

## EFRAG SECRETARIAT PAPER FOR PUBLIC MEETING

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# Conceptual Framework

## How reliability matters from a European perspective

### Objective

- 1 The purpose of this paper is to ask for the EFRAG Board's view on how reliability matters from a European perspective.

### IAS Regulation

- 2 According to the IAS Regulation, whether a Standard is suitable for application in the EU will depend on that standard meeting certain criteria. 'Reliability' is one of the criteria a Standard would have to meet. The IAS regulation does not provide additional guidance on how 'reliability' should be interpreted. Nor does the "Accounting directive". The "Accounting directive", however, notes in its introduction that:  
  
"Items recognised in annual financial statements should be measured on the basis of the principle of purchase price or production cost to ensure the reliability of information contained in financial statements. However, Member States should be allowed to permit or require undertakings to revalue fixed assets in order that more relevant information may be provided to the users of financial statements."
- 3 More guidance on how to interpret 'reliability' in relation to the IAS Regulation may, however, be found in *Comments concerning certain Articles of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards and the Fourth Council Directive 78/660/EEC of 25 July 1978 and the Seventh Council Directive 83/349/EEC of 13 June 1983 on accounting* issued by the European Commission in November 2003.
- 4 The document includes in the Appendix the pre-2010 IASB Conceptual Framework "[i]n view of its importance to the resolution of accounting issues". The pre-2010 IASB Conceptual Framework could thus be considered as a valid source of information on how 'reliability' was intended to be interpreted in relation to the IAS Regulation.

### Reliability versus faithful representation

- 5 In the 2010 revision of the Conceptual Framework, the IASB replaced the term 'reliability' with 'faithful representation' as it was argued that 'reliability' was not understood as intended by many of the IASB's constituents. The term 'faithful representation' has been kept in the Exposure Draft *Conceptual Framework for Financial Reporting* ('the ED'),
- 6 A comparison between the elements of 'reliability' and the elements of 'faithful representation' as suggested in the ED is provided in Table 1 below.

**Table 1**

Reliability in the pre-2010 Conceptual Framework	Faithful representation in the ED
Can be depended on by users to faithfully represent what it purports to represent	Information is useful if it faithfully represents the phenomena that it purports to represent
Substance over form	Substance over form
Free from material error and bias	Free from error
Neutral	Neutral (including prudence)
Complete	Complete
Prudence	

- 7 With the re-introduction of “substance over form” and “prudence” (provided prudence is re-introduced to its full extent), it would seem that reliability and faithful representation would be equivalents. However this is not the case as is explained below.
- 8 The pre-2010 Conceptual Framework noted under ‘reliability’:  
 “Information may be relevant but so unreliable in nature or representation that its recognition may be potentially misleading. For example, if the validity and amount of a claim for damages under a legal action are disputed, it may be inappropriate for the entity to recognise the full amount of the claim in the balance sheet, although it may be appropriate to disclose the amount and circumstances of the claim.”
- 9 In sharp contrast with this description, the ED considers measurement uncertainty to be something that affects the relevance of the information provided, taking away the basis for striking trade-offs between relevance and reliability, and hence having a basis to select between recognition and disclosures. Another consequence of this is that “faithful representation” in the ED has no other role to play in recognition (despite being identified as a recognition criterion) than in the inter-relationships that can exist between various accounting requirements (for example for the avoidance of accounting mismatches).

**EFRAG’s document for public consultation**

- 10 Some of the views expressed in EFRAG’s document for public consultation on reliability relate to:
- (a) Whether the term ‘reliability’ or ‘faithful representation’ should be used;
  - (b) The notion of reliable measurement; and
  - (c) Effectiveness in applying the fundamental characteristics.
- 11 On whether the term ‘reliability’ or ‘faithful representation’ should be used, the document for public consultation includes arguments for using the term ‘reliability’ instead of ‘faithful representation’. The document, however, includes a question to constituents asking whether constituents have become used to the term ‘faithful

representation' and have a good understanding of it, and therefore would prefer not to revert to 'reliability'.

- 12 On the notion of reliable measurement, the document agrees with the IASB Exposure Draft *Conceptual Framework for Financial Reporting* ('the ED') that "the use of estimates is an essential part of the preparation of financial information" and that this use should not be unduly restricted by being constrained by too narrow an approach of what 'reliable' means. The consultation document, however, disagrees with the idea that any number could qualify as a reliable estimate, provided that "the reporting entity has properly applied an appropriate process, properly described the estimate and explained any uncertainties that significantly affect the estimate". An estimate will only represent what it purports to represent, provided the link between the economic reality that is considered and the estimate that is provided can be identified.
- 13 The consultation document notes that what the problem the IASB seems to be dealing with is a perceived lack of common understanding between the IASB and some of its constituents on what a reliable measurement is. The revision of the Conceptual Framework is considered an ideal opportunity to clarify the boundary of a 'reliable estimate'.
- 14 On the effectiveness in applying the fundamental characteristics, it is noted that the ED considers 'measurement uncertainty' to be an issue to be taken into account when assessing the extent to which information is relevant. The consultation document presents the view that considering 'relevance' and 'reliability' - including measurement uncertainty - as two separate and key components of 'useful', as in the pre-2010 conceptual framework, better describes the two-step an approach and trade-off when deciding that certain items should not be recognised in the financial statements but only disclosed in the notes.

**Question for EFRAG Board members**

- 15 Is a potential gap between definitions of qualitative characteristics a concern for EFRAG Board members? Is it essential that EU institutions, European stakeholders and the IASB have the same understanding of the qualitative characteristics of financial reporting when those qualitative characteristics serve as endorsement criteria? Or would differences help in keeping those criteria fully independent?