic resources and the claims on those resources. That information is useful to capital providers for assessing an entity's ability to generate net cash inflows and for assessing the effectiveness with which management has fulfilled its stewardship responsibilities.

Economic resources and claims on them

OB16 Information about an entity's economic resources and the claims on them—its financial position—can provide a user of the entity's financial reports with a good deal of insight into the amount, timing and uncertainty of its future cash flows. That information helps capital providers to identify the entity's financial strengths and weaknesses and to assess its liquidity and solvency. Moreover, it indicates the cash flow potentials of some economic resources and the cash needed to satisfy most claims of lenders and other creditors. Users also assess the effectiveness with which management has discharged its stewardship responsibilities to capital providers by comparing their expectations with actual results. Some of an entity's economic resources, such as accounts receivable, are direct sources of future cash inflows. In addition, many lenders' and other creditors' claims, such as debt instruments, are direct causes of future cash outflows. However, many of the cash flows generated by an entity's operations result from combining several of its economic resources to produce, provide and market goods or services to customers. Although those cash flows cannot be identified with individual economic resources (or claims), capital providers need to know the nature and quantity of the resources available for use in an entity's operations. That information is also likely to help those who wish to estimate the value of the entity; however, financial reports are not designed to show the value of an entity.

OB17 Information about an entity's financial structure, as reflected in its financial position, helps users to assess its needs for additional borrowing or other financing and how successful it is likely to be in obtaining that financing. This information also helps users to predict how future cash flows will be distributed among those with a claim on the entity's economic resources.

Changes in economic resources and claims on them

OB18 Information about effects of transactions and other events and circumstances that change an entity's economic resources and the claims on them helps a user of the entity's financial reports to assess the amount, timing and uncertainty of its future cash flows. Such information also helps a user to assess the effectiveness with which management has discharged its stewardship responsibilities to the capital providers of the entity. That information includes quantitative measures and other information about changes in economic resources and claims that are a result of the entity's financial performance, which are reflected by accrual accounting and cash flows during a period, and changes that are not a result of the entity's financial performance (such as financing transactions between the entity and its owners).

Changes in resources and claims resulting from financial performance

OB19 An entity's financial performance provides information about the return it has produced on its economic resources. In the long run, an entity must produce a positive return on its economic resources if it is to generate net cash inflows and thus provide a return to its capital providers. The variability of that return is also important, especially in assessing the uncertainty of future cash flows, as is information about the components of that return. Capital providers usually find information about an entity's past financial performance helpful in predicting the entity's future returns on its resources and also in assessing management's ability to discharge its stewardship responsibilities to its capital providers.

Financial performance reflected by accrual accounting

OB20 Accrual accounting depicts the financial effects of transactions and other events and circumstances that have cash or other consequences for an entity's resources and the claims on them in the periods in which those transactions, events or circumstances occur. The buying, producing, selling and other operations of an entity during a period, as well as changes in fair value and other events that affect its economic resources and the claims on them, often do not coincide with the cash receipts and payments of the period. Information in financial reports about an entity's resources and claims and changes in resources and claims generally provides a better basis for assessing past performance and future prospects than information solely about the entity's current cash receipts and payments. Without accrual accounting, important economic resources and claims on resources would be excluded from financial statements.

OB21 Information about an entity's financial performance during a period reflected by changes in its resources and the claims on those resources, other than changes resulting from financing transactions, is also useful in assessing the entity's past and future ability to generate net cash inflows. That information indicates the extent to which the entity has increased its available economic resources, and thus its capacity for generating net cash inflows, through its operations rather than by obtaining additional capital from capital providers.

OB22 Information about an entity's financial performance during a period depicted by changes in its resources and the claims on those resources may also indicate the extent to which events, such as changes in market prices or interest rates, have increased or decreased the entity's economic resources and the claims on those resources, thereby affecting the entity's ability to generate net cash inflows.

Financial performance reflected by cash flow accounting

OB23 Information about an entity's cash flows during a period also helps users to assess the entity's ability to generate future net cash inflows. Information about an entity's cash flows during a period indicates how it obtains and spends cash, including information about its borrowing and repayment of borrowing, cash dividends or other distributions to equity owners, and other factors that may affect the entity's liquidity or solvency. Capital providers use information about cash flows to help them understand an entity's business model and operations, evaluate its financing and investing activities, assess its liquidity or solvency, or interpret information provided about financial performance.

Changes in resources and claims not resulting from financial performance

OB24 Financial reporting should also provide information about changes in an entity's economic resources and claims on those resources that do not result from its financial performance, such as financing transactions between the entity and its owners. This information helps capital providers to distinguish between changes that are the result of the entity's financial performance and those that are not. By distinguishing between these changes, capital providers can assess to what extent the total change in economic resources and claims on those resources are attributable to management's ability to protect and enhance the entity's economic resources and, therefore, form expectations about its future financial performance.

Management's explanations

OB25 Financial reporting should include management's explanations and other information needed to enable users to understand the information provided. Management's explanations of the information in financial reports enhance the ability of capital providers to assess the entity's performance and form expectations about the entity. Management knows more about the entity than external users and can often increase the usefulness of financial reports by identifying and explaining particular transactions and other events and circumstances that have affected or may affect the entity. In addition, financial reporting often provides information that depends on, or is affected by, management's estimates and judgements. Capital providers are better able to evaluate financial information when they are provided with management's explanations of underlying assumptions or methods used, including disclosure of significant uncertainties about principal underlying assumptions or estimates.

Basis for Conclusions on draft Chapter 1

Introduction

BC1.1 This Basis for Conclusions summarises considerations that Board members thought significant in reaching the conclusions in Chapter 1 *The objective of financial reporting* of the draft conceptual framework. It includes reasons for accepting some alternatives and rejecting others. Individual Board members gave greater weight to some factors than to others.

BC1.2 In July 2006 the boards published for public comment a discussion paper *Preliminary Views on an improved Conceptual Framework for Financial Reporting: The Objective of Financial Reporting and Qualitative Characteristics of Decision-useful Financial Reporting Information*. The boards received 179 comment letters on that discussion paper. This exposure draft represents the boards' views after considering respondents' comments and the views received through other outreach initiatives. When appropriate, this appendix discusses the boards' basis for modifying their preliminary views to reach the conclusions in this exposure draft.

General purpose financial reporting

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

BC1.4 The boards concluded that the objective should be broad enough to encompass information that might eventually be provided by financial reporting outside financial statements. Thus, the objective pertains to financial reporting as a whole, not just to financial statements. However, financial statements are a central part of financial reporting, and most of the issues that need to be resolved to enable the boards to make progress on standards projects involve financial statements. Therefore, the boards also concluded that consideration of specific issues concerning the boundaries of financial reporting and distinctions between financial statements and other parts of financial reporting should be deferred to a later phase of the conceptual framework project.

BC1.5 The boards do not expect that resolution of issues in that later phase will significantly change the objective of financial reporting stated in the framework. However, reaching conclusions on the boundaries of financial reporting might result in adding information helpful in achieving the objective. For example, whether financial reporting should include prospective information or forecasts and, if so, how that information should be provided, will be considered as part of that phase.

Common needs of users

BC1.6 General purpose financial reporting stems from the common information needs of users, particularly capital providers. Other users of financial statements have specialised information needs that go beyond those of an entity's capital providers. Those other users may have the authority to demand information from all of the entities for which information is desired. Therefore, the boards concluded that, to the extent that the needs of those other users do not overlap with the common needs of capital providers, those needs are beyond the scope of general purpose financial reporting.

One set of general purpose financial reports

BC1.7 Some have suggested that the focus on a single set of financial reports intended to meet the needs of a wide range of users may no longer be appropriate. They think that advances in technology may make general purpose financial reporting obsolete. New technologies, for example the use of eXtensible Business Reporting Language (XBRL), may make it practicable for entities either to prepare or to make available the information necessary for different users to assemble different financial reports.

BC1.8 To provide different reports for different users or to make available the information that users need to assemble their own reports raises cost-benefit concerns. This would place potentially unreasonable demands on many users of financial reporting information. For example, to make informed choices about which of several financial reports to select or which information to select to assemble their own reports or perhaps a single financial statement, many users would need to have a greater understanding of accounting than they have now. Many users of financial reports are not accounting experts and may not wish to acquire such expertise. Furthermore, requiring entities to provide either a variety of different reporting packages or the information sufficient for users to assemble their own reporting packages would also greatly expand the amount of information that entities must make available. That would increase both the costs of providing financial reports and the costs of using them in exchange for benefits that seem questionable, especially if users continue to want general purpose financial reports.

