FASB Conceptual Framework

Statement of Financial Accounting Concepts No. 8

As Amended

August 2018

Conceptual Framework for Financial Reporting

Chapter 1, *The Objective of General Purpose Financial Reporting,* and Chapter 3, *Qualitative Characteristics of Useful Financial Information*

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

Financial Accounting Standards Board

Statement of
Financial Accounting Concepts No. 8

As Amended

August 2018

Conceptual Framework for Financial Reporting

Chapter 1, *The Objective of General Purpose Financial Reporting,* and Chapter 3, *Qualitative Characteristics of Useful Financial Information*

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

Financial Accounting Standards Board
401 MERRITT 7, PO BOX 5116, NORWALK, CONNECTICUT 06856-5116

Statements of Financial Accounting Concepts

This Statement of Financial Accounting Concepts (Concepts Statement) is one of a series of publications in the Board's Conceptual Framework for financial accounting and reporting. Since the publication of the last Concepts Statement, the Board has undertaken a project with the International Accounting Standards Board (IASB) to improve and converge their frameworks. This Concepts Statement, which includes two chapters of that new conceptual framework, supersedes FASB Concepts Statements No. 1, *Objectives of Financial Reporting by Business Enterprises,* and No. 2, *Qualitative Characteristics of Accounting Information*. As the Board and the IASB complete additional phases of their joint project, new chapters will be added to this Concepts Statement, and other Concepts Statements will be superseded.

Concepts Statements are intended to set forth objectives and fundamental concepts that will be the basis for development of financial accounting and reporting guidance. The objectives identify the goals and purposes of financial reporting. The fundamentals are the underlying concepts of financial accounting—concepts that guide the selection of transactions and other events and conditions to be accounted for; their recognition and measurement; and the means of summarizing and communicating them to interested parties. Concepts of that type are fundamental in the sense that other concepts flow from them and repeated reference to them will be necessary in establishing, interpreting, and applying accounting and reporting guidance.

The Conceptual Framework is a coherent system of interrelated objectives and fundamental concepts that prescribes the nature, function, and limits of financial accounting and reporting and that is expected to lead to consistent guidance. It is intended to serve the public interest by providing structure and direction to financial accounting and reporting to facilitate the provision of unbiased financial and related information. That information helps capital and other markets to function efficiently in allocating scarce resources in the economy and society.

Establishment of objectives and identification of fundamental concepts will not directly solve financial accounting and reporting problems. Rather, objectives give direction, and concepts are tools for solving problems.

The Board itself is likely to be the most direct beneficiary of the guidance provided by Concepts Statements. They will guide the Board in developing accounting and reporting guidance by providing the Board with a common foundation and basic reasoning on which to consider merits of alternatives.

However, knowledge of the objectives and concepts the Board will use in developing new guidance also should enable those who are affected by or interested in generally accepted accounting principles (GAAP) to understand better the purposes, content, and characteristics of information provided by financial accounting and reporting. That knowledge is expected to enhance the usefulness of, and confidence in, financial accounting and reporting. The objectives and fundamental concepts also may provide some guidance in analyzing new or emerging problems of financial accounting and reporting in the absence of applicable authoritative pronouncements.

Concepts Statements are not part of the *FASB Accounting Standards Codification*™, which is the source of authoritative GAAP recognized by the FASB to be applied by nongovernmental entities (Topic 105, Generally Accepted Accounting Principles). Rather, Concepts Statements describe concepts that will underlie guidance on future financial accounting practices and in due course will serve as a basis for evaluating existing guidance and practices.

The Board recognizes that in certain respects current generally accepted accounting principles may be inconsistent with those that may derive from the objectives and fundamental concepts set forth in Concepts Statements. However, a Concepts Statement does not (a) require a change in existing U.S. GAAP; (b) amend, modify, or interpret the Accounting Standards Codification; or (c) justify either changing existing generally accepted accounting and reporting practices or interpreting the Accounting Standards Codification based on personal interpretations of the objectives and concepts in the Concepts Statements.

