



AMERICAN ACCOUNTING ASSOCIATION

5717 Bessie Drive • Sarasota, FL 34233-2399 • Phone: (941) 921-7747 • Fax (941) 923-4093
Email: Office@aaahq.org • <http://AAAhq.org>

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Response to the Conceptual Framework for Financial Reporting: The Objective of Financial Reporting and Qualitative Characteristics and Constraints of Decision-Useful Financial Reporting Information¹

Patrick E. Hopkins, Chair; Mark Bradshaw; Carolyn Callahan; Jack Ciesielski; Elizabeth Gordon (principal co-author), Mark Kohlbeck; Leslie Hodder; Robert Laux; Sarah McVay; Thomas Stober; Phillip Stocken (principal co-author); and Teri Lombardi Yohn.

INTRODUCTION

The Financial Reporting Policy Committee (“Committee”) of the Financial Accounting and Reporting Section of the American Accounting Association (“AAA”) is charged with responding to discussion papers and exposure drafts related to financial accounting and reporting issues.²

The Committee is pleased to respond to the Exposure Draft on the *Conceptual Framework for Financial Reporting: The Objective of Financial Reporting and Qualitative Characteristics and Constraints of Decision-Useful Financial Reporting Information* issued jointly by the Financial Accounting Standards Board and the International Accounting Standards Board (“Boards”).

¹ This comment letter was developed by the members of the Financial Reporting Policy Committee of the Financial Accounting and Reporting Section of the American Accounting Association and does not represent an official position of the American Accounting Association.

² The Committee is independent of the Financial Accounting Standards Committee (FASC) of the American Accounting Association.

The Exposure Draft contains two chapters: Chapter One—The Objective of Financial Reporting and Chapter Two—Qualitative Characteristics and Constraints of Decision-Useful Financial Reporting Information. With regard to Chapter One, we agree with the Boards’ position that present and potential capital providers, which include equity investors, lenders, employees, suppliers, customers, and other creditors, should be identified as the primary user group. The Committee also generally agrees with the Boards’ position that the entity’s financial reporting should be prepared from the perspective of the entity rather than the perspective of its owners or a particular class of owner, although differing views were expressed. Importantly, we note that there are variety of decision-making models in the accounting, economics, and finance literature suggesting types of information useful to capital providers for assessing an entity’s cash flow prospects. Outlining models for typical resource allocation decisions would be fruitful to the Boards and reporting entities when deciding on the types of information that should be included in general purpose financial reports. Further, to the extent that different user groups have heterogeneous information needs, summarizing the common models that generate their different information needs could potentially give the Boards and reporting entities greater insight into the informational needs of financial report users.

In our response to issues raised in Chapter Two, we discuss how statistical decision theory can provide a particularly useful framework for discussing the qualitative characteristics of decision useful information. On specific characteristics proposed, we view that distinction between *relevance* and *faithful representation* as a distracting and unnecessary remnant of the current relevance-versus-reliability trade-off. We view relevance as being equivalent to usefulness; thus, we regard relevance as being *the* primary characteristic of useful information. We agree that *comparability*, *verifiability*, and *timeliness* are enhancing qualitative characteristics of information. In contrast, the notion of *understandability* is a function of the cognitive ability of a particular, incompletely specified user and not a qualitative characteristic of the information itself. We also recommend removing (1) *confirmatory* as a feature of relevance, (2) *complete* as a component of faithful representation, and (3) *materiality* as a modifier of *free from error*, as materiality is a pervasive constraint.

The Exposure Draft includes several questions on page ii. The remainder of this document contains the Committee’s response to these questions; each question posed is stated in bold and our response follows each of the questions.

Chapter 1: The Objective of Financial Reporting

1. The Boards decided that an entity's financial reporting should be prepared from the perspective of the entity (entity perspective) rather than the perspective of its owners or a particular class of owners (proprietary perspective). (See paragraphs OB5–OB8 and paragraphs BC1.11–BC1.16.) Do you agree with the Boards' conclusion and the basis for it? If not, why?