BC1.9 The boards concluded that, at least for the time being, users' information needs continue to be best served by general purpose financial reports. Moreover, because users of financial reports have a common interest in assessing an entity's ability to generate net cash inflows and management's ability to protect and enhance the investments of capital providers, a financial report that focuses on information that is helpful in making those assessments is likely to continue to be needed regardless of how much additional financial data are made available to users.

BC1.10 In the discussion paper, the boards used the term *general purpose external financial reporting*. *External* was intended to convey that internal users such as management were not intended beneficiaries for financial reporting established by the boards. During their redeliberations, the boards concluded that this distinction was unnecessary because management reporting is not general purpose financial reporting. In addition, the boards observed that *external* might imply that a controlling shareholder was not included in the primary user group because the controlling shareholder might be deemed to be an internal user. The boards think the objective of general purpose financial reporting should encompass the needs of all capital providers. Therefore, the exposure draft uses *general purpose financial reporting*.

Entity perspective

BC1.11 Both the FASB's and the IASB's existing frameworks discuss the objective of financial reporting in terms of information that is useful to a wide range of users in making economic decisions. Both frameworks list a variety of existing and potential users, including equity investors, lenders, other creditors, employees, suppliers, customers and governmental agencies.

BC1.12 Under the entity perspective (also known as the entity theory) the reporting entity is deemed to have substance of its own, separate from that of its owners. Economic resources provided by capital providers become resources of the entity and cease to be resources of the capital providers. In exchange for the resources provided, capital providers are granted claims on the economic resources of the reporting entity. Claims of different capital providers have different priorities and different rights with respect to the reporting entity, but they all represent claims on the economic resources of the reporting entity. Therefore, financial reporting from the perspective of the entity involves reporting on the economic resources of that entity and the claims on those resources held by its capital providers.

BC1.13 In contrast, under the proprietary perspective (also known as the proprietary theory), the reporting entity does not have substance of its own separately from that of its proprietors or owners. The resources of equity capital providers remain their resources and do not become resources of an entity because the entity does not exist separately from its owners. Lenders and other creditors provide economic resources to the owners of an entity in exchange for a claim against the resources that would otherwise accrue to the benefit of the owners. In other words, the claims of lenders and other creditors reduce the owners' equity in the resources associated with the reporting entity. Therefore, financial reporting from the perspective of the proprietor involves reporting on the assets of the owners, the liabilities of the owners to their lenders and other creditors, and the net residual owners' equity in the reporting entity.

BC1.14 The proprietary perspective has its roots in the days when most businesses were sole proprietorships and partnerships that were managed by their owners. When most entities were owner-managed and owner-managers had unlimited liability for the debts incurred in the course of the business, the business did not have any substance separate from that of the owner. Over time, the separation grew between the owners of businesses and the businesses themselves. New ways of conducting business evolved in which the owners did not actively manage the business, but instead engaged others to do so. As businesses grew larger and capital needs increased, new business forms evolved as well. Most of today's businesses that are the focus of the objective of financial reporting have legal substance by virtue of their legal form of organisation, multiple capital providers with limited legal liability, and professional managers separate from the capital providers.

BC1.15 The boards concluded that the entity perspective is more consistent with the fact that the vast majority of today's business entities engaged in financial reporting have substance distinct from that of their capital providers. As such, the proprietary perspective generally does not reflect a realistic view of financial reporting.

BC1.16 Questions continue to be raised about the standards-level implications of adopting the entity perspective of financial reporting. Some constituents argue that an entity perspective logically rules out some alternatives for the elements of financial statements, for determining the boundaries of a reporting entity, or for other future phases of the conceptual framework project. Others argue that although the entity perspective is helpful for defining the primary user group and the objective of financial reporting, it does not have important implications for later phases of the conceptual framework project. Although the boards decided to adopt the entity perspective as it pertains to the objective of financial reporting, they have not yet considered all the possible implications of that decision on future phases of the framework. The boards have not yet considered the effect that adopting the entity perspective in Chapter 1 will have on phases that have yet to be deliberated, and therefore have not yet decided whether there are implications for decisions to be made in those phases. Those decisions will be made when the boards deliberate those phases.

Primary user group

BC1.17 Both the FASB's and the IASB's existing frameworks identify a particular group of primary users. Information that satisfies the needs of that particular group of users is likely to meet most of the needs of other users. The IASB *Framework*, paragraph 10, says:

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

FASB Concepts Statement 1 focuses on information for investment and credit decisions, which means that existing and potential investors, lenders, and other creditors are the primary users on which the objective focuses.

BC1.18 The boards concluded that identifying a group of primary users of financial reports, as the existing frameworks do, provides an important focus for the objective and the other parts of the conceptual framework. Without a defined group of primary users, the framework would risk becoming unduly abstract or vague.

BC1.19 Present and potential capital providers are the most prominent users of an entity's financial reports. They have the most critical and immediate need for the information in financial reports. They are interested in assessing an entity's ability to generate future net cash inflows, which significantly affects the entity's ability to distribute cash to them in the form of dividends or other types of distributions to owners, or interest and repayment of borrowing. Capital providers also compare the information in financial reports with their expectations over time to make decisions about management's ability to protect and enhance their investments. Other potential users of financial reports who are not capital providers also have an interest in making these assessments. Because present and potential capital providers have the most direct and immediate interest in an entity's ability to generate net cash inflows and management's ability to protect and enhance capital providers' interests, the boards decided to designate them as the primary users of financial reporting information.

BC1.20 Designating a primary user group that comprises all capital providers, present and potential, does not imply that financial reporting may neglect the information needs of existing ordinary shareholders. Rather, it means that standard-setters should strive to meet the information needs of all members of the primary user group. The boards expect that the needs of those other members generally will be essentially the same as the needs of ordinary shareholders. However, some information may be more significant to the needs of lenders and other creditors than to those of existing ordinary shareholders. In that situation, designating present equity investors as the primary users of financial reporting information could imply an inadequate focus on the needs of other capital providers, such as lenders and other creditors.

BC1.21 Although the boards adopted the entity perspective as the basic perspective underlying financial reports, they also observed that including in financial reports some information that is primarily directed to equity investors, present or potential (information that some view as more consistent with the proprietary perspective), is appropriate. The boards observed that adopting the entity perspective does not preclude deciding in future standards also to include in financial statements information that might be viewed as consistent with a proprietary perspective.

BC1.22 The boards concluded that a focus on a broader primary user group fulfils the needs of the full range of capital providers both in jurisdictions with a corporate governance model defined in the context of shareholders and in jurisdictions with a corporate governance model that focuses on stakeholders, which is a broader group than shareholders.

Usefulness for making decisions

Evaluating past performance and predicting future cash flows

BC1.23 The existing frameworks of both the IASB and the FASB focus on providing information that is useful in making economic decisions as the fundamental objective of financial reporting. As part of that objective, both frameworks also discuss providing information that is helpful in assessing how management has fulfilled its stewardship responsibility.

BC1.24 Differing views continue to exist on whether providing information that is useful in assessing management's stewardship should be a stated objective of financial reporting, either in addition to the objective of providing information that is useful in making resource allocation decisions or in place of that objective. Views about the meaning and implications of a stewardship objective differ. Supporters of such an objective do not necessarily view the implications of a separate objective focusing on stewardship in the same way. The views of opponents of a stewardship objective are also diverse.

BC1.25 In the discussion paper, the boards concluded that providing information that is useful in assessing how management has fulfilled its stewardship responsibility should remain part of the overall objective of providing information that is useful in making resource allocation decisions. The boards concluded that users of financial reports who wish to assess how well management has discharged its stewardship responsibility generally are interested in making resource allocation decisions. The boards also concluded that eliminating any discussion of stewardship, even with an explanation of why such a discussion is unnecessary, could erroneously imply that the boards do not think that financial reports should provide information that is useful in assessing how management has fulfilled its responsibility to protect and enhance the investments of capital providers.

BC1.26 The boards also concluded in the discussion paper that adding a separate objective for stewardship might imply that financial reporting should attempt to separate the effects of management's performance from the effects of events and circumstances that are beyond management's control. Examples are general economic conditions and the supply and demand characteristics of an entity's inputs and outputs. Moreover, the boards observed that those who consider providing information that is useful in assessing management's stewardship a broader objective than decision-usefulness may be confusing corporate governance with financial reporting.

