FASB CONCEPTUAL FRAMEWORK

Statement of Financial Accounting Concepts No. 8

As Amended

August 2018

Conceptual Framework for Financial Reporting

Chapter 3, *Qualitative Characteristics of Useful Financial Information*

a replacement of FASB Concepts Statements No. 1 and No. 2

Financial Accounting Standards Board

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CHAPTER 3: QUALITATIVE CHARACTERISTICS OF USEFUL FINANCIAL INFORMATION

Introduction

QC1. The qualitative characteristics of useful financial information discussed in this chapter identify the types of information that are likely to be most useful to the existing and potential investors, lenders, and other creditors for making decisions about the reporting entity on the basis of information in its financial report (financial information).

QC2. Financial reports provide information about the reporting entity's economic resources, claims against the reporting entity, and the effects of transactions and other events and conditions that change those resources and claims. (This information is referred to in the Conceptual Framework as information about the economic phenomena.) Some financial reports also include explanatory material about management's expectations and strategies for the reporting entity and other types of forward-looking information.

QC3. The qualitative characteristics of useful financial information[1] apply to financial information provided in financial statements, as well as to financial information provided in other ways. Cost, which is a pervasive constraint on the reporting entity's ability to provide useful financial information, applies similarly. However, the considerations in applying the qualitative characteristics and the cost constraint may be different for different types of information. For example, applying them to forward-looking information may be different from applying them to information about existing economic resources and claims and to changes in those resources and claims.

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[1]Throughout this Conceptual Framework, the terms *qualitative characteristics* and *constraint* refer to the qualitative characteristics of, and the constraint on, useful financial information.

Qualitative Characteristics of Useful Financial Information

QC4. If financial information is to be useful, it must be relevant and faithfully represent what it purports to represent. The usefulness of financial information is enhanced if it is comparable, verifiable, timely, and understandable.

Fundamental Qualitative Characteristics

QC5. The fundamental qualitative characteristics are *relevance* and *faithful representation*.

Relevance

QC6. Relevant financial information is capable of making a difference in the decisions made by users. Information may be capable of making a difference in a decision even if some users choose not to take advantage of it or already are aware of it from other sources.

QC7. Financial information is capable of making a difference in decisions if it has predictive value, confirmatory value, or both.

QC8. Financial information has predictive value if it can be used as an input to processes employed by users to predict future outcomes. Financial information need not be a prediction or forecast to have predictive value. Financial information with predictive value is employed by users in making their own predictions.

QC9. Financial information has confirmatory value if it provides feedback (confirms or changes) about previous evaluations.

QC10. The predictive value and confirmatory value of financial information are interrelated. Information that has predictive value often also has confirmatory value. For example, revenue information for the current year, which can be used as the basis for predicting revenues in future years, also can be compared with revenue predictions for the current year that were made in past years. The results of those comparisons can help a user to correct and improve the processes that were used to make those previous predictions.

Materiality

QC11. Relevance and materiality are defined by what influences or makes a difference to an investor or other decision maker; however, the two concepts can be distinguished from each other. Relevance is a general notion about what type of information is useful to investors. Materiality is entity specific. The omission or misstatement of an item in a financial report is material if, in light of surrounding circumstances, the magnitude of the item is such that it is probable that the judgment of a reasonable person relying upon the report would have been changed or influenced by the inclusion or correction of the item.

QC11A. A decision not to disclose certain information or recognize an economic phenomenon may be made, for example, because the amounts involved are too small to make a difference to an investor or other decision maker (they are immaterial). However, magnitude by itself, without regard to the nature of the item and the circumstances in which the judgment has to be made, generally is not a sufficient basis for a materiality judgment.

QC11B. No general standards of materiality could be formulated to take into account all the considerations that enter into judgments made by an experienced, reasonable provider of financial information. That is because materiality judgments can properly be made only by those that understand the reporting entity's pertinent facts and circumstances. Whenever an authoritative body imposes materiality rules or standards, it is substituting generalized collective judgments for specific individual judgments, and there is no reason to suppose that the collective judgments always are superior.

Faithful Representation

QC12. Financial reports represent economic phenomena in words and numbers. To be useful, financial information not only must represent relevant phenomena, but it also must faithfully represent the phenomena that it purports to represent. To be a perfectly faithful representation, a depiction would have three characteristics. It would be *complete, neutral,* and *free from error*. Of course, perfection is seldom, if ever, achievable. The Board's objective is to maximize those qualities to the extent possible.

