CHAPTER 2: THE QUALITATIVE CHARACTERISTICS OF FINANCIAL INFORMATION

LEARNING OUTCOME

At the end of the chapter, you should be able to:

TLO B1a. **Define (understand)** and **apply** qualitative accounting characteristics relating to

i. Relevance
ii. Faithful representation
iii. Comparability
iv. Verifiability
v. Timeliness
vi. Understandability

TLO B1b. **Define (understand)** and **apply** accounting concepts:

i. Materiality
ii. Substance over form
iii. Going concern
iv. Business entity concept
v. Accruals
vi. Prudence
vii. Consistency

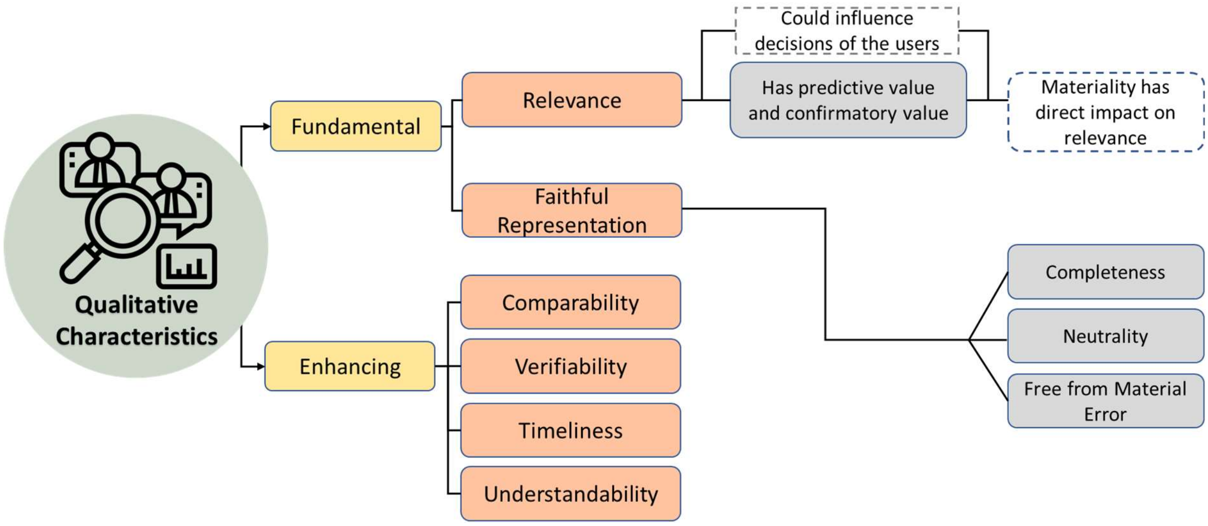
2.1 Qualitative Characteristics of Financial Information

Learning Outcome (ACCA Study Guide Area B)

B1a: Define, **understand** and **apply** qualitative characteristics.

i. Relevance
ii. Faithful representation
iii. Comparability
iv. Verifiability
v. Timeliness
vi. Understandability

Diagram 2.1: Qualitative characteristics of financial information



2.1.1 The qualitative characteristics of financial information

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

The Conceptual Framework splits qualitative characteristics into **two categories**:

Fundamental qualitative characteristics	**Enhancing** qualitative characteristics
• Relevance • Faithful representation	• Comparability • Verifiability • Timeliness • Understandability

2.1.2 Fundamental qualitative characteristics

(i) Relevance

It has the ability to influence the economic decisions of users - Information that is relevant has **predictive** or **confirmatory** value or both.

Predictive value	Confirmatory value
• Helps users to predict future outcomes	• Helps users to confirm or correct previous evaluations and assessments

The predictive value and confirmatory value of financial information are interrelated.

Example of Relevance (i)
Revenue information for the current year, which can be used as the basis for predicting revenues can also be compared with revenue predictions for the current year that were made in past years.

Materiality has a direct impact on the relevance of information.