BC1.27 Several respondents to the discussion paper expressed a concern that the proposed objective was too narrowly focused on resource allocation decisions. Although most respondents agreed that decision-usefulness was the appropriate objective, respondents argued that capital providers make other decisions that are aided by financial reporting information in addition to resource allocation decisions. Those decisions, which are typically made after the decision to allocate resources to a particular entity, involve influencing management of the entity. For example, shareholders must decide how to vote on whether to retain directors or replace them and how members of management should be remunerated for their services. Shareholders' decision-making process may include evaluating how management of the entity performed against management in competing entities in similiar circumstances.

BC1.28 Capital providers also decide whether to use their influence to affect the operating and financing decisions made by management. For example, bondholders often have contractual rights to approve or block particular actions of management that might have an effect on the bondholders' investment. A lender with the power to call in a loan may opt to use that power to persuade management to take a specific course of action in managing the business. Examples of matters of interest to capital providers are the performance and strategy of management, corporate governance and social responsibility.

BC1.29 The boards concluded that the objective of financial reporting should be broad enough to encompass all the decisions that are made by capital providers at least in part on the basis of their legitimate reliance on financial reporting information. Those decisions include resource allocation decisions as well as subsequent decisions made to protect and enhance their investment. As a result, the boards modified the proposed objective in paragraph OB2 to include those decisions made to protect and enhance an investment.

Decision-usefulness for different types of entities

BC1.30 The boards also considered whether the objective of general purpose financial reporting should differ for different types of entities. Possibilities include:

(a) smaller entities versus larger entities

(b) entities with listed (publicly traded) debt or equity financial instruments versus those without such instruments (sometimes referred to as non-public or private entities)

(c) closely held entities versus those with widely dispersed ownership.

BC1.31 The boards concluded that the objective of general purpose financial reporting should be the same for all entities that issue such reports. That conclusion is consistent with the IASB *Framework* and FASB Concepts Statement 1, as well as the frameworks of other national standard-setters. The boards observed that the users of some entities' financial reports, for example, smaller, closely held entities, may be able to specify and receive the information they need. Such entities may have little need to prepare general purpose financial reports for external users. However, for entities that have external users of their financial reports, the objective of the reports issued to them is the same because the information needs of capital providers generally are the same.

BC1.32 Although the objective of financial reporting is the same for all entities, cost constraints sometimes may lead standard-setters to permit or require differences in reporting for some types of entities. In those situations, standard-setters have concluded that such differences are a result of variations in the perceived costs and benefits of the information when applied to different entity types, not different objectives. Financial reports prepared in accordance with such requirements are nonetheless intended to meet the objective of financial reporting.

Financial reporting and management's information needs

BC1.33 Another issue involves the interaction between general purpose financial reporting and management's needs. The proposed framework makes it clear that general purpose financial reporting is directed to the common needs of capital providers. An entity's management has information needs that differ, to some extent, from those of capital providers. In addition, management has the ability to access financial information to meet its unique needs. Thus, general purpose financial reporting is not explicitly directed to the information needs of management. However, an entity's management and its governing board are also interested in the entity's ability to generate net cash inflows. Thus, financial reporting information is likely to be useful to them as well as to capital providers.

BC1.34 Three additional aspects of the management perspective potentially pertain to later phases of the conceptual framework project. First, whether management's perspective or intentions should affect recognition or measurement will be considered in the phase of the project that deals with recognition and measurement concepts. Second, the extent to which, and how, financial reports should include management commentary will be addressed in the phase dealing with presentation and display of financial reporting information. The third issue is whether some information in financial reports should be presented in a way that is consistent with how management views the business. Segment information prepared in accordance with FASB Statement No. 131 *Disclosures about Segments of an Enterprise and Related Information* or IFRS 8 *Operating Segments*, and financial risk management information prepared in accordance with IFRS 7 *Financial Instruments: Disclosures*, are examples of that type of management perspective. That issue also will be considered in the phase dealing with presentation and display of financial reporting information.

The significance of information about financial performance

BC1.35 Another issue concerning the objective of financial reporting is the relative importance of information about an entity's financial performance provided by comprehensive income and its components.* FASB Concepts Statement 1 (paragraph 43) says:

> The primary focus of financial reporting is information about an enterprise's performance provided by measures of comprehensive income and its components. Investors, creditors, and others who are concerned with assessing the prospects for enterprise net cash inflows are especially interested in that information.

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

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

BC1.36 The boards concluded that it is important for the framework to explain that to assess an entity's ability to generate net cash inflows or to assess management's discharge of its stewardship responsibility, users need information about the entity's *financial performance measured by accrual accounting*. However, to designate one type of information as the primary focus of financial reporting would be inappropriate.

BC1.37 The net change during a period in economic resources and the claims on them, other than those resulting from transactions with owners as owners, or components of that net change, may be referred to by a variety of terms, such as *comprehensive income*, *net income*, or *profit or loss*. The boards concluded that none of the terms communicates the critical idea that in measuring performance, an entity first identifies and measures its economic resources and the claims on them in accordance with the applicable recognition and measurement guidance. In the process, the entity separates claims by owners from claims by other parties. The entity then calculates the net change in economic resources and claims other than changes resulting from transactions with owners as owners, as well as the net change in claims by owners. Displays of those changes in economic resources and displays of the list of economic resources and claims are equally important.

BC1.38 Information about cash flows during a period is also important in assessing an entity's financial performance. However, financial performance measured by accrual accounting more closely tracks the occurrence of transactions and other events and circumstances that have affected the entity's wealth during the period. In addition, financial reports based on accrual accounting include much information about an entity's existing economic resources and the claims on them that would be omitted if only cash flows were reported. Thus, the boards concluded that information about an entity's economic resources and claims on them and the changes in resources and claims as reflected by various measurement attributes within accrual accounting is essential to assessing the entity's ability to generate net cash inflows.

Financial position and solvency

BC1.39 In response to suggestions received, the boards considered whether the main purpose of the statement of financial position should be to provide information that helps particular groups of users, such as lenders, other creditors and regulators, to assess the entity's solvency. The boards noted that similar questions could be asked about whether other financial statements should be directed to the needs of particular users.

BC1.40 The question is not whether information provided in the financial statements should be helpful in assessing solvency—clearly it should. Assessing solvency is of interest to capital providers, and the overriding objective of general purpose financial reporting is to provide information that is useful to capital providers for making decisions. However, some have suggested that the statement of financial position should be directed toward the needs of lenders, other creditors and regulators, possibly to the exclusion of other users. But to do so would be inconsistent with the objective of serving the common needs of the capital providers as the primary user group. Therefore, the boards rejected the notion of directing the statement of financial position (or any other particular financial statement) towards the needs of particular groups of users.

Chapter 2 Qualitative characteristics and constraints of decision-useful financial reporting information

Introduction

QC1 The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to present and potential equity investors, lenders, and other creditors in making decisions in their capacity as capital providers. Qualitative characteristics are the attributes that make financial information useful. They can be distinguished as fundamental or enhancing characteristics, depending on how they affect the usefulness of the information. Regardless of its classification, each qualitative characteristic contributes to the usefulness of financial reporting information. However, providing useful financial information is limited by two pervasive constraints on financial reporting—*materiality* and *cost*.

Fundamental qualitative characteristics

QC2 Economic phenomena are economic resources, claims on those resources, and the transactions and other events and circumstances that change them. Financial reporting information depicts economic phenomena (that exist or have already occurred) in words and numbers in financial reports. For financial information to be useful, it must possess two fundamental qualitative characteristics—*relevance* and *faithful representation*.

Relevance

QC3 Information is relevant if it is capable of making a difference in the decisions made by users in their capacity as capital providers. Information about an economic phenomenon is capable of making a difference when it has predictive value, confirmatory value or both. Whether information about an economic phenomenon is capable of making a difference is not dependent on whether the information has actually made a difference in the past or will definitely make a difference in the future. Information may be capable of making a difference in a decision—and thus be relevant—even if some users choose not to take advantage of it or are already aware of it.

QC4 Information about an economic phenomenon has *predictive value* if it has value as an input to predictive processes used by capital providers to form their own expectations about the future. Information itself need not be predictable to have predictive value. Some highly predictable information may not have any predictive value for a particular purpose. For example, straight-line depreciation of plant and equipment may be highly predictable from year to year but may not be very helpful in assessing an entity's ability to generate net cash inflows. Also, information about an economic phenomenon need not be in the form of an explicit forecast to have predictive value; it needs only to be a useful input to predictive processes of use to capital providers.

QC5 Information about an economic phenomenon has confirmatory value if it confirms or changes past (or present) expectations based on previous evaluations. Information that confirms past expectations increases the likelihood that the outcomes or results will be as previously expected. If the information changes expectations, it also changes the perceived probabilities of the range of possible outcomes.

