Statement of Accounting Concepts **SAC 3**
(8/90)

Qualitative Characteristics of Financial Information

Prepared by the **Public Sector Accounting Standards Board** of the **Australian Accounting Research Foundation** and the **Accounting Standards Review Board**

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STATEMENT OF ACCOUNTING CONCEPTS

SAC 3 “QUALITATIVE CHARACTERISTICS OF FINANCIAL INFORMATION”

Citation

1 This Statement may be cited as Statement of Accounting Concepts SAC 3 "Qualitative Characteristics of Financial Information".

Application and Operative Date

2 This Statement applies to each reporting entity in relation to its first reporting period that ends on or after 31 August 1990, and in relation to subsequent reporting periods.

INTRODUCTION

3 Statement of Accounting Concepts SAC 2 "Objective of General Purpose Financial Reporting" identifies the objective of general purpose financial reporting as the disclosure of information useful to users for making and evaluating decisions about the allocation of scarce resources. When general purpose financial reports meet this objective they will also be the means by which preparers of such reports discharge their accountability to those users. The purpose of this Statement is to identify those attributes (hereinafter "qualitative characteristics") that financial information should possess if it is to serve the specified objective.

4 The qualitative characteristics will provide assistance when choices have to be made between reporting policies - whether by preparers, auditors, those participating in the standard-setting process, regulators or others - and be indicative of the qualities that users can expect of the financial information provided to them.

DEFINITIONS

5 For the purposes of this Statement:

"comparability" means that quality of financial information which exists when users of that information are able to discern and evaluate similarities in, and differences between, the nature and effects of transactions and events, at one time and over time, either when assessing aspects of a single reporting entity or of a number of reporting entities;

"materiality test" means that test which is used to assess the extent to which relevant and reliable information may be omitted, misstated or not disclosed separately without having the potential to adversely affect the decisions about the allocation of scarce resources made by users of a general purpose financial report or the rendering of accountability by preparers;

"relevance" means that quality of financial information which exists when that information influences decisions by users about the allocation of scarce resources by:

(a) helping them form predictions about the outcomes of past, present or future events; and/or

(b) confirming or correcting their past evaluations;

and which enables users to assess the rendering of accountability by preparers;

"reliability" means that quality of financial information which exists when that information can be depended upon to represent faithfully, and without bias or undue error, the transactions or events that either it purports to represent or could reasonably be expected to represent; and

"understandability" means that quality of financial information which exists when users of that information are able to comprehend its meaning.

DISCUSSION

General

6 General purpose financial reporting involves making decisions about the selection of financial information to be included in general purpose financial reports, the measurement of that information and its presentation. These decisions should be consistent with the objective of general purpose financial reporting and should yield information which possesses the qualitative characteristics set out in this Statement.

Qualitative Characteristics - Selection of Financial Information

7 This Statement identifies relevance and reliability as the primary qualitative characteristics which financial information should possess in order to be the subject of general purpose financial

reporting. These characteristics may need to be balanced against each other; however, this Statement does not rank either characteristic above the other.

Relevance

8 For financial information to be relevant it must have value in terms of assisting users in making and evaluating decisions about the allocation of scarce resources and in assessing the rendering of accountability by preparers. If information is to assist users in making decisions about the allocation of scarce resources, it must assist them in making predictions about future situations and in forming expectations, and/or it must play a confirmatory role in respect of their past evaluations.

9 The predictive and confirmatory roles of financial information are inter-related. For example, financial information about the current level and structure of asset holdings will have value to users when they endeavour to assess an entity's ability to take advantage of opportunities in the market place. That same information will play a confirmatory role in respect of past predictions about the way in which the entity would be structured and about the outcome of planned operations. Analysis of the relationship between predictions and outcomes will assist users to identify the range of variables they ought to be considering when making predictions.

10 To have predictive value, financial information need not be in the form of an explicit forecast. The example given in the previous paragraph illustrates this point. It should also be noted that in that example the preparers of the information relating to asset levels and structures would have needed to make predictions about future cash flows in order to determine appropriate measurements for the assets (for example, the carrying amounts of debtors, inventories and non-current assets would need to have been assessed for recoverability). Recognition of this measurement process by users will play a part in users' predictions of cash flows.

11 Financial information may be relevant because of its nature, its nature and magnitude, or because of its magnitude in relation to its nature. In some cases, the nature of information will be sufficient to establish its relevance to users of general purpose financial reports. For example, the reporting of a new segment by a company in the private sector may affect the assessment by users of the risks and opportunities facing the company, irrespective of any results achieved by the new segment during the reporting period. In the public sector, knowledge that a statutory authority operates under a

government policy of break-even pricing may be vital when assessing performance.