Because a Concepts Statement does not establish U.S. GAAP for the disclosure of financial information outside of financial statements in published financial reports, it is not intended to invoke application of Rule 203 or 204 of the Rules of Conduct of the Code of Professional Ethics of the American Institute of Certified Public Accountants (or successor rules or arrangements of similar scope and intent).*

A Concepts Statement may be amended, superseded, or withdrawn by appropriate action under the Board's *Rules of Procedure.*

---

*Rule 203 prohibits a member of the American Institute of Certified Public Accountants from expressing an opinion that financial statements conform with generally accepted accounting principles if those statements contain a material departure from an accounting principle promulgated by the Financial Accounting Standards Board, unless the member can demonstrate that because of unusual circumstances the financial statements otherwise would have been misleading. Rule 204 requires members of the Institute to justify departures from guidance promulgated by the Financial Accounting Standards Board for the disclosure of information outside of financial statements in published financial reports.

Statement of Financial Accounting Concepts No. 8

As Amended

Conceptual Framework for Financial Reporting

August 2018

CONTENTS

Paragraph Numbers

Chapter 1: The Objective of General Purpose Financial Reporting...... OB1–OB21
Introduction OB1
Objective, Usefulness, and Limitations of General Purpose Financial Reporting OB2–OB11
Information about a Reporting Entity's Economic Resources, Claims, and Changes in Resources and Claims OB12–OB21
Economic Resources and Claims OB13–OB14
Changes in Economic Resources and Claims OB15–OB21
Financial Performance Reflected by Accrual Accounting OB17–OB19
Financial Performance Reflected by Past Cash Flows OB20
Changes in Economic Resources and Claims Not Resulting from Financial Performance OB21
Appendix: Basis for Conclusions for Chapter 1 .... BC1.1–BC1.35
Introduction BC1.1–BC1.2
Background BC1.3
General Purpose Financial Reporting BC1.4–BC1.7
Financial Reporting of the Reporting Entity BC1.8
Primary Users BC1.9–BC1.23
Should There Be a Primary User Group? BC1.14
Why Are Existing and Potential Investors, Lenders, and Other Creditors Considered the Primary Users? BC1.15–BC1.17
Should There Be a Hierarchy of Users? BC1.18
Information Needs of Other Users Who Are Not within the Primary User Group BC1.19–BC1.23
Management's Information Needs BC1.19
Regulators' Information Needs BC1.20–BC1.23
Usefulness for Making Decisions BC1.24–BC1.30

Paragraph Numbers

The Objective of Financial Reporting for Different Types of Entities BC1.29–BC1.30
Information about a Reporting Entity's Resources, Claims against That Entity, and Changes in Resources and Claims BC1.31–BC1.35
The Significance of Information about Financial Performance BC1.31–BC1.33
Financial Position and Solvency BC1.34–BC1.35

Chapter 2: (Reserved for the Chapter on the Reporting Entity) .... XX–XX

Chapter 3: Qualitative Characteristics of Useful Financial Information QC1–QC39
Introduction QC1–QC3
Qualitative Characteristics of Useful Financial Information QC4–QC34
Fundamental Qualitative Characteristics QC5–QC18
Relevance QC6–QC11
Materiality QC11–QC11B
Faithful Representation QC12–QC16
Applying the Fundamental Qualitative Characteristics QC17–QC18
Enhancing Qualitative Characteristics QC19–QC34
Comparability QC20–QC25
Verifiability QC26–QC28
Timeliness QC29
Understandability QC30–QC32
Applying the Enhancing Qualitative Characteristics QC33–QC34
The Cost Constraint on Useful Financial Reporting QC35–QC39
Appendix: Basis for Conclusions for Chapter 3 .... BC3.1–BC3.48
Introduction BC3.1–BC3.3
Background BC3.3
The Objective of Financial Reporting and the Qualitative Characteristics of Useful Financial Information BC3.4–BC3.7
Fundamental and Enhancing Qualitative Characteristics BC3.8–BC3.43
Fundamental Qualitative Characteristics BC3.11–BC3.31
Relevance BC3.11–BC3.18
Predictive and Confirmatory Value BC3.14–BC3.15
The Difference between Predictive Value and Related Statistical Terms BC3.16
Materiality BC3.17–BC3.18D