QC6 The predictive and confirmatory roles of information are interrelated; information that has predictive value usually also has confirmatory value. For example, information about the current level and structure of an entity's economic resources and claims helps users to predict an entity's ability to take advantage of opportunities and to react to adverse situations. The same information helps to confirm or correct users' past predictions about that ability.

Faithful representation

QC7 To be useful in financial reporting, information must be a faithful representation of the economic phenomena that it purports to represent. Faithful representation is attained when the depiction of an economic phenomenon is complete, neutral, and free from material error. Financial information that faithfully represents an economic phenomenon depicts the economic substance of the underlying transaction, event or circumstances, which is not always the same as its legal form.

QC8 A single economic phenomenon may be represented in multiple ways. For example, an estimate of the risk transferred in an insurance contract may be depicted qualitatively (eg a narrative description of the nature of possible losses) or quantitatively (eg an expected loss). Additionally, a single depiction in financial reports may represent multiple economic phenomena. For example, the presentation of the item called plant and equipment in a financial statement may represent an aggregate of all of an entity's plant and equipment.

QC9 A depiction of an economic phenomenon is *complete* if it includes all information that is necessary for faithful representation of the economic phenomena that it purports to represent. An omission can cause information to be false or misleading and thus not helpful to the users of financial reports.

QC10 *Neutrality* is the absence of bias intended to attain a predetermined result or to induce a particular behaviour. Neutral information is free from bias so that it faithfully represents the economic phenomena that it purports to represent. Neutral information does not colour the image it communicates to influence behaviour in a particular direction. Financial reports are not neutral if, by the selection or presentation of financial information, they influence the making of a decision or judgement in order to achieve a predetermined result or outcome. However, to say that financial reporting information should be neutral does not mean that it should be without purpose or that it should not influence behaviour. On the contrary, relevant financial reporting information is, by definition, capable of influencing users' decisions.

QC11 Faithful representation does not imply total freedom from error in the depiction of an economic phenomenon because the economic phenomena presented in financial reports are generally measured under conditions of uncertainty. Therefore, most financial reporting measures involve estimates of various types that incorporate management's judgement. To represent an economic phenomenon faithfully, an estimate must be based on the appropriate inputs, and each input must reflect the best available information. Completeness and neutrality of estimates (and inputs to estimates) are desirable; however, some minimum level of accuracy is also necessary for an estimate to be a faithful representation of an economic phenomenon. For a representation to imply a degree of completeness, neutrality or freedom from error that is impracticable would diminish the extent to which the information faithfully represents the economic phenomena that it purports to represent. Thus, to attain a faithful representation, it may sometimes be necessary to disclose explicitly the degree of uncertainty in the reported financial information.

Application of the fundamental qualitative characteristics

QC12 The qualitative characteristic of relevance is concerned with the connection of economic phenomena to the decisions of capital providers and other users of financial reporting information—the pertinence of the phenomena to those decisions. Application of the qualitative characteristic of relevance will identify which economic phenomena should be depicted in financial reports, with the intention of providing decision-useful information about those phenomena. Relevance refers to the economic phenomena, not to their depictions, and therefore will be considered before the other qualitative characteristics.

QC13 Once relevance is applied to determine which economic phenomena are pertinent to the decisions to be made, faithful representation is applied to determine which depictions of those phenomena best correspond to the relevant phenomena. Application of the faithful representation characteristic determines whether a proposed depiction in words and numbers is faithful (or unfaithful) to the economic phenomena being depicted.

QC14 As fundamental qualitative characteristics, relevance and faithful representation work together to contribute to the decision-usefulness of information in different ways. A depiction that is a faithful representation of an irrelevant phenomenon is not decision-useful, just as a depiction that is an unfaithful representation of a relevant phenomenon results in information that is not decision-useful. Thus, either irrelevance (the economic phenomenon is not connected to the decision to be made) or unfaithful representation (the depiction is not connected to the phenomenon) results in information that is not decision-useful. Together, relevance and faithful representation make financial reporting information decision-useful.

Enhancing qualitative characteristics

QC15 Enhancing qualitative characteristics are complementary to the fundamental qualitative characteristics. Enhancing qualitative characteristics distinguish more useful information from less useful information. The enhancing qualitative characteristics are *comparability*, *verifiability*, *timeliness* and *understandability*. These characteristics enhance the decision-usefulness of financial reporting information that is relevant and faithfully represented.

Comparability

QC16 *Comparability* is the quality of information that enables users to identify similarities in and differences between two sets of economic phenomena. Consistency refers to the use of the same accounting policies and procedures, either from period to period within an entity or in a single period across entities. Comparability is the goal; consistency is a means to an end that helps in achieving that goal.

QC17 The essence of decision making is choosing between alternatives. Thus, information about an entity is more useful if it can be compared with similar information about other entities and with similar information about the same entity for some other period or some other point in time. Comparability is not a quality of an individual item of information, but rather a quality of the relationship between two or more items of information.

QC18 Comparability should not be confused with uniformity. For information to be comparable, like things must look alike and different things must look different. An overemphasis on uniformity may reduce comparability by making unlike things look alike. Comparability of financial reporting information is not enhanced by making unlike things look alike any more than it is by making like things look different.

QC19 Some degree of comparability should be attained by maximising the fundamental qualitative characteristics. That is to say, a faithful representation of a relevant economic phenomenon should naturally possess some degree of comparability to a faithful representation of a similar relevant economic phenomenon by another entity. Although a single economic phenomenon can be faithfully represented in multiple ways, permitting alternative accounting methods for the same economic phenomenon diminishes comparability and, therefore, may be undesirable.

Verifiability

QC20 *Verifiability* is a quality of information that helps assure users that information faithfully represents the economic phenomena that it purports to represent. Verifiability implies that different knowledgeable and independent observers could reach general consensus, although not necessarily complete agreement, that either:

(a) the information represents the economic phenomena that it purports to represent without material error or bias; or

(b) an appropriate recognition or measurement method has been applied without material error or bias.

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

QC21 Verification may be direct or indirect. With *direct verification*, an amount or other representation itself is verified, such as by counting cash or observing marketable securities and their quoted prices. With *indirect verification*, the amount or other representation is verified by checking the inputs and recalculating the outputs using the same accounting convention or methodology. An example is verifying the carrying amount of inventory by checking the inputs (quantities and costs) and recalculating the ending inventory using the same cost flow assumption (eg average cost or first-in, first-out).

Timeliness

QC22 *Timeliness* means having information available to decision makers before it loses its capacity to influence decisions. Having relevant information available sooner can enhance its capacity to influence decisions, and a lack of timeliness can rob information of its potential usefulness. Some information may continue to be timely long after the end of a reporting period because some users may continue to consider it when making decisions. For example, users may need to assess trends in various items of financial reporting information in making investment or credit decisions.

Understandability

QC23 *Understandability* is the quality of information that enables users to comprehend its meaning. Understandability is enhanced when information is classified, characterised and presented clearly and concisely. Comparability can also enhance understandability.

QC24 Although presenting information clearly and concisely helps users to comprehend it, the actual comprehension or understanding of financial information depends largely on the users of the financial report. Users of financial reports are assumed to have a reasonable knowledge of business and economic activities and to be able to read a financial report. In making decisions, users also should review and analyse the information with reasonable diligence. However, when underlying economic phenomena are particularly complex, fewer users may understand the financial information depicting those phenomena.

In those cases, some users may need to seek the aid of an adviser. Information that is relevant and faithfully represented should not be excluded from financial reports solely because it may be too complex or difficult for some users to understand without assistance.

Application of the enhancing qualitative characteristics

QC25 Enhancing qualitative characteristics improve the usefulness of financial information and should be maximised to the extent possible. However, the enhancing qualitative characteristics, either individually or in concert with each other, cannot make information useful for decisions if that information is irrelevant or not faithfully represented.

QC26 The application of the enhancing qualitative characteristics is an iterative process that does not follow a prescribed order. Sometimes, one or more enhancing qualitative characteristics may be sacrificed to varying degrees to maximise another qualitative characteristic. For example, a temporary reduction in comparability may be worthwhile to improve relevance or faithful representation in the longer term. A temporary reduction in period-to-period consistency, and thus in comparability, may occur when a new financial reporting standard that improves relevance or faithful representation requires prospective application. Such a change in reporting effectively trades a temporary reduction in period-to-period consistency for greater comparability in the future. In that situation, appropriate disclosures can help to compensate for the temporary reduction in comparability.

