RESPONSE TO THE EXPOSURE DRAFT
ON QUALITATIVE CHARACTERISTICS:
CRITERIA FOR SELECTING AND EVALUATING
FINANCIAL ACCOUNTING AND REPORTING POLICIES
OF THE
FINANCIAL ACCOUNTING STANDARDS BOARD

from the

Qualitative Characteristics Subcommittee

of the

Committee on Financial Reporting

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The guidelines for responses of subcommittees of the American Accounting Association's Committee on Financial Accounting Standards recommend a two part response written in a spirit similar to a "friend of the court" position. The three sections of the recommended Part I of the report contain (a) issues to be raised, (b) the research results that are important, and (c) the potential consequences of policy choices. Part II of the report consists of "advocacy positions on selected issues." This response includes materials with respect to (a) and (b) above. It does not discuss potential consequences of policy changes given that the Exposure Draft (ED) recommends no accounting or reporting policies per se. In addition, the subcommittee has chosen not to develop advocacy positions on specific issues except those which are implicit in the discussion of existing research results and certain conceptual and implementation issues which are evident in the ED.

This response is organized under the following major headings:

I. Specification Issues Concerned with the Measurement, Definition and Implementation of the Recommended Criteria

II. Evaluation Issues Concerned with the Choice of Financial Accounting and Reporting Policies

III. Comments on Specific Criteria

In summary, our subcommittee finds that the ED has not successfully confronted many of the specification and evaluation issues raised by an earlier subcommittee (AAA, Subcommittee on Conceptual Framework for Financial Accounting, 1977). In particular, the ED's specification of criteria does not seem to be operational. And even if operationality is assumed, existing research results imply significant problems in evaluating accounting policies based on a cost-benefit analysis. These problems are magnified if social welfare and distribution effects of possible Board decisions are considered.

SPECIFICATION ISSUES

The proposed Statement of Financial Accounting Concepts contains criteria which "are intended to guide those who choose between accounting and reporting alternatives" (ED, p. v). But,

> . . . Statements of Financial Accounting Concepts are intended to establish the objectives and concepts that the Financial Accounting Standards Board <u>will use</u> in developing standards of financial accounting and reporting (ED, p. i, emphasis added).

Usable criteria require at least a partial solution to the "specification problem," which includes the development of a set of consistent, well-defined, and operational criteria, and to the "evaluation problem," the actual application of the <u>multiple</u> criteria to an accounting or reporting alternative. A review of extant accounting research[1] indicates that each of these problems is somewhat problematic but several promising approaches have been proposed. In this section, the discussion is focused on "specification" problems related to the definition and operationalization of the proposed criteria.

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[1]As the Exposure Draft is currently written, it contains insufficient reference to existing literature and research results. This weakness hinders one in interpreting the meaning of many of the proposed criteria and results, in some cases, in definitions which are not consistent with the literature. An extensive, although not comprehensive, bibliography is appended to this discussion.

A common distinction often made in science is that

> . . . Words or constructs can be defined in two general ways. . . a constitutive definition defines a construct with other constructs. . . an operational definition assigns meaning to a construct or a variable by specifying the activities or operations necessary to measure it (Kerlinger, 1973, p. 30-31).

Furthermore,

> . . . The importance of operational definitions cannot be overemphasized. They are indispensable ingredients. . . because they are bridges between the theory-hypothesis-construct level and the level of observation (Ibid., p. 32).

In the ED, most of the important criteria are not defined in either a rigorous constitutive (dictionary) or operational manner. The ED recognizes the importance of operational definitions in its discussion of a dictionary definition of relevance (paragraph 32). "This kind of definition is not wrong, but it is also not useful for this Statement, because it is not operational." In our view, only the verifiability criterion is satisfactorily defined in an operational sense. In contrast, numerous academic studies exist that specify operational (quantitative) ways to apply these "qualitative characteristics." Prime references for the major "qualitative characteristics" include Collins (1978), Grove (1975), Ijiri (1967 and 1975), Krantz, et al. (1971), Mock (1976), Mock and Grove (1979), and Murphy (1976). ALthough the above references are not unanimous in their approaches to operationalization, they do present both promising methods and discussions of difficulties which should be explicitly considered in a Statement concerned with FASB decision criteria.