Paragraph
Numbers

Faithful Representation BC3.19–BC3.31
Replacement of the Term *Reliability* BC3.20–BC3.25
Substance over Form BC3.26
Prudence (Conservatism) and Neutrality BC3.27–BC3.29
Can Faithful Representation Be Empirically Measured? BC3.30–BC3.31
Enhancing Qualitative Characteristics BC3.32–BC3.43
Comparability BC3.32–BC3.33
Verifiability BC3.34–BC3.36
Timeliness BC3.37–BC3.39
Understandability BC3.40–BC3.43
Qualitative Characteristics Not Included BC3.44–BC3.46
The Cost Constraint on Useful Financial Reporting BC3.47–BC3.48

Statement of Financial Accounting Concepts No. 8

As Amended

Conceptual Framework for Financial Reporting

CHAPTER 1: THE OBJECTIVE OF GENERAL PURPOSE FINANCIAL REPORTING

Introduction

OB1. The objective of general purpose financial reporting forms the foundation of the Conceptual Framework. Other aspects of the Conceptual Framework—a reporting entity concept; the qualitative characteristics of, and the constraints on, useful financial information; elements of financial statements; recognition, measurement; presentation; and disclosure—flow logically from the objective.

Objective, Usefulness, and Limitations of General Purpose Financial Reporting

OB2. The objective of general purpose financial reporting[1] 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. Those decisions involve buying, selling, or holding equity and debt instruments and providing or settling loans and other forms of credit.

OB3. Decisions by existing and potential investors about buying, selling, or holding equity and debt instruments depend on the returns that they expect from an investment in those instruments; for example, dividends, principal and interest payments, or market price increases. Similarly, decisions by existing and potential lenders and other creditors about providing or settling loans and other forms of

[1]Throughout this Conceptual Framework, the terms *financial reports* and *financial reporting* refer to *general purpose financial reports* and *general purpose financial reporting* unless specifically indicated otherwise.

credit depend on the principal and interest payments or other returns that they expect. Investors', lenders', and other creditors' expectations about returns depend on their assessment of the amount, timing, and uncertainty of (the prospects for) future net cash inflows to the entity. Consequently, existing and potential investors, lenders, and other creditors need information to help them assess the prospects for future net cash inflows to an entity.

OB4. To assess an entity's prospects for future net cash inflows, existing and potential investors, lenders, and other creditors need information about the resources of the entity, claims against the entity, and how efficiently and effectively the entity's management and governing board[2] have discharged their responsibilities to use the entity's resources. Examples of such responsibilities include protecting the entity's resources from unfavorable effects of economic factors such as price and technological changes and ensuring that the entity complies with applicable laws, regulations, and contractual provisions. Information about management's discharge of its responsibilities also is useful for decisions by existing investors, lenders, and other creditors who have the right to vote on or otherwise influence management's actions.

OB5. Many existing and potential investors, lenders, and other creditors cannot require reporting entities to provide information directly to them and must rely on general purpose financial reports for much of the financial information they need. Consequently, they are the primary users to whom general purpose financial reports are directed.

OB6. However, general purpose financial reports do not and cannot provide all of the information that existing and potential investors, lenders, and other creditors need. Those users need to consider pertinent information from other sources, for example, general economic conditions and expectations, political events and political climate, and industry and company outlooks.

OB7. General purpose financial reports are not designed to show the value of a reporting entity; but they provide information to help existing and potential investors, lenders, and other creditors to estimate the value of the reporting entity.

OB8. Individual primary users have different, and possibly conflicting, information needs and desires. The Board, in developing financial reporting standards, will seek to provide the information set that will meet the needs of the maximum number of primary users. However, focusing on common information needs does not prevent the reporting entity from including additional information that is most useful to a particular subset of primary users.

[2]Throughout this Conceptual Framework, the term *management* refers to *management and the governing board of an entity* unless specifically indicated otherwise.

OB9. The management of a reporting entity also is interested in financial information about the entity. However, management need not rely on general purpose financial reports because it is able to obtain the financial information it needs internally.