Constraints on financial reporting

QC27 Two pervasive constraints limit the information provided by financial reporting: *materiality* and *cost*.

Materiality

QC28 Information is material if its omission or misstatement could influence the decisions that users make on the basis of an entity's financial information. Because materiality depends on the nature and amount of the item judged in the particular circumstances of its omission or misstatement, it is not possible to specify a uniform quantitative threshold at which a particular type of information becomes material.

When considering whether financial information is a faithful representation of what it purports to represent, it is important to take into account materiality because material omissions or misstatements will result in information that is incomplete, biased or not free from error.

Cost

QC29 Financial reporting imposes costs; the benefits of financial reporting should justify those costs. Assessing whether the benefits of providing information justify the related costs will usually be more qualitative than quantitative. In addition, the qualitative assessment of benefits and costs will often be incomplete.

QC30 The costs of providing information include costs of collecting and processing the information, costs of verifying it, and costs of disseminating it. Users incur the additional costs of analysis and interpretation. Omission of decision-useful information also imposes costs, including the costs that users incur to obtain or attempt to estimate needed information using incomplete data in the financial report or data available elsewhere. Preparers expend the majority of the effort towards providing financial information. However, capital providers ultimately bear the cost of those efforts in the form of reduced returns.

QC31 Financial reporting information helps capital providers make better decisions, which results in more efficient functioning of capital markets and a lower cost of capital for the economy as a whole. Individual entities also enjoy benefits, including improved access to capital markets, favourable effect on public relations, and perhaps lower costs of capital. The benefits may also include better management decisions because financial information used internally is often based at least partly on information prepared for general purpose financial reporting purposes.

Application of the constraints on financial reporting

QC32 Materiality is a pervasive constraint on financial reporting because it pertains to all the qualitative characteristics of decision-useful financial reporting information. For example, materiality should be considered when determining whether information has sufficient predictive or confirmatory value to be relevant to users and is sufficiently complete, neutral and free from error to represent faithfully the economic phenomenon that it purports to represent.

QC33 Application of the cost constraint involves assessing whether the benefits of reporting information are likely to justify the costs incurred to provide and use that information. When making this assessment, it is necessary to consider whether one or more qualitative characteristics might be sacrificed to some degree to reduce cost. When applying the cost constraint to a proposed standard, standard-setters seek information from preparers, users, academics and others about the expected nature and quantity of the benefits and costs of that standard.

Basis for Conclusions on draft Chapter 2

Introduction

BC2.1 This Basis for Conclusions summarises the considerations that Board members thought significant in reaching the conclusions in Chapter 2 *Qualitative characteristics and constraints of decision-useful financial reporting information* of the draft conceptual framework. It includes reasons for accepting some alternatives and rejecting others. Individual Board members gave greater weight to some factors than to others.

BC2.2 In July 2006 the boards published for public comment a discussion paper *Preliminary Views on an improved Conceptual Framework for Financial Reporting: The Objective of Financial Reporting and Qualitative Characteristics of Decision-useful Financial Reporting Information*. The boards received 179 comment letters on that discussion paper. This exposure draft represents the boards' views after considering respondents' comments and the views received through other outreach initiatives. When appropriate, this Basis for Conclusions discusses the boards' basis for modifying their preliminary views to reach the conclusions in this exposure draft.

Fundamental qualitative characteristics

Relevance

Capable of making a difference in decisions

BC2.3 In their existing frameworks, the FASB's and the IASB's definitions of relevance are similar, with one difference. The IASB *Framework*, paragraph 26, says that information is relevant 'when it influences the economic decisions of users by helping them evaluate past, present or future events or confirming, or correcting, their past evaluations.' FASB Concepts Statement No. 2 *Qualitative Characteristics of Accounting Information*, paragraph 47, says that to be relevant, '... accounting information must be capable of making a difference in a decision by helping users to form predictions about the outcomes of past, present, and future events or to confirm or correct expectations.' Thus, the definitions differ in whether information actually makes a difference or is capable of making a difference in a decision.

BC2.4 The boards concluded that information must be capable of making a difference in a decision to be relevant. In making decisions, users consider many individual items of financial reporting information, along with other types of information from many other sources. The extent to which users' decisions were affected by a particular item of financial reporting information often would be difficult to determine, even after the information has become available.

BC2.5 Whether or not it is possible to demonstrate conclusively that a particular item of information will affect, or has affected, users' decisions, the boards take steps to understand how capital providers use financial reporting information and how financial reports might better serve their needs. This includes actively soliciting written comments on proposed standards from capital providers and other users of financial reporting. The boards also frequently meet users and user organisations to discuss not only the potential benefits and costs of proposed standards but also potential agenda decisions and other matters. Such steps provide standard-setters with knowledge about the types of information that are capable of affecting users' decisions.

BC2.6 In addition, the boards assess relevance in relation to a decision—not in relation to particular decision makers. For example, some users may have been obtaining an item of information from a source other than financial reporting, or some users may have been estimating the amount of an item that financial reporting does not provide using other items that are provided. For various reasons, some users may choose not to take advantage of a particular item of information. However, the fact that some users have been expending the effort to obtain the information elsewhere may emphasise the relevance of the information to their decisions.

Predictive and confirmatory value

BC2.7 The IASB *Framework* identifies *predictive value* and *confirmatory value* as components of relevance, and the FASB's Concepts Statement 2 refers to *predictive value* and *feedback value*. The boards concluded that confirmatory value and feedback value have the same meaning. In the interest of adopting common terminology, the boards decided to use *confirmatory value*, which means confirming the validity of prior predictions or correcting them.

What does predictive value mean?

BC2.8 The boards identified the meaning of *predictive value* as an issue needing attention because it is easy to confuse *predictive value* as used in financial reporting concepts with *predictability* and related terms used in statistics.

BC2.9 Information has *predictive value* if it can be used in making predictions about the eventual outcomes of past, present or future events or their effects on future cash flows. In contrast, statisticians use *predictability* to refer to the accuracy with which it is possible to foretell the next number in a series. This is distinguished from *persistence*, which refers to the tendency of a series of numbers to continue as it has been going.

BC2.10 The boards concluded that adopting statistical notions and terminology in the framework would be inappropriate. To do so would imply that relevant financial reporting information must, in itself, predict the future. Although financial reporting might include forward-looking information, the boards noted that information need not be forward-looking to have predictive value. Rather, information that has predictive value is valuable as an input to the processes that capital providers and others use to develop their own predictions. In other words, financial reports supply the information; users make the predictions, including predictions that a reported item will not repeat.

Faithful representation and reliability

BC2.11 Concepts Statement 2, the IASB *Framework* and other conceptual frameworks that the boards reviewed include *reliability* as an essential qualitative characteristic of decision-useful financial reporting information. However, the boards identified several issues about reliability and its components. They also noted that neither board's existing framework conveys the meaning of reliability clearly enough to avoid misunderstandings.

How can the framework best convey what reliability means?

BC2.12 In Concepts Statement 2, the components of reliability are *representational faithfulness*, *verifiability* and *neutrality*, and its discussion of representational faithfulness also encompasses *completeness* and *freedom from bias*. The IASB *Framework* (paragraph 31) says:

> Information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully that which it either purports to represent or could reasonably be expected to represent.

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

BC2.13 In considering the issues related to *reliability*, the boards observed that there is a variety of notions of what the concept means. For example, some focus on *verifiability* or *free from material error* to the virtual exclusion of the *faithful representation* aspect of reliability. Others focus more on *faithful representation*, perhaps combined with neutrality. And to some, reliability apparently refers primarily to *precision*. The comments on almost any controversial proposal by a standard-setting body also indicate the lack of a common understanding of reliability. Sometimes, one group of respondents criticises the proposal as likely to reduce the reliability of the resulting financial reporting; another group supports the same proposal as likely to improve reliability. Generally, neither group explains clearly what it means by *reliability*, and each group seems to have in mind a different notion. Those considerations led the boards to consider how they could better convey what the proposed framework means by *reliability*.

BC2.14 Given the nature and extent of the longstanding problems with the qualitative characteristic of *reliability*, as well as previous efforts to address them, the boards concluded that the term itself needed reconsideration. Because further efforts to explain what *reliability* means were not likely to be productive, the boards sought a term that would more clearly convey the intended meaning.

BC2.15 *Faithful representation*—the faithful depiction in financial reports of economic phenomena—is essential if information is to be decision-useful. To represent economic phenomena faithfully, accounting representations must be complete, neutral and free from material error. Accordingly, the boards proposed that faithful representation encompasses all the key qualities that the previous frameworks included as aspects of reliability.