12 Often both the nature and magnitude of financial information will be important ingredients in relevance (for example, the shortfall of rate revenues in comparison with expenses for a local government, the sales of a trading entity, and the existence and size of a foreign currency borrowing).

13 In certain instances, unusual magnitude in relation to the nature of the financial information involved will lead to items not normally critical to users' decision-making being separately disclosed in financial statements and/or facing more exacting requirements in relation to measurement or presentation. Tolerances will vary according to the nature of the information concerned. For example, unusual increases in directors' or elected officials' emoluments may be critical even though the absolute amounts of those emoluments may be much smaller than many other costs which do not need to be separately disclosed. This is due to the fiduciary responsibilities of those directors or officials.

14 Apart from changes in magnitude influencing the importance of financial information, comparative rarity in relation to the experiences of similar entities can also have a bearing on assessing relevance. Unless warned otherwise, users may assume that an entity will be subject to the same influences as similar entities in an industry. Thus, although an amount may be normal for the entity concerned, it may still be regarded as unusual by industry standards and warrant separate disclosure. This could occur, for example, where an entity was the only one in an industry dependent on supplies of raw materials from a politically unstable part of the world.

15 The issuance of an Accounting Standard on a topic implicitly reduces the need for preparers, auditors and others to consider the general relevance of a particular type of financial information. The information covered by the Standard is to be presumed to be of a type that would be relevant. However, there will remain a need for those parties applying Accounting Standards to exercise judgement when conducting materiality tests in the context of particular reporting entities and their general purpose financial reports (refer to paragraphs 27 to 30).

Reliability

16 The reliability of financial information will be determined by the degree of correspondence between what that information conveys to

users and the underlying transactions and events that have occurred and been measured and displayed. Reliable information will, without bias or undue error, faithfully represent those transactions and events.

17 It is important that financial information be reliable. Information may be of a type which bears upon users' decision-making, that is, be relevant, but be so unreliable in nature or representation as to be useless or potentially misleading. For example, if an entity takes legal action against another entity for damages, and the validity and amount of the claim involved are seriously disputed, it would normally be inappropriate for the plaintiff to recognise prior to judgement an asset for the face value of the claim.

18 Minimum recognition criteria need to be met before assets, liabilities or other elements can be recognised in the financial statements. Users can therefore assume some consistency of reliability for those elements. However, this does not preclude presentation of financial information which is subject to material uncertainties in the notes or supplementary schedules to those financial statements. The manner of presenting such information can ensure that users do not place undue reliance on it. In other words, if there is faithful representation of information, including the uncertainties surrounding it, it may be possible for it to be regarded as being reliable.

19 A distinction needs to be drawn between faithful representation of transactions and events and effective representation of them. For example, it is possible to report the historical cost of an asset in a manner that conveys to the user that no attempt is being made to ascribe a current value to it; that it is a dated cost and nothing more. An assessment as to whether the historical cost is the most effective basis of measurement would flow from considerations of the objective of general purpose financial reporting and from the concept of relevance, rather than from considerations of reliability, unless current values were inherently unreliable.

20 An important concept employed in general purpose financial reporting is that of recognition, that is, the inclusion of an item in the financial statements and not merely disclosure in the notes to the financial statements. After deciding what type of financial information should be included in general purpose financial reports there is also a need to decide under what conditions and when it should be so included. For example, when should revenues and expenses arising under a long-term construction contract be recognised? Recognition criteria have been developed to provide guidance in these types of situations. Invariably those criteria

involve the assessment of probabilities and require the exercise of professional judgement. Implicit in those criteria is the concept of reliability. Under a long-term construction contract, for example, revenues and expenses are to be recognised when certain levels of assurance are reached in respect of stages of completion, estimated costs and estimated proceeds.

21 General purpose financial reporting should, if it is to be reliable, be free from bias (that is, be neutral). It should not be designed to lead users to conclusions that serve particular needs, desires or preconceptions of the preparers. Bias can stem from deliberate misstatement of financial information for fraudulent purposes and it can also stem from misguided conservatism, resulting in preparers filtering the information provided and thereby usurping the rights of users to make their own decisions.

22 General purpose financial reporting should also be free from undue error if it is to be reliable. Most financial information is subject to some risk of being less than a faithful representation of what it purports to be. This is not due to bias, but rather to either inherent difficulties in identifying the economic phenomena to be measured or in devising or applying measurement or presentation techniques which can convey messages which correspond with those phenomena. For example, though most entities generate goodwill over time, it is usually very difficult to identify or measure that goodwill reliably. The risk of error can be offset in some cases by disclosure of the uncertainties surrounding the information.