Response:

We agree with the Boards' position that the entity's financial reporting should be prepared from the perspective of the entity rather than the perspective of its owners or a particular class of owner. It is unclear, however, why it is imperative to choose between the entity and proprietary perspectives. We support this view by claiming that meeting the needs of the providers of equity financing necessitates also meeting the information needs of the providers of debt financing.³

Capital providers consider various issues when deciding whether to allocate resources to an entity. A key issue for equity investors is determining the value of the entity. Using the discounted cash flow model discussed in many finance textbooks (e.g., Brealey and Myers 1984) to value an entity, an entity's expected unlevered free cash flows are discounted at the entity's weighted average cost of capital. The weighted average cost of capital equals the product of the proportion of debt to assets and the after-tax expected return on debt plus the product of the proportion of equity to assets and the expected return on equity. The value of the entity's debt is then subtracted from the entity's total value to determine the value of equity. Thus, to value the entity from the perspective of equity investors necessitates determining the value of the entity's debt. It follows that satisfying the information needs of the providers of equity financing requires satisfying the information needs of the providers of debt financing, or the information needs of any other claimant. We therefore conclude that adopting the entity perspective seems to best satisfy the information needs of all capital providers.

³ Although our discussion distinguishes between providers of equity and debt financing, analogous arguments apply to those instances where an entity has various classes of claim holders.

2. The Boards decided to identify present and potential capital providers as the primary user group for general purpose financial reporting. (See paragraphs OB5–OB8 and paragraphs BC1.19–BC1.22.) Do you agree with the Boards’ conclusion and the basis for it? If not, why?

Response:

We agree with the Boards’ position that present and potential capital providers, which include equity investors, lenders, employees, suppliers, customers, and other creditors, should be identified as the primary user group. While we agree that this focus does not necessarily imply that financial reporting would neglect the information needs of existing common shareholders, as argued in BC1.20, there might be circumstances in which the information needs of the different constituencies might conflict, and in those circumstances, we contend that the information needs of existing common shareholders should dominate those of prospective common shareholders and of other claimants.

There often are instances in which serving the information needs of one of the firm’s capital provider constituencies prejudices other constituents.⁴ For instance, an entity’s suppliers might find detailed information about the geographic composition of the entity’s sales to be helpful because it would allow the entity and its suppliers to streamline their production and distribution function. This information, however, might also facilitate a supplier nefariously marketing its products to the entity’s competitors, particularly in those geographic areas in which there is strong demand for the supplier’s products. This arrangement between the entity’s supplier and the entity’s rival would shift the entity’s demand function and harm its profitability. Similarly, among classes of claimants, debt holders may wish to have more detailed information about risk management strategies, but this may cause proprietary information to be revealed. As another example, consider the information needs of current versus prospective claimants regarding the treatment of employee stock options. Changes in the fair value of employee stock options should be expensed if one views the income statement as reflecting costs to current shareholders.

⁴ Several accounting studies have examined the consequence of conflicting information needs on firm disclosure choices (e.g., Newman and Sansing 1992).

However, if one views the income statement as reflecting costs to current and prospective shareholders, then the increase in fair value should not be expensed.

In this light, we suggest that when the provision of proprietary information would harm the interests of the entity's existing common shareholders, satisfying the interests of the firm's existing shareholders should dominate satisfying the interest of the other capital providers.

In addition, when deciding whether to require the provision of information, it should be recognized that the providers of equity capital often do not have the same contractual ability to demand information as providers of debt capital (see Bharath, Sunder, and Sunder 2008). Accordingly, the Committee recommends that the Boards work to ensure that the information needs of providers of equity capital are satisfied.

3. The Boards decided that the objective should be broad enough to encompass all of the decisions that equity investors, lenders, and other creditors make in their capacity as capital providers, including resource allocation decisions as well as decisions made to protect and enhance their investments. (See paragraphs OB9–OB12 and paragraphs BC1.23–BC1.29.) Do you agree with that objective and the Boards' basis for it? If not, why? Please provide any alternative objective that you think the Boards should consider.