QC13. A complete depiction includes all information necessary for a user to understand the phenomenon being depicted, including all necessary descriptions and explanations. For example, a complete depiction of a group of assets would include, at a minimum, a description of the nature of the assets in the group, a numerical depiction of all of the assets in the group, and a description of what the numerical depiction represents (for example, original cost, adjusted cost, or fair value). For some items, a complete depiction also may entail explanations of significant facts about the quality and nature of the items, factors and circumstances that might affect their quality and nature, and the process used to determine the numerical depiction.

QC14. A neutral depiction is without bias in the selection or presentation of financial information. A neutral depiction is not slanted, weighted, emphasized, deemphasized, or otherwise manipulated to increase the probability that financial information will be received favorably or unfavorably by users. Neutral information does not mean information with no purpose or no influence on behavior. On the contrary, relevant financial information is, by definition, capable of making a difference in users' decisions.

QC15. Faithful representation does not mean accurate in all respects. Free from error means there are no errors or omissions in the description of the phenomenon, and the process used to produce the reported information has been selected and applied with no errors in the process. In this context, free from error does not mean perfectly accurate in all respects. For example, an estimate of an unobservable price or value cannot be determined to be accurate or inaccurate. However, a representation of that estimate can be faithful if the amount is described clearly and accurately as being an estimate, the nature and limitations of the estimating process are explained, and no errors have been made in selecting and applying an appropriate process for developing the estimate.

QC16. A faithful representation, by itself, does not necessarily result in useful information. For example, a reporting entity may receive property, plant, and equipment through a government grant. Obviously, reporting that an entity acquired an asset at no cost would faithfully represent its cost, but that information probably would not be very useful. A slightly more subtle example is an estimate of the amount by which an asset's carrying amount should be adjusted to reflect an impairment in the asset's value. That estimate can be a faithful representation if the reporting entity has applied properly an appropriate process, described properly the estimate, and explained any uncertainties that significantly affect the estimate. However, if the level of uncertainty in such an estimate is sufficiently large, that estimate will not be particularly useful. In other words, the relevance of the asset being faithfully represented is questionable. If there is no alternative representation that is more faithful, that estimate may provide the best available information.

Applying the Fundamental Qualitative Characteristics

QC17. Information must be both relevant and faithfully represented if it is to be useful. Neither a faithful representation of an irrelevant phenomenon, nor an unfaithful representation of a relevant phenomenon, helps users make good decisions.

QC18. The most efficient and effective process for applying the fundamental qualitative characteristics usually would be as follows (subject to the effects of enhancing characteristics and the cost constraint, which are not considered in this example). First, identify an economic phenomenon that has the potential to be useful to users of the reporting entity's financial information. Second, identify the type of information about that phenomenon that would be most relevant if it is available and can be faithfully represented. Third, determine whether that information is available and can be faithfully represented. If so, the process of satisfying the fundamental qualitative characteristics ends at that point. If not, the process is repeated with the next most relevant type of information.

Enhancing Qualitative Characteristics

QC19. *Comparability, verifiability, timeliness,* and *understandability* are qualitative characteristics that enhance the usefulness of information that is relevant and faithfully represented. The enhancing qualitative characteristics also may help determine which of two ways should be used to depict a phenomenon if both are considered equally relevant and faithfully represented.

Comparability

QC20. Users' decisions involve choosing between alternatives, for example, selling or holding an investment, or investing in one reporting entity or another. Consequently, information about a reporting entity is more useful if it can be compared with similar information about other entities and with similar information about the same entity for another period or another date.

QC21. Comparability is the qualitative characteristic that enables users to identify and understand similarities in, and differences among, items. Unlike the other qualitative characteristics, comparability does not relate to a single item. A comparison requires at least two items.

QC22. Consistency, although related to comparability, is not the same. Consistency refers to the use of the same methods for the same items, either from period to period within a reporting entity or in a single period across entities. Comparability is the goal; consistency helps to achieve that goal.

QC23. Comparability is not uniformity. For information to be comparable, like things must look alike and different things must look different. Comparability of financial information is not enhanced by making unlike things look alike any more than it is enhanced by making like things look different.

