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FINANCIAL ACCOUNTING QUALITY AND ITS DEFINING CHARACTERISTICS

Theoretical article

Keywords
Financial accounting quality
Conceptual Framework
Qualitative characteristics
Reporting information

JEL Classification
M41

Abstract

The importance ofhigh-quality financial statements is highlighted by the main standard-setting institutions activating in the field of accounting and reporting. These have issued Conceptual Frameworks which state and describe the qualitative characteristics of accounting information. In this qualitative study, the research methodology consists of reviewing the literature related to the definition of accounting quality and striving for understanding how it can be explained. The main objective of the study is to identify the characteristics information should possess in order to be of high quality. These characteristics also contribute to the way of defining financial accounting quality. The main conclusions that arise from this research are represented by the facts that indeed financial accounting quality cannot be uniquely defined and that financial information is of good quality when it enhances the characteristics incorporated in the conceptual frameworks issued by both International Accounting Standards Board and Financial Accounting Standards Board.

1. INTRODUCTION

The quality of financial statements is not an indicator that can be easily quantified, as it cannot be observed directly, being based on the perception of the users of financial information. Each category of users has its own expectations and perceptions regarding what information is useful and of good quality.

Recent studies in the field of economics and accounting are analysing more and more the term of financial accounting quality. One of the main objectives of the large number of papers upon this subject consists of finding an appropriate measure for it. That is why, it is important to understand what financial accounting quality represents and how it can be explained and quantified.

The primary objective of this paper is to identify the key characteristics that financial accounting information should possess in order to be of good quality. As the Conceptual Framework of FASB clearly states and describes the qualitative characteristics of accounting information, this article reviews the Framework and presents the findings.

This paper is a theoretical qualitative study upon the field of financial accounting quality, concentrated upon the way of defining this term and presenting its fundamental characteristics. The research methodology consists of searching the literature, using large databases as JSTORE, SpringerLink, ISIDORE, ScienceDirect and Emerald, for articles regarding definition and characteristics of financial accounting quality. In order to identify relevant studies conducted upon financial accounting quality, we have selected the following key words: financial accounting quality, financial reporting, qualitative characteristics, conceptual framework and reporting information.

The paper contributes to the literature concerning financial accounting quality with an overview upon financial accounting quality, summarizing the main definitions and characteristics of financial accounting quality.

The remainder of the papers is organized as follows: part two presents a literature review upon the vast definitions of financial accounting quality, part three analyses the Conceptual Framework, describing the characteristics of accounting information and the last part draws some conclusion upon this subject.

2. DEFINING FINANCIAL ACCOUNTING QUALITY

The value of financial accounting is generally determined by its quality.(Pounder,2013). The central concept of financial accounting quality is that some accounting information is better and more reliable than other accounting information in relation to its characteristic of communicating what it purports to communicate. That is why, accounting quality is of great interest to several types of users involved in the financial reporting chain.

The term of financial accounting quality has no single, widely accepted definition. We can find a large amount of definitions, which vary significantly across individuals, projects, companies and organizations, depending also on the purpose for which the financial information is to be used.

Studying the literature, we can see that on the one hand, accounting quality can be seen as the precision with which the financial reports convey information to equity investors about the firms expected cash-flows (Biddle *et al*., 2009). On the other hand, reporting quality refers to the extent to which financial reports of a company communicate its underlying economic state and its performance during the period of measurement. (Elbannan, 2010).

Biddle *et. al*(2009) defines financial accounting quality as the precision with which financial reports convey information about the firm's operations, in particular its cash flows, in order to inform the equity investors. Q. Tang *et al* (2008) define financial reporting quality as the extent to which the financial statements provide true and fair information about the underlying performance and financial position. Anyway, a commonly accepted definition is provided by Jonas and Blanchet (2000), who argue that quality financial reporting is full and transparent financial information that is not designed to obfuscate or mislead users.

The role of financial reporting is complex and, according to FASB, it aims to provide even handed financial and other information that together with information of other sources facilitates the efficient functioning of capital and other markets and assists the efficient allocation of the scarce resources in the economy. Therefore, the concept of financial accounting quality is broad and includes financial information, disclosures and non-financial information useful for decision making.(Tasios andBekiaris, 2012)

Many times, accounting quality is defined using its characteristics. In this context, prior literature research shows that key determinants of financial reporting quality include legal system, source of financing, characteristics of the tax system, involvement of the accounting profession, economic development and accounting education. The quality of financial reporting is a broad concept which has a series of diverse measurable attributes. Anyway, one property of accounting which is frequently mentioned in support of harmonization is comparability. It cannot be clearly concluded if harmonization results in significantly greater comparability across countries. That is why, this aspect is intensively studied and the results are still very different, causing diverse points of view upon this subject. We will try to clarify what are the characteristics of financial accounting information that makes it of good quality.