23 The role of independent audit is important in relation to reliability. In part, the auditor is concerned with ensuring that general purpose financial reports represent what they purport to represent, that their contents are verifiable and that there is an absence of bias. However, the auditor's attention is not confined to reliability, as the auditor must also consider the relevance of what is being reported. The user will expect that the auditor, as an independent expert, is satisfied as to the relevance and reliability of the general purpose financial report for assessments of the performance, financial position, financing and investing, and compliance of the reporting entity, and that reliance may be placed on the auditor's opinion. The user will also develop an attitude toward the reliability of the general purpose financial reports as a result of the success of past decisions or evaluations.

24 If financial information is to be both relevant and reliable it is necessary that the substance rather than the form of transactions or events be reported. The concept of relevance indicates the type of information with which general purpose financial reporting should

be concerned, and this will not always be consistent with legal or contrived form. For example, an entity may "sell" an asset to another party and this may be documented in a way which purports to pass legal ownership to that party, despite agreements which ensure that the vendor continues to enjoy the economic benefits involved. To report a sale in such circumstances would be unreliable as it would not be a true reflection of the type of transaction entered into (if indeed there was a transaction) and would omit the appropriate asset from the vendor's general purpose financial reports, thus depriving the users of relevant information about the resources of the vendor.

25 The prudence concept has been cited often in accounting literature, and has been explained in terms of the need to exercise care when dealing with uncertainties in the process of recognition and measurement. This concept is subsumed in that of reliability.

26 The concept of conservatism, where it is understood to lead to a deliberate bias toward understatement of revenues or assets and/or maximum recognition of expenses or liabilities, is at odds with many of the desirable qualitative characteristics, including reliability. On the other hand, conservatism is sometimes defined or used in an acceptable manner; that is, when it is synonymous with reliability. This Statement does not employ the term.

Test of materiality

27 Once it has been decided that financial information is, in general terms, capable of being classified as relevant and reliable, it is necessary to consider the information in the context of the individual circumstances of the reporting entity in question. For example, information may be relevant and reliable in general nature, but be immaterial in the circumstances of the reporting entity. The inclusion of immaterial information in financial reports may well impair their understandability.

28 The materiality test is concerned with assessing whether omission, misstatement or non-disclosure of an item of relevant and reliable information could affect decision-making about the allocation of scarce resources by the users of a general purpose financial report of an entity. For example, it may be argued that information about secured non-current liabilities could be expected to be relevant to the decisions of potential lenders and be capable of being reliably determined. However, in a particular entity it could be that total debt is so small in comparison to available collateral that dissection of existing debt between the secured and unsecured portions would be immaterial. Therefore, in this Statement materiality is employed

as a threshold test of which relevant and reliable financial information should be excluded from a general purpose financial report of an entity.

29 The assessment of materiality needs to be carried out not only in relation to individual items but also in relation to classes of similar items. For example, errors in individual items may be immaterial in their own right, but material in aggregate.

30 As indicated in paragraph 15, although the issuance of an Accounting Standard on a topic indicates to preparers, auditors and others that the type of financial information in question should be presumed to be relevant, those parties still need to assess materiality. For example, Accounting Standards require certain reporting entities to disclose information about their segments. It would be inappropriate for a preparer or auditor to conclude that segmental information is not particularly useful in general, and decide that the Standards do not apply to the reporting entity. Rather, those parties need to assess whether there are distinguishable components of the entity which face significantly different risks or prospects. If those components exist, they need to be reported in the manner specified in the Standards. If, however, such components as can be discerned are very similar in nature and face much the same risks and prospects, it may be concluded that, in the circumstances of the particular entity in question, much of the segmental information is immaterial. In this case many of the requirements in the Standards would not apply and there would be no question of non-compliance with those requirements.

Qualitative Characteristics - Presentation of Financial Information

Comparability

31 It is not sufficient that financial information is relevant and reliable at a particular time, in a particular circumstance or for a particular reporting entity. The users of general purpose financial reports need to be able to compare aspects of an entity at one time and over time, and between entities at one time and over time.

32 This implies that the measurement and display of transactions and events need to be carried out in a consistent manner throughout an entity, and over time for that entity, and that there is consistency between entities in these regards.

33 An important implication of this concept of comparability is that users need to be informed of the policies employed in the

preparation of the general purpose financial reports, changes in those policies and the effects of those changes.

34 Comparability should not be interpreted as mere consistency and should not be allowed to become an impediment to the introduction of improved accounting. It would be unacceptable for all entities to be accounting in the same manner for a transaction or event if the policy adopted was not in keeping with the concepts of relevance and reliability. Consistency is not an end in itself. Nor would it be acceptable for an entity to remain rigid in its accounting policies when more relevant or reliable alternatives exist.

