Comments on the Consultation Paper
September 2008

Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities:

The Objectives of Financial Reporting

The Scope of Financial Reporting

The Qualitative Characteristics of Information Included in General Purpose Financial Reports

The Reporting Entity

Comments are requested by March 31, 2009
Email responses should be sent to: edcomments@ifac.org

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1. Introduction

This is a comment letter on the IPSASB (International Public Sector Accounting Standards Board) Consultation Paper (IPSASB CP, 2008): *Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities.* The Paper covers the following four areas: The Objectives of Financial Reporting, The Scope of Financial Reporting, The Qualitative Characteristics of Information Included in General Purpose Financial Reports (GPFRs), and The Reporting Entity.

The comment letter will discuss the following four topics:

1. The *meaning* of the concept framework in the phrase "international conceptual framework for general purpose financial reporting (briefly, financial reporting) by public sector entities";

2. The *objectives* of financial reporting by public sector entities (that is, View 4);

3. The *scope* of financial reporting by public sector entities (that is, View 5); and

4. The *qualitative characteristics* of information included in general purpose financial reports (GPFRs) (that is, View 7).

1. A conceptual framework may have two distinct *meanings*. Each meaning is communicated using different concepts and terminologies. The problem with the IPSASB Framework is that it takes the meaning for the conceptual framework from the one approach but the concepts and terminology from the other approach. This will result in misunderstandings. The most harmful of them is the illusion of certainty that the IPSASB Framework is likely to create.

2. The *objectives* of financial reporting by public sector entities are seen in the IPSASB Framework as providing information about the reporting entity useful to users of GPFRs for two kinds of purposes: accountability purposes and decision-making purposes (IPSASB CP 2008, p. 8). The problem lies with the extensiveness of these objectives. Accountability is related with the past, or more specifically, with the control of the managerial actions taken in the past while decision-usefulness is related with the future, that is, with the usefulness of information in forecasting relevant outcomes of future phenomena. There is a clear tension between these two perspectives. It is not practicable to construct the financial statements of an entity without giving the priority to one perspective or the other. It should be explicitly said which perspective is used in preparing these "general purpose" financial statements and which perspective is then accounted for by supplying additional information. Actually using the term "general purpose" is hiding the problem and is therefore somewhat misleading.

3. The *scope* of financial reporting encompasses the provision of financial and non-financial information about the total of five items including the two that are familiar from the business environment: (1) economic resources and claims to those resources (the balance sheet) and (2) the effect of transactions, other events and activities that change the economic resources and claims to those resources (the income statement and the statement of cash flows). The additional items make the scope larger than that of financial reporting for business entities in the private sector and reflect the wider range of potential users of GPFRs of public sector entities. The problem is that the proposed framework does not acknowledge at all that the wider scope may have implications to the definition of some key concepts, particularly that of an asset.

What is a relevant definition for an asset in the context of business entities in the private sector where the objective 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 may not be a relevant definition in the context where public sector entities operate (cf. IASB ED 2008, p. 14 and IPSASB CP 2008, p. 18).

4. The *qualitative characteristics* of information included in GPFRs are defined as the attributes that make that information useful to users for accountability purposes and for making various decisions. There are at least three problems concerning these attributes. The first of them, which is also acknowledged in the Consultation Paper, is that in practice all the given qualitative characteristics may not be fully achieved, and therefore a balance or trade-off between certain of them may be necessary (IPSASB CP 2008, p. 31). That, of course, is true and requires no further comments here.

The second problem concerns the derivation of the qualitative characteristics. They are just enumerated in the Paper without an explicit attempt to derive them from the concept of usefulness. To describe the process, the Paper only explains that these qualitative characteristics have been "developed" after considering the qualitative characteristics in the IASB Framework (ED, 2008). Obviously some "development" has been required. As the Paper indicates, the qualitative characteristics of information included in GPFRs must (a) respond to the objectives of GPFRs of public sector entities (which are to some extent different from those of the business entities in the private sector), and (b) reflect a potentially broader scope of financial information than what the IASB has currently identified (IPSASB CP 2008, p. 31). Despite these deficiencies in the process of "developing" the qualitative characteristics, the process itself will not be further commented here. Instead the focus will be on the outcome, that is, on the qualitative characteristics themselves, where the third problem lies.

The third problem lies with the terminology of the qualitative characteristics and the underlying concepts. The concept of faithful representation that has been borrowed from the theory of measurement should be replaced with the more familiar concept of reliability. Relevance and reliability should be regarded as the two fundamental qualitative characteristics of useful financial reporting information (cf. IASB ED 2008, pp. 35-38). The concept of verifiability should be considered subordinate to reliability and given its customary, more restricted scientific meaning. Moreover, to fill the resulting gap, the new concept of supportability should be introduced and defined. It should also be considered subordinate to reliability. In addition, all the constraining factors should be regarded as elements of sufficiency. Therefore, to ensure usefulness of the reported information, it should have the fundamental qualitative characteristics of *relevance* and *reliability* (or freedom from error, if you prefer) under the general constraint of *sufficiency*. These three key concepts are hierarchical as will be discussed below.