OB10. Other parties, such as regulators and members of the public other than investors, lenders, and other creditors, also may find general purpose financial reports useful. However, those reports are not primarily directed to these other groups.

OB11. To a large extent, financial reports are based on estimates, judgments, and models rather than exact depictions. The Conceptual Framework establishes the concepts that underlie those estimates, judgments, and models. The concepts are the goal towards which the Board and preparers of financial reports strive. As with most goals, the Conceptual Framework's vision of ideal financial reporting is unlikely to be achieved in full, at least not in the short term, because it takes time to understand, accept, and implement new ways of analyzing transactions and other events. Nevertheless, establishing a goal towards which to strive is essential if financial reporting is to evolve so as to improve its usefulness.

Information about a Reporting Entity's Economic Resources, Claims, and Changes in Resources and Claims

OB12. General purpose financial reports provide information about the financial position of a reporting entity, which is information about the entity's economic resources and the claims against the reporting entity. Financial reports also provide information about the effects of transactions and other events that change a reporting entity's economic resources and claims. Both types of information provide useful input for decisions about providing resources to an entity.

Economic Resources and Claims

OB13. Information about the nature and amounts of a reporting entity's economic resources and claims can help users to identify the reporting entity's financial strengths and weaknesses. That information can help users to assess the reporting entity's liquidity and solvency, its needs for additional financing, and how successful it is likely to be in obtaining that financing. Information about priorities and payment requirements of existing claims helps users to predict how future cash flows will be distributed among those with a claim against the reporting entity.

OB14. Different types of economic resources affect a user's assessment of the reporting entity's prospects for future cash flows differently. Some future cash flows result directly from existing economic resources, such as accounts receivable. Other cash flows result from using several resources in combination to produce and market goods or services to customers. Although those cash flows cannot be identified with individual economic resources (or claims), users of financial reports need to know the nature and amount of the resources available for use in a reporting entity's operations.

Changes in Economic Resources and Claims

OB15. Changes in a reporting entity's economic resources and claims result from that entity's financial performance (see paragraphs OB17–OB20) and from other events or transactions, such as issuing debt or equity instruments (see paragraph OB21). To properly assess the prospects for future cash flows from the reporting entity, users need to be able to distinguish between both of these changes.

OB16. Information about a reporting entity's financial performance helps users to understand the return that the entity has produced on its economic resources. Information about the return the entity has produced provides an indication of how well management has discharged its responsibilities to make efficient and effective use of the reporting entity's resources. Information about the variability and components of that return also is important, especially in assessing the uncertainty of future cash flows. Information about a reporting entity's past financial performance and how its management discharged its responsibilities usually is helpful in predicting the entity's future returns on its economic resources.

Financial Performance Reflected by Accrual Accounting

OB17. Accrual accounting depicts the effects of transactions, and other events and circumstances on a reporting entity's economic resources and claims in the periods in which those effects occur, even if the resulting cash receipts and payments occur in a different period. This is important because information about a reporting entity's economic resources and claims and changes in its economic resources and claims during a period provides a better basis for assessing the entity's past and future performance than information solely about cash receipts and payments during that period.

OB18. Information about a reporting entity's financial performance during a period, reflected by changes in its economic resources and claims other than by obtaining additional resources directly from investors and creditors (see paragraph OB21), is useful in assessing the entity's past and future ability to generate net cash inflows. That information indicates the extent to which the reporting entity has increased its available economic resources, and thus its capacity for generating net cash inflows through its operations rather than by obtaining additional resources directly from investors and creditors.

OB19. Information about a reporting entity's financial performance during a period also may indicate the extent to which events such as changes in market prices or interest rates have increased or decreased the entity's economic resources and claims, thereby affecting the entity's ability to generate net cash inflows.

Financial Performance Reflected by Past Cash Flows

OB20. Information about a reporting entity's cash flows during a period also helps users to assess the entity's ability to generate future net cash inflows. It indicates how the reporting entity obtains and spends cash, including information about its borrowing and repayment of debt, cash dividends or other cash distributions to investors, and other factors that may affect the entity's liquidity or solvency. Information about cash flows helps users understand a reporting entity's operations, evaluate its financing and investing activities, assess its liquidity or solvency, and interpret other information about financial performance.