BC2.16 Many respondents to the discussion paper commented unfavourably on the boards' preliminary decision to replace *reliability* with *faithful representation*. However, in those comments, each respondent described reliability differently from how the boards described reliability in their existing frameworks. Furthermore, many respondents' descriptions of reliability more closely resembled the boards' notion of verifiability than reliability. These comments led the boards to affirm their decision to replace the term reliability with faithful representation. During their redeliberations, the boards took several steps to try to prevent further misunderstandings about faithful representation. These steps included explicitly identifying freedom from material error as a component of faithful representation and removing verifiability as a component of it.

BC2.17 To avoid confusing two similar terms, the remainder of this Basis for Conclusions uses the term *faithful representation* rather than *reliability*, except when directly quoting existing frameworks that use the latter term.

Substance over form

BC2.18 The IASB *Framework* includes *substance over form* among the components of reliability. Paragraph 35 includes the following:

> For example, an entity may dispose of an asset to another party in such a way that the documentation purports to pass legal ownership to that party; nevertheless, agreements may exist that ensure that the entity continues to enjoy the future economic benefits embodied in the asset. In such circumstances, the reporting of a sale would not represent faithfully the transaction entered into...

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

BC2.19 The boards concluded that *faithful representation* means that financial reporting information represents the substance of an economic phenomenon rather than solely its legal form. To represent legal form that differs from the economic substance of the underlying economic phenomenon could not result in a faithful representation. Accordingly, the proposed framework does not identify *substance over form* as a component of faithful representation because to do so would be redundant.

Neutrality, prudence and conservatism

BC2.20 Both boards' existing frameworks include *neutrality* as an essential component of faithful representation, and both define it similarly. The FASB's and the IASB's existing frameworks also discuss the role of conservatism or prudence. For example, the following is from paragraphs 92 and 93 of Concepts Statement 2. (The phrase in quotation marks is from paragraph 171 of APB Statement No. 4 *Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises*.)

> There is a place for a convention such as conservatism—meaning prudence—in financial accounting and reporting, because business and economic activities are surrounded by uncertainty, but it needs to be applied with care. Since a preference "that possible errors in measurement be in the direction of understatement rather than overstatement of net income and net assets" introduces a bias into financial reporting, conservatism tends to conflict with

> significant qualitative characteristics, such as representational faithfulness, neutrality, and comparability (including consistency) ….
>
> Conservatism in financial reporting should no longer connote deliberate, consistent understatement of net assets and profits. The Board emphasizes that point because conservatism has long been identified with the idea that deliberate understatement is a virtue.

Paragraph 37 of the IASB *Framework* says that the exercise of prudence is an appropriate response to the uncertainties inherent in preparing financial statements. It defines *prudence* as 'the inclusion of a degree of caution in the exercise of the judgements needed in making the estimates required under conditions of uncertainty, such that assets or income are not overstated and liabilities or expenses are not understated.' However, that paragraph also notes that the exercise of prudence does not allow for deliberate understatement of assets or income or overstatement of liabilities or expenses.

BC2.21 Being careful in the presence of uncertainty includes searching for additional information to reduce uncertainty, reflecting the uncertainty of a range of potential amounts in making an estimate, or selecting an amount from the midpoint of a range if a point estimate is required. Going beyond that to reflect conservative estimates of income and equity has sometimes been considered desirable to ensure that financial reports do not reflect excessive optimism or bias on the part of management. However, the boards concluded that describing *prudence* or *conservatism* as a qualitative characteristic or a desirable response to uncertainty would conflict with the quality of *neutrality* because, even with the proscriptions of deliberate misstatement that appear in the existing frameworks, an admonition to be prudent is likely to lead to a bias in the reported financial position and financial performance. Introducing biased understatement of assets (or overstatement of liabilities) in one period frequently leads to overstating financial performance in later periods—a result that cannot be described as prudent. This is inconsistent with *neutrality*, which encompasses freedom from bias. Accordingly, the proposed framework does not include *prudence* or *conservatism* as desirable qualities of financial reporting information.

Can faithful representation be empirically measured?

BC2.22 Another issue involving faithful representation or any other of the qualitative characteristics is whether the framework should attempt to develop empirical measures of them. The boards considered whether at least some aspects of faithful representation might be quantifiable due to its relation to certain statistical concepts. But how or whether financial reporting concepts could objectively quantify neutrality (freedom from bias) or the overall degree of faithful representation is far from clear. Conceivably, the boards might attempt to quantify faithful representation by calculating closeness to an ideal (for example, total reported assets as a percentage of total ideally recognised and measured assets). But the so-called ideal would be so subjective, so controversial, that the attempt at quantification would probably fail.

BC2.23 Empirical accounting research techniques have accumulated considerable evidence supporting the combination of relevance and faithful representation of accounting information for measurement purposes by correlation to market prices and changes in them. For example, some studies provide evidence that a particular financial reporting requirement results in information that the market regards as sufficiently relevant and faithfully represented to be decision-useful. However, such studies have generally not provided useful techniques for consistently empirically measuring faithful representation apart from relevance.

BC2.24 Both boards' existing frameworks note the desirability in some circumstances of providing statistical information about how faithfully a financial reporting measure is represented. For example, paragraph 72 of Concepts Statement 2 says:

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

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

Enhancing qualitative characteristics

Comparability

BC2.25 The IASB *Framework* discusses *comparability* as a qualitative characteristic of decision-useful information as equally important as relevance and faithful representation. Concepts Statement 2 describes comparability as a quality of the relationship between two or more pieces of information that, although important, is secondary to relevance and faithful representation. Both frameworks, however, indicate that comparability should not be overemphasised at the expense of improved relevance or faithful representation.

BC2.26 The boards concluded that comparability was an enhancing qualitative characteristic because it logically follows relevance and faithful representation. Comparability is achieved when information being compared is a faithful representation of a relevant phenomenon. When information faithfully represents relevant phenomena, similar phenomena are represented similarly and dissimilar phenomena are represented dissimilarly. Consistency of information across entities or time periods enhances its comparability, which improves its decision-usefulness. Regardless of how comparable information may be, it will not be useful if it is irrelevant to users' decisions or does not faithfully represent the economic phenomena it purports to represent. In addition, standard-setters sometimes temporarily sacrifice some consistency to achieve improved relevance or faithful representation (or both) of the information in financial reports. For example, an entity's adoption of a new method of accounting or reporting applied prospectively will temporarily reduce the consistency of its financial reporting, thereby temporarily decreasing comparability.

Verifiability

BC2.27 The IASB *Framework* does not include verifiability as an explicit aspect or component of reliability, yet Concepts Statement 2 does. The boards, however, noted that their existing frameworks are not as different with respect to veriability as it might appear because paragraph 31 of the *Framework* contains the phrase *and can be depended upon by users*, which implies the need for a means of assuring users that they can depend on the information. In the discussion paper, the boards' preliminary views were that information needs to be verifiable to assure users that it is free from material error and bias and can thus be depended on to represent what it purports to represent. Therefore, verifiability was a component of faithful representation.

BC2.28 Some respondents pointed out that including verifiability as a component of faithful representation could result in some information being excluded from financial reporting. For example, an entity can faithfully depict a piece of information that represents management's opinion or intentions and this information is normally useful for decision-making. However, this information may not necessarily be directly or indirectly verifiable. The boards observed that many pieces of information included in financial reports are not verifiable and therefore concluded that verifiability cannot be a required component of faithful representation. However, the boards agreed that information that is verifiable is generally more decision-useful than information that cannot be independently verified; they therefore concluded that verifiability is an enhancing qualitative characteristic.

Timeliness

BC2.29 The IASB *Framework* discusses *timeliness* separately, as a constraint that could rob information of relevance. Concepts Statement 2 includes timeliness as an ancillary aspect of relevance. However, the substance of the concepts as discussed in the two frameworks is essentially the same.

BC2.30 In the discussion paper, the boards tentatively concluded that timeliness pertains only to relevance. However, some respondents pointed out that timeliness affects many of the qualitative characteristics and thus should not be characterised as a component of relevance. In their redeliberations, the boards concluded that timeliness is different from the other components of relevance. Whereas something that has predictive value or confirmatory value is relevant, information can be reported in a timely manner and have no relevance at all, or information can be delayed in reporting and remain relevant. Thus, the boards concluded that reporting information in a timely manner can enhance both the relevance and the faithful representation of that information and, therefore, timeliness is best described as an enhancing qualitative characteristic.