2. The meaning of an international conceptual framework

The Consultation Paper does not define the phrase "international conceptual framework", but it says enough so that one is able conclude the intended meaning. The Paper explains that the IPSASB Framework will establish the concepts that underpin financial reporting by public sector entities that adopt the accrual basis of financial accounting (IPSASB CP 2008, p. 6). Generally speaking this description gives the concept of framework about the same meaning that, for example, Hendriksen and van Breda (1992, p. 22) obviously have in mind when they define the concept of (accounting) theory in the following terms:

"Accounting theory has been defined as a coherent set of logical principles that:

1. Provides a better understanding of existing practices to practitioners, investors, managers, and students.
2. Provides a conceptual framework for evaluating existing accounting practices.
3. Guides the development of new practices and procedures."

Here the word "theory" refers to an agreed-upon coherent set of logical principles expressed in specific terms. The same applies to the word "framework". The principles involved are selected to enhance understanding and thus facilitate communication. Such principles can never be refuted. There is no empirical evidence that could contradict with them. Therefore, the acceptance of any such theory is a matter of agreement rather than a matter of truth. This is in sharp contrast to what may be said about the more rigorous empirical theories. Their acceptance is based on the truth which must be established using the so called "scientific method".

Hence the concept of theory has two distinct meanings. It may be understood as a framework consisting of a set of coherent principles and underlying concepts that are formulated to enhance understanding or it may be understood as a deductive conceptual system for which the truth is established empirically by applying the scientific method. To elaborate the difference between these two views of a theory (or framework), let us take a closer look at the scientific method and its key concepts.

It is not a straightforward matter to explain briefly what the meaning of the scientific method is. The issue is complex because there are so many different techniques at the practical level. However, at the sufficiently general level one can identify a pattern in any empirical scientific research that may be called the "scientific method" (see, e.g., Cohen 1964, p. 79). In the heart of this pattern there is the cycle that is illustrated in Diagram 1 on the following page.

The cycle starts from observable empirical facts (phases 1 and 2). It continues with logical argumentation using those facts (phase 3) and theories or models (phase 4) to derive statements that are either theoretical propositions (phase 5a) or empirical propositions (i.e., hypotheses) (phase 5b). They offer a link back to observable real-world phenomena (phases 6 and 7). This link is crucial in verifying empirical theories. Verification (phase 8) connects theoretical thinking back to observable phenomena. It provides the observer with empirical evidence that may or may not support the proposed theory. When the facts and hypotheses agree (phase 9a), the theory is said to be confirmed. It has gained empirical support. This does not mean, however, that it has been logically proven true because it is always possible that the very same empirical propositions could have been derived from some competing but different theory. When the facts and hypotheses disagree (phase 9b), the theory together with the test setting is said to be refuted (or "falsified"). It has been logically proven that something is wrong somewhere and thus revisions are needed (phase 10). This process continues indefinitely.

Scientists have regarded this endless cycle as the distinctive characteristic of the scientific method. Let us take a few quotations. The first relates to the ultimate goal of any empirical science. The goal is to produce true empirical knowledge. Therefore the crucial question is: When can one say that empirical knowledge is true? The truth of any empirical statement is said to depend on how well it corresponds to empirical facts. This important starting point is expressed quite clearly, for example, by Popper (1966, p. 369) (see Chambers 2002, p. 761):

"…an assertion, proposition, statement or belief, is true if, and only if, it corresponds to the facts."