Changes in Economic Resources and Claims Not Resulting from Financial Performance

OB21. A reporting entity's economic resources and claims also may change for reasons other than financial performance, such as issuing additional ownership shares. Information about this type of change is necessary to give users a complete understanding of why the reporting entity's economic resources and claims changed and the implications of those changes for its future financial performance.

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

APPENDIX: BASIS FOR CONCLUSIONS FOR CHAPTER 1

Introduction

BC1.1 This basis for conclusions summarizes considerations of the Financial Accounting Standards Board (the Board) in reaching the conclusions in Chapter 1, *The Objective of General Purpose Financial Reporting*. It includes reasons for accepting some alternatives and rejecting others. Individual Board members gave greater weight to some factors than to others.

BC1.2 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

BC1.3 The Board began the process of developing the objective of financial reporting 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.

General Purpose Financial Reporting

BC1.4 Consistent with the Board's responsibilities, the Conceptual Framework establishes an objective of financial reporting and not just of financial statements. Financial statements are a central part of financial reporting, and most of the issues that the Board addresses involve financial statements. Although the scope of FASB Concepts Statement No. 1, *Objectives of Financial Reporting by Business Enterprises,* was financial reporting, the other FASB Concepts Statements focused on financial statements. The scope of the IASB's *Framework for the Preparation and Presentation of Financial Statements,* which was published by the IASB's predecessor body in 1989 (hereinafter called *Framework* (1989)), dealt with financial statements only. Therefore, for both Boards the scope of the Conceptual Framework is broader.

BC1.5 Some constituents suggested that advances in technology may make general purpose financial reporting obsolete. New technologies, for example the use of eXtensible Business Reporting Language (XBRL), may make it practicable in the future for reporting entities either to prepare or to make available the information necessary for different users to assemble different financial reports to meet their individual information needs.

BC1.6 To provide different reports for different users or to make available all of the information that users would need to assemble their own custom-designed reports would be expensive. Requiring users of financial information to assemble their own reports also might be unreasonable because many users would need to have a greater understanding of accounting than they have now. Therefore, the Board concluded for now that a general purpose financial report is still the most efficient and effective way to meet the information needs of a variety of users.

BC1.7 In the Discussion Paper, the Board used the term *general purpose external financial reporting*. *External* was intended to convey that internal users such as management were not the intended beneficiaries for general purpose financial reporting as established by the Board. During redeliberations, the Board concluded that this term was redundant. Therefore, this chapter uses *general purpose financial reporting*.

Financial Reporting of the Reporting Entity

BC1.8 Some respondents to the Exposure Draft said that the reporting entity is not separate from its equity investors or a subset of those equity investors. This view has its roots in the days when most businesses were sole proprietorships and partnerships that were managed by their owners who had unlimited liability for the debts incurred in the course of the business. Over time, the separation between businesses and their owners has grown. The vast majority of today's businesses have legal substance separate from their owners by virtue of their legal form of organization, numerous investors with limited legal liability, and professional managers separate from the owners. Consequently, the Board concluded that financial reports should reflect that separation by accounting for the entity (and its economic resources and claims) rather than its primary users and their interests in the reporting entity.

Primary Users

BC1.9 The objective of financial reporting set out in paragraph OB2 refers to existing and potential investors, lenders, and other creditors. The description of the primary users in paragraph OB5 refers to existing and potential investors, lenders, and other creditors who cannot require reporting entities to provide information directly to them. Paragraph OB10 states that "regulators and members of the public other than investors, lenders, and other creditors" may find information in general purpose financial reports useful but clearly states that those are not the parties to whom general purpose financial reports are primarily directed.

BC1.10 Paragraph 9 of the *Framework* (1989) stated that users included "present and potential investors, employees, lenders, suppliers and other trade creditors," (and later added advisers in the discussion of investors' needs) all of which are intended to be encompassed by the phrase in paragraph OB2. Paragraph 9 of the *Framework* (1989) also included a list of other potential users such as customers, governments and their agencies, and the public, which is similar to the list in paragraph OB10 of those who may be interested in financial reports but are not primary users.

