The qualitative characteristics of financial information

According to the Framework 'qualitative characteristics are attributes that make the information provided in financial statements useful to users.' The Framework identifies four principle qualitative characteristics. These are summarized in Figure 6.1:

- **Understandability**, including taking into consideration users’ abilities, and aggregation and classification of information.
- **Relevance**, including having predictive value and confirmatory value.
- **Reliability**, including faithful representation, being neutral, free from material error, complete and prudent.
- **Comparability**, including consistency and disclosure.

**Figure 6.1** Diagram showing the four principle qualitative characteristics of financial information
The ASB developed a diagram showing the qualitative characteristics of financial information and how these characteristics are related to each other. This is shown in Figure 6.2. Though this book focuses on the international framework for accounting, this diagram is reproduced as it is an excellent aide-memoire. There is one difference between the ASB’s interpretation of the qualitative characteristics of useful information and the IASB’s interpretation. According to the ASB’s (1999) Statement of Principles for Financial Reporting, as shown by the diagram (Figure 6.1), there is a threshold quality (of materiality); whereas the Framework includes materiality as being an attribute of relevance, that is, only material information is relevant.

Each of the principal qualitative characteristics of useful accounting information as identified in the Framework is now explained.

### Understandability

Understandability includes users’ abilities and aggregation and classification. According to the Framework ‘information provided by financial statements needs to be readily understandable by users’ – in other words, users need to be able to perceive its significance. The Framework states that those preparing financial statements are entitled to assume that users have a reasonable knowledge of business, economic activities and accounting and a willingness to study with reasonable diligence the information provided. To aid understandability, financial information is aggregated and classified according to standard disclosure formats (the statement of profit and loss and the statement of financial position). It was explained in Chapter 5 ‘Accounting Principles, Concepts and Policies’ that too much detail in financial statements can actually camouflage the real information that should be portrayed by the financial statements. The adage ‘one cannot see the wood for the trees’ captures this issue. Each entity
has numerous different ledger accounts; indeed, large companies will have thousands of these. To provide a list of all the balances would be meaningless to users. For example, the benefit of providing a list of all the credit customer balances at the year end is limited, whereas a total figure for all the trade receivables does provide information that can be of use to users. They can compare the trade receivables this year to those last year. This will give some indication as to how credit management has changed over time.

Obtain the financial statements for Tesco plc, Ryanair plc, Diageo plc and Morrison Supermarkets plc. Go to the pages showing the statement of comprehensive income and statement of financial position. Note the standardized presentation adopted by all of the companies. They are following the presentation rules set out in IAS 1. This consistent format aids understandability.

6.3 Relevance

According to the Framework information is relevant if it has ‘the ability to influence the economic decisions of users by helping them to evaluate past, present or future events or confirming, or correcting, their past evaluations.’ Therefore, according to the Framework relevant information should have predictive value or confirmatory value. Information has predictive value if it helps users to evaluate or assess past, present or future events. To have predictive value, information need not be in the form of an explicit forecast. However, the ability to make predictions from financial statements is enhanced by the manner in which the information on the past is presented. For this reason, comparatives are provided and exceptional, one-off and abnormal items are identified separately in the financial statements from normal activities. In addition, transactions involving newly acquired businesses, or businesses that are being disposed of, are reanalysed and separately disclosed from transactions from continuing operations. Therefore, a diligent user can determine changes in the performance and financial position of the entity that resulted from normal activities that are expected to continue into the future.

Information has confirmatory value if it helps users to confirm or correct their past evaluations and assessments. Information may have both predictive and confirmatory value. Though not mentioned in the Framework, it is commonly considered that relevant information is more relevant when it is provided in a timely manner as it is more likely to influence decision-making (timeliness concept).

Materiality

As mentioned in the previous chapter, materiality is an underlying accounting concept. According to the Framework the relevance of information is affected by its nature and materiality.