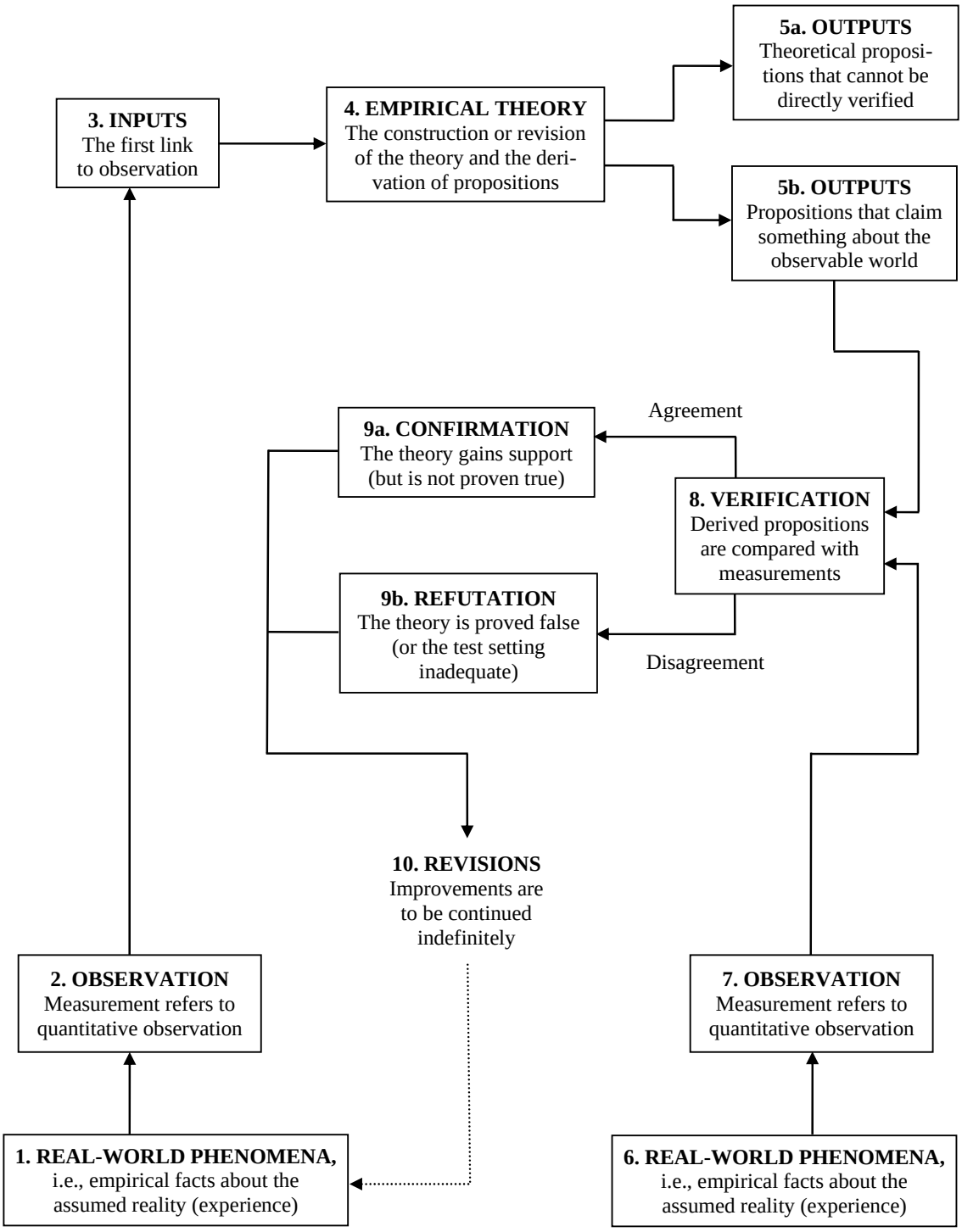

Diagram 1. The continuing cycle of scientific method

It should be emphasized, however, that science and theories in general are not concerned with isolated empirical facts. This is reflected in the typical definition of a scientific theory as a set of sentences or statements (see, e.g., AAA 1971, p. 54). The idea of a more comprehensive correspondence with a variety of empirical facts is also evident in the citation from Einstein (1935, p. 133) emphasizing that all knowledge of real-world phenomena must start from empirical experience and also end in it (see Chambers 2002, p. 753):

> "Pure logical thinking cannot yield us any knowledge of the empirical world; all knowledge of reality starts from experience and ends in it. Propositions arrived at by purely logical means are completely empty as regards reality."

Besides emphasizing the importance of empirical experience (that is, "real-world phenomena" in Diagram 1) the above citations also reflect the cyclic pattern of the scientific method. Even more explicitly, however, the endless continuity of this cycle is formulated by Homans and Curtis (1970, p. 21) (see Cambers 2002, p. 765):

> "To reach a theory, science observes certain facts and argues logically therefrom. The theory is submitted again to facts. The cycle is: observation, theory, verification, more observation, and so on forever."

The cyclic and self-correcting pattern of the scientific method is obvious in the above citation. However, it lacks two specific concepts (measurement and prediction) that relate to phases 2, 5b, and 7 in Diagram 1. To indicate their role, let us quote Walker (1963, p. 5), who includes these concepts in his definition of the scientific method:

> "The scientific method (1) postulates a model based on existing experimental observations or measurements; (2) checks the predictions of this model against further observations or measurements; (3) adjusts or replaces the model as required by the new observations or measurements. The third step leads back to the first step, and the process continues without end."

These citations show clearly how important empirical observation is for the production of scientific knowledge (phases 2 and 7 in Diagram 1). Of course, logical thinking, too, has a role to play in this process (phases 4, 5a, and 5b in Diagram 1) but it can never replace empirical observation. Therefore, human opinions, too, are of little value in producing scientific knowledge. Empirical facts are far more relevant. A scientist does not have to persuade anybody to think as he or she does, nor need a group of scientists reach consensus on matters being researched. It suffices that the empirical facts and the corresponding propositions agree. For example, Goode and Hatt (1952, p. 7) formulate the very same point as follows (see Chambers 2002, p. 754):

> "Science is a method of approach to the entire empirical world… It is furthermore an approach which does not aim at persuasion, at the finding of ultimate truth…"

To summarize this brief introduction to scientific method, a few points should be stressed. First, scientific method consists of an endless cycle, where one starts from empirical observation and ends in empirical observation. Second, from this it follows that the concept of measurement must be inextricably linked to empirical observation. Third, the process of verification cannot be properly carried out without true measurements (see phases 8, 9a, and 9b in Diagram 1). Fourth, any attempt to verify without true measurements will lead to speculative information that does not meet the requirements of empirical science.

It is obvious that the IPSASB Framework is not proposed as an application of the scientific method. It is not an empirical theory that might be refuted by appropriate empirical evidence. Therefore it is misleading to adopt terms from the scientific method but not their meaning. To the extent that scientific terms are being used, one should also accept their meaning as a given fact. To follow this principle, one must modify the qualitative characteristics proposed in the Consultation Paper (IPSASB CP 2008, pp. 31-39). These details will be discussed later.

3. The objectives of financial reporting by public sector entities

The Consultation Paper (IPSASB CP 2008, p. 18) recognizes that the objectives of financial reporting are at the core of the Framework and that financial reporting is not an end in itself. The ultimate purpose is to provide information useful to users of GPFRs which means that one should specify (a) who the users are and (b) what kind of information the users are assumed to require.

(a) The Consultation Paper (IPSASB CP 2008, p. 18) gives a long list of potential users including taxpayers, citizens and other recipients of services from government as well as the legislature and oversight bodies. Users such as these are not given as users of general purpose financial reports by business entities in the private sector. For these reports the list of users is much shorter consisting typically only of equity investors, lenders and other creditors. More precisely, the objective of the reports by business entities in the private sector 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 (IASB ED 2008, p. 14).