Response:

We agree with the position that the objective of financial reporting should be broad enough to encompass all of the decisions that equity investors, lenders, and other creditors make in their capacity as capital providers, including resource allocation decisions as well as decisions made to protect and enhance their investments. Because the Exposure Draft did not specify these users' decision-making models, however, it is unclear whether the subsequent discussion in paragraphs OB9 through OB12 sufficiently outlines the types of information that would meet this objective. This section raises this concern and suggests an avenue for enhancing the usefulness of information in general purpose financial reports.

The Boards' focus on the financial information needs of present and potential providers of capital calls for the provision of a larger set of information than the set of financial information aimed at meeting the needs of a particular group of capital providers, such as

equity investors. For instance, providers of equity financing that are capable of holding a diversified portfolio are concerned with systematic risk when evaluating a firm; providers of debt financing are concerned with an entity's total risk, that is, both its unsystematic (or idiosyncratic risk) and its systematic risk. Hence, the Boards' focus on present and potential capital providers as the primary user group for general purpose financial reporting will yield a larger set of information than if the Boards focused exclusively on equity holders.

Because the providers of equity capital often do not have the same contractual ability to demand information as providers of debt capital, insuring that the information needs of providers of equity capital are satisfied is important. In this regard, it is helpful to outline the information that providers of equity capital use when making decisions. To this end, the Boards note that "[W]hen making those decisions, capital providers are interested in assessing the entity's ability to generate net cash inflows and management's ability to protect and enhance the capital providers' investments" (OB9). This broad outline of financial information that investors are expected to find necessary for assessing an entity's cash flow prospects and its compliance with its stewardship responsibilities does not seem sufficiently descriptive of equity investors' information needs. We argue that more thoroughly outlining capital providers' decision-making models could help assess their information needs. The Committee's recommendation that the Boards examine the relation between decision-makers, their decisions, and accounting information is not new: see, for instance, Devine (1960) and Bruns (1968).

To illustrate this approach, consider the usefulness of information for valuing an entity. The commonly used *Gordon Growth Model*, which under constant expected returns is specified as follows:

$$\text{Price at beginning of period} = \frac{\text{Expected dividend at end of period}}{\text{Expected equity discount rate} - \text{Expected growth rate}} .$$

This model highlights that investors seek information for assessing future cash flows, a discount rate, and the cash-flow growth rate. More general equity pricing models (e.g., Hughes, Liu, and Liu 2008) include parameters for financial leverage, growth in cash flows, volatility of factor risk premiums (e.g., betas), volatility of cash flows (or idiosyncratic risk), and correlation between cash flows and expected returns. These models suggest a role for

information about an entity's expected growth in cash flows. This observation contrasts with the Boards' position in BC1.5 which notes that whether financial reports should include prospective information or forecasts will be considered in a later phase of the conceptual framework project. Because equity pricing models suggest that information about the growth in prospective cash flows is useful for making resources allocation decisions, the provision of this type of information should be addressed at this phase of the conceptual framework.

In addition to these models explicitly suggesting that information about growth in an entity's cash flows should be included in general purpose financial reports, these models suggest a role for information about cash flow volatility and volatility of systematic risk factors.⁵ At present, the Exposure Draft does not include a decision-making model that describes equity investors, and hence the extent to which the Boards view providing this type of information as being useful for making resource allocation decisions is unclear.⁶ In summary, there are a multitude of decisions that equity investors, lenders, and other creditors make in their capacity as capital providers.

There are numerous decision-making models in the accounting, economics, and finance literature, each suggesting the type of information useful to capital providers for assessing an entity's cash flow prospects. In contrast, the identification of information that meets the stewardship demand is difficult because there is "no satisfactory theory of stewardship demand for information", although agency theoretic models do offer some insight (Gjesdal 1981, 213). Accordingly, outlining models for typical resource allocation decisions would be fruitful to the Boards and reporting entities when deciding on the types of information that should be included in general purpose financial reports. Further, to the extent that different user groups have heterogeneous information needs as discussed in OB6, outlining the models that generate their different information needs is expected to give the Boards and reporting entities greater insight into the informational needs of financial report users.