As written, the ED implies that it enjoys a comparative advantage over other criteria frameworks that have been proposed in both authoritative literature (see, Anton, 1976) and academic literature. In fact, the draft suggests that the following benefits will be obtained from the present effort:

> The Board itself is likely to be the major user and thus the most direct beneficiary of the guidance provided by the Statements in this series. However, knowledge of the objectives and concepts the Board uses should enable all who are affected by or interested in financial accounting standards to better understand the content and limitations of information provided by financial accounting and reporting, thereby furthering their ability to use that information effectively and enhancing confidence in financial accounting and reporting. The knowledge, if used with care, may also provide guidance in resolving new or emerging problems of financial accounting and reporting in the absence of applicable authoritative pronouncements.

This claim raises several unanswered questions, including the following: How reasonable is it to expect that the benefits of a statement on Qualitative Characteristics expected by the Board will be realized? What does this statement contain that is not already available to the members of the FASB, so that the availability of this material will enhance the ability of the Board in developing accounting policy? What does this statement contain that is not generally known to those affected by or interested in financial accounting standards so that the issuance of this statement will enhance their ability to use the information effectively and to increase their confidence in financial reporting? And, last, how were these qualitative characteristics selected?

The opening sentence in paragraph 1 of the ED suggests that the Board has looked at a larger set of criteria and has arrived at a subset that ought to be used for evaluation of accounting methods. The Board does not view the Qualitative Characteristics identified in the statement as the criteria presently used, but as a normative recommendation for the criteria that <u>should</u> be used in the future. The Board has not explicated their basis of selecting these criteria or has not discussed why (if there are any other possible criteria that have been left out from the recommended set) other criteria have been left out. In the absence of a justification for selecting the criteria that they have, it is difficult to see how one can proceed with a scientific discussion of this theory building effort on the part of a rule-making body.

A fundamental assumption of the ED is that the benefits of alternative accounting methods cannot be measured in dollar terms, and therefore it is useful to decompose the benefits into abstract qualities such as reliability and relevance in order for the Board or others to be able to make better judgments about the accounting choices that do indeed have larger benefits and to avoid those whose are smaller. If the dollar benefits cannot be measured or estimated with an acceptable degree of accuracy, it may be useful to search for surrogate benefits that can be measured with an acceptable degree of accuracy. Measurability (operationality) of these surrogates for benefits is therefore a key issue with respect to Qualitative Characteristics, but as noted earlier, it seems to have received little attention in the ED.

EVALUATION ISSUES

Even if we assume that the surrogate measures of benefits listed in the ED are measurable, two further problems must be addressed before such an approach can be considered an improvement on direct dollar cost-benefit analysis of accounting policies. First, while dollar benefits are homogeneous in the sense that they can be added and subtracted and therefore be directly compared, the surrogate measures of benefits considered in the exposure draft are not comparable among themselves, and even in the absence of any problems of measurement, they raise a further problem of comparison across attributes and comparison across the methods of accounting.

Thus, suppose one method of accounting is more relevant than another, while the second is more reliable than the first; which one should be chosen? A shift to surrogate measures of benefits forces us to think in terms of rates of substitution of one surrogate benefit measure for another. It is not clear what the tradeoffs among these measures are, and the Board has not provided guidance that will facilitate actual use of the criteria.[2]

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[2]The evaluation problems associated with rates of substitution among criteria and the related value judgments that must be made have been discussed in more detail in a previous AAA subcommittee response (American Accounting Association, 1972).

Even if the problems of measurement and comparison of surrogate measures of benefits are set aside, a further question must be considered: Can better decisions be made by using the Qualitative Characteristics than could have been made without using them and by simply doing a direct cost-benefit comparison? This is an empirical question. Without evidence that the use of the Qualitative Characteristics actually results in better (in some reasonable sense) decisions than could be made without them, it is difficult to make and defend claims about the value of the present document.