It is obvious therefore that the number of different users of GPFRs by entities in the public sector is far greater than the number of different users in the private sector. What is not so obvious, however, is the question whether this fact has any impact on the kind of information that will be required by the users. That is, the number of different users of GPFRs may not be so important if different users find the same kind of information useful. Is this the case?

(b) From the perspective of how provided information should be classified in terms of its usefulness to users the Consultation Paper identifies two categories of information. The first one consists of information that is useful for accountability purposes, and the second one consists of information that is useful for decision making purposes, or more specifically, in making resource allocation, political and social decisions (IPSASB CP 2008, p. 8).

Two things should be noted here. First, it has been recognized long ago in the accounting literature about business entities in the private sector that an accounting theory or framework developed under the accountability view differs in many respects from a theory based on the decision-oriented view (e.g., Ijiri 1975, pp. ix-xi). For example, while the decision-oriented view emphasizes the usefulness of information to decisions, the accountability view emphasizes the plausibility to evaluate the past performance of management on the basis of the accounting system as a whole, or while the decision-oriented view emphasizes unbiased information for decision making, the accountability view emphasizes such designs of accounting systems that make it difficult or impossible to produce biased information at all. It is evident that the potential benefits involved cannot be simultaneously maximized in a single accounting system, and therefore one view or the other must be given the priority. This, however, has not been done in the Consultation Paper. The whole issue has not even been discussed there.

Second, there are many kinds of decisions and many kinds of information needs. The Paper (IPSASB CP 2008, p. 20) claims that some of these needs are similar for entities in the private sector and entities in the public sector. To some extent this claim is probably true but generally speaking it is hardly the case that the decision-making model for investors in the public sector is as straightforward as it is in the private sector where the risk-adjusted return on investment is about the only thing that matters (see, e.g., Ross et al. 2002, chapters 10 and 12). Potential investors in the private sector are typically seen to focus almost exclusively on the forecast future cash flows and the risk involved.

This model of how investors are assumed to behave in the private sector has been so influential that it has even effected the definition of an asset which is now typically defined in terms of "future economic benefits" that "are expected to flow to the entity" (IASB Framework, par. 49(a)). What is important here is that eventually all the future economic benefits are assumed to flow to the entity in the form of cash and cash equivalents. The IASB Framework (par. 53) formulates this as follows: "The future economic benefit embodied in an asset is the potential to contribute, directly or indirectly, to the flow of cash and cash equivalents to the entity." Are these definitions really proper in the conditions where entities operate in the public sector?

The point is: the objectives of financial reporting by business entities in the private sector are very closely tied to the forecast future cash flows and the related risk while the objectives of financial reporting by entities in the public sector are more diverse. This is likely to have two implications. First, the scope of financial reporting by entities in the public sector must be wider than that of business entities in the private sector. Second, and more importantly, the key concepts such as economic resources and claims to those resources may have to be defined in a different way for entities in the public sector. It may be questioned whether it is informative at all to talk about resources (and consequently assets) in terms of forecast future cash flows. It may be preferable to replace these output-based (i.e., benefit-based) definitions with input-based (i.e., sacrifice-based) definitions where assets would be defined in terms of unexpired costs. The attribute "unexpired" means that there are future benefits being expected but the amounts may be unknown to the extent that is preferable to define the concept of asset in terms of incurred costs rather than expected future economic benefits.

4. The scope of financial reporting by public sector entities

The scope of financial reporting by public sector entities encompasses the provision of financial and non-financial information about the total of five items. The first one is related to the balance sheet (economic resources and claims to those resources). The second one is concerned with the income statement and the statement of cash flows (the effect of transactions, other events and activities that change the economic resources of the reporting entity and claims to those resources during the reporting period, including cash inflows and outflows and financial performance). The last three items widen this traditional scope of financial reporting. They consist of the reporting entity's compliance with relevant legislation, the reporting entity's achievement of its service delivery objectives, and prospective financial and other information about the reporting entity's delivery activities and objectives as well as the resources necessary to support those activities.

Defined in this way the scope is larger than that of financial reporting for business entities in the private sector. This is only natural reflecting the wider range of potential users of GPFRs of public sector entities. There is a problem, however, because the proposed framework does

not acknowledge that the wider scope may have implications to the definitions of some key concepts. For example, as indicated above, the concept of economic resource and consequently the concept of asset may have to be reconsidered. What is a relevant definition for an asset in the conditions of business entities in the private sector where the objective 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 may not be a relevant definition in the conditions where public sector entities are operating (cf. IASB ED 2008, p. 14 and IPSASB CP 2008, p. 18).

This problem is closely related to the above concern about the tension between the two major kinds of accounting systems, that is, systems that are designed to support accountability (and control) and systems that are designed to support various kinds of decisions. It was claimed that both kinds of systems may have their benefits but the benefits cannot be simultaneously maximized in a single accounting system, and therefore one approach or the other must be given the priority. If this is accepted then one should stop calling these financial statements "general purpose" financial statements. They would simply be financial statements based on selected premises and only financial reporting that also consists of supplementary information could be labeled as being designed for general purposes.

For entities in the public sector, it may be argued that the priority should be given to the accountability purposes. Assets (being economic resources) and liabilities (being claims to those resources) should then be defined keeping this priority in mind. Moreover, the objectives should also be slightly modified to reflect the priority. The formulation could be as follows:

The *objectives* of financial reporting by public sector entities are to provide information in the form of financial statements and supplementary information about the reporting entity useful to users of this information for: (a) accountability purposes; and (b) making resource allocation, political and social decisions. The balance sheet and the income statement are to be constructed giving the priority to the accountability perspective.