⁵ Many studies in the accounting literature have examined the relation between firm disclosure and cost of capital, representative of which include Botosan (1997) and Botosan and Plumlee (2003).

⁶ It is worthwhile observing that these models motivate providing information about an entity's financial structure, which the Boards do in OB17, and it supports the Boards' position in BC 1.40 of directing the statement of financial position toward equity investors rather than exclusively toward lenders, other creditors, and regulators.

Chapter 2: Qualitative Characteristics and Constraints of Decision-Useful Financial Reporting Information

This section responds to the questions the Boards' posed regarding the characteristics of decision-useful information. Before responding to each question, we offer background supporting the perspective from which the Committee addressed the questions.

Disagreement and uncertainty among financial report users about the qualitative criteria in Statement of Financial Accounting Concepts (SFAC) No. 2, in part, motivated the Boards to revisit the qualitative characteristics of decision-useful financial reporting information. The arguments offered in the Exposure Draft contribute relatively little to the extant pronouncements regarding the qualitative characteristics of decision-useful information and seem unlikely to remedy the uncertainty that characterizes application of the framework in SFAC No. 2. In this section, we suggest that examining the generic properties of information within a Bayesian framework offers a structure that would allow the Boards to discuss many of the qualitative criteria in a systematic fashion that may be less susceptible to alternative interpretations.

For several decades, accountants have struggled to identify and characterize the properties of useful information. Among the seminal studies, the American Accounting Association published a monograph in 1966 that identified *usefulness* as being the "all inclusive" criterion. This criterion was then partitioned into criteria that were "more susceptible to measurement and implementation" (AAA 1966, 3). The four essential standards identified for evaluating information were: *relevance*, *verifiability*, *freedom from bias*, and *quantifiability*. Snavelly (1967) extended this earlier work and offered a hierarchy of criteria. He identified four levels. The first level criterion of the hierarchy was *usefulness*, which was identified as being applicable to any information. The second level criteria were *relevance*, *reliability*, *understandability*, *significance*, *sufficiency*, and *practicality*. These criteria were viewed as being "mutually exclusive and singularly powerful" (p. 232) in the sense that if information does not meet any one of these criteria, then it is not useful even though it might comply perfectly with all the other criteria. The third and fourth levels specified supporting characteristics of the second level criteria; for instance, the third level criteria *worth more than cost* and *timely* were identified as supporting the second level criterion of *practicality*. Snavelly (1967) did not explicitly use a model to serve as an organizing framework in the development of his hierarchy. Subsequently, Feltham (1968)

considered the value of changes in an information system within the context of a decision-theoretic model and considered the concepts of *relevance*, *timeliness*, and *accuracy*. This antecedent literature seems to have provided the key ingredients for the hierarchy of qualitative characteristics developed in SFAC No. 2.

A fundamental feature of this work is that the properties of information are considered, for the most part, within a single decision-maker context. Within this context, Blackwell's Theorem provides a relation that allows for a partial ordering over alternative information systems. This theorem, which is based on the relation among the likelihood functions of alternative information systems, in casual terms, states that one information system is more valuable than other information systems if it has less randomness or uncertainty in the association between the set of states and the set of signals. Equivalently, Laffont (1993) points out that one information system is more valuable than another if it provides a finer partition of the state space than the other information system. Blackwell's Theorem implies, for instance, that information that is *complete* (i.e., "it includes all information that is necessary for faithful representation of the economic phenomena that it purports to represent" (QC9)) is more useful than information that is not *complete*.

Before proceeding, it is important to recognize that Blackwell's Theorem does not generally hold in settings in which multiple decision-makers interact strategically. Indeed, in a strategic setting containing more than one decision-maker, the introduction of additional information can reduce the welfare of the decision-makers. As an illustration, Christensen (1982) studied performance standards in an agency setting and established that the principal may be worse-off when the principal and agent observe additional contractual information before the agent takes an action. The development of the information economics and accounting literature subsequent to the early accounting studies discussed above, therefore, suggests caution when using the notion that providers of capital would prefer finer (or *complete*) information over less fine information (or less *complete* information). Unfortunately, the extant literature offers little generalizable guidance regarding the properties of valuable information in strategic settings; rather the properties of the most desirable information are typically sensitive to the particular features of the information environment within which decision-makers interact. In this light, the following discussion will typically restrict attention to the characterization of information within a single decision-maker context.