Understandability

BC2.31 Both the IASB *Framework* and Concepts Statement 2 include *understandability*, a quality of information that enables users to comprehend its meaning and therefore make it useful for decision-making. Both frameworks also similarly describe that for financial reporting information to be understandable, users should have a reasonable degree of financial knowledge and a willingness to study the information with reasonable diligence.

BC2.32 Despite those discussions of understandability and the users' responsibilities for understanding financial reports, misunderstandings persist. For example, some have argued that a new accounting method should not be implemented because some users might not understand it, even though the new accounting method is useful for decision making. They imply that understandability is more important than relevance.

BC2.33 The boards concluded that the draft framework needed to clarify both the qualitative characteristic of understandability and users' responsibilities in understanding financial reports. The revised discussion of understandability now explains that users are responsible for studying financial reporting information with reasonable diligence rather than only being willing to do so. In addition, the boards clarified that when an economic phenomenon is particularly complex, users may need to seek the aid of an adviser to understand that particular transaction. For example, capital providers unfamiliar with actions an entity might take to hedge its exposure to financial risks might have difficulty understanding a note to the financial statements that explains its hedging activities. That information, however, is relevant to users in making decisions about the entity. The understandability of information about hedging activities and related hedge accounting might be improved by a standard-setter requiring, or an entity voluntarily providing, tabular or graphic formats (or both) as well as narrative explanations. Standard-setters, together with those who prepare financial reports, should take steps that are necessary and feasible to improve the clarity and conciseness of financial reporting information so that the intended users can understand it.

BC2.34 Some users have noted that financial reports sometimes obscure important information by using convoluted terminology or an excessively detailed presentation. Accordingly, the draft framework explains that understandability will be enhanced when information is clear and concise. Overwhelming users with unnecessarily lengthy narratives or irrelevant information can decrease the understandability of financial information and deprive it of its usefulness.

Should additional qualitative characteristics be added?

BC2.35 The boards considered whether other qualitative characteristics should be added.

Transparency

BC2.36 Recently, standard-setters, regulators and others have used the terms *transparent* and *transparency* with increasing frequency in describing high quality financial reporting. The FASB's mission statement says that 'accounting standards are essential to the efficient functioning of the economy because decisions about the allocation of resources rely heavily on credible, concise, transparent, and understandable financial information.' The IASB's mandate also uses the term in a similar way in describing its objectives. That raises the question of whether transparency should be a qualitative characteristic of decision-useful information.

BC2.37 The boards concluded that transparency should not be added as a qualitative characteristic of decision-useful financial reporting information because to do so would be redundant. Transparent information results from applying several qualitative characteristics that the draft framework already incorporates, including faithful representation and understandability.

True and fair view

BC2.38 Some discussions of accounting concepts or principles refer to a *true and fair view* or *fair presentation*. For example, the UK *Statement of Principles for Financial Reporting* says:

> The concept of a true and fair view lies at the heart of financial reporting in the UK and the Republic of Ireland. It is the ultimate test for financial statements and, as such, has a powerful, direct effect on accounting practice. No matter how skilled the standard-setters and law-makers are, it is the need to show a true and fair view that puts their requirements in perspective.[*]

BC2.39 The Companies Act of 1947 introduced the notion of a true and fair view into law in the United Kingdom and the European Union's Fourth Directive (Article 2) and Seventh Directive also use the term. Other countries have used similar terminology in their legislation regulating business entities. However, none of that legislation defines *true and fair view*. The use of the term in legislation generally is in the context of providing an exception if compliance with accounting standards would not result in a true and fair view. However, the issue here is whether the

---

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

boards should add true and fair view as a qualitative characteristic of financial reporting information—not whether the authoritative literature should provide an exception to the application of accounting standards in some circumstances.

BC2.40 The IASB *Framework*, paragraph 46, explains how a true and fair view applies in the following way:

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

BC2.41 The boards agreed with the conclusions reached in the existing IASB *Framework*. True and fair view or fair presentation is not a qualitative characteristic and instead should result from applying the qualitative characteristics. The boards also observed that for financial reports to present a true and fair view or to present fairly is the same as faithful representation, which is already included as a qualitative characteristic.

Credibility

BC2.42 *Credibility*, which is another term that standard-setters or their constituents cite as a desirable attribute of financial reporting information, might be considered an additional qualitative characteristic.

BC2.43 Among the several definitions of *credible* in the Oxford English Dictionary Online, the most pertinent one is 'worthy of belief or confidence; trustworthy, reliable.' Clearly, information will not be of much help in decision making if users do not consider it worthy of belief. The need for credibility is the reason that verifiability is a qualitative characteristic. However, the boards concluded that credibility is not itself a characteristic of decision-useful financial information. Instead, credibility is a desired result of the process by which that information is developed. Whether users consider the information in an entity's financial report to be credible will depend heavily on their view of the trustworthiness of the entity's management and auditors, as well as on their view of the relevance of the information in the report and the degree to which it faithfully represents the underlying economic phenomenon.

Internal consistency

BC2.44 Another potential candidate for an additional qualitative characteristic is *internal consistency*. The discussion paper *Qualitative Characteristics of Accounting Information* published by the Accounting Standards Board of Japan (ASBJ) discusses internal consistency as follows (paragraph 16):

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

BC2.45 Thus, the Japanese discussion paper focuses on internal consistency of financial reporting standards rather than of financial reporting information. The ASBJ further explained that, in developing financial reporting standards, internal consistency is needed to infer relevance, which usually can be demonstrated only after the information resulting from a proposed standard has actually improved users' decisions, especially if the standard pertains to new types of transactions or other events. Therefore, if the economic environment has not changed radically, a standard-setter may infer that a proposed standard that is internally consistent with the existing system of standards that result in information accepted as relevant should also provide information that is relevant and useful for decision making.

BC2.46 The boards observed that internal consistency of accounting standards is desirable and that it should naturally result from developing standards that are consistent with the same conceptual framework. In addition, if an existing standard is generally considered to provide relevant information, it is helpful for standard-setters to be able to infer that a new standard that is consistent with the existing standard will do the same. However, the boards concluded that *internal consistency* should not be added as a qualitative characteristic of decision-useful financial reporting information. To do so could impede evolution in the body of financial reporting standards to improve the decision-usefulness of financial reports on the grounds that adopting new standards would not result in internal consistency.

---

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

High quality

BC2.47 In its report *International Accounting Standard Setting: A Vision for the Future*,* the FASB considered *high quality* a desirable characteristic of both financial reporting information and financial reporting standards. The report indicates that application of objectives and qualitative characteristics should lead to high quality accounting standards, which in turn should lead to high quality financial reporting information that is useful for making decisions. That is to say, *quality* is defined by the objective and qualitative characteristics of financial reporting information.

BC2.48 The boards concluded that high quality is achieved by adherence to the objective and qualitative characteristics of financial reporting information. *High quality* information is the goal to which financial reporting and standard-setters aspire. Therefore, the boards did not add *high quality* as a qualitative characteristic.

Other decision criteria sometimes suggested

BC2.49 Constituents have sometimes suggested other criteria for standard-setting decisions, and the boards have at times cited some of those criteria as part of the rationale for some decisions. Those criteria include:

(a) simplicity

(b) preciseness

(c) operationality

(d) practicability or practicality

(e) acceptability.

BC2.50 To the extent that criteria such as those listed are appropriate for standard-setters to consider, the boards concluded that they are generally part of the overall weighing of benefits and costs of providing financial information. For example, a simpler method may be less costly to apply than a more complex method. In some circumstances, a simpler method may result in information that is essentially the same as, but somewhat less precise than, a more complex method. In that situation, a standard-setter would include the decrease in precision and the decrease in implementation cost in weighing benefits against costs.

---

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

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

BC2.51 Both boards' existing frameworks discuss the need to exchange a degree of one desirable characteristic for an increased amount of another (trade-offs). For example, the IASB *Framework*, paragraph 45, says:

> In practice a balancing, or trade-off, between qualitative characteristics is often necessary. Generally the aim is to achieve an appropriate balance among the characteristics in order to meet the objective of financial statements. The relative importance of the characteristics in different cases is a matter of professional judgement.

Concepts Statement 2 discusses necessary trade-offs at greater length, but the essence of that discussion is the same—that applying judgement is necessary to achieve an appropriate balance of the qualitative characteristics. The pervasive constraints on financial reporting may also be considered when making such trade-offs.

BC2.52 To explain the relationships between the qualitative characteristics, the boards considered using a chart, such as *A Hierarchy of Accounting Qualities* in Concepts Statement 2. However, the boards agreed with Concepts Statement 2 that the chart is 'a limited device ... for showing certain relationships among the qualities that make accounting information useful' (paragraph 33), and that 'the hierarchy should be seen as no more than an explanatory device, the purpose of which is to clarify certain relationships ... ' (paragraph 34).