What has been said above does not necessarily change the *scope* of financial reporting at all. The scope only establishes the boundary around the transactions, other events, and activities that may be reported in GPFRs (IPSASB CP 2008, p. 6). It is the implications of the wider scope of financial reporting by public sector entities that should be acknowledged in one way or the other. Currently there are no signs of such implications.

5. The qualitative characteristics of information included in GPFRs

The qualitative characteristics of information included in GPFRs are defined as the attributes that make that information useful to users for accountability purposes and for making various decisions (IPSASB CP 2008, p. 31). Three problems concerning these attributes were mentioned at the beginning of this paper but only the third one will be discussed here. It will be suggested that the terminology of the qualitative characteristics of information and the underlying concepts should be modified and then portrayed hierarchically. In addition, to evaluate whether the information to be disclosed really has the required qualitative characteristics, their presence should be considered in a process comparable to that of the scientific method.

The Paper (IPSASB CP 2008, p. 7 and p. 9) identifies the following qualitative characteristics of information included in GPFRs of public sector entities: relevance, faithful representation, understandability, timeliness, comparability, and verifiability. Materiality, cost and achieving

an appropriate balance between the qualitative characteristics are then given as pervasive constraints on that information. Relevance is considered to encompass confirmatory value, predictive value, or both (IPSASB CP 2008, p. 32). Faithful representation is claimed to be attained when the depiction of economic or other phenomena is complete, neutral, and free from material error (page 33). The only indication of a hierarchy is the distinction between the attributes that are called the qualitative characteristics of information and the attributes that are called the constraints on that information.

Here the following system of qualitative characteristics is proposed. To ensure the usefulness of the information in financial reports, it should have the fundamental qualitative characteristics of (1) ***relevance*** and (2) ***reliability*** (or freedom from error) under the general constraint of (3) ***sufficiency***. The two fundamental qualitative characteristics may be seen to encompass several enhancing qualitative characteristics (cf. IASB ED 2008, pp. 38-41). For relevance they are (1a) *confirmatory value*, (1b) *predictive value*, (1c) *understandability*, (1d) *timeliness* and (1e) *comparability*. Similarly for reliability the enhancing qualitative characteristics are (2a) *verifiability* and (2b) *supportability*. The two fundamental qualitative characteristics are not absolute but show in degrees. Therefore the general constraint of sufficiency must be introduced and adopted. It consists of the requirement to achieve a balance between the ideal requirement of (3a) *completeness* and the following moderating elements: (3b) *neutrality*, (3c) *materiality* and (3d) *cost-benefit-reasonableness*. A detailed discussion is given below.

The ***relevance*** of information is defined in the Paper as follows (IPSASB CP 2008, p. 32):

> "Information is relevant if it is capable of making a difference in achieving the objectives of financial reporting – that is, in the discharge of the entity's accountability obligations or in the decisions made by users of GPFRs."

This is a good definition, particularly because it is so comprehensive. It encompasses both *confirmatory value* and *predictive value* as properly mentioned in the Consultation Paper. In addition, it encompasses even more making thus redundant (or at least subordinate) several of the attributes proposed in the Paper.

First, the attribute of *understandability* (defined on page 35 as the quality of information that enables users to comprehend its meaning) is redundant to relevance. How could information be relevant to a person without first being understandable to him or her? In precisely the same way that understandability is dependent on a person's education and knowledge, relevance, too, is dependent on such matters. The Paper (IPSASB CP 2008, p. 35) explains that understandability may be enhanced in many ways. For example, comparability is said to enhance understandability. Precisely in the same way it may be said that understandability enhances relevance. Therefore, relevance may be said to encompass understandability. In other words, understandability may be considered an enhancing qualitative characteristic of relevance.

Second, the attribute of *timeliness* (defined on page 35 in terms of having information available to users before it loses its capacity to be useful for accountability and decision-making purposes) is redundant to relevance for the same reason. No matter how potentially useful a piece of information may be, this potential will be lost if the piece of information is not available at the proper point in time. Therefore, the attribute of timeliness is also a distinct feature of relevance rather than a parallel qualitative characteristic of financial information. In other words, timeliness, too, may be regarded as an enhancing qualitative characteristic of relevance.

Third, the attribute of *comparability* (defined on page 36 as the quality of information that enables users to identify similarities in, and differences between, two sets of phenomena) is also redundant. In other words, comparability is encompassed by relevance. This should be evident if one considers the opposite. How could a piece of information be relevant if there were no way whatsoever to compare it with any other piece of information? For example, the piece of information saying that X has the value of 20 per cent is meaningless as long as one is unable to compare it with something else. Therefore it cannot be relevant, either. The situation would change essentially, if one learned that the value of X is typically less than a half of the return on investment in the same conditions. This new piece of information would not only make the first piece of information comparable to a known variable but it would also make it highly relevant. Consequently, the attribute of comparability should also be considered a distinct feature of relevance, that is, an enhancing qualitative characteristic of relevance, rather than a parallel qualitative characteristic of financial information.