BC1.11 Paragraph 10 of the *Framework* (1989) stated that "as investors are providers of risk capital to the entity, the provision of financial statements that meet their needs will also meet most of the needs of other users that financial statements can satisfy," which might have been read to narrow the focus to investors only. However, paragraph 12 explicitly stated that the objective of financial statements is to provide information "that is useful to a wide range of users in making economic decisions." Thus, the *Framework* (1989) focused on investors' needs as representative of the needs of a wide range of users but did not explicitly identify a group of primary users.

BC1.12 FASB Concepts Statement 1 referred to "present and potential investors and creditors and other users in making rational investment, credit, and similar decisions" (paragraph 34). It also stated that "major groups of investors are equity securityholders and debt securityholders" and "major groups of creditors are suppliers of goods and services who extend credit, customers and employees with claims, lending institutions, individual lenders, and debt securityholders" (paragraph 35). One difference in emphasis from the *Framework* (1989), which emphasized providers of risk capital, is that Concepts Statement 1 referred to "both those who desire safety of investment and those who are willing to accept risk to obtain high rates of return" (paragraph 35). However, like the *Framework* (1989), Concepts Statement 1 stated that the terms investors and creditors "also may comprehend security analysts and advisors, brokers, lawyers, regulatory agencies, and others who advise or represent the interests of investors and creditors or who otherwise are interested in how investors and creditors are faring" (paragraph 35).

BC1.13 Paragraphs OB3, OB5, and OB10 differ from the *Framework* (1989) and Concepts Statement 1 for two reasons—to eliminate differences between the *Framework* (1989) and Concepts Statement 1 and to be more direct by focusing on users making decisions about providing resources (but not to exclude advisors). The reasons are discussed in paragraphs BC1.15–BC1.24.

Should There Be a Primary User Group?

BC1.14 The Discussion Paper and the Exposure Draft proposed identifying a group of primary users of financial reports. Some respondents to the Exposure Draft said that other users who have not provided and are not considering providing resources to the entity, use financial reports for a variety of reasons. The Board sympathized with their information needs but concluded that without a defined group of primary users, the Conceptual Framework would risk becoming unduly abstract or vague.

Why Are Existing and Potential Investors, Lenders, and Other Creditors Considered the Primary Users?

BC1.15 Some respondents to the Discussion Paper and the Exposure Draft suggested that the primary user group should be limited to existing shareholders or the controlling entity's majority shareholders. Others said that the primary users should be existing shareholders and creditors and that financial reports should focus on their needs.

BC1.16 The reasons why the Board concluded that the primary user group should be the existing and potential investors, lenders, and other creditors of a reporting entity are:

a. Existing and potential investors, lenders, and other creditors have the most critical and immediate need for the information in financial reports and many cannot require the entity to provide the information to them directly.
b. The Board's and the IASB's responsibilities require them to focus on the needs of participants in capital markets, which include not only existing investors, but also potential investors and existing and potential lenders and other creditors.
c. Information that meets the needs of the specified primary users is likely to meet the needs of users both in jurisdictions with a corporate governance model defined in the context of shareholders and those with a corporate governance model defined in the context of all types of stakeholders.

BC1.17 Some respondents expressed the view that the specified primary user group was too broad and that it would result in too much information in the financial reports. However, *too much* is a subjective judgment. In developing financial reporting requirements that meet the objective of financial reporting, the Boards will rely on the qualitative characteristics of, and the cost constraint on, useful financial information to provide discipline to avoid providing too much information.

Should There Be a Hierarchy of Users?

BC1.18 Some respondents to the Exposure Draft who supported the composition of the primary user group also recommended that the Board should establish a hierarchy of primary users because investors, lenders, and other creditors have different information needs. However, the Board observed that individual users may have information needs and desires that are different from, and possibly conflict with, those of other users with the same type of interest in the reporting entity. General purpose financial reports are intended to provide common information to users and cannot accommodate every request for information. The Board will seek the information set that is intended to meet the needs of the maximum number of users in cost-beneficial ways.