QC24. Some degree of comparability is likely to be attained by satisfying the fundamental qualitative characteristics. A faithful representation of a relevant economic phenomenon should naturally possess some degree of comparability with a faithful representation of a similar relevant economic phenomenon by another reporting entity.

QC25. Although a single economic phenomenon can be faithfully represented in multiple ways, permitting alternative accounting methods for the same economic phenomenon diminishes comparability.

Verifiability

QC26. Verifiability helps assure users that information faithfully represents the economic phenomena it purports to represent. Verifiability means that different knowledgeable and independent observers could reach consensus, although not necessarily complete agreement, that a particular depiction is a faithful representation. Quantified information need not be a single point estimate to be verifiable. A range of possible amounts and the related probabilities also can be verified.

QC27. Verification can be direct or indirect. Direct verification means verifying an amount or other representation through direct observation, for example, by counting cash. Indirect verification means checking the inputs to a model, formula, or other technique and recalculating the outputs using the same methodology. An example is verifying the carrying amount of inventory by checking the inputs (quantities and costs) and recalculating the ending inventory using the same cost flow assumption (for example, using the first-in, first-out method).

QC28. It may not be possible to verify some explanations and forward-looking financial information until a future period, if at all. To help users decide whether they want to use that information, it normally would be necessary to disclose the underlying assumptions, the methods of compiling the information, and other factors and circumstances that support the information.

Timeliness

QC29. Timeliness means having information available to decision makers in time to be capable of influencing their decisions. Generally, the older the information is, the less useful it is. However, some information may continue to be timely long after the end of a reporting period because, for example, some users may need to identify and assess trends.

Understandability

QC30. Classifying, characterizing, and presenting information clearly and concisely makes it *understandable*.

QC31. Some phenomena are inherently complex and cannot be made easy to understand. Excluding information about those phenomena from financial reports might make the information in those financial reports easier to understand. However, those reports would be incomplete and therefore potentially misleading.

QC32. Financial reports are prepared for users who have a reasonable knowledge of business and economic activities and who review and analyze the information diligently. At times, even well-informed and diligent users may need to seek the aid of an adviser to understand information about complex economic phenomena.

Applying the Enhancing Qualitative Characteristics

QC33. Enhancing qualitative characteristics should be maximized to the extent possible. However, the enhancing qualitative characteristics, either individually or as a group, cannot make information useful if that information is irrelevant or not faithfully represented.

QC34. Applying the enhancing qualitative characteristics is an iterative process that does not follow a prescribed order. Sometimes, one enhancing qualitative characteristic may have to be diminished to maximize another qualitative characteristic. For example, a temporary reduction in comparability as a result of prospectively applying a new financial reporting standard may be worthwhile to improve relevance or faithful representation in the longer term. Appropriate disclosures may partially compensate for noncomparability.

The Cost Constraint on Useful Financial Reporting

QC35. Cost is a pervasive constraint on the information that can be provided by financial reporting. Reporting financial information imposes costs, and it is important that those costs are justified by the benefits of reporting that information. There are several types of costs and benefits to consider.

QC36. Providers of financial information expend most of the effort involved in collecting, processing, verifying, and disseminating financial information, but users ultimately bear those costs in the form of reduced returns. Users of financial information also incur costs of analyzing and interpreting the information provided. If needed information is not provided, users incur additional costs to obtain that information elsewhere or to estimate it.

QC37. Reporting financial information that is relevant and faithfully represents what it purports to represent helps users to make decisions with more confidence. This results in more efficient functioning of capital markets and a lower cost of capital for the economy as a whole. An individual investor, lender, and other creditor also receive benefits by making more informed decisions. However, it is not possible for general purpose financial reports to provide all the information that every user finds relevant.

QC38. In applying the cost constraint, the Board assesses whether the benefits of reporting particular information are likely to justify the costs incurred to provide and use that information. When applying the cost constraint in developing a proposed financial reporting standard, the Board seeks information from providers of financial information, users, auditors, academics, and others about the expected nature and quantity of the benefits and costs of that standard. In most situations, assessments are based on a combination of quantitative and qualitative information.