To define the value of information, it is necessary to specify several features of the environment, including the capital provider's payoff function and the set of alternative action choices (see Hilton 1981). As a consequence, the usefulness of information varies from user to user when the primary user group is widely defined. For instance, current equity shareholders might prefer to report a financial arrangement in a fashion that removes the obligation from the entity's balance sheet and obfuscates the extent of the entity's financial leverage. Information about an entity's financial risk would be helpful to potential providers of debt financing. This information, however, might affect the entity's ability to borrow or the rates at which it can borrow. The inability to borrow or incurring higher interest rates would affect the entity's profitability to the detriment of the existing common shareholders. The conflicting effect of information has implications for the cost-benefit tradeoff of providing information. In the absence of the Boards specifying the particular features of the environment, the value of information generally cannot be assessed.

Nevertheless, the generic properties of decision-useful information can be examined within a Bayesian statistical decision framework. Within this framework, when the distribution of the parameters of the accounting information (which includes the mean and, at times, the variance) that characterize an entity take on unknown values in the total parameter space, the capital provider's prior, joint distribution of the unknown parameters is revised after receiving accounting information to yield the posterior joint distribution of the unknown parameters; see DeGroot (1970) for a formal discussion.⁷

The position in this comment contrasts with the Exposure Draft's suggestion that adopting statistical notions and terminology in the framework would be inappropriate (see BC2.24) because, among other things, doing so would imply that relevant financial reporting information must predict the future.⁸ In contrast, we argue that statistical decision theory provides a particularly useful framework for discussing the qualitative characteristics of decision useful information. Within a Bayesian statistical framework, information is regarded as altering beliefs about an unknown parameter. Accordingly, confirmatory information, even though it might not

⁷ Subramanyam (1996) uses a sample drawn from a normal distribution with unknown mean and unknown variance to model the well documented feature of the financial disclosure environment that the returns-earnings news relation is non-linear, or "S-shaped", with the average stock price response declining in the absolute magnitude of the earnings news (e.g., Freeman and Tse 1992; Lipe, Bryant, and Widener 1998).

⁸ Although the Boards noted that information need not be forward looking to have predictive value (BC2.10).

change the mean of capital providers' beliefs about an unknown parameter, has the potential to alter the actions of capital providers to the extent that it reduces the variance. Given this view of information, the motivation for dropping "statistical notions and terminology" should be better developed in the Boards' conceptual framework. Furthermore, given that users have debated the appropriate interpretation of the qualitative characteristics of useful information, reconciling the use of the terms in this Exposure Draft to their use in decision theory might be helpful.

The rest of this section responds to the specific questions the Exposure Draft raises.

Are the distinctions—fundamental and enhancing qualitative characteristics and pervasive constraints of financial reporting—helpful in understanding how the qualitative characteristics interact and how they are applied in obtaining useful financial reporting information? If not, why?

Response:

The distinctions in the Exposure Draft provide a framework helpful in evaluating the provision of accounting information to capital providers. An appealing feature of the Exposure Draft is that it does not characterize in much detail how the properties of information interact; this feature stands in contrast to the hierarchy of accounting qualities presented in SFAC No. 2 and earlier academic studies (e.g., Snively 1967). Given our understanding of the complexity of cognitive processes, any such detailed characterization is likely to be artificial (and perhaps even misleading). Thus, the Boards' broad classification of characteristics coupled with a discussion of some of the subtle interactions between the characteristics seems to be more helpful.

1. Do you agree that:

a. *Relevance* and *faithful representation* are fundamental qualitative characteristics? (See paragraphs QC2–QC14 and BC2.3–BC2.24.) If not, why?