In order to have a certain degree of quality, financial statements should meet certain qualitative criteria. These criteria are stated by both boards of IASB and FASB in their conceptual frameworks, where they conclude that high quality is achieved by adherence to the objective and the qualitative characteristics of financial reporting information.(IASB, 2008).

3. QUALITATIVE CHARACTERISTICS OF ACCOUNTING INFORMATION

Financial Accounting Standards Board issued the Conceptual Framework for Financial Reporting which treats the subject of qualitative characteristics of useful financial information. We will analyse the Framework in order to highlight the most important attributes of the accounting information which lead to the enhancement of its quality.

Financial accounting information is used for multiple and specific purposes, mainly related to the process of decision making. There are several categories of users, among which we can name investors, creditors, government agencies, management, employees and clients, each of them being interested in some specific information which is valuable for them. Based on this information, they take decisions. That is why, accounting information should be of high quality. Financial statements provide information about the economic state of a company. Analysing the accounting figures we can find out the financial position and performance of an entity. Moreover, financial statements include information regarding applied accounting policies, expectations of the management, strategies for the future and other types of forward-looking information.

According to FASB, 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.

The fundamental qualitative characteristics of accounting information are considered to be *relevance* and *faithful representation*.

Relevance

Regarding relevance, it is considered that financial information is relevant if it is capable of making a difference in the decision making process. In order to make this difference in decisions, financial information should have predictive value, confirmatory value or both of them.

Financial information has predictive value if it can predict future outcomes, being employed by users in making their own predictions. It has confirmatory value if it provides feedback regarding previous evaluations. Moreover, the predictive and confirmatory values of financial information are interrelated. As many decisions of the investors and creditors are based on predictions about the amount and timing of the return on an equity investment or credit instrument, accounting information is valuable when it can be used in order to make predictions about the eventual outcomes of past or current events. When these predictions are also confirmed by the reality, it means that the accounting information has also confirmatory value. Confirmatory value can be used in confirming or correcting prior decisions, based on what has really happened.

Closely related to relevance, we can mention *materiality*. According to FASB's Conceptual Framework for Financial Reporting, information is material if omitting it or misstating it could influence decisions made by users on the basis of the financial information of a specific reporting entity. Consequently, materiality is an entity specific aspect.

Faithful representation vs Reliability

FASBstates that in order 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, information has to be complete, neutral and free from error. A complete depiction includes all information necessary for a user to understand phenomenon being depicted, including all necessary descriptions, explanations and details. Moreover, in order to achieve faithful representation, a neutral depiction is mandatory. Neutral information does not mean information with no purpose or no influence upon behaviour. On the contrary, as it was already mentioned before, relevant information is capable of making a difference in users' decisions. A neutral depiction is not manipulated in order to alter or change users' decisions, to influence them.

Faithful representation is a term that is used also when trying to explain what reliability means. It is important to notice that in the past IASB used the term reliability to describe what is now called faithful representation. The Framework (1989) said that 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. It also discussed substance over form, neutrality, prudence and completeness as aspects of faithful representation. Anyway, due to the fact that IASB did not succeed to define clearly reliability, this was a confusing term, not fully understood by the users of financial information. That is why, IASB sought a different term that would more clearly convey the intended meaning and the term faithful representation was the result of this search. This term incorporates the main characteristics that were previously seen as aspects of reliability.

When trying to quantify faithful representation, we cannot find in the literature specific techniques for empirically measuring it. We can only find relevance as a way of measuring faithful representation. 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.

Besides the fundamental qualitative characteristics of accounting information, FASB's Framework states also the enhancing qualitative characteristics. These are comparability, verifiability, timeliness and understandability, which enrich the usefulness of information that is relevant and faithfully represented.

Comparability

Users' decisions involve choosing between alternatives. That is why, information is useful if it can be compared with similar information about other entities or the same, from previous periods. Comparability helps users to identify and understand similarities and differences and to fundamental their decisions. This term also refers to how easily various companies can be compared with each other. According to Braam and Beest (2013), the quality of comparability is measured by means of items relating to a consistent application of accounting policies and procedures and intercompany comparability.