Materiality provides guidance as to how a transaction or item of information should be classified in financial statements and/or whether it should be disclosed separately rather than being aggregated with other similar items. This depends on whether the item is of a significant amount, relative to the size of the enterprise. Whether or not a transaction or item is material or significant is generally taken to be a matter of professional judgement. In practice, this is usually regarded as dependent on how large the amount is in relation to an entity’s total sales revenue, its profitability, the value of its assets or other items of the same type. However, sometimes an item is taken as not being material simply because the absolute amount is small.

A common application of materiality concerns whether an item of expenditure is to be regarded as a non-current asset or an expense. Where the amount is not material, the item would be treated as an
expense even though it is expected to have a useful life of more than one accounting period and thus normally regarded as a non-current asset (e.g. relatively inexpensive tools (a spanner), sundry items of office equipment/stationery (hole punch, stapler) and sundry fixtures and fittings (picture hooks)).

Another common application of materiality relates to the separate disclosure of certain items in financial statements. There are numerous references to materiality in the Companies Act 2006, IFRSs that require separate disclosure of items such as plant hire charges and rents receivable, where the amounts are material. In most instances separate disclosure of an income or an expense is required if it is considered that the separate disclosure will be useful to users when making economic decisions in respect of the entity.

A related, but slightly different, way of explaining materiality is in terms of the degree of aggregation of data in financial statements. Users are unable to assimilate large amounts of detailed information. This necessitates considerable aggregation of data. Materiality provides guidance on what transactions are to be aggregated by virtue of its specifying which items should be disclosed separately.

Finally, another interpretation of materiality concerns whether the separate disclosure of certain items is likely to influence decisions made by the users of financial statements. One criterion that can be used to decide whether an item is material is whether or not it may be expected to influence the judgements, decisions or actions of users of financial statements. If this is expected to occur, then the item is said to be material and should be disclosed separately from other similar items. This interpretation of materiality is contained in the Framework that states that ‘information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of financial statements. Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement. Thus, materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which information must have if it is to be useful.’

Methods of determining materiality levels

The principal factors to be taken into account when determining if information is material are set out below. It will usually be a combination of these factors, rather than any one in particular, that will determine materiality.

a An item’s size is judged in the context both of the financial statements as a whole and of the other information available to users that would affect their evaluation of the financial statements. If the item is likely to influence users’ perceptions of the trends in the performance and financial position of the entity, then it is material. For example, if the item were to cause a profit to turn to a loss, then it is more likely to be material. If there are two or more similar items, the materiality of the items in aggregate as well as the materiality of the items individually needs to be considered.

b Consideration should also be given to the item’s nature. In particular, in relation to:
   i what gave rise to the item;
   ii how legal, sensitive and normal the transaction is;
   iii the potential consequences of the event or transaction underlying the item;
   iv the identity of the parties involved;
   v the particular headings and disclosures that are affected.

An example provided in the Framework is that of the reporting of a new segment. The Framework suggests that this may affect the assessment of the risks and opportunities facing the entity irrespective of the materiality of the results achieved by the new segment in the reporting period. This would be particularly important if the new segment were located in a risky country such as Afghanistan or Iraq (given the current unstable economic climates in both countries).
Reliability

According to the Framework, ‘to be useful, information must also be reliable’. Information has the quality of reliability when:

1. it is free from material error;
2. it is free from deliberate or systematic bias (i.e. it is neutral);
3. it can be depended upon by users to represent faithfully that which it either purports to represent or could reasonably be expected to represent.

To be reliable, information should faithfully represent the underlying transaction or event, reflect the substance of the underlying transaction or event, be neutral (free from bias and material error), be prudent and complete. These attributes are now discussed in more detail.

Free from material error

Though not mentioned in the Framework, the UK equivalent, the ASB's Statement of Principles for Financial Reporting, states that to be reliable and to faithfully represent what it purports to, information should also be free from material error. Information that contains a material error can cause the financial statements to be false or misleading and thus unreliable and deficient in terms of their relevance.

Neutrality

According to the Framework, to be reliable, information provided in financial statements needs to be neutral – in other words, free from bias. Financial statements are not neutral if, by the selection or presentation of information, they influence the making of a decision or judgement in order to achieve a predetermined result or outcome.