What is claimed here is that the concept of relevance is even more powerful than the Consultation Paper acknowledges. It does not only encompass confirmatory value and predictive value but also such features as understandability, timeliness and comparability. Therefore any piece of information that (a) has either confirmatory value or predictive value and (b) at the same time is understandable, available at the proper time, and comparable to some other interesting pieces of information, is relevant. And conversely, a piece of information is not relevant even if it potentially has confirmatory value or predictive value but it is not in an understandable form, or it is not available when needed, or it cannot be compared to anything that is meaningful to the user.

Besides relevance the Paper also regards *faithful representation* as a necessary qualitative characteristic of useful information in financial reporting. It argues that a piece of information is a faithful representation of the economic or other phenomenon that it purports to represent when the depiction of the phenomenon is complete, neutral, and free from material error (IPSASB CP 2008, p. 33). Moreover, the Paper implies implicitly (see, e.g., pages 9, 28 and 29) that prospective information about the future might also serve as a faithful representation of something.

Such arguments and implications are problematic, however, because they give the term “faithful representation” a totally new meaning that is very different from its established meaning in the theory of measurement. There faithful representation is related to quantification which must be made so that the functional correspondence between the degrees of the observable property and the numbers assigned to these degrees become a faithful representation. The issue of how to create a proper functional correspondence is called the representation problem (see, e.g., Krantz et al. 1971, Scott & Suppes 1969, Suppes & Zinnes 1963), and it is concerned with the isomorphism between the *observable* degrees of the given property in an empirical system and the relational numerical system selected to represent the empirical system.

This means that the property being faithfully represented for measurement purposes must be *observable*. However, the future cannot be observed. Therefore there is no way in practice to achieve a faithful representation of any future phenomenon. Consequently the term “faithful representation” should not be used in this new context where empirical observation is not required. Of course, it could not even be required precisely because faithful representation is extended to concern the future, too. But since future phenomena cannot be currently observed, talking about faithful representation of them is simply misleading and should be stopped.

Instead of faithful representation, one should talk about reliability of information. ***Reliability*** refers to freedom from error and nothing else. One should not even say that reliability refers to freedom from *material* error, which would make the definition equal to one of the qualitative characteristics of faithful representation (IPSASB CP 2008, p. 33). This is so because it is just freedom from error, not materiality of it that should be considered fundamental. Materiality is only related to the degree of this fundamental characteristic that one may want to consider sufficient in any given case. Materiality is thus only a moderating factor, not a distinct feature of the fundamental qualitative characteristic.

This raises the question of how reliability may be established. How could one know whether a piece of information is reliable or not? The best answer is to apply the scientific method as shown in Diagram 1. This means that one should first and foremost try to verify the truth of the given empirical statement by comparing it with what may be observed. This process is called verification. A statement is verifiable if its truth can be verified. Here it is proposed that *verifiability* in this sense should be the first enhancing characteristic of reliability. Actually this is nothing new. The meaning of verifiability in this sense is essentially equivalent to that of direct verifiability in the IASB Exposure Draft (2008, p. 40).

Verifiability is truly a desired qualitative characteristic of information but in many cases it is too demanding. Therefore one may ask what the next step should be if a piece of information cannot be verified. The answer might be in the process that is familiar from auditing. It may be required possible to check the inputs and recalculate the corresponding outputs. Such checking would not be verification but rather auditing that gives support and credibility to information. One may then say that a piece of information is supportable if it is possible for different knowledgeable and independent observers to reach general consensus that the methods used in producing the information have been properly applied (cf. IASB ED 2008, pp. 39-40 and IPSASB CP 2008, pp. 36-37). Consequently, one may say that *supportability* is the second enhancing characteristic of reliability. Its meaning is essentially equivalent to that of indirect verifiability in the IASB Exposure Draft (2008, p. 40).

Whether even supportability is to be required before a piece of information may be disclosed is an open question. It is possible that a piece of information that can neither be verified nor even properly supported is so relevant that it would be useful to users although its reliability cannot be independently verified or checked. The IASB Exposure Draft (2008, p. 52) gives management's intentions as an example of a piece of information that perhaps can neither be verified (directly verified) nor supported (indirectly verified). Yet it may be useful to users.

Relevance and reliability are thus the two fundamental qualitative characteristics of financial information. That is, if the user had all the relevant information and it was completely reliable, he or she would need nothing else. Usefulness of information would be secured. However, relevance and reliability are not absolute concepts but show in degrees. Therefore, as the first step, it was above stated what the additional qualitative characteristics are that enhance these fundamental characteristics. The second step will now be to set limits to enhancing. The question is: when does a user have enough of relevant information that is reliable to the required degree? In other words: when is the supplied information sufficient to the user?

The concept of ***sufficiency*** is a moderating concept that aims at an acceptable balance between the qualitative characteristics in terms of a few selected dimensions. The dimensions of moderation are completeness, neutrality, materiality and cost-benefit-reasonableness. Because

it is not practicable to produce and disclose every piece of relevant information with absolute reliability to all potential users, it must then be asked what is practicable and sufficient. The answer is briefly discussed in terms of the given four dimensions.

Completeness establishes the fundamental starting point to disclose all the information that is relevant. That is, if a piece of information is capable of making a difference in achieving the objectives of financial reporting, then it should be produced and disclosed. This is an extreme requirement demanding that not only part of relevant information should be available but all of it. Without moderation, however, this requirement would result in great practical difficulties but it is a necessary starting point.

