Objectives and Qualitative Characteristics

Financial reports are designed to provide **useful information for economic decision-making** by various stakeholders, including existing and potential investors, lenders, and creditors. To be truly useful, this information must possess certain qualitative characteristics, which are broadly categorized into **fundamental characteristics** and **enhancing characteristics**. The fundamental characteristics are essential for information to be considered useful, while the enhancing characteristics improve the usefulness of information that already meets the fundamental criteria.

Fundamental Characteristics

The two **fundamental characteristics** are **relevance** and **faithful representation**. Both are required for information to be useful.

Relevance

Relevance means that information is **"capable of making a difference in the decisions made by users"**. This capacity to influence decisions is present if the information has **predictive value**, **confirmatory value**, or both. The relevance of information is also significantly affected by its **nature and materiality**.

- **Predictive Value**: This refers to the ability of information to **assist in making predictions about future events**. For instance, financial statements can help users forecast future cash flows, profitability, and overall financial stability, aiding in the formation of expectations and strategies. While information may assist in these predictions, it is important to note that the information itself is not a prediction or forecast; rather, it serves as the "raw material" for decision-makers to make their own predictions. For example, a company's strong quarterly results can predict its ability to manage future obligations. Predictive value accounting leverages forecasts and estimates to offer insights into future financial performance, which is particularly valuable in complex markets.
- **Confirmatory Value**: This characteristic means that information **provides feedback about previous decisions** that were made. It allows stakeholders to assess whether their past predictions and evaluations were accurate, thereby reinforcing or challenging their confidence in an entity's financial health and performance. For example, an income statement might help an investor decide to invest, and the subsequent year's income statement provides feedback on that investment decision. Often, the same information can be useful for both prediction and feedback, albeit in different time periods. Financial analysts use historical trends, once confirmed for accuracy, as a basis for predicting future performance, demonstrating the interaction between confirmatory and predictive values. Consistent accounting policies and standards, such as IFRS or GAAP, enhance confirmatory value by ensuring financial information is comparable over time, which is vital for tracking trends and evaluating management's stewardship. Elements like historical cost, fair value, and amortized cost contribute to confirmatory value by providing a reliable and consistent basis for evaluating past transactions and reflecting current financial conditions.

- **Materiality**: Information is considered **material if its omission or misstatement could reasonably be expected to influence a user's decision**. It is a pervasive concept in accounting and auditing. Materiality is not defined quantitatively but depends on the **size and nature** of the item in the surrounding circumstances. An item deemed immaterial is not relevant because it wouldn't affect a user's decision.
    - **Determination**: Materiality is a **key judgment area for auditors**, determined at the planning stage of an audit. It is also reassessed as the audit progresses, considering quantitative changes and qualitative factors.
    - **Benchmarks**: Auditors choose a "materiality base" or "benchmark" to calculate materiality, typically based on what is most important to the users of the financial statements and the nature of the entity and its industry.
        - For profitable entities, **Profit Before Tax (PBT)** or **Earnings Before Taxes (EBT)** is widely accepted as a primary benchmark. Materiality can range from 3% to 10% of PBT, with lower percentages for listed entities.
        - If PBT/EBT is volatile (e.g., for start-ups or loss-making entities), other metrics like **total revenues, net assets, or total assets** may be more appropriate. Investment funds, for example, often use total assets as their benchmark.
    - **Quantitative vs. Qualitative**: Materiality has both **quantitative (size)** and **qualitative (nature)** aspects. Fraud, lying, or dishonesty are often considered **always qualitatively material**, as they would certainly influence an investor's view of the company, regardless of the monetary amount.
    - **Application in Audits**: Auditors set an **overall materiality for the financial statements as a whole**. To mitigate **aggregation risk** (where many individually immaterial misstatements could collectively become material), auditors also determine **performance materiality**, which is a lower amount. Performance materiality can range from 50% to 85% of overall materiality, depending on factors like internal control deficiencies and history of misstatements. Auditors may also set even lower materiality levels for particular significant accounts or disclosures if misstatements in those areas could influence user decisions. However, some sources suggest that materiality numbers generally do not change by individual account in practice.

Faithful Representation

Faithful representation means that the financial information **"presents the true economic substance or state of the item being reported"**. It does not imply 100% accuracy, as perfection is rarely attainable. For information to faithfully represent an economic phenomenon, it must be **complete, neutral, and free from error**. An error-free representation of an irrelevant phenomenon is not useful.

- **Completeness**: Information is **complete if there is sufficient disclosure** for the reader to understand the underlying phenomenon or event. This often necessitates additional explanations in financial disclosures beyond quantitative values, such as notes to financial statements, to provide the detail users need for predictions.

- **Neutrality**: This concept suggests that information is **not biased and does not favor one particular outcome or prediction**. Achieving neutrality can be challenging due to judgments required in accounting measures and potential motivations for managers to bias reporting. The role of a professional accountant is to understand and control these biases to prevent misleading financial results. Neutrality is supported by **prudent judgment**, which is the exercise of caution under uncertainty. Prudence advises against overstating assets or income and understating liabilities or expenses, aiming for balance rather than asymmetry in standards.
- **Freedom from Error**: This criterion does not guarantee 100% accuracy but rather suggests that the **economic phenomenon is accurately described and the process for arriving at the reported amount has been properly applied**. Estimates, such as an allowance for doubtful accounts, can be considered "free from error" if a logical, consistent process was applied and adequately described, even if the final amount is not 100% certain until the future.

Enhancing Characteristics

The conceptual framework describes four additional qualitative characteristics that **enhance the usefulness of information** that is already relevant and faithfully represented.

- **Comparability**: This quality allows users to **compare financial results across different entities** (e.g., competitors) or **within the same entity across different time periods**. A key component of comparability is **consistency**, which refers to using the same accounting methods for the same items over time or across entities. While consistency aids comparability, comparability is a broader concept. It's crucial not to confuse comparability with uniformity, as fundamentally different items should be accounted for differently.
- **Verifiability**: This quality suggests that **two or more independent and knowledgeable observers could come to the same conclusion** about the reported amount of a financial statement item. This does not require complete agreement but rather agreement within a reasonable range for estimated amounts. Verification can be direct (e.g., examining an invoice) or indirect (e.g., reviewing assumptions and recalculating an estimate).
- **Timeliness**: This is a crucial concept meaning that information needs to be **current to be useful** and available to stakeholders for decision-making purposes. Investors need to know a business's economic condition in the present, though past information remains useful for tracking trends and evaluating management stewardship. Delays in issuing financial statements violate timeliness.
- **Understandability**: This characteristic implies that preparers have **classified, characterized, and presented information clearly and concisely**. It assumes that users of financial statements have a reasonable understanding of business issues and basic accounting terminology. Accountants face the challenge of crafting disclosures that are both complete and comprehensible, often requiring review by non-specialist, knowledgeable readers. Obscuring material information with immaterial information reduces understandability.

Constraints

The usefulness of financial information is also subject to constraints, primarily the **cost-benefit principle**. This principle states that **information should only be provided if the benefits outweigh the costs of preparing it**. Accountants often face trade-offs when applying the various qualitative characteristics; for example, the need for timeliness might result in less-than-optimal verifiability due to time constraints, forcing estimations. This highlights that accounting is an imperfect measurement system requiring judgment in both preparation and interpretation.