Faithful representation/substance over form

According to the Framework, reliable information is ‘information that represents faithfully the transactions and other events it either purports to represent or could reasonably be expected to represent’. It involves identifying all the rights and obligations arising from a transaction or event, and accounting for the transaction or event in a way that reflects its economic substance. Information must be accounted for and presented with regard for the economic substance of a transaction and not merely its legal form (although the effects of the legal characteristics of a transaction or other event are themselves a part of its substance and commercial effect). The legal form of a transaction or event is not always consistent with the economic reality of the transaction. For example, an entity may pass legal ownership of an item of property to another party, yet, when the circumstances are looked into in full, it may be that the entity continues to have access to all the future economic benefits of the item of property. In such circumstances, the reporting of a sale of the property would not represent faithfully the transaction entered into. In this instance it might be more appropriate to account for this as obtaining a loan using the property as security.

The classic example of the relevance of substance relates to certain types of lease, such as where a company has contracted to lease a motor vehicle at a given monthly rental for a period of, say, three years, at the end of which it has the option to purchase the vehicle for a nominal/small amount. The legal form of this transaction is a rental agreement. If the legal form were to dictate the accounting entries, the rental payments would appear as an expense in the statement of comprehensive income and the vehicle would not be included in the non-current assets on the statement of financial position. This is why such transactions are referred to as a form of off-balance-sheet finance. However, the economic substance of this transaction is the purchase of a vehicle payable by instalments, very similar to a hire purchase transaction. Thus, the substance characteristic dictates that the rental payments are not treated as an
expense; instead, they are capitalized. This means that the vehicle is recorded as the purchase of a non-
current asset and the total rental payments for the three years are shown as a finance lease liability.

To sum up, a statement of financial position should represent faithfully the transactions and other events
that give rise to assets, liabilities and owners’ equity and the statement of profit and losses should represent
faithfully the transactions that give rise to income and expenditure in the period. Therefore, a transaction
or other event is faithfully represented in the financial statements if the way in which it is recognized,
measured and presented in those statements corresponds closely to the economic effect of that transaction
or event.

Prudence

Prudence is historically one of the fundamental accounting concepts as discussed in the previous
chapter. The crux of this concept is that preparers of accounting information should exercise prudent
views when making judgements about uncertain items such as provisions for doubtful debts, asset
lives or the number of warranty claims that might occur. It is also highlighted as one of the qualitative
characteristics of accounting information. According to the Framework information included in
financial statements should be prudent. The Framework defines prudence as ‘the inclusion of a degree
of caution in the exercise of the judgements needed in making the estimates required under conditions
of uncertainty, such that assets and income are not overstated and liabilities and expenses are not
understated’. In the past more emphasis was placed on ensuring that assets and incomes were not
overstated. However, this is no longer the case, as prudence had been used in the past as a reason to
overstate liabilities (provisions) and expenses, particularly in years when the entity performed well.
The Framework makes particular reference to this by stating ‘the exercise of prudence does not allow,
for example, the creation of hidden reserves or excessive provisions, the deliberate understatement
of assets or income, or the deliberate overstatement of liabilities or expenses, because the financial
statements would not be neutral and, therefore, not have the quality of reliability’. An example of where
prudence was used inappropriately to the extent that it undermined the reliability of the financial state-
ments is now provided.

REAL WORLD

EXAMPLE

6.1

Nortel — accounting irregularities involving the
manipulation of reserves to obtain bonuses

‘In November 2002, three senior managers of Nortel – Dunn, Beatty and Gollogly – learned that Nortel
was carrying over $300 million in excess reserves. Dunn, Beatty and Gollogly did not release these excess
reserves into income as required under US GAAP. Instead, they concealed their existence and maintained
them for later use. Further, in early January 2003, Beatty, Dunn and Gollogly directed the establishment
of yet another $151 million in unnecessary reserves during the 2002 year-end closing process to avoid
posting a profit and paying bonuses earlier than Dunn had predicted publicly. These reserve manipula-
tions erased Nortel’s pro forma profit for the fourth quarter of 2002 and caused it to report a loss instead.