Information is material if **omitting, misstating or obscuring** it could reasonably **be expected to influence decisions that the primary users** of general-purpose financial statements make on the basis of those financial statements, which provide financial information about a specific reporting entity.

Materiality is an **entity-specific aspect of relevance**, based on the **nature or magnitude (or both)** of the items to which the information relates in the context of an individual entity's financial report.

Example of Relevance (ii)
Shareholders are interested in the trend of dividends paid by the company. Employees or lenders might find this information not very relevant to their concerns.

(ii) Faithful Representation

To be useful, financial information must faithfully represent the phenomena that it purports to represent. Faithful representation means representation of the substance of an economic phenomenon rather than merely its legal form **(substance over form)**.

A faithful representation is, to the maximum extent possible, complete, neutral and free from error.

a) Completeness
All impacts of transactions must be recorded and not omitted (i.e., information must contain necessary descriptions and explanations).

b) Neutrality
Free from bias (i.e., Financial Statements are not neutral if, by the selection or presentation of information, thus making of a decision or judgement in order to achieve a predetermined result or outcome.)

Example of Neutrality
In deciding whether to make an allowance for a substantial doubtful account, the directors or others responsible for the decision should not be influenced by the possible impact on their personal position as regards, for example profit-related bonuses.

Neutrality is supported by the exercise of prudence. Prudence is the exercise of caution when making judgements under conditions of uncertainty. Prudence does not allow for overstatement or understatement of assets, liabilities, income or expenses.

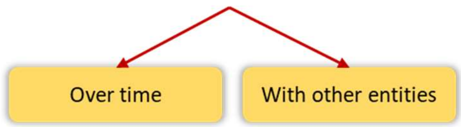
c) Free from Material Error
Free from material misstatements or omissions as material error or an omission can cause false or misleading information to the users (free from error does not mean perfectly accurate in all respects, particularly when estimates have to be made).

2.1.3 Enhancing qualitative characteristics

Enhancing qualitative characteristics are to enhance the usefulness of information that is relevant and faithful represented.

(i) Comparability

Users must be able to compare the Financial Statement of an entity:



To ensure information is comparable, there must be:

- **Consistent application** of accounting policies from one period to the next.

- **Disclosure of accounting policies** being applied so that users are able to distinguish between different accounting policies in order to be able to make a valid comparison of similar items in the account of different entities.

Example of Comparability
If certain types of tools purchased are treated as non-current assets in one period, similar tools purchased in subsequent periods should also be treated as non-current assets.

(ii) Verifiability

Information is verifiable (capable of being verify) in the sense that it should ensure credibility and objectivity. It requires that independent observers reach the same or similar conclusions that:

- is not biased or contains material errors and
- recognition of the chosen method of assessment is applied free from material error and subjectivity.

(iii) Timeliness

Timeliness means **having information available to decision makers in time** to be capable of influence decisions. (i.e., the older the information is the less useful it becomes)

(iv) Understandability

Classifying, characterising and presenting information clearly and concisely makes it understandable.

However, by excluding complex information from financial reports might make the financial report less understandable, would be incomplete and therefore potentially misleading.

Financial reports are prepared for users who have a reasonable knowledge of business and economic activities and who review and analyse the information diligently.

Check Understanding

Topic 2.1: Qualitative Characteristic

Learning Outcome (ACCA Study Guide Area B)

B1a: Define, **understand** and **apply** qualitative characteristics.

i. Relevance
ii. Faithful representation
iii. Comparability
iv. Verifiability
v. Timeliness
vi. Understandability

Question 1

According to the IASB's Conceptual Framework for Financial Reporting, **which TWO of the following are part of faithful representation?**

i. It is neutral
ii. It is relevant
iii. It is presented fairly
iv. It is free from material error

A. i and ii
B. ii and iii
C. i and iv
D. iii and iv

Question 2

Listed below are some characteristics of financial information.

i. Relevance
ii. Comparability
iii. Faithful representation
iv. Timeliness

Which of these are fundamental characteristics, according to the IASB's Conceptual Framework for Financial Reporting?