Information Needs of Other Users Who Are Not within the Primary User Group

Management's Information Needs

BC1.19 Some constituents questioned the interaction between general purpose financial reporting and management's needs. The Board stated that some of the information directed to the primary users is likely to meet some of management's needs but not all of them. However, management has the ability to access additional financial information, and consequently, general purpose financial reporting need not be directed explicitly to management.

Regulators' Information Needs

BC1.20 Some constituents said that maintaining financial stability in capital markets (the stability of a country's or region's economy or financial systems) should be an objective of financial reporting. They stated that financial reporting should focus on the needs of regulators and fiscal policy decision makers who are responsible for maintaining financial stability.

BC1.21 Other constituents opposed establishing an objective to maintain financial stability. They said that financial statements should present the economic reality of the reporting entity with as little bias as possible but that such a presentation is not necessarily inconsistent with a financial stability objective. By presenting economic reality, financial statements could lead to more informed decision making and, thereby, support financial stability even if that is not the primary aim.[3]

BC1.22 However, advocates of a financial stability objective had a different outcome in mind. They did not encourage the Board to require reporting entities to provide information for use by regulators and fiscal policy decision makers. Instead, they recommended that the Board consider the consequences of new financial reporting standards for the stability of the world's economies and financial systems and, at least at times, assign greater weight to that objective than to the information needs of investors, lenders, and other creditors.

BC1.23 The Board acknowledged that the interests of investors, lenders, and other creditors often overlap with those of regulators. However, expanding the objective of financial reporting to include maintaining financial stability could at times create conflicts between the objectives that the Board is not well equipped to resolve. For example, some may take the view that the best way to maintain financial stability is to require entities not to report or to delay reporting some changes in asset or liability values. That requirement almost certainly would result in depriving investors, lenders, and other creditors of information that they need. The only way to avoid conflicts would be to eliminate or deemphasize the existing objective of providing information to investors, lenders, and other creditors. The Board concluded that eliminating that objective would be inconsistent with its basic mission, which is to serve the information needs of participants in capital markets. The Board also noted that providing relevant and faithfully represented financial information can improve users' confidence in the information and, thus, contribute to promoting financial stability.

Usefulness for Making Decisions

BC1.24 Both the Board's and the IASB's previous frameworks focused on providing information that is useful in making economic decisions as the fundamental objective of financial reporting. Those frameworks also state that financial information that is useful in making economic decisions would also be helpful in assessing how management has fulfilled its stewardship responsibility.

BC1.25 The Discussion Paper that led to this chapter stated that the objective of financial reporting should focus on resource allocation decisions. Although most respondents to the Discussion Paper agreed that providing useful information for decision making was the appropriate objective, they said that investors, lenders, and other creditors make other decisions that are aided by financial reporting information in addition to resource allocation decisions. For example, shareholders

[3]One group expressing that view was the Financial Crisis Advisory Group (FCAG). The FCAG comprised approximately 20 senior leaders with broad experience in international financial markets and an interest in the transparency of financial reporting information. The FCAG was formed in 2009 to advise the Board and the IASB about the standard-setting implications of the financial crisis and potential changes in the global regulatory environment.

who vote on whether to retain directors or replace them, and on how members of management should be remunerated for their services, need information on which to base their decisions. Shareholders' decision-making process may include evaluating how management of the entity performed against management in competing entities in similar circumstances.

BC1.26 The Board agreed with these respondents and noted that, in most cases, information designed for resource allocation decisions also would be useful for assessing management's performance. Therefore, in the Exposure Draft leading to this chapter, the Board proposed that the objective of financial reporting is to provide financial information about the reporting entity that is useful to present and potential investors, lenders, and other creditors in making decisions in their capacity as capital providers. The Exposure Draft also described the role financial statements can have in supporting decisions related to the stewardship of an entity's resources.