BC2.53 Therefore, the boards decided to search for a better way of explaining the relationships between the characteristics. They considered a chart that would illustrate how standard-setters might apply the qualitative characteristics in making decisions about financial reporting issues. However, they concluded that a chart that illustrated the standard-setting process would necessarily involve matters that the boards had not yet addressed in the conceptual framework project, including recognition, measurement, presentation (display) and disclosure. For that reason, the boards concluded that to include such a chart in a chapter focusing solely on qualitative characteristics would be premature. Therefore, in the discussion paper they preliminarily decided that the chapter should explain the relationships of the qualitative characteristics to the objective of financial reporting and to each other.

BC2.54 In reviewing comments from respondents, the boards noted respondents' confusion about how the qualitative characteristics relate to each other. Therefore, the boards proposed that the qualitative characteristics should be distinguished as fundamental or enhancing, depending on how they affect the usefulness of information. Regardless of its classification, each qualitative characteristic contributes to the usefulness of financial reporting information.

BC2.55 The boards observed that both relevance and faithful representation are fundamental qualitative characteristics because they work together to make financial reporting information useful in making decisions. A depiction that is a faithful representation of an irrelevant phenomenon is not decision-useful, nor is a depiction that is an unfaithful representation of a relevant phenomenon.

BC2.56 The boards also concluded that relevance is the quality that should be considered first. If information about a particular real-world economic phenomenon is not pertinent to investment or credit decisions, none of the other qualitative characteristics matters. Accordingly, it would be inefficient to consider faithful representation, comparability, verifiability, timeliness or understandability for irrelevant items. The boards then concluded that faithful representation is the quality that should be considered next. If the depiction of information about a relevant phenomenon is a faithful representation of what it purports to represent, the information will be decision-useful.

BC2.57 Next in the logical progression are the enhancing qualitative characteristics—comparability, timeliness, understandability and verifiability. The enhancing qualitative characteristics, either individually or in concert with each other, cannot make information useful for decisions if that information is irrelevant or not faithfully represented. Rather, enhancing qualitative characteristics improve the usefulness of financial information and should be maximised to the extent possible.

Constraints on financial reporting

Materiality

BC2.58 Both Concepts Statement 2 and the IASB *Framework* discuss *materiality*, and both define it similarly. However, Concepts Statement 2 describes *materiality* as a constraint on financial reporting that can only be considered together with the qualitative characteristics, especially relevance and faithful representation. The IASB *Framework*, on the other hand, discusses materiality as an aspect of relevance and does not indicate that materiality has a role in relation to the other qualitative characteristics.

BC2.59 The boards concluded that materiality is a pervasive constraint on financial reporting because it is pertinent to all of the other qualitative characteristics—not just to relevance. For example, a depiction may faithfully represent a relevant, real-world economic phenomenon in all material respects. The boards also concluded that materiality is a consideration for individual entities and their auditors, not standard-setters, because whether something is material can be assessed only in relation to a particular reporting entity's situation.

Cost

BC2.60 Both boards' existing frameworks describe the need to balance the benefits of financial reporting information with the costs of providing it as a pervasive constraint on financial reporting that standard-setters, as well as preparers and users of financial reports, should keep in mind. However, the discussion of benefits and costs in both frameworks focuses primarily on the difficulty of conducting cost-benefit analyses for financial reporting requirements.

BC2.61 The boards concluded that the balance between the benefits of financial reporting information and the costs of providing and using it is a pervasive constraint on financial reporting rather than a qualitative characteristic of decision-useful financial reporting information. In the light of the increased emphasis on the need for cost-benefit assessments in other areas since the existing frameworks were developed, the boards also considered whether standard-setters should conduct more rigorous cost-benefit analyses, perhaps on a quantitative basis.

BC2.62 Standard-setting bodies have long acknowledged the need to ensure that the benefits of financial reporting information justify its costs. In recent years, both the FASB and the IASB have attempted to develop more structured methods of obtaining information about the perceived benefits and costs of proposed standards. The methods used included requests—some more formal than others—to constituents to submit information about the nature and amount of the benefits and costs they expect to result from a specific proposal. Those requests have resulted in helpful information and in some situations led directly to changes to proposed requirements intended to reduce the costs of compliance without significantly reducing the related benefits.

BC2.63 The boards observed that the major problem for standard-setters in conducting rigorous cost-benefit analyses in financial reporting is the inability to quantify the benefits of a particular reporting requirement, or even to identify all of them. However, obtaining complete, objective quantitative information about the initial and ongoing costs of a requirement, or the failure to impose that requirement, would also be extremely difficult. Regardless of the difficulty, standard-setters should endeavour to take into account both the benefits and the costs of proposed financial reporting requirements.

BC2.64 The boards concluded that the proposed framework should commit standard-setters to seek information from constituents about their expectations of the nature and quantity of the benefits and costs of proposed standards and to consider that information in their deliberations. In other words, the boards concluded that the improved framework should go further in the area of assessing benefits and costs than the existing frameworks do. But the proposed framework stops short of committing standard-setters to demonstrate that the benefits of a proposed requirement would justify the related costs. To suggest in the proposed framework that standard-setters should attempt to conduct rigorous, quantitative cost-benefit analyses would raise expectations beyond what is feasible and might make it more difficult for standard-setters to improve financial reporting.

Appendix
Proposed amendments to the *Framework for the Preparation and Presentation of Financial Statements*

How will Chapters 1 and 2 fit with the existing IASB *Framework*?

The US Financial Accounting Standards Board and the International Accounting Standards Board (IASB) have agreed that *each board* will finalise the common framework chapter by chapter. Each board will finalise the chapters within the context of its current financial reporting hierarchy.

When each chapter is finalised, the relevant paragraphs in the IASB's existing *Framework for the Preparation and Presentation of Financial Statements* will be withdrawn. This exposure draft proposes that Chapters 1 (the objective of financial reporting) and 2 (the qualitative characteristics and constraints of decision-useful financial reporting information) should supersede paragraphs 9–22 and 24–46 of the *Framework*, which would consequently be withdrawn. This means that the IASB will use a new framework that will appear as follows:

The *Framework* (as revised in 20XX) will be:

New framework = (20XX)	Add: Preface and Summary [as contained in this exposure draft]
	Add: new Chapters 1 and 2 [as contained in this exposure draft]
	Add: existing *Framework*
	Less: (paragraphs 9–22 and 24–46)
	Add: other necessary consequential amendments (see below)

The amendments in this appendix shall be applied for annual reporting periods beginning on or after DD Month 20XY. If an entity applies this Framework *for an earlier period, those amendments shall be applied for that earlier period. In the amended paragraphs, new text is underlined and deleted text is struck through.*

A1 The heading '**Preface**' in the *Framework for the Preparation and Presentation of Financial Statements* is amended to *Preface to the Framework for the Preparation and Presentation of Financial Statements*.

A2 Paragraphs 9–21 and the headings above them are deleted.

A3 Paragraph 22 and the heading above it are deleted.

A4 Paragraphs 24–46 and the headings above them are deleted.

A5 Paragraph 83 is amended as follows:

83 An item that meets the definition of an element should be recognised if:

(a) it is probable that any future economic benefit associated with the item will flow to or from the entity; and

(b) the item has a cost or value that can be measured with reliability.[*]

[*]Footnote: Information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully that which it either purports to represent or could reasonably be expected to represent.

A6 Paragraph 84 is amended as follows:

84 In assessing whether an item meets these criteria and therefore qualifies for recognition in the financial statements, regard needs to be given to the materiality considerations discussed in ~~paragraphs 29 and 30~~ Chapter 2 *Qualitative characteristics and constraints of decision-useful financial reporting information*. The interrelationship between the elements means that an item that meets the definition and recognition criteria for a particular element, eg an asset, automatically requires the recognition of another element, eg income or a liability.

A7 Paragraph 86 is amended as follows:

86 The second criterion for the recognition of an item is that it possesses a cost or value that can be measured with reliability ~~as discussed in paragraphs 31 to 38 of this Framework~~. In many cases, ...

A8 Paragraph 111 and a heading are added as follows:

Effective date

111 An entity shall apply this *Framework* (as revised in 20XX) for annual periods beginning on or after DD Month 20XY. Earlier application is encouraged. If an entity applies the *Framework* for a period beginning before DD Month 20XY, it shall disclose that fact.