Consistency, although related to comparability, is not the same. Consistency refers to the use of the same methods for the same items. This can be done in two ways: from period to period within a single reporting entity or in the same period for more than one company. Moreover, comparability is the goal, consistency helps to achieve that goal.

Comparability should not be confused with uniformity, because as to be able to compare things, like things must look alike and different things must look different. This means that we do not have to make unlike things look alike or like things look different.

Although a single economic phenomenon can be faithfully represented in multiple ways, permitting alternative accounting methods for the same economic phenomenon diminishes comparability.

Comparability is strictly related to relevance and faithful representation and it is useless if these two basic characteristics are missing. Comparable information 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 one. But anyway, no enhancing qualitative characteristic is valid if the fundamental characteristics are missing.

Verifiability

Statement of Financial Accounting Concepts defines verifiability as the ability through consensus among measurers to ensure that information represents what it purports to represent or that the chosen method of measurement has been used without errors or bias.

Verifiability is used for assuring users that information faithfully represents the reality. There are two ways of verifying things, direct or indirect. Direct verification implies verifying an amount or other representation through direct means, like observation, counting or measurement. Indirect verification means checking the inputs by using a model, formula or other technique and recalculating the outputs using the same methodology that was initially used.

There are cases and items that cannot be verified. We include here explanations and forward-looking financial information. In these cases, in order to help users decide if they want to use that information, it is normally necessary to disclose the underlying assumptions, the methods of compiling the information and the factors and circumstances that support the information.

Timeliness

Timeliness means having information available before it loses its capacity to influence decisions. Generally, the older the information is, the less useful it becomes. Anyway, there are cases when information continues to be timely long after the end of a reporting period. This happens when users need to identify and assess trends, to make predictions based on what has happened in the past.

There were discussions if timeliness is an aspect of relevance. Many respondents pointed out that timeliness is not part of relevance in the same sense that predictive and confirmatory value are. It is desirable, but is not as critical as relevance and faithful representation.

Understandability

Conceptual Framework for Financial Reporting affirms that classifying, characterizing and presenting information clearly and concisely makes it understandable. Some transactions are very complex and contain many details and, consequently, cannot be understood very quickly. In these cases, any available information may help the user to understand the transaction. The solution is not to exclude the information from the financial statements in order not to confuse the user, but to display all the available details. It is assumed that the user of the financial statement has at least a basic knowledge of business and economics and a willingness to study the information with reasonable diligence.

Regarding understandability, there are some opinions according to which no new accounting method should be used unless the user does understand it. This means that even though the method might bring a consistent value-added, of the user does not have the necessary knowledge, it cannot be implemented. Proceeding this way, it would mean that understandability is more important than relevance. But we should keep in mind that relevance is a fundamental characteristic of financial information, while understandability is an enhancing one. As it is clearly stated in the Conceptual Framework, 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. If users do not completely understand the information from the financial statements, they should seek the help of advisers and experts in the field, in order to understand all the complex transactions and processes.

After studying the documents issued by FASB regarding financial accounting quality, it can be noticed that there are some characteristics that we frequently refer to, that are not included in any of the two categories of characteristics. These excluded characteristics are transparency, high quality, consistency, true and fair view or fair presentation and credibility. The reason is that all these are in fact different ways of describing information that already displays fundamental and enhancing characteristics.

4. CONCLUSIONS

Financial accounting quality is a key requirement for the effective functioning of the accounting system and its usefulness. In order to meet their primary objective, which is to facilitate the economic decision making process, financial statements should display certain qualitative characteristics. These characteristics are explained in the Conceptual Framework issued by IASB/FASB, where they are divided into two categories: fundamental and enhancing. The fundamental characteristics consist of relevance and faithful representation, while the enhancing characteristics include comparability, verifiability, timeliness and understandability. All of these are described in the present paper, in order to understand what makes information to be of good quality.

Moreover, stating the qualitative characteristics of financial accounting information facilitates the way of defining financial accounting quality. We can see that financial accounting quality is often defined in the literature considering its qualitative characteristics. That is why, researchers define it as being comparable, relevant or presenting a fair image.

Future research will concentrate upon measuring accounting quality, reviewing the possible ways of doing this and selecting the appropriate ones accordingly to the specific market that is to be analysed.

Aknowledgements

This paper was co-financed from the European Social Fund through Sectorial Operational Programme Human Resources Development 2007-2013, project number POSDRU/159/1.5/S/142115 „Performance and excellence in doctoral and postdoctoral research in Romanian economics science domain”.

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