BC1.27 The Exposure Draft discussed the *Objective of Financial Reporting* and *Decision Usefulness* in separate sections. The Board combined those two sections in this chapter because usefulness in making decisions is the objective of financial reporting. Consequently, both sections addressed the same points and provided more detail than was necessary. Combining those two sections resulted in eliminating the separate subsections on usefulness in assessing cash flow prospects and usefulness in assessing stewardship. The Board did not intend to imply that assessing prospects for future cash flow or assessing the quality of management's stewardship is more important than the other. Both are important for making decisions about providing resources to an entity, and information about stewardship also is important for resource providers who have the ability to vote on, or otherwise influence, management's actions.

BC1.28 The Board decided not to use the term *stewardship* in this chapter because there would be difficulties in translating it into other languages. Instead, the Board described what stewardship encapsulates. Accordingly, the objective of financial reporting acknowledges that users make resource allocation decisions as well as decisions as to whether management has made efficient and effective use of the resources provided.

The Objective of Financial Reporting for Different Types of Entities

BC1.29 The Board also considered whether the objective of general purpose financial reporting should differ for different types of entities. Possibilities include the following:

a. Smaller entities versus larger entities
b. Entities with listed (publicly traded) debt or equity financial instruments versus those without such instruments
c. Closely held entities versus those with widely dispersed ownership.

BC1.30 External users of financial reporting have similar objectives, irrespective of the type of entities in which they invest. Therefore, the Board concluded that the objective of general purpose financial reports is the same for all entities. However, cost constraints and differences in activities among entities sometimes may lead the Board to permit or require differences in reporting for different types of entities.

Information about a Reporting Entity's Resources, Claims against That Entity, and Changes in Resources and Claims

The Significance of Information about Financial Performance

BC1.31 A longstanding assertion by many constituents is that a reporting entity's financial performance as represented by comprehensive income and its components is the most important information.[4] Concepts Statement 1 (paragraph 43) stated:

> The primary focus of financial reporting is information about an enterprise's performance provided by measures of comprehensive income and its components. Investors, creditors, and others who are concerned with assessing the prospects for enterprise net cash inflows are especially interested in that information.

In contrast, the *Framework* (1989) considered information on the reporting entity's financial position and financial performance of equal importance.

BC1.32 To be useful for decision making, financial reports must provide information about a reporting entity's economic resources and claims and the change during a period in economic resources and claims. A reporting entity cannot provide reasonably complete information about its financial performance (as represented by comprehensive income, profit or loss or other similar terms) without identifying and measuring its economic resources and the claims. Consequently, the Board concluded that to designate one type of information as the primary focus of financial reporting would be inappropriate.

BC1.33 In discussing the financial position of an entity, the Exposure Draft referred to *economic resources and claims on them*. The chapter uses the phrase *economic resources of the reporting entity and the claims against the reporting entity* (see paragraph OB12). The reason for the change is that, in many cases, claims against an entity are not claims on specific resources. In addition, many

---

[4]Concepts Statement 1 refers to *earnings and its components*. However, FASB Concepts Statement No. 6, *Elements of Financial Statements,* substituted the term *comprehensive income* for the term *earnings*. The latter term is reserved for a component of comprehensive income.

claims will be satisfied using resources that will result from future net cash inflows. Thus, while all claims are claims against the entity, not all are claims against the entity's existing resources.

Financial Position and Solvency

BC1.34 Some constituents have suggested that the main purpose of the statement of financial position should be to provide information that helps assess the reporting entity's solvency. The question is not whether information provided in the financial reports should be helpful in assessing solvency; clearly, it should. Assessing solvency is of interest to investors, lenders, and other creditors, and the objective of general purpose financial reporting is to provide information that is useful to them for making decisions.

BC1.35 However, some have suggested that the statement of financial position should be directed towards the information needs of lenders, other creditors, and regulators, possibly to the detriment of investors and other users. To do so would be inconsistent with the objective of serving the common information needs of the primary user group. Therefore, the Board rejected the notion of directing the statement of financial position (or any other particular financial statement) towards the needs of a particular subset of users.

CHAPTER 2: [RESERVED FOR THE CHAPTER ON THE REPORTING ENTITY]

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[5] 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.

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*.

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

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[5a] 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).

[5a]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.[6]

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

[6]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.