Neutrality is defined in the Paper typically as "the absence of bias that is intended to attain a predetermined result or to induce a particular behavior" (IPSASB CP 2008, p. 33). The Paper continues: "Neutral information is free from bias, so that it faithfully represents the economic and other phenomena that it purports to represent." Taken literally this means that neutrality is actually redundant to the proposed system. If it is taken to mean that one is not allowed to select or present information so that it favors some particular perspective, say, an interest group then it is simply redundant to requiring that the set of relevant information to be disclosed should be complete. If pieces of information were left out that are relevant from some perspective, then the disclosed set would not be complete. On the other hand, if it is taken to mean that one is not allowed to present information so that it is excessively cautious or in some other way biased then it is simply redundant to requiring that the set of relevant information to be disclosed should be reliable. A biased piece of information can never be the best estimate in terms of reliability. Therefore, the complete set of relevant and reliable information is necessarily sufficient for making neutral estimates of the financial conditions and hence, as a distinct qualitative characteristic, neutrality is redundant.

However, if neutrality is interpreted as a moderating characteristic then it has a role to play. In this role neutrality is taken to mean that it is sufficient to report information for general purposes instead of tailoring it for the purposes of any particular interest groups. The "general purpose" implies that the selection and presentation of financial information are not biased to serve particularly any specific groups or goals but "neutrally" to all groups that are interested in the financial information of the entity. In this sense neutrality moderates the requirement of completeness.

Materiality is regarded as a pervasive constraint in the Consultation Paper (IPSASB CP 2008, p. 38). That is a misleading statement in a way. Rather than being a pervasive constraint materiality is a pervasive moderating factor. Instead of requiring the complete set of relevant financial information, it is sufficient to require all the relevant information that is material with respect to the objectives of financial reporting, that is, serving the discharge of accountability by the entity for the reporting period and serving the decisions that users make on the basis of the entity's GPFRs prepared for that period (cf. IPSASB CP 2008, p. 37). Similarly, instead of requiring complete freedom from error in the reporting of relevant financial information, it is sufficient to require that all the disclosed information is free from material error. Therefore, materiality is clearly a dimension of sufficiency (cf. IPSASB CP 2008, p. 38).

The Consultation Paper does not acknowledge that materiality is a moderating factor. This becomes evident in the discussion on faithful representation which is claimed to be "attained when the depiction of the phenomenon is complete, neutral, and free from *material* [emphasis added] error" (IPSASB CP 2008, p. 33). Faithful representation, or reliability, simply refers to

freedom from error, however, not to freedom from material error, and it is a distinct issue to consider the extent to which this characteristic should be required. Completeness is thus the starting point and materiality is the factor that moderates this extreme requirement.

Cost-benefit-reasonableness refers to requiring that the benefits of financial reporting should justify the costs that it imposes (IPSASB CP 2008, p. 38). From the economic perspective this requirement is clearly acceptable. However, it is also a moderating requirement. It asserts that rather than requiring the complete set of relevant information with perfect reliability it is only economically reasonable to require information for which the related benefits justify the corresponding cost. This means that for economic reasons less than perfect information may be sufficient. The principle is simple and clear but it may be difficult to apply. Assessing whether the benefits of providing information really justify the related cost will typically be more qualitative than quantitative. The question is then a little ambiguous asking whether one or more qualitative characteristics should be sacrificed to "some degree" in order to reduce costs.

Diagram 2 on the following page summarizes the above discussion on the qualitative characteristics of information in GPFRs. The evaluation of a potentially useful piece of information starts from asking whether it has the first fundamental qualitative characteristic of being relevant, that is, whether it is capable of making a difference in achieving the objectives. If the answer is "no", the piece of information is useless and no further analysis is needed. If the answer is "yes", one must ask if the piece of information has the second fundamental qualitative characteristic of being reliable, that is, whether it is free from error. Again, if the answer is "no", the piece of information is useless and it should not be disclosed. If the answer is "yes", then this piece of relevant information has the proper characteristics and should be disclosed.

This is an ideal picture of the evaluation process. In practice it becomes more complicated because the fundamental qualitative characteristics of relevance and reliability are not absolute but show in degrees. Therefore, one must introduce enhancing qualitative characteristics for the both of these fundamental characteristics. For relevance they are confirmatory value, predictive value, understandability, timeliness and comparability. An increase in the attainment of any of these characteristics enhances relevance. Similarly, for reliability the enhancing characteristics are verifiability and supportability. An increase in the attainment of these characteristics enhances reliability.

Enhancing could be performed without an end. Therefore one must ask what amount of enhancing is sufficient. Consequently sufficiency becomes the moderating factor. As such it is too ambiguous and therefore it must be made more specific by introducing some dimensions to it. Four dimensions of moderation were proposed: completeness, neutrality, materiality and cost-benefit-reasonableness. Therefore, sufficiency reduces to asking if there is a balance between the given qualitative characteristics in terms of the selected dimensions of moderation. Assessing whether the balance is in fact achieved will typically be more qualitative than quantitative.

6. Concluding remarks

The term "conceptual framework" may have two distinct meanings using different auxiliary terminologies. The first problem with the IPSASB Framework is that it takes the meaning from the one approach but the terminology from the other. This will result in misunderstandings. The most harmful of them is the illusion of certainty in the disclosed information.