Even more difficult evaluation issues are evident at the social welfare level. The ED notes (paragraphs 6 - 7) that accounting choices are made at two different levels: at the social level, by the FASB and other agencies, and at the level of individual firms. The criteria for evaluating the accounting methods presented in the ED are intended for both types of choices. There is, however, a difference of perspective in the choices made at the social and individual enterprise levels.

The social rule-making bodies have to justify their decisions on the basis of enhancing the social welfare of a broad class of economic agents that includes the investors, managers, auditors, employees, and the public in general. On the other hand, the decisions taken at the level of individual enterprise have to satisfy a narrower constituency of parties involved in the enterprise itself and do not have to worry about the broader welfare of the society as a whole.

The basic framework used in the ED is defined in paragraph 10 and summarized in Figure 1. If the benefits that flow from an accounting alternative exceed the costs associated with the alternative, it should be adopted. If the benefits exceed the costs for more than one alternative, the method associated with the maximum of excess benefits over costs should be adopted over all others.

Much of the rest of the statement is devoted to elaborating the elements of the benefits with a cursory treatment given to the costs at the end in paragraphs 115 - 123 of the ED. The elements of benefits have been organized into a "hierarchy" in Figure 1. A few elements of costs have been briefly identified (but not discussed) in paragraph 119 on the grounds that we know little about such costs.

Implicit in the ED is the cost-benefit approach to social decision making that has been thoroughly analyzed in the economics literature, e.g., Mishan (1976). The fundamental justification for cost-benefit analysis rests on the "potential" Pareto criterion, which means that a social decision is to be considered desirable if the sum of the benefits generated to all individuals exceeds the sum of the costs borne by all individuals. If such a social decision were undertaken, it is at least <u>conceptually possible</u> to make everybody at least as well off after the decision as they were before and even a few people better off.

Whether actual redistribution of benefits takes place under the decision is not considered in the cost-benefit analysis or in the potential Pareto criterion. The (strict) Pareto criterion, on the other hand, requires that nobody be hurt by the decision and everybody in the society should either benefit from the decision or be left as well off as he or she was before the social decision was taken. The Pareto criterion is more difficult to satisfy, because for practically any social decision, it is easy to find a party who will be hurt by such a decision. This observation does not imply that Pareto improvements are impossible, but the social decisions that may make everybody better off without hurting anybody have probably already been taken.

In selecting the cost-benefit approach over the strict Pareto criterion, the FASB has implicitly decided that the distribution effects of financial accounting policies can be or should be ignored. Given the popularity of the cost-benefit approach in recent years, this choice is not surprising. However, it is surprising that there is no discussion in the ED of the distribution effects of the accounting choices on the welfare of individuals and various groups in the society. The staunchest advocates of cost-benefit analysis will admit that even if the formal use of the Pareto criterion is too difficult in practice, the social decisions cannot be made unless the effect of such decisions on the welfare of various groups in the society is given a fair or even-handed consideration.

In contrast, the ED seems to assume that the society consists of only one interested party--the so-called users of the financial statements--and no other interests such as those of the auditors or the managers need be taken into account when making the social level choices of accounting. This singlemindedness with the so-called users of the financial statements has led the Board in the past to issue a statement of objectives that may overemphasize the objectives of investors (SFAC #1).[3] The current exposure draft is an attempt to build a theory of accounting choice that seems entirely unrelated to the social choice literature.

Benefits to other classes of decision makers are an important consideration in the social process of making choices of accounting methods. By ignoring these classes of decision makers, it is not clear that the developed criteria will be useful in setting and evaluating accounting methods and policies in a world where managers oppose the methods of accounting that are seen by them to hurt their interests,

[3]See Dopuch and Sunder (1980) for detailed discussion.

and auditors influence the standard setting process according to their own interests.