QC39. Because of the inherent subjectivity, different individuals' assessments of the costs and benefits of reporting particular items of financial information will vary. Therefore, the Board seeks to consider costs and benefits in relation to financial reporting generally, and not just in relation to individual reporting entities. That does not mean that assessments of costs and benefits always justify the same reporting requirements for all entities. Differences may be appropriate because of different sizes of entities, different ways of raising capital (publicly or privately), different users' needs, or other factors.

This Concepts Statement was adopted by the unanimous vote of the five members of the Financial Accounting Standards Board:

Robert H. Herz, *Chairman*
Thomas J. Linsmeier
Leslie F. Seidman
Marc A. Siegel
Lawrence W. Smith

The amendments in this Concepts Statement were adopted by the unanimous vote of the seven members of the Financial Accounting Standards Board:

Russell G. Golden, *Chairman*
James L. Kroeker, *Vice Chairman*
Christine A. Botosan
Marsha L. Hunt
Harold L. Monk, Jr.
R. Harold Schroeder
Marc A. Siegel

APPENDIX: BASIS FOR CONCLUSIONS FOR CHAPTER 3

Introduction

BC3.1 This basis for conclusions summarizes considerations of the Board in reaching the conclusions in Chapter 3, *Qualitative Characteristics of Useful Financial Information*. It includes reasons for accepting some alternatives and rejecting others. Individual Board members gave greater weight to some factors than to others.

BC3.2 The Board developed this chapter jointly with the International Accounting Standards Board (IASB). Consequently, this basis for conclusions also includes some references to the IASB's literature.

Background

BC3.3 The Board began the process of developing the qualitative characteristics of useful financial information by reviewing its own framework and concepts as well as those of other standard setters. In July 2006, the Board published for public comment a Discussion Paper on this topic. That same paper also was published by the IASB. The Board and the IASB received 179 responses. In its redeliberations of the issues on this topic, the Board considered all of the comments received and information gained from other outreach initiatives. In May 2008, the Board and the IASB jointly published an Exposure Draft. The Boards received 142 responses. The Board reconsidered all of the issues. This document is the result of those reconsiderations.

The Objective of Financial Reporting and the Qualitative Characteristics of Useful Financial Information

BC3.4 Alternatives are available for all aspects of financial reporting, including recognition, derecognition, measurement, classification, presentation, and disclosure. When developing financial reporting standards, the Board will choose the alternative that goes furthest towards achieving the objective of financial reporting. Providers of financial information also will have to choose among the alternatives if there are no applicable standards available, or if application of a particular standard requires judgments or options, to achieve the objective of financial reporting.

BC3.5 Chapter 1 specifies that the objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity. The decision makers on which this

Conceptual Framework focuses are existing and potential investors, lenders, and other creditors.

BC3.6 That objective by itself leaves a great deal to judgment and provides little guidance on how to exercise that judgment. This chapter describes the first step in making the judgments needed to apply that objective. It identifies and describes the qualitative characteristics that financial information should have if it is to meet the objective of financial reporting. It also discusses cost, which is a pervasive constraint on financial reporting.

BC3.7 Subsequent chapters will use the qualitative characteristics to help guide choices about recognition, measurement, and the other aspects of financial reporting.

Fundamental and Enhancing Qualitative Characteristics

BC3.8 This chapter distinguishes between the fundamental qualitative characteristics that are the most critical, and the enhancing qualitative characteristics that are less critical but still highly desirable. The Discussion Paper did not explicitly distinguish between those qualitative characteristics. The Board made the distinction later because of confusion among respondents to the Discussion Paper about how the qualitative characteristics relate to each other.

BC3.9 Some respondents to the Exposure Draft stated that all of the qualitative characteristics should be considered equal and that the distinction between fundamental and enhancing qualitative characteristics was arbitrary. Others said that the most important qualitative characteristic differs depending on the circumstances; therefore, differentiating among the qualitative characteristics was not appropriate.

BC3.10 The Board does not agree that the distinction is arbitrary. Financial information without the two fundamental qualitative characteristics of relevance and faithful representation is not useful, and it cannot be made useful by being more comparable, verifiable, timely, or understandable. However, financial information that is relevant and faithfully represented may still be useful even if it does not have any of the enhancing qualitative characteristics.

