The objective of financial reporting and the qualitative characteristics of useful information—what investors should know

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On 28 September 2010, we and the FASB completed the first phase of our joint project to develop a converged and improved conceptual framework—click here to listen to a podcast recording on this subject. Because it is the basis on which we set standards, the conceptual framework is important to an investor's understanding of the information provided in financial reports. Consequently, investors should be aware of what changes we are making to the framework.

The improvements to our existing *Framework for the Preparation and Presentation of Financial Statements*, published in 1989, are being undertaken in phases and will take many years to complete. However, as each phase is completed, we are removing the old text and adding the new text to the framework, which is now called the *Conceptual Framework for Financial Reporting 2010* (*Framework 2010*).

The name change is the first thing of importance. The old framework referred to financial 'statements'; instead, the new framework refers to financial 'reporting'. While the definition of financial reporting and its boundaries will be dealt with in a later phase, our intention is to include in financial reporting information in addition to what is found in a traditional set of financial statements. However, financial statements are still the heart of financial reporting.

The first phase of the project has not merely changed the title of the framework. It has also updated the definitions of the objective of financial reporting and the qualitative characteristics of useful information. The objective of financial reporting is the foundation of our *Framework 2010*. It defines who our primary audience is and what we should be providing to them. The qualitative characteristics are the qualities that we believe financial information must have to meet the objective.

Objective of financial reporting and the capital markets

The objective of financial reporting focuses on the information needs of capital providers. Specifically, the *Framework 2010* states:

> The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decision about providing resources to the entity.

The *Framework 2010* goes on to explain that the primary users to whom financial reporting is directed are those investors, lenders and other creditors that must rely on general purpose financial reports for much of the information on which they base their decisions. The *Framework 2010* observes that others, such as regulators, may find the information in financial reports useful, but financial reporting is not directed at them.

Qualitative characteristics of useful information

The *Framework 2010* identifies two fundamental qualitative characteristics of useful financial information: relevance and faithful representation. In order to be useful, financial information must be both relevant and faithfully represented. Comparability, verifiability, timeliness and understandability are identified as enhancing qualitative characteristics. They increase the usefulness of information that is relevant and faithfully represented. However, the framework acknowledges that information may not possess all of the enhancing characteristics but that it may still be useful. The framework also acknowledges that the cost of providing financial information is a pervasive constraint upon our ability to satisfy the objective of financial reporting.

In setting standards we will strive to require information that has both of the fundamental characteristics and as many of the enhancing characteristics as possible while minimising the cost of producing it.

Fundamental characteristics: relevance and faithful representation

Relevant information has predictive value, confirmatory value, or both and is therefore capable of making a difference to decisions made by investors, lenders and other creditors. Financial information has predictive value if it can be used as an input to processes used to predict future outcomes. It has confirmatory value if it provides feedback about previous predictions.

Materiality is an entity-specific aspect of relevance in the *Framework 2010*, rather than a stand-alone concept. Information is material if omitting it or mis-stating it could influence decisions based on the information. Immaterial information does not affect decisions. Consequently, immaterial information is not relevant. Because materiality is entity-specific, we will not consider materiality separately when developing standards.

A faithful representation is complete, neutral and free from error. Information is complete if a user can understand the phenomenon being depicted. This may require descriptions and explanations as well as a numerical depiction. Information is neutral if it is without bias in its selection or presentation. In other words, it is not intentionally overstated, understated, emphasised or de-emphasised.

Neutral information does not mean the information does not have an impact on decisions. By definition, useful information affects decisions. Likewise, free from error does not mean perfectly accurate. It means that there are no errors in the process used to produce the information and no errors in its description.

How we might use the qualitative characteristics in setting standards

This is how we might apply these concepts. First, we would identify an economic phenomenon that is potentially useful to investors, lenders and other creditors in making decisions. Then we would identify the type of information about that phenomenon that would be most relevant if it were available. We would then determine whether that information is available and if it can be faithfully represented at a reasonable cost. If so, we would require that information. If not, we would repeat the process with the next most relevant type of information.

One way in which we determine whether financial information is relevant is by publishing an exposure draft or other document seeking the views of investors, lenders and other creditors about whether the information proposed to be required would make a difference to their decisions.

Enhancing qualitative characteristics enhances the usefulness of information

If two ways of depicting an economic phenomenon are considered equally relevant and faithfully represented, we can make the choice between them by examining them to see which embodies more of the enhancing characteristics (comparability, verifiability, timeliness and understandability).

Comparability enables investors, lenders and other creditors to identify and understand similarities in, and differences among, items. Occasionally, a single economic phenomenon can be faithfully represented in multiple ways, but permitting alternative accounting methods for the same economic phenomena diminishes comparability. It is important to note that, comparability does not mean uniformity. For information to be comparable, like things must look alike and different things must look different.

Verifiability lends credibility to financial information by providing assurance that information faithfully represents what it purports to represent.

Timeliness means that information is available to investors, lenders and other creditors in time to be used in their decision making processes.

The enhancing qualitative characteristic of understandability means that information that may be difficult to understand is made more useful by presenting and explaining it as clearly as possible. Investors, lenders and other creditors are expected to actually study the reported financial information with reasonable diligence and to seek the aid of advisors to understand information that they find particularly complex.

Some old favourites have been dropped

Some familiar terms such as reliability, substance over form, and prudence (conservatism) are no longer mentioned in the *Framework*.

The *Framework 2010* uses faithful representation in place of reliability because there was great confusion about what was meant by reliability in the old framework. We had always meant faithfully represented, but it was often not understood to mean that. Substance over form was removed because we considered it to be redundant.

A faithful representation is complete, neutral and free from error. In other words, it represents the substance of an economic phenomenon rather than merely its legal form. Prudence and conservatism are excluded because these concepts are incompatible with neutrality. We believe that an admonition to be prudent is likely to lead to a bias.

The next step

We are currently working on defining the term reporting entity. We issued an exposure draft in March 2010. The comment period ended in July. At our joint board meeting in October the staff presented a summary of the comments received on the exposure draft. We decided that the staff had appropriately identified the issues to be discussed at future meetings. At our joint board meeting in November we asked the staff to continue to work on the issues and come back to the boards after June 2011.