Challenges in Reliable Financial Reporting

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Katherine Schipper
Duke University

Overview of challenges

- *Challenge 1:* Disputes/confusion about terminology and definitions
  - Concept Statement 2: Reliability as a qualitative characteristic of decision-useful information
  - Concept Statement 5: Reliability as a recognition criterion
  - Concept Statement 8: Representational faithfulness replaces reliability
- *Challenge 2:* Characteristics of standards and their implementation
  - Financial reporting requirements
  - Implementation difficulties

Reliability vs representational faithfulness

- Concept Statement 2 (1980): Reliability
  - Verifiable, neutral and representationally faithful (including completeness)

    The reliability of a measure rests on the faithfulness with which it represents what it purports to represent, coupled with an assurance for the user that it has that representational quality….Reliability rests on the extent to which the accounting description or measurement is verifiable and representationally faithful…A neutral choice between accounting alternatives is free from bias toward a predetermined result

  - The IASB's *Framework* (1989)*:* Reliability

    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

- *Observations:*
  - Descriptions of reliability in concepts statements do not specify what kinds of information or phenomena should be represented
  - Presumably, the qualitative characteristic relevance and financial statement elements definitions specify what should be represented

Reliability vs representational faithfulness

- Concept Statement 8 (2010)
  - Replace reliability with “representational faithfulness”
    - A (hypothetical) “perfectly faithful representation” would be complete, neutral and free from error
      - Complete => depiction includes all information necessary for understanding
      - Neutral => without bias in the selection or presentation of information
      - Free from error
        - » No errors or omissions in the description of the phenomenon
        - » Process to produce the information has been selected and applied without errors in that process
        - » Does not mean “accurate”
    - Verifiability is an enhancing qualitative characteristic, not a component of representational faithfulness
      - Enhancing characteristics are desirable, not necessary

Why replace reliability with representational faithfulness?

- The IASB and FASB concluded that their conceptual frameworks did not convey “the meaning of reliability clearly” (Concept Statement 8, para. BC3.23)
    - Comment letters on proposed standards conflated reliability with:
        - Verifiability (Concept Statement 8, para. BC 3.25)
            - Results “would be substantially duplicated by independent measurers using the same measurement method…Verification implies consensus.” (Concept Statement 2, para. 82, 84)
        - Free from material error
        - Precision, possibly meaning certainty (Concept Statement 2, para. 72)
- Why would different interpretations of “reliability” be a problem?
    - Items can be verifiable without being representationally faithful
        - *Example 1, from Concept Statement 2 para 88:* Recording actuarially computed “expected future losses”
            - Allocated losses do not represent an economic phenomenon
        - *Example 2:* Balance sheet amount that results from applying the equity method
    - Materiality is a component of relevance and an entity-specific consideration, not a standard-setting consideration (Concept Statement 8, para. BC 3.17)

Why replace reliability with representational faithfulness?

- *Observation and questions to consider*
- The FASB may have added to the confusion/disagreement with Concept Statement 5
  - "Sufficient" reliability is a recognition criterion for financial statement elements (Concept Statement 5, para. 75)
  - Information about some items that meet the definition of a financial statement element "may never become sufficiently reliable at a justifiable cost to recognize the item" (Concept Statement 5, para. 76)
  - "At some intermediate point, uncertainty may be reduced at a justifiable cost to a level tolerable in view of the perceived relevance of the information" (Concept Statement 5, para. 77)
- *Questions to consider:*
  - Does Concept Statement 5 conflate "reliability" with precision, meaning something like certainty?
  - What is the level of un-reliability that would cause an item that meets the definition of a financial statement element *not* to be recognized?

Is representational faithfulness an operational construct?

- Can a standard setter (or anyone else) objectively analyze, apply and assess representational faithfulness?
  - Refers to “faithful depiction in financial reports of economic phenomena” (Concept Statement 8, para BC 24)
    - Disagreement can exist about the nature of an “economic phenomenon”
      - *Example:* Does conversion of a convertible debt instrument into shares result in an economic loss to the issuer?
  - Explicitly *does not* mean “verifiability”
    - The FASB “repositioned verifiability as an enhancing characteristic, very desirable but not necessarily required” (para. BC 3.36)
    - Disagreement can exist about what it means to “verify” information or about presenting, in financial reports, information which is “not readily verifiable” (Concept Statement 8, para. BC 3.36)
      - *Questions to consider:*
        - Under what conditions should verifiability be sacrificed?
        - What is the relation between verifying and observing?
          - ASC topic 820 defines level 3 inputs as “unobservable”
          - “Unobservable” does not equate to “unverifiable”
          - Verification can occur by direct observation or indirectly by “checking the inputs….and recalculating the outputs” (para. QC27)

Is representational faithfulness an operational construct?