A. i and ii only
B. ii and iv only
C. iii and iv only
D. i and iii only

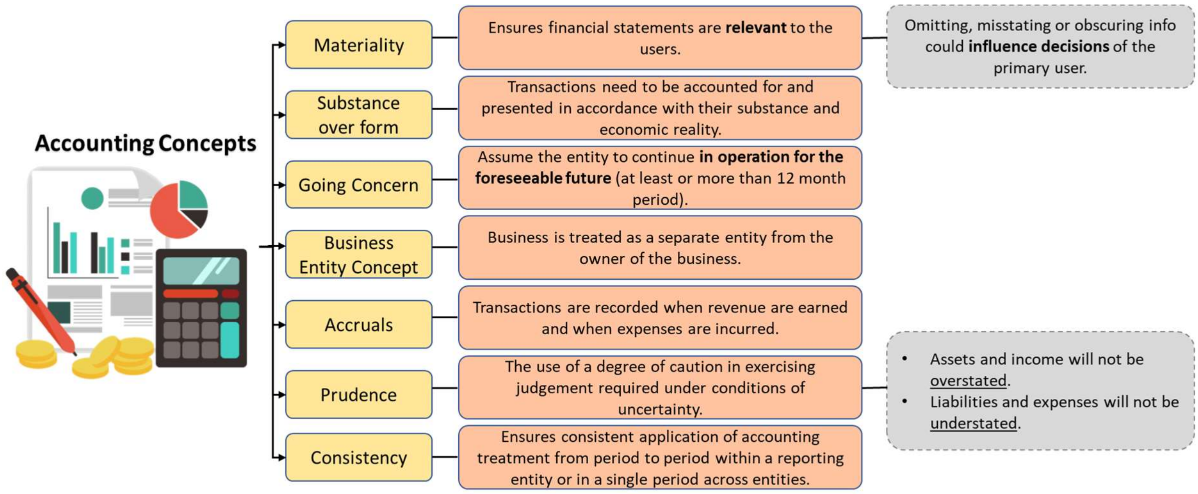
2.2 Accounting Concepts

Learning Outcome (ACCA Study Guide Area B)

B1b: Define, understand and **apply** accounting concepts.

i. Materiality
ii. Substance over form
iii. Going concern
iv. Business entity concept
v. Accruals
vi. Prudence
vii. Consistency

Diagram 2.2: Accounting concepts



2.2.1 Accounting Concepts

(i) Materiality

> **Materiality** convention ensures financial statements are **relevant** to their users.

Information is material if **omitting, misstating or obscuring** it could reasonably **be expected to influence decisions** that the **primary users** of general purpose financial statements make on the basis of those financial statements, which provide financial information about a specific reporting entity.

Certain items disclosed in the accounts are particularly sensitive. Even a small misstatement is a material error. In considering materiality, both the amount (**quantity**) and context (**quality**) must be taken into account.

Why? Ensures that the information provided is clear to the users.

Financial statements are prepared for the benefit of various user groups. It is essential that the information provided is both significant and easily understood by the various user groups. The materiality convention ensures that the information provided is clear by omitting items that are not significant to the user in understanding the overall financial position of the organization.

(ii) Substance Over Form

Transactions need to be accounted for and presented in accordance with their substance and economic reality even if their legal form is different. It may be that the legal form of a transaction differs from its real nature.

Example of Substance Over Form

If a company is acquiring a long-term asset under a hire-purchase agreement, the legal position is that ownership does not pass until the last hire-purchase payment is made. The substance over form convention is that the reality and commercial effect of the transaction are recognised - the asset is controlled by the company and is therefore included as such in the Statement of Financial Position, with a corresponding liability recognised for the unpaid amount.

(iii) Going Concern

Financial statements are normally prepared on the assumption that an entity is a going concern **in operation for the foreseeable future** (at least > 12 month period)

Hence, it is assumed that the entity has neither the intention nor the need to liquidate or curtail scale of its operations.

If such an intention or need exists, the financial statements may have to be prepared on a differs so, the basis used is disclosed. (For example, break up basis)

Assets will NOT be valued at net book value, at break up /force saleable value.