Fundamental Qualitative Characteristics

Relevance

BC3.11 It is self-evident that financial information is only useful for making a decision if it is capable of making a difference in that decision. *Relevance* is the term used in the Conceptual Framework to describe that capability. It is a fundamental qualitative characteristic of useful financial information.

BC3.12 The definition of relevance in the Conceptual Framework is consistent with the definition in FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information.* The definition of relevance in the *Framework* (1989) was that information is relevant only if it actually makes a difference in users' decisions. However, users consider a variety of information from many sources, and the extent to which a decision is affected by a particular economic phenomenon is difficult, if not impossible, to determine, even after the fact.

BC3.13 In contrast, whether information *is capable* of making a difference in a decision (relevance as defined in the Conceptual Framework) can be determined. One of the primary purposes of publishing Exposure Drafts and other due process documents is to seek the views of users on whether information that would be required by proposed financial reporting standards is capable of making a difference in their decisions. The Board also assesses relevance by meeting with users to discuss proposed standards, potential agenda decisions, effects on reported information from applying recently implemented standards, and other matters.

Predictive and confirmatory value

BC3.14 Many decisions by investors, lenders, and other creditors are based on implicit or explicit predictions about the amount and timing of the return on an equity investment, loan, or other credit instrument. Consequently, information is capable of making a difference in one of those decisions only if it will help users to make new predictions, confirm or correct prior predictions, or both (which is the definition of predictive or confirmatory value).

BC3.15 The *Framework* (1989) identified predictive value and confirmatory value as components of relevance, and Concepts Statement 2 referred to predictive value and feedback value. The Board concluded that confirmatory value and feedback value were intended to have the same meaning. The Board and the IASB agreed that both Boards would use the same term (confirmatory value) to avoid giving the impression that the two frameworks were intended to be different.

The difference between predictive value and related statistical terms

BC3.16 Predictive value, as used in the Conceptual Framework, is not the same as predictability and persistence as used in statistics. Information has predictive value if it can be used in making predictions about the eventual outcomes of past or current events. In contrast, statisticians use predictability to refer to the accuracy with which it is possible to foretell the next number in a series and persistence to refer to the tendency of a series of numbers to continue to change as it has changed in the past.

Materiality

BC3.17 Concepts Statement 2 and the *Framework* (1989) discussed materiality and defined it similarly. Concepts Statement 2 described materiality as a constraint on financial reporting that can only be considered together with the qualitative characteristics, especially relevance and faithful representation. The *Framework* (1989), on the other hand, discussed materiality as an aspect of relevance and did not indicate that materiality has a role in relation to the other qualitative characteristics.

BC3.18 The Discussion Paper (July 6, 2006, FASB Preliminary Views, *Conceptual Framework for Financial Reporting: Objective of Financial Reporting and Qualitative Characteristics of Decision-Useful Financial Reporting Information*) and the Exposure Draft (May 29, 2008, FASB Exposure Draft, *Conceptual Framework for Financial Reporting: The Objective of Financial Reporting and Qualitative Characteristics and Constraints of Decision-Useful Financial Reporting Information*) proposed that materiality is a pervasive constraint in financial reporting because it is pertinent to all of the qualitative characteristics. Some respondents to the Exposure Draft agreed that any entity can consider materiality in its reporting decisions; however, it is not a constraint on a reporting entity's ability to report information because the entity can choose to report immaterial information. Furthermore, a standard setter does not consider materiality when developing standards because it is an entity-specific consideration. As a result, entity-specific assessments of materiality are not directly relevant to the Board's assessments on whether the guidance that the Board sets meets the qualitative characteristics of financial reporting. Instead, the Board evaluates the potential relevance of its guidance (and other qualitative characteristics of the reported information) in the context of a broader financial reporting environment rather than on the materiality of the information to individual entities.

BC3.18A The Board decided to continue to include a discussion of materiality in the Concepts Statements to (a) demonstrate its understanding of the reporting environment in which the guidance it sets is applied and (b) highlight the difference between relevance and materiality.