In the first and second quarters of 2003 Dunn, Beatty and Gollogly directed the release of at least $490
million of excess reserves specifically to boost earnings, fabricate profits and pay bonuses. These efforts
turned Nortel’s first quarter 2003 loss into a reported profit under US GAAP, which allowed Dunn to
claim that he had brought Nortel to profitability a quarter ahead of schedule. In the second quarter of
2003, their efforts largely erased Nortel’s quarterly loss and generated a pro forma profit. In both quarters,
Nortel posted sufficient earnings to pay tens of millions of dollars in so-called “return to profitability”
bonuses, largely to a select group of senior managers.’

Prudence is deeply embedded in accounting and possibly even in the personality of many accountants. It is one of the main reasons why accountants are often described as conservative, prudent, cautious, pessimistic, and so on. Correctly applied, prudence refers to not overstating the profit in the statement of profit and loss and the financial position in the statement of financial position. This is achieved by making cautious estimates of items such as the amount of potential bad debts and the depreciation of non-current assets; that is, where the estimate is a range of amounts, prudence dictates that the amount entered in the financial statements will be the highest figure of a probable loss or liability, and the lowest figure of a gain or asset.

Completeness

According to the Framework, to be reliable the information in financial statements must be complete within the bounds of materiality and cost. An omission can cause the financial statements to be false or misleading and thus unreliable and deficient in terms of its relevance.

6.5 Comparability

According to the Framework, users must be able to compare the financial statements of an entity: (1) over time; and (2) relative to other entities, in order to properly assess the entity’s relative financial position, performance and changes in financial position. Therefore, financial statements should include the current year statements, the statement of comprehensive income and statement of financial position, presented beside the prior year statements (called comparatives). In the following example, Tesco plc provide their previous years income and expense figures alongside the current years items to aid comparison.

### Tesco plc

<table>
<thead>
<tr>
<th>Group income statement</th>
<th>52 weeks 2010</th>
<th>53 weeks 2009 Restated*</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Year ended 27 February 2010</strong></td>
<td>£m</td>
<td>£m</td>
</tr>
<tr>
<td><strong>Continuing operations</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Revenue (sales excluding VAT)</td>
<td>2</td>
<td>56,910</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>(52,303)</td>
<td>(49,713)</td>
</tr>
<tr>
<td>Gross profit</td>
<td>4,607</td>
<td>4,185</td>
</tr>
<tr>
<td>Administrative expenses</td>
<td>(1,527)</td>
<td>(1,252)</td>
</tr>
<tr>
<td>Profit arising on property-related items</td>
<td>3</td>
<td>377</td>
</tr>
<tr>
<td>Operating profit</td>
<td>3,457</td>
<td>3,169</td>
</tr>
<tr>
<td>Share of post-tax profits of joint ventures and associates</td>
<td>13</td>
<td>33</td>
</tr>
<tr>
<td>Finance income</td>
<td>5</td>
<td>265</td>
</tr>
<tr>
<td>Finance costs</td>
<td>5</td>
<td>(579)</td>
</tr>
<tr>
<td>Profit before tax</td>
<td>3</td>
<td>1,176</td>
</tr>
<tr>
<td>Taxation</td>
<td>6</td>
<td>(840)</td>
</tr>
<tr>
<td>Profit for the year</td>
<td>2,336</td>
<td>2,138</td>
</tr>
</tbody>
</table>

To be able to view similarly prepared financial statements over time allows users to make judgements about trends in performance and in changes in financial position and to use this information to predict into the future. This is required for economic decision-making, such as deciding whether to buy, sell or retain a holding of equity shares in the entity.

As well as providing a copy of the previous period’s statement of profit and loss and statement of financial position, the user needs to be able to ascertain if the figures have been prepared using the same methods of recognition and measurement; therefore, the material accounting policies should be disclosed and consistently applied.