35 The setting of Accounting Standards sometimes involves the balancing of the potentially competing ends of the promulgation of standards specifying accounting policies to be adopted and the need for sufficient flexibility for voluntary development of general purpose financial reporting. The style of Accounting Standards, particularly in relation to the level of detailed prescription, can be important in this regard, as can the preparedness of the standard-setters to amend Accounting Standards relatively quickly. Standard-setters, preparers and auditors also need to consider how best to introduce change so that comparability is not impaired over time and between entities.

Understandability

36 The ability of users to understand financial information will depend in part on their own capabilities and in part on the way in which the information is displayed. General purpose financial reports ought to be constructed having regard to the interests of users who are prepared to exercise diligence in reviewing those reports and who possess the proficiency necessary to comprehend the significance of contemporary accounting practices.

37 Preparers should present information in the most understandable manner without sacrificing relevance or reliability. In meeting this objective, it may not always be possible to report complex transactions and events in simple or simplified terms. It should be borne in mind that professional advice can be obtained by the users of general purpose financial reports.

38 Standard-setters, preparers and auditors need to be mindful of the role of disclosure and transitional arrangements as methods of facilitating understanding of new financial information.

Constraints on Relevant and Reliable Financial Information

Timeliness

39 Financial information which is relevant and reliable and which passes the materiality test may lose its relevance if there is undue delay in it being reported. Thus, the time available to gather and report financial information is a constraint on providing relevant information.

40 There may, on occasion, be a need to weigh the relative merits of timely reporting and the provision of relevant and reliable financial information. Application of the reporting period convention can often lead to the need to report before all aspects of a transaction or event are known. This can limit the availability of relevant information and have an impact upon reliability. Conversely, if reporting is delayed until all facts are known, this may be too late for users who have to make decisions in the interim.

41 The need for timely reporting raises questions for standard-setters, preparers, auditors and regulators about the desirable frequency of general purpose financial reporting and the length of time that ought to be allowed to elapse between the reporting date and the date when general purpose financial reports are made available to users.

Costs versus benefits

42 A major difficulty facing preparers, auditors, standard-setters and others is whether the cost of providing certain financial information exceeds the benefits to be derived from its provision. The costs could include those of collection, storage, retrieval, presentation, analysis and interpretation of the information, possible loss or diminution of competitive position and, if the information is not reliable, misdirection of resources and other related undesirable consequences. The benefits of financial information will come from sound economic decision-making by the various user groups.

43 The costs of providing financial information will be initially incurred, in the main, by the preparer, but will flow in various direct and indirect ways to many other parties in the community. They may be immediate in their incidence or they may be incurred in the future. The benefits may be enjoyed by parties external to the entity, or by management and/or employees. There is no guarantee that costs will be borne ultimately by those who reap the benefits.

44 There is no universally acceptable methodology for measuring costs and benefits of financial information. It is a matter for professional judgement by those who have to prepare, or influence the preparation of, financial information. Standard-setters and regulators of financial information need to employ processes for gathering information about the merits of requirements that they are proposing. These processes can give insight into the perceptions of the various categories of users about the costs and benefits of the requirements being considered. However, it is unlikely that these processes will significantly reduce the need for judgement in relation to costs and benefits. Preparers who do not normally have the opportunity of consulting with various groups of people when contemplating a voluntary change in accounting policy will need to exercise judgement and can only be assisted in this by general practice, the concepts underlying general purpose financial reporting and, perhaps, experience in other countries.

45 Assessments of costs and benefits of reporting particular items of financial information may vary between individual preparers, auditors and other interested parties. Therefore, if assessments of costs and benefits were to be made only by those individuals, the assessments would be likely to be specific to the entity and unable to have regard to the general benefits of financial reporting. Consequently, they may fail to optimise the cost/benefit function of financial reporting generally and may disregard the benefits likely to flow from the inter-entity comparability of financial reports. In the process of setting accounting standards, standard-setters seek to consider all costs and benefits in relation to financial reporting generally, and not just as they pertain to individual reporting entities.

ACCOUNTING CONCEPTS

Discussion and Definitions

46 The following concepts shall be interpreted in the context of paragraphs 1 to 45 of this Statement.

47 Paragraph 5 (definitions) shall be read as forming part of the accounting concepts set out in this Statement.

Qualitative Characteristics

48 General purpose financial reports shall include all financial information which satisfies the concepts of relevance and reliability, and which passes the materiality test.

49 General purpose financial reports shall be presented on a timely basis and in a manner which satisfies the concepts of comparability and understandability.