COMMENTS ON SPECIFIC CRITERIA

One of the initial questions which should be raised in considering the proposed criteria is the use of the phrase, "Qualitative Characteristic" in the ED's title. It may be conventional to use this phrase, but the criteria discussed in the ED are not necessarily all qualitative (e.g., costs, benefits, timeliness, and reliability); thus one is left in doubt as to the nature of the criteria which are discussed. The clarity of the ED would be enhanced if a distinction between qualitative and quantitative criteria were made. Further, the notion of quantitative criteria implies the stipulation of standards for reaching decisions based on criteria such as reliability and cost.[3] In general, such standards are not considered in the ED.

This section of our discussion considers the specific criteria as they are defined and discussed in the ED. As has been noted, the ED makes few attempts to explicitly link their definitions with either the professional/authoritative or scientific/research literature. This approach enhances the possibility of increasing jargon and of failing to take advantage of research findings in accounting and related disciplines.

[3]See Collins (1978).

Relevance

The ED states that the dictionary definition of relevance "as pertaining to or having a bearing on the matter in question," is not useful for this statement because it is not operational (paragraph 32), and then, presumably giving an operational definition, goes on to say that:

> The relevance of accounting information must be judged in relation to the decision maker's objective. To be relevant, information must be capable of making a difference to the decision maker by changing the assessment of the probability of occurence of some event relating to the attainment of a goal.

When the FASB's definition is shorn of its jargon, it is readily reduced to a standard dictionary definition which lacks operationality with respect to its use in policy decisions. Substitute "matter in question" for "some event relating to the attainment of a goal" and "bearing on" for "capable of making a difference to the decision maker," and we are back to the dictionary definition sans the jargon. Whether the decision maker uses probabilities assessments or does not is irrelevant to the definition of relevance.

Under any definition, relevance still depends on the matter on hand and is therefore a joint property of the accounting method and the matter on hand. Accounting methods themselves or the information produced by these methods cannot, themselves, be characterized as relevant or irrelevant.

Any accounting method may produce information that is relevant to some matters and irrelevant to others. This much is clear from the dictionary definition alone. How do we determine and compare the relevance of the accounting methods themselves when we know that they produce general-purpose statements and not either specific-purpose statements or all-purpose statements?

Paragraph 36 of the ED seems to argue that relevance may be quantified, but in doing so, mixes the concepts of "value of information" and "amount of information" which appear in the literature. Whether this represents an omission in the ED "hierarchy" is not clear as the ED criteria are not compared with other frameworks nor are the rules for inclusion or exclusion presented. Thus, a prospective policy maker may be uncertain as to where concepts such as disclosure or information value fit into the part of the conceptual framework represented by the "hierarchy."

Predictive Value

The ED discusses predictive value as it relates to relevance and argues that "if information about past events and transactions has predictive value, it will be relevant" (paragraph 39). This assertion either is a tautology or incorrect whenever the predicted event is not a part of the user's decision model.

Timeliness

FASB defines timeliness as a separate attribute of information ancillary to, but distinct from, relevance. But, if a piece of information arrives that is not pertaining to any of the matters on hand at the time, the dictionary definition will reject that information as being irrelevant to the matters on hand at the time. To the extent that the word is well defined in the dictionary and is well understood by much of the population, there seems little need for the FASB to prepare yet another definition of timeliness.

Reliability

The interrelated notions of reliability and validity (a concept usually defined identical to "representational faithfulness") appear frequently in the literature. In fact, many attempts have been made at operationalizing these criteria and their interrelationship (e.g., Ijiri, 1975; Kerlinger, 1973; Mock, 1976; and Mock & Grove, 1979). It seems unwise to discard such a wide body of research in favor of one which relegates validity to a "level below" reliability. A particularly important aspect of the literature which is overlooked by the ED is the error notion of reliability. Such a notion seems relevant in a profession where many of its members (auditors) daily concern themselves with errors and irregularities. Whether users can "depend on" information somehow seems less important and certainly less operative than how much measurement error is likely in an accounting alternative. The ED does contain discussion that relates to accounting errors, but it is couched in the value-laden term bias.