Application of Going Concern

If management determines after the reporting period:

- **Intends to liquidate** the entity or to **cease trading**, or
- It has **no realistic alternative but to do so**

It shall not prepare its financial statements on a going concern basis

Deterioration in operating results and financial position after the reporting period may indicate a need to consider whether the going concern assumption is still appropriate.

If the going concern assumption is no longer appropriate, the effect is so pervasive that this Standard requires a fundamental change in the basis of accounting, rather than an adjustment to the amounts recognised within the original basis of accounting.

Example of Going Concern

Co A is preparing its FS for the year ended 31 Dec 2010. On Jan 2011, the directors decided to sell the company's assets and liquidate the company.

Adjustment: The FS to 31 Dec 2010 should be produced on a liquidation (break up) basis, not a going concern basis.

(iv) Business Entity

For the purpose of maintaining accounting records, the business is treated as a separate entity from the owner of the business.

Accounting Perspective

Accountants regard business as a separate entity, distinct from its owners or managers. This is known as the business entity concept. This applies to a limited liability company, a partnership or a sole trader.

	A/C.	Legal
Ltd. L. Company	√	√
Partnership	√	X
Sole Trader	√	X

Legal Perspective

In the eye of law, Limited Liability Company is treated as a separate entity. But a sole trader and partnership are not legally recognized as separate from its owners.

(v) Accruals

The accruals concept requires that revenue and costs be matched in the same period. The date on which cash is paid or received is not treated as the date on which the transaction took place (to recognise accrual and prepayment).

How to differentiate between Accruals Concept and Matching Concept?

i. The matching concept is similar to the accruals concept but goes one step further
ii. It attempts to match the revenue earned in a period with the expenses consumed in earning that revenue.
iii. Expenditure has been incurred in a period, but it has not been used to generate revenue during the same period
iv. E.g. Goods purchased that remain unused to generate revenue in the period of purchase, so they are not included as part of the cost of goods sold in that period; on the assumption that they will be used to generate revenue in the future, thus, they are carried forward and matched with the sales of the future.
v. Therefore, SOPL has "Cost of Goods Sold" instead of "Purchases" as the expense item.

Exam Tips

Prudence ≠ Accruals.

- The use of a degree of caution in exercising judgement is required under conditions of uncertainty.
- Assets and income will not be overstated.
- Liabilities and expenses will not be understated.

(vi) Prudence

The exercise of caution when making judgements under conditions of uncertainty so that assets and income will not be overstated, liabilities and expenses will not be understated.

Equally, prudence does not allow for the understatement of assets or income or the overstatement of liabilities or expenses.

(vii) Consistency

Same items are required to be given similar accounting treatment either from period to period within a reporting entity or in a single period across entities.

Why? Allows valid comparisons to be made within accounting periods

It's intended to enhance financial reporting by making it easier for users to make comparisons. In that sense, it contributes towards comparability.

Examples of consistent treatments:

1. Inventory valuation (FIFO, CWA, PWA)
2. Depreciation method (SLM, RBM)

Check Understanding

Topic 2.2: Accounting Concepts

Learning Outcome (ACCA Study Guide Area B)

B1b: Define, **understand** and **apply** accounting concepts.

i. Materiality
ii. Substance over form
iii. Going concern
iv. Business entity concept
v. Accruals
vi. Prudence
vii. Consistency

Question 1

Which accounting concept should be considered if the owner of the business takes goods from inventory for his own personal use?