Response:

The distinction between the *relevance* and *faithful representation* is not convincingly justified and appears to be a remnant of the relevance-versus-reliability trade-off that played a prominent role in SFAC No.2. *Relevance* is inextricably linked to decision usefulness. From a Bayesian decision framework perspective, the concepts are synonymous. If information is not relevant, it will not alter the capital provider's beliefs. Therefore, relevance is a fundamental qualitative characteristic.

Faithful representation, on the other hand, is an enhancing qualitative characteristic of relevant information. The notion of faithful representation (i.e., accounting representations that are complete, neutral, and free from material error) is analogous to the notion of precision or variance of the information the capital provider obtains. Hence, when information is more faithfully representative, capital providers place more weight on the information and less weight on their prior beliefs when estimating an unknown population parameter.

1. Do you agree that:

b. *Comparability, verifiability, timeliness, and understandability* are enhancing qualitative characteristics? (See paragraphs QC16–QC26 and BC2.25–BC2.34.) If not, why?

Response:

We agree with the position that the notions of *comparability, verifiability, and timeliness* are enhancing qualitative characteristics of information. These notions reflect properties of information that are independent of the decision-maker. In contrast, *understandability* is a function of the cognitive ability of a particular user and this ability may vary across users (see SFAC No. 2, para. 40-41). In this sense, understandability, like cost, requires the Boards to consider the capability and payoff functions of capital providers. Accordingly, it seems understandability and the cost of information, as in SFAC No. 2, should be separated from the characteristics of information.

1. Do you agree that:

c. *Materiality* and *cost* are pervasive constraints? (See QC28–QC33 and BC2.58–BC2.64.) If not, why? Is the importance of the pervasive constraints relative to the qualitative characteristics appropriately represented in Chapter 2?

Response:

We agree that *cost* is a pervasive constraint that dictates whether providing information is economically sensible. Specifically, the net value of information is the expected value of the change in behavior that the information causes less the cost of providing the information. While information may be useful in the sense that the expected value of the change in the capital providers' behavior is positive, the net value of the information might be negative because the expected value of the change in behavior is not sufficient to justify its cost. In addition, applying this constraint requires that the Boards consider the payoff function of capital providers. Appropriately, therefore, the Exposure Draft separates this constraint from the fundamental and enhancing qualitative characteristics of accounting information.

Immaterial information should not be reported and material information should not be omitted. However, the notion of *materiality* is synonymous with relevance (or, equivalently, usefulness) because information is immaterial when its communication would not affect the decisions of users. Consequently, materiality is a redundant notion and should be dropped from the set of pervasive constraints.

2. The Boards have identified two fundamental qualitative characteristics—*relevance* and *faithful representation*:

- a. Financial reporting information that has *predictive value* or *confirmatory value* is relevant.**
- b. Financial reporting information that is *complete, free from material error, and neutral* is said to be a faithful representation of an economic phenomenon.**

(1) Are the fundamental qualitative characteristics appropriately identified and sufficiently defined for them to be consistently understood and useful? If not, why?

Response:

As suggested in our response to question (1.a.), it is not clear that relevance and faithful representation should be assigned to the same category, however it might be labeled. Specifically, the notions of relevant information and useful information are equivalent. Relevant information is useful by definition, and conversely, information that is not useful is not relevant. It is worth recognizing that the expected economic value of useful information need not be positive if the cost of providing the information exceeds its expected benefit. Therefore, relevance is a fundamental qualitative characteristic. Faithful representation, on the other hand, is an enhancing qualitative characteristic of relevant information. In an environment in which a parameter in some space is unknown, then information about the unknown parameter that has less variance is more relevant or useful.

(2) Are the components of the fundamental qualitative characteristics appropriately identified and sufficiently defined for them to be consistently understood and useful? If not, why?

Response:

The Boards' position is that relevant information has predictive value or confirmatory value. From a Bayesian decision framework perspective, information is useful if it causes capital providers to revise their prior beliefs about the value of an unknown parameter. Any information that alters beliefs has predictive value, and thus the distinction between information having confirmatory value or predictive value is not meaningful.