- Can a standard setter (or anyone else) objectively analyze, apply and assess representational faithfulness?
  - Can faithful representation be empirically measured?
    - Concept Statement 8 para BC 3.30 refers to research showing correlations between financial information and returns of equity and debt securities
      - At best, correlation suggests some combination of relevance + representational faithfulness
    - Extremely unfaithful representation is sometimes observed in the form of fraudulent financial reporting
      - Relatively rare, and probably not useful for generalizable assessments
  - *Question to consider:* What are the implications for teaching financial reporting?
    - Representational faithfulness is analyzed using qualitative assessments
    - Instruction in analyzing representational faithfulness relies on examples
    - Accountants and auditors require skills of indirect verification in addition to skills of direct observation
      - Expertise in evaluating inputs
      - Expertise in models, formulas and other estimation techniques
    - Acceptance of (likely) continued disagreements at the level of proposals for standards

Reliability or representational faithfulness

- *Challenge 2:* Characteristics of standards and their implementation
  - *Claim:* Representational faithfulness is impaired by financial reporting requirements that do not result in a "faithful depiction of economic phenomena"
    - *Case 1:* Required accounting does not represent the assets and liabilities in an arrangement
      - *Example 1:* Balance sheet classification of leases based on the terms of the contract, not on the presence of assets and liabilities in the contract
        - This treatment predates the FASB's conceptual framework, and was (recently) replaced by new guidance (ASC 842)
        - *However*, the new guidance contains an income statement treatment that is based on the terms of the contract and does not separately present financing cost and amortization-of-asset cost
      - *Example 2:* Accounting treatment of a sale of receivables with a 5% credit guarantee as a secured loan
        - Transferor has no claim on the cash flows of the receivables
        - Transferor does not owe the amount recorded as a loan
        - The obligation (credit guarantee) is not recorded as a liability

Reliability or representational faithfulness

- *Challenge 2:* Characteristics of standards and their implementation
  - *Claim:* Representational faithfulness is impaired by financial reporting requirements that do not result in a "faithful depiction of economic phenomena"
    - *Case 2:* Can the same economic phenomenon be faithfully represented in multiple ways?
      - *Example 1:* LIFO and FIFO balance sheet representations of inventories
      - *Example 2:* Optional hedge accounting for certain derivatives, subject to qualifying conditions
    - *Case 2a:* Does management intent for realizing cash from an asset or settling an obligation affect faithful representation?
      - *Example:* Account for a US treasury security at fair value or at amortized cost, depending on intent and subject to qualifying conditions
      - Management's *actions* can be verified *ex post* but management's *intentions* are a state of mind that can and should vary with economic conditions

Reliability or representational faithfulness

- *Challenge 2:* Characteristics of standards and their implementation
  - Measurement difficulties, perhaps linked to concerns about verifiability
    - Inputs to models, formulas and calculations that cannot be observed in the sense of vouched or confirmed to external sources
      - Some focus on fair value vs historical cost, but the use of entity-specific unobservable inputs is pervasive
        - » Bad debt expense, warranty costs and depreciation/amortization
      - As a general matter, representational faithfulness of a measurement requires:
        - » Information systems that gather the required information inputs
        - » Existence of an appropriate model, formula or estimation technique
        - » Competence (expertise) on the part of preparers
        - » Unbiased implementation of the applicable guidance
      - *Questions to consider:*
        - » What is the relative importance of these factors?
        - » To what extent do these factors differ depending on the type of measurement, for example, acquisition cost or fair value?

Reliability or representational faithfulness

- *Challenge 2:* Characteristics of standards and their implementation
  - Measurement difficulties, perhaps linked to concerns about verifiability
    - Question to consider about fair value vs historical/acquisition cost:
      - Is cost *inherently* more verifiable than an (estimated) fair value?
      - *Example:* Measuring the acquisition of a parcel of land + building

        Potential components of "cost"

        » Transaction amount paid to seller

        » Fees to consulting engineer for professional opinion on the building's structural soundness

        » Attorney fees

        » Real estate transfer taxes

        » Management salaries during the search and negotiation process

          » Operating costs of company cars used during the search

        » Cost to remodel the building for use

        Fair value estimate

        » Hypothetical sale price in a market transaction at the balance sheet date

        » Could be based on appraisals and valuation models

Concluding comments

- Standard setters have dealt with the question of reliability/representational faithfulness in concepts statements
  - Concept Statement 2: Reliability as a qualitative characteristic of decision-useful information that includes verifiability as a component
  - Concept Statement 5: Reliability as a recognition criterion
  - Concept Statement 8: Replace reliability with representational faithfulness and characterize verifiability as an enhancing characteristic of decision-useful information
- Multiple factors can affect representational faithfulness
  - In the absence of an agreed-upon empirical measure, assessments of representational faithfulness must be qualitative
  - Disagreements may exist about the economic phenomenon to be depicted
  - Disagreements may persist about the meaning and importance of “verifiability”
  - There is little empirical evidence as to what are the most important factors that affect or determine representational faithfulness
    - Standards themselves
    - Implementation
      - Information systems, competence and incentives