A. The substance over form concept
B. The accruals concept
C. The going concern concept
D. The business entity concept

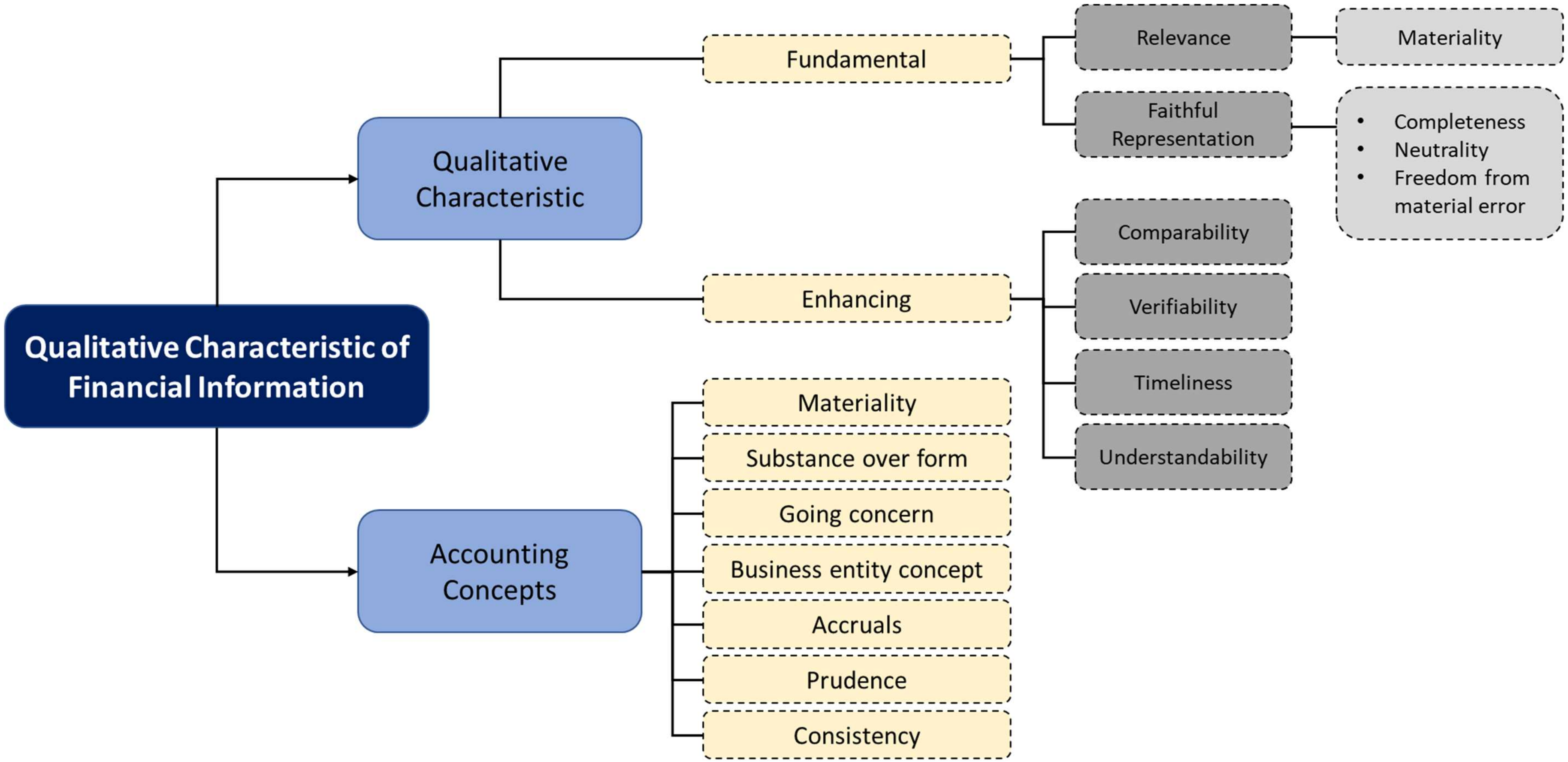
Question 2

Which of the following accounting concepts means that similar items should receive a similar accounting treatment?

A. Going concern
B. Accruals
C. Prudence
D. Consistency

2.3 Chapter 2 Summary

Diagram 2.3: Summary of the qualitative characteristic of financial information



2.4 Chapter 2 Check Understanding: Answer

Topic 2.1: Qualitative Characteristic

Answer:

1. C
2. D

Topic 2.2: Accounting Concepts

Answer:

1. D
2. D