BC3.18B The Board observed that the definition of materiality in this chapter as originally issued is inconsistent with the definitions and discussions by the U.S. Securities and Exchange Commission (SEC), auditing standards of the Public Company Accounting Oversight Board (PCAOB) and the American Institute of Certified Public Accountants (AICPA), and the judicial system in the United States. That inconsistency does not help the Board to understand the environment in which reporting entities operate. In September 2015, the Board issued proposed Accounting Standards Update, *Notes to Financial Statements (Topic 235): Assessing Whether Disclosures Are Material*, which stated that materiality is a legal concept and that the Board observed that the U.S. Supreme Court definition of materiality is the appropriate definition. Preparers and practitioners objected to stating that materiality is a legal concept because it may imply that only legal professionals can make materiality judgments and that materiality should be considered an accounting concept. Others objected to the citing of the U.S. Supreme Court definition of materiality because of its origins in antifraud litigation. Still others stated that the meaning of the term is debatable and there is a concern that the definition may change. Some stakeholders suggested that the definition in Concepts Statement 2[1a] would be a better definition. After considering the feedback, the Board decided to replace the current definition of materiality in this chapter with the superseded definition in Concepts Statement 2. The definition of materiality that is in Concepts Statement 2 is quoted in SEC Staff Accounting Bulletin No. 99, *Materiality*. SAB 99 notes that the definition that is in Concepts Statement 2 is in substance identical to the definition of the U.S. Supreme Court, which in turn results in the definition in this chapter being in substance identical to the definition in the auditing standards of the AICPA and the PCAOB.

BC3.18C The Board decided not to incorporate all the content of the definition of materiality from Concepts Statement 2 into this chapter. The language that was not carried forward included, in large part, examples of how one might think about a materiality assessment. In the Board's view, the examples in Concepts Statement 2 were not necessary to capture the substance of the definition.

BC3.18D The Board is aware that the discussion of materiality as amended in this Concepts Statement is no longer identical to the definition in the International Accounting Standards Board's (IASB) *Conceptual Framework for Financial Reporting,* though both were identical when originally issued. IAS 1, *Presentation of Financial Statements,* and IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors,* also include definitions of materiality. It is preferable that both the FASB's and the IASB's Conceptual Frameworks converge. However, that is not possible because (a) the IASB's definitions of materiality are not consistent with the definition used in the United States and (b) the IASB is working to further amend its definitions of materiality.

Faithful Representation

BC3.19 The discussion of faithful representation in Chapter 3 differs from that in the previous frameworks in two significant ways. First, it uses the term *faithful representation* instead of the term *reliability*. Second, substance over form, prudence (conservatism), and verifiability, which were aspects of reliability in Concepts Statement 2 or the *Framework* (1989), are not considered aspects of faithful representation. Substance over form and prudence were removed for the reasons described in paragraphs BC3.26–BC3.29. Verifiability is now described as an enhancing qualitative characteristic rather than as part of this fundamental qualitative characteristic (see paragraphs BC3.34–BC3.36).

[1a]Superseded.

Replacement of the term *reliability*

BC3.20 Concepts Statement 2 and the *Framework* (1989) used the term *reliability* to describe what is now called faithful representation.

BC3.21 Concepts Statement 2 listed representational faithfulness, verifiability, and neutrality as aspects of reliability and discussed completeness as part of representational faithfulness.

BC3.22 The *Framework* (1989) said:

> Information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully that which it either purports to represent or could reasonably be expected to represent.

The *Framework* (1989) also discussed substance over form, neutrality, prudence, and completeness as aspects of faithful representation.

BC3.23 Unfortunately, neither framework conveyed the meaning of reliability clearly. The comments of respondents to numerous proposed standards indicated a lack of a common understanding of the term *reliability*. Some focused on *verifiability* or *free from material error* to the virtual exclusion of faithful representation. Others focused more on faithful representation, perhaps combined with neutrality. Some apparently think that reliability refers primarily to precision.

BC3.24 Because attempts to explain what reliability was intended to mean in this context have proven unsuccessful, the Board sought a different term that would more clearly convey the intended meaning. The term *faithful representation,* the faithful depiction in financial reports of economic phenomena, was the result of that search. That term encompasses the main characteristics that the previous frameworks included as aspects of reliability.

BC3.25 Many respondents to the Discussion Paper and the Exposure Draft opposed the Board's preliminary decision to replace *reliability* with *faithful representation*. Some said that the Board could have better explained what reliable means rather than replacing the term. However, many respondents who made those comments assigned a different meaning to reliability from what the Board meant. In particular, many respondents' descriptions of reliability more closely resembled the Board's notion of verifiability than its notion of reliability. Those comments led the Board to affirm its decision to replace the term *reliability* with *faithful representation*.