Verifiability

It might be useful to distinguish in the ED between verifiability and verified where the latter term is used in the auditing sense. Verifiability as a potentiality can affect reliability and decision usefulness only in some inductance or behavioral sense. The fact that the IRS may audit a taxpayer's return may induce more careful preparation of the return. In contrast, an actual audit (verification) will directly affect the error characteristics (reliability) of the data.

Representational Faithfulness

The representational faithfulness of accounting methods (paragraphs 59 - 62) is defined in the ED as "the property that the resulting numbers represent what they purport to represent," which is a frequent definition of validity in the literature. Even though many different accountants may apply the same method and arrive at an identical result, it does not necessarily mean that the result represents what it purports to represent. Therefore, the representational faithfulness of the method is not established by mere agreement among accountants on a method or a result.

Implicit in this definition is an assumption that a method of accounting or a result exists which is true, independent of the accountants, and knowable to the accountant so that it can be used to determine the representational faithfulness of the accountant's results. The ED never clarifies what this absolute standard is, against which the accounting representational faithfulness is measured.

The Board is encouraged to review existing research into the validity of various measures and operational methods of accessing this equivalent criterion.

Precision and Uncertainty

Paragraph 63 on precision and uncertainty is imprecise and lacks clarity of meaning. The Board criticizes "bogus precision" while discussing the link between reliability and precision. The fact that sometimes the information can be conveyed better in the form of probability estimates does not imply that reliability and precision of an accounting method have a relationship. What is being denied or negated by the Board in this paragraph is unclear.

Conservatism

The discussion of conservatism in paragraphs 66 - 68 is confusing and even misleading. The Board rejects the relatively well-known and well-understood definition of the term given in APBS #4, advances a new definition which is difficult to distinguish from the old, and then replaces the terms conservative reporting and accounting practices by yet another term, prudent reporting, that is not defined in the ED.

The Board's definition of conservatism is

> . . . a way of dealing with uncertainties and is intended to avoid recognition of income on the basis of inadequate evidence but to require the recognition of losses when assets have been impaired or liabilities incurred.

Since the Board's definition does not mention the need to avoid recognition of losses on the basis of inadequate evidence, nor requires that the income be recognized when assets have appreciated or liabilities impaired, we are hard pressed to understand how the Board views its definition of conservatism to be different from the one given by the APBS #4.

Materiality

The ED's discussion of materiality is extensive and does provide adequate linkage with previous research and literature. But the Draft concludes with a definition of materiality which is difficult to distinguish from relevance. Consider the following paraphrased definition:

> . . . an item in a financial report is relevant if it is probable that a user's judgment would be changed by the omission or misstatement of that item.

The conceptual similarity between the usage of relevance and materiality sheds doubt on the entire structure of the ED's "hierarchy" where relevance is treated as a "first level" criterion and materiality as an unlinked, but pervasive criterion. The notion of an hierarchy is not defined in the ED and its usage does not seem to conform to standard scientific definitions.

Neutrality

In discussing the property of neutrality in paragraphs 87 - 100, the Board does not seem to have come to grips with the essential problem that any rules issued by the Board will have different effects on various members of the society and will induce them to react to the Board's actions in different ways. The question of the distribution of the welfare effects of the actions of the Board cannot be solved by either the cost-benefit analysis or by professions of neutrality. When the Board does something that is seen to hurt the interests of one party, the action cannot be seen to be neutral in any sense of the word unless the party is appropriately compensated for the damage.

In the ED, the Board has attempted to trivialize this important problem through simplistic if not simple-minded examples (paragraphs 91 and 95) and at times tried to defend the neutrality of its actions by exhortations to the notions of truth and completeness of information. The example given in paragraph 91 is irrelevant, because it does not deal with the question of which measure of performance should be selected by the Board when it is known that each candidate measure will affect the welfare of various parties in different ways. An appeal to the notions of truth and completeness is not enough to resolve the tough problem of dealing with the distributional consequences of the actions of a social rule-making body such as the FASB.

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