Consider the following two cases. On one hand, information in an environment characterized by uncertainty can reduce the variance of the capital providers' posterior distribution of the unknown parameter even if it does not change the mean of the posterior distribution. Consequently, information that does not alter capital providers' expected value of the unknown parameter can still have predictive value because it reduces the variance of the capital providers' expected value, which typically enhances a risk-averse capital provider's expected utility. On the other hand, information that alters the capital providers' expected value of the posterior distribution clearly has predictive value. These two

possibilities suggest that any information that alters beliefs has predictive value. Therefore, the distinction between information having confirmatory value or predictive value is nonsubstantive. Conversely, if confirmatory information is viewed as that which causes the capital providers not to revise their prior beliefs, then such information cannot be regarded as being useful.

The Exposure Draft suggests that faithful representation is attained when information is complete, neutral, and free from material error. It is not clear, however, that these components have been sufficiently specified to be helpful. If information is regarded as being faithfully representative only when it is complete, then the remaining components—neutrality and free from material error—are redundant.

We support this view by noting that information is regarded as being complete if it perfectly reveals the unknown parameter in a state space. Clearly, in this case, the issues of neutrality and freedom from material error are moot. Thus, for the components of faithful representation to be meaningful, it seems necessary to consider an environment where capital providers remain uncertain about a parameter even after they have obtained accounting information. In such an environment, which seems descriptive of the institutional environment, the notion of information being complete is not meaningful.

The other two components, however, are meaningful. First, information that is strategically reported is intended to induce a predetermined result. Thus, the criterion that information should be neutral to be representational faithful is helpful because this component is aimed at eliminating information reported in a self-serving, manipulative fashion. Second, capital providers weight neutral information that contains less error, or has less variance, more heavily when forming posterior beliefs than neutral information that contains more error or has more variance. Thus, including this notion of free from error or variance is helpful. We suggest, however, that the component should be adjusted by dropping the notion of *materiality* as a modifier. Specifically, if information is provided in a non-strategic fashion but is imprecise, then the cost constraint when coupled with the notion of relevance (or usefulness) will eliminate the provision of information that contains too much error or, equivalently, is too noisy. Further, setting aside the arguments presented here, because materiality is defined as a pervasive constraint, it is unclear why it should be introduced again as a fundamental qualitative characteristic.

In summary, we recommend dropping *confirmatory* as a feature of *relevance*, as useful confirmatory information will have predictive value, we recommend dropping *complete*, as a component of *faithful representation* as complete implies that the value is known with certainty, which does not apply and thus is not meaningful in this setting, and we recommend dropping *materiality* as a modifier of *free from error*, as materiality is a pervasive constraint.

3. Are the enhancing qualitative characteristics (*comparability, verifiability, timeliness, and understandability*) appropriately identified and sufficiently defined for them to be consistently understood and useful? If not, why?

Response:

The notions of *comparability, verifiability, and timeliness* are appropriately identified. To illustrate, suppose both the mean and the variance of the accounting information are unknown. In this case, the provision of information causes capital providers to revise their prior beliefs about both the mean and variance of the accounting information. Information that is comparable, verifiable (i.e., information that is not self-servingly misrepresented), or timely (i.e., information more correlated with information about the unknown parameter) enhances the precision of the capital providers' beliefs about the variance of the accounting information; for instance, capital providers might believe that the variance of an entity's information is low or that it is high. Accordingly, capital providers then are more capable of appropriately adjusting their beliefs because they can more appropriately weight the accounting information when forming the posterior probability distribution of the unknown population parameter in response to the accounting information.⁹

As discussed earlier, understandability relates to the properties of the capital provider and hence it is not clear that it should be categorized as an enhancing qualitative characteristic.

4. Are the pervasive constraints (*materiality and cost*) appropriately identified and sufficiently defined for them to be consistently understood and useful? If not, why?

⁹ DeGroot (1970, p. 169) characterizes the development of beliefs within the context of a Bayesian statistical framework when sampling from a normal distribution with unknown mean and unknown variance.

Response:

As discussed in our response to question (1.c.), the notion of materiality is redundant in the presence of the notion of relevance (or, equivalently, usefulness). Cost seems appropriately defined. However, specifying how costs are to be quantified is unclear.

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