Substance over form

BC3.26 Substance over form is not considered a separate component of faithful representation because it would be redundant. Faithful representation means that financial information represents the substance of an economic phenomenon rather than merely representing its legal form. Representing a legal form that differs from the economic substance of the underlying economic phenomenon could not result in a faithful representation.

Prudence (conservatism) and neutrality

BC3.27 Chapter 3 does not include prudence or conservatism as an aspect of faithful representation because including either would be inconsistent with neutrality. Some respondents to the Discussion Paper and Exposure Draft disagreed with that view. They said that the framework should include conservatism, prudence, or both. They said that bias should not always be assumed to be undesirable, especially in circumstances when bias, in their view, produces information that is more relevant to some users.

BC3.28 Deliberately reflecting conservative estimates of assets, liabilities, income, or equity sometimes has been considered desirable to counteract the effects of some management estimates that have been perceived as excessively optimistic. However, even with the prohibitions against deliberate misstatement that appear in the existing frameworks, an admonition to be prudent is likely to lead to a bias. Understating assets or overstating liabilities in one period frequently leads to overstating financial performance in later periods—a result that cannot be described as prudent or neutral.

BC3.29 Other respondents to the Exposure Draft said that neutrality is impossible to achieve. In their view, relevant information must have purpose, and information with a purpose is not neutral. In other words, because financial reporting is a tool to influence decision making, it cannot be neutral. Obviously, reported financial information is expected to influence the actions of users of that information, and the mere fact that many users take similar actions on the basis of reported information does not demonstrate a lack of neutrality. The Board does not attempt to encourage or predict specific actions of users. If financial information is biased in a way that encourages users to take or avoid predetermined actions, that information is not neutral.

Can faithful representation be empirically measured?

BC3.30 Empirical accounting researchers have accumulated considerable evidence supporting relevant and faithfully represented financial information through correlation with changes in the market prices of entities' equity or debt instruments. However, such studies have not provided techniques for empirically measuring faithful representation apart from relevance.

BC3.31 Both previous frameworks discussed the desirability of providing statistical information about how faithfully a financial measure is represented. That would not be unprecedented. Other statistical information is sometimes reflected in financial reports. For example, some entities disclose value at risk from derivative financial instruments and similar positions. The Board expects that the use of statistical concepts for financial reporting in some situations will continue to be important. Unfortunately, the Boards have not identified any way to quantify the faithfulness of the representations in a financial report.

Enhancing Qualitative Characteristics

Comparability

BC3.32 Comparability was an important concept in both Concepts Statement 2 and the *Framework* (1989), but the two previous frameworks disagreed on its importance. Concepts Statement 2 described comparability as a quality of the relationship between two or more pieces of information that, although important, is secondary to relevance and faithful representation. The *Framework* (1989) stated that comparability is as important as relevance and faithful representation.[2]

BC3.33 Relevant and faithfully represented information is most useful if it can be readily compared with similar information reported by other entities and by the same entity in other periods. One of the most important reasons that financial reporting standards are needed is to increase the comparability of reported financial information. However, even if it is not readily comparable, relevant and faithfully represented information is still useful. Comparable information, however, is not useful if it is not relevant and may mislead if it is not faithfully represented. Therefore, *comparability* is considered an enhancing qualitative characteristic instead of a fundamental qualitative characteristic.

Verifiability

BC3.34 Verifiable information can be used with confidence. Lack of verifiability does not necessarily render information useless, but users are likely to be more cautious because there is a greater risk that the information does not faithfully represent what it purports to represent.

BC3.35 The *Framework* (1989) did not explicitly include verifiability as an aspect of reliability, but Concepts Statement 2 did. However, the two frameworks are not as different as it might appear because the definition of reliability in the *Framework* (1989) contained the phrase *and can be depended upon by users,* which implies that users need assurance on the information.