**Consistency**

According to the *Framework*, consistency in the application of accounting policies is vital for producing comparable information. Any changes to the accounting policies and the impact of these changes should be disclosed (discussed in detail in Chapter 5, ‘Accounting Principles, Concepts and Policies’).

**Disclosure**

According to the *Framework*, ‘compliance with IASs, including disclosure of the accounting policies adopted by the entity, helps to achieve comparability’. To assist in the making of comparisons despite inconsistencies, users need to be able to identify any differences between:

1. the accounting policies adopted by an entity to account for some transactions relative to others;
2. the accounting policies adopted from period to period by an entity;
3. the accounting policies adopted by different entities.

Users also need to be able to assess the impact of changes in the accounting policies of the entity. Therefore, disclosures are required detailing the reason for the change, the impact and cumulative impact on two years’ statements of financial position and the opening balances.

Some academics regard disclosure as a fundamental qualitative characteristic of financial statements. In crude terms, it is argued that if companies use different accounting policies and/or these change over time (i.e. there is a lack of consistency) and/or if companies do not comply with accounting standards, this is not critical; provided there is full disclosure of how the figures are derived, users can make the necessary adjustments in order to achieve comparability. This view is in conflict with the understandability principle as users would need to have a sophisticated knowledge of accounting to perform some of the adjustments that would be required to make the financial statements comparable.

**Constraints on the qualitative characteristics**

The *Framework* explicitly refers to three underlying constraints on relevant and reliable information (timeliness, balance between benefit and cost, and balance between qualitative characteristics).
6.6 Constraints on the qualitative characteristics

Timeliness
Conflict between relevance and reliability can arise over the timeliness of information. If there is undue delay in the reporting of information making it out of date, then this will affect its relevance. On the other hand, reporting on transactions and other events before all the uncertainties involved are resolved may affect the information’s reliability. This information cannot be omitted as omitting information from the financial statements because of reliability concerns may affect the completeness, and therefore reliability of the information provided. If reporting is delayed until the underlying information is reliable, it may be of little use to users who have economic decisions to make in the interim. In achieving a balance between timeliness and relevance and reliability, the entity should take all steps possible to produce reliable information in a timely manner. The overriding consideration affecting the timing of reporting should be ‘how best to satisfy the information needs of users for economic decision-making’.

Balance between benefit and cost
The general rule laid down in the Framework is that ‘the benefits derived from information should exceed the cost of providing that information’. The evaluation of the benefits and costs is regarded as judgemental and the costs may not fall on the users who benefit from that particular piece of information. It is difficult to undertake a practical cost–benefit study on the provision of a particular type of information; nevertheless, the Framework states that the preparers and indeed standard setters should be aware of this general constraint.

Balance between qualitative characteristics
In some instances, a conflict may arise between the characteristics of relevance, reliability, comparability and understandability. In such circumstances, a trade-off needs to be found that still enables the objective of financial statements to be met. The relative importance of some of the characteristics in different instances is a matter for professional judgement. Some examples include the following:

1 Relevance and reliability. Sometimes information that is the most relevant is not the most reliable and vice versa. Choosing the amount at which to measure an asset or liability will sometimes involve such a conflict. In such circumstances, it will usually be appropriate to use the information that is the most relevant of whichever information is reliable. For example, when a realistic estimate of the impact of a transaction or an event (such as the potential damages to be paid on a legal claim) cannot be made, that fact and details of the transaction or event should be disclosed.

2 Neutrality and prudence. There can also be tension between two aspects of reliability – neutrality and prudence – because, while neutrality involves freedom from bias, prudence is a potentially biased concept that seeks to ensure that, under conditions of uncertainty, gains and assets are not overstated and losses and liabilities are not understated. This tension exists only where there is uncertainty, because it is only then that prudence needs to be exercised. When there is uncertainty, the competing demands of neutrality and prudence are reconciled by finding a balance that ensures that the deliberate and systematic understatement of income and assets and overstatement of expenses and liabilities do not occur.