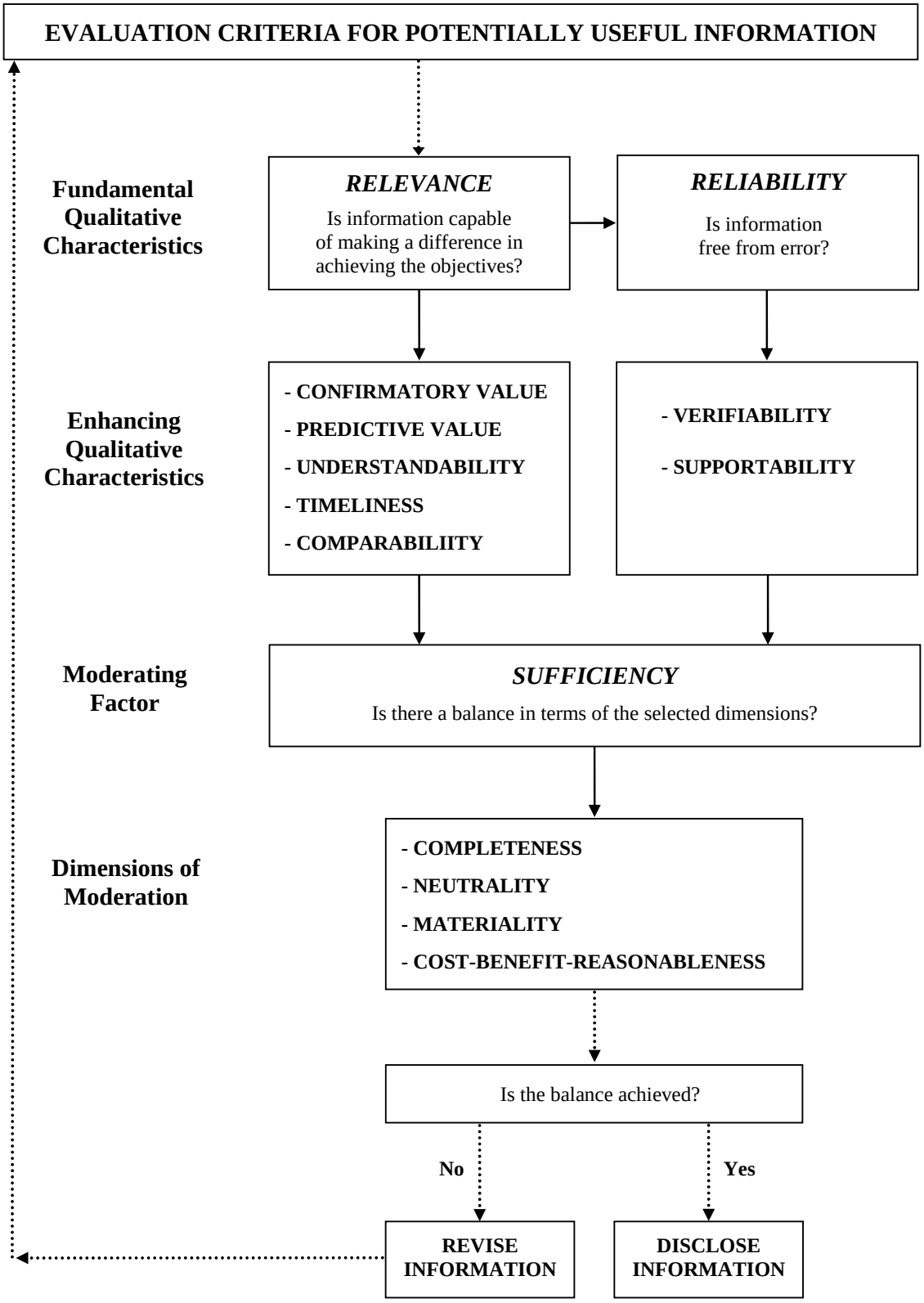

Diagram 2. The qualitative characteristics of information in GPFRs

The second problem with the IPSASB Framework is in the extensiveness of its two objectives, that is, to serve both accountability purposes and decision-making purposes. Accountability is related with the past while decision-usefulness is related with the future. There is a clear tension between these two. It is not practicable to construct the financial statements of an entity without giving the priority to one objective or the other. It should be explicitly said which objective is given the priority in preparing the "general purpose" financial statements and which objective is then accounted for by supplying additional information.

The third problem with the IPSASB Framework is in the extensiveness of its scope. The proposed framework does not acknowledge that the wide scope may have implications to the definition of some key concepts, particularly that of an asset. What is a relevant definition for an asset in the context of business entities in the private sector where the objective 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 may not be a relevant definition in the context where public sector entities operate.

The fourth problem with the IPSASB Framework concerns the qualitative characteristics it proposes. Particularly faithful representation and verifiability are misleading in this context. They are both adopted from the scientific method but they are both given a new meaning, too. These homemade constructs give the illusion of a scientific approach to producing information that in a closer examination only turns out to be quasi-scientific (for more details, see, e.g., Vehmanen 2007, pp. 152-168). Adopting a quasi-scientific framework would only raise false expectations regarding the certainty of the reported information. Therefore it is highly recommended here that one should modify the terminology of the framework to better match the level of certainty that may be achieved in financial reporting.

The proposed modification is by no means radical. It only replaces the concept of faithful representation with the concept of reliability, redefines the concept of verifiability, introduces the moderating factor of sufficiency and portrays the whole set of qualitative characteristics hierarchically as a dynamic process comparable to that of the scientific method. However, although the approach is comparable to that of the scientific method, the difference between the two should be evident: supportability of information is far less than verifiability in terms of how convincing or confirming the provided evidence is.

What may be achieved in practice at best by applying these qualitative characteristics is a systematic approach to producing information based on hard facts and general consensus. What may not be achieved, however, is refutable financial information based on observable empirical evidence. That would make financial reporting a true empirical science.

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