BC3.36 The Discussion Paper stated that reported financial information should be verifiable to assure users that it is free from material error and bias and can be depended on to represent what it purports to represent. Therefore, verifiability was

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[2]The term *reliability* was used instead of *faithful representation*, but the meaning was intended to be similar.

considered an aspect of faithful representation. Some respondents pointed out that including verifiability as an aspect of faithful representation could result in excluding information that is not readily verifiable. Those respondents recognized that many forward-looking estimates that are very important in providing relevant financial information (for example, expected cash flows, useful lives, and salvage values) cannot be verified directly. However, excluding information about those estimates would make the financial reports much less useful. The Board agreed and repositioned verifiability as an enhancing qualitative characteristic, very desirable but not necessarily required.

Timeliness

BC3.37 Concepts Statement 2 described timeliness as an aspect of relevance. The *Framework* (1989) discussed timeliness as a constraint that could rob information of relevance. However, the substance of timeliness as discussed in the two previous frameworks was essentially the same.

BC3.38 The Discussion Paper described timeliness as an aspect of relevance. However, some respondents pointed out that timeliness is not part of relevance in the same sense that predictive and confirmatory value are. The Board was persuaded that timeliness is different from the other components of relevance.

BC3.39 Timeliness is very desirable, but it is not as critical as relevance and faithful representation. Timely information is useful only if it is relevant and faithfully represented. In contrast, relevant and faithfully represented information may still be useful (especially for confirmatory purposes) even if it is not reported in as timely a manner as would be desirable.

Understandability

BC3.40 Both Concepts Statement 2 and the *Framework* (1989) included understandability, a qualitative characteristic that enables users to comprehend the information and therefore make it useful for making decisions. Both frameworks also similarly described that for financial information to be understandable, users should have a reasonable degree of financial knowledge and a willingness to study the information with reasonable diligence.

BC3.41 Despite those discussions of understandability and users' responsibilities for understanding financial reports, misunderstanding persists. For example, some have expressed the view that a new accounting method should not be implemented because some users might not understand it, even though the new accounting method would result in reporting financial information that is useful for decision making. They imply that understandability is more important than relevance.

BC3.42 If understandability considerations were fundamental, it might be appropriate to avoid reporting information about very complicated things even if the information is relevant and faithfully represented. Classifying understandability as an enhancing qualitative characteristic is intended to indicate that information that is difficult to understand should be presented and explained as clearly as possible.

BC3.43 To clarify another frequently misunderstood point, the Conceptual Framework explains that users are responsible for *actually* studying reported financial information with reasonable diligence rather than only being *willing* to do so (which was the statement in the previous frameworks). In addition, the Conceptual Framework states that users may need to seek the aid of advisers to understand economic phenomena that particularly are complex.

Qualitative Characteristics Not Included

BC3.44 *Transparency, high quality, internal consistency, true and fair view* or *fair presentation,* and *credibility* have been suggested as desirable qualitative characteristics of financial information. However, transparency, high quality, internal consistency, true and fair view or fair presentation are different words to describe information that has the qualitative characteristics of relevance and representational faithfulness enhanced by comparability, verifiability, timeliness, and understandability. Credibility is similar but also implies trustworthiness of a reporting entity's management.

BC3.45 Interested parties sometimes suggested other criteria for standard-setting decisions, and the Board has at times cited some of those criteria as part of the rationale for some decisions. Those criteria include simplicity, operationality, practicability or practicality, and acceptability.

BC3.46 Those criteria are not qualitative characteristics. Instead, they are part of the overall weighing of benefits and costs of providing useful financial information. For example, a simpler method may be less costly to apply than a more complex method. In some circumstances, a simpler method may result in information that is essentially the same as, but somewhat less precise than, information produced by a more complex method. In that situation, a standard setter would include the decrease in faithful representation and the decrease in implementation cost in weighing benefits against costs.

The Cost Constraint on Useful Financial Reporting

BC3.47 Cost is a pervasive constraint that standard setters, as well as providers and users of financial information, should keep in mind when considering the benefits of a possible new financial reporting requirement. Cost is not a qualitative characteristic of information. It is a characteristic of the process used to provide the information.

BC3.48 The Board has attempted and continues to attempt to develop more structured methods of obtaining information about the cost of gathering and processing the information that proposed standards would require entities to provide. The primary method used is to request interested parties, sometimes formally (such as by field tests and questionnaires), to submit cost and benefit information for a specific proposal that is quantified to the extent feasible. Those requests have resulted in helpful information and have led directly to changes to proposed requirements to reduce the costs without significantly reducing the related benefits.