3 Understandability. It may not always be possible to present a piece of relevant, reliable and comparable information in a way that can be understood by all users. However, information that is relevant and reliable should not be excluded from the financial statements simply because it is too difficult for some users to understand.

4 Consistency and relevance and reliability. Consistency should not be confused with mere uniformity. It is not an end in itself and it should not be allowed to become an impediment to the introduction of improved accounting practices and accounting standards. It is not appropriate to keep accounting for an item in the same manner as before, when a new treatment emerges that provides more relevant and reliable information.
True and fair view/fair presentation

The Framework does not specifically deal with the concept of fair presentation; however, the Framework does state that it considers that the application of the principal qualitative characteristics of information and the application of appropriate accounting standards will result in financial statements that portray a true and fair view of the entities’ financial performance and financial position.

Summary

Qualitative characteristics are the attributes that make the information provided in financial statements useful to users. According to the Framework the qualitative characteristics of financial information comprise four principal characteristics that make financial information useful. These comprise understandability, relevance, reliability and comparability. Understandability includes users’ abilities, and aggregation and classification. Relevance includes materiality, predictive value and confirmatory value. Reliability includes faithful representation, substance over form, neutrality, prudence, completeness and being free from material error. Comparability includes consistency and disclosure. There are several constraints on the qualitative characteristics that relate to timeliness, cost versus benefit, relevance versus reliability, neutrality versus prudence and understandability versus consistency.

Overall summary (conceptual framework)

The major issues considered in this chapter and in the previous chapters can be briefly summarized as follows:

1. The accounting entity is used to determine the boundaries of the organizational unit to be reported upon. The accounting entity is created as an artificial construct, and as such cannot own itself. The external owners’ interests are identified as owners’ capital (equity).

2. The life of an accounting entity is divided into accounting periods usually of a year, each seen as a separate entity. Financial statements are produced to show the results relating to a particular period. Division into periods is reflected by the emphasis given to periodic reporting.

3. Profit can be defined in terms of changes in capital represented in the statement of financial position at the start and end of the period.

Another approach is to calculate profit using a transaction-based, or a net production approach. Here, revenues are recognized in the period when they are realized and the matching principle identifies the costs to be traced to the appropriate period. Critical in this process is the classification of expenditure as either capital or revenue. Costs that are capitalized are carried forward from period to period as statement of financial position items. Assets in the statement of financial position are carried forward in anticipation of providing benefits to future periods and this may then lead to matching in those periods.

4. Recognition and measurement in financial statements involves the application of two accounting concepts – the accruals concept and the going concern assumption – as well as the selection of measurement bases, estimation techniques and accounting policies.

5. Any system of accounting for profit has to define either explicitly or implicitly three basic dimensions. These are the unit of measurement, the valuation model and the concept of capital maintenance.

6. Selecting and applying appropriate accounting policies are necessary for the proper application of the conceptual framework of accounting. To be appropriate, accounting policies should be relevant, reliable and comparable from period to period.
An asterisk after the question number indicates that there is a suggested answer on the Online Learning Centre (www.mcgraw-hill.co.uk/textbooks/thomas).

Review questions

6.1  
   a Briefly explain the nature of a qualitative characteristic of financial information.
   b Prepare a diagram showing the qualitative characteristics of financial information and the relationship between each of them as identified in the ASB Statement of Principles for Financial Reporting (1999).

6.2 Define and explain the qualitative characteristic of relevance, including its predictive value and confirmatory value.

6.3 Define and explain the qualitative characteristic of reliability, including the attributes of faithful representation, substance over form, neutrality, free from material error, completeness and prudence.

6.4 Define and explain the qualitative characteristics of comparability and understandability.

6.5 Define and explain materiality.

6.6 Describe the constraints on the qualitative characteristics of financial information.

6.7 According to the Framework there is a potential conflict between the characteristics of relevance and reliability. There can also be tension between two aspects of reliability – neutrality and prudence. Explain the nature of these conflicts/tensions and how they can be reconciled.

6.8* Define the following terms: Off-Balance sheet finance; Substance over form; Threshold quality.

References


