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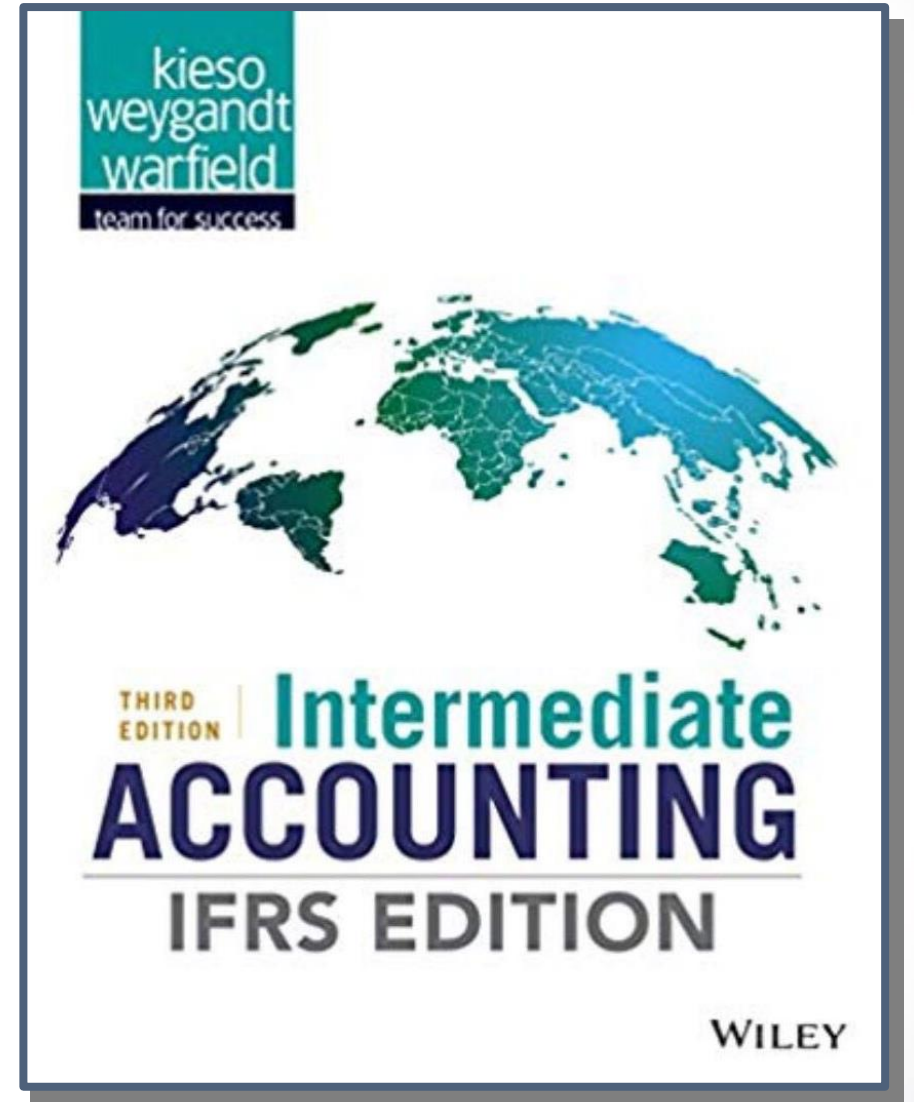
American University Of The Middle East

Intermediate Accounting I

CHAPTER 2

Conceptual Framework for Financial Reporting

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LEARNING OBJECTIVES

After studying Chapter 2, you should be able to:

1. Understand the **objective** of **financial reporting (Financial Statements)**.
2. Identify the **qualitative characteristics** of accounting information
3. Describe the **basic assumptions** of accounting.
4. Explain the **application** of the **basic principles** of accounting

IFRS - International Financial Reporting Standards

What IFRS stands for?

IFRS is an acronym for **International Financial Reporting Standards**

Why do we need standards?

- ❖ World markets are becoming increasingly intertwined. Due to technological advances investors are able to engage in financial transactions across national borders.
- ❖ Investors need relevant information to enable them to make comparisons across borders.
- ❖ A single, widely accepted set of high-quality accounting standards is a necessity to ensure comparability

IFRS - International Financial Reporting Standards

What are the main standard-setting bodies?

In the past, most of the countries had their own standard-setting body. This resulted in financial information that was not easily comparable across borders.

Today, the main standard-setting body worldwide is **International Accounting Standards Board (IASB)**, based in London, United Kingdom.

The IASB issues International Financial Reporting Standards (IFRS) which are used by **most** foreign capital markets. As of today more than 149 jurisdictions (similar to countries) use IFRS and the number is rapidly growing.

IFRS - International Financial Reporting Standards

What are the major types of IASB pronouncements?

The IASB issues **three** major types of **pronouncements**:

International Financial Reporting Standards: To date the IASB has issued 13 standards.

Conceptual Framework for Financial Reporting: The Conceptual Framework serves as a tool for solving existing and emerging problems in a consistent manner. It is not an IFRS and does not override (replace) any specific IFRS.

International Financial Reporting Interpretations: Interpretations cover (1) *newly identified financial reporting issues not specifically dealt with in IFRS*, and (2) *issues where unsatisfactory or conflicting interpretations have developed*.

Learning Objective 1: Understand the objective of financial reporting

What is the Conceptual Framework?

Conceptual Framework **establishes the concepts** that underlie **financial reporting**.

Why do we need a Conceptual Framework?

- ▶ **Rule-making** should **build on** and relate to an **established body of concepts**.
- ▶ Enables IASB to issue more useful and **consistent pronouncements over time**.

Overview of the Conceptual Framework

Three levels:

- ▶ **First Level:** Objective of Financial Reporting
- ▶ **Second Level:** Qualitative Characteristics and Elements of Financial Statements
- ▶ **Third Level:** Recognition, Measurement, and Disclosure Concepts.

Learning Objective 1: Understand the objective of financial reporting

What is the Objective of Financial Reporting?

- 1- To provide **financial information** about the reporting entity (company)
- 2- Information should be **useful** to present and potential **equity investors, lenders, and other creditors**
- 3- They need information to make **decisions** about providing resources to the entity.”

Those decisions involve **buying, selling, or holding equity (shares) and debt instruments, and providing or settling loans and other forms of credit.**

To make effective decisions, these parties need information to help them assess a company's prospects for future net cash flows and/or generate profits.

Information that is decision-useful to capital providers may also be helpful to other users of financial reporting who are not capital providers

Learning Objective 2: Identify the qualitative characteristics of accounting information

What are the Qualitative Characteristics of Accounting Information?

In order to be **useful**, financial information needs to meet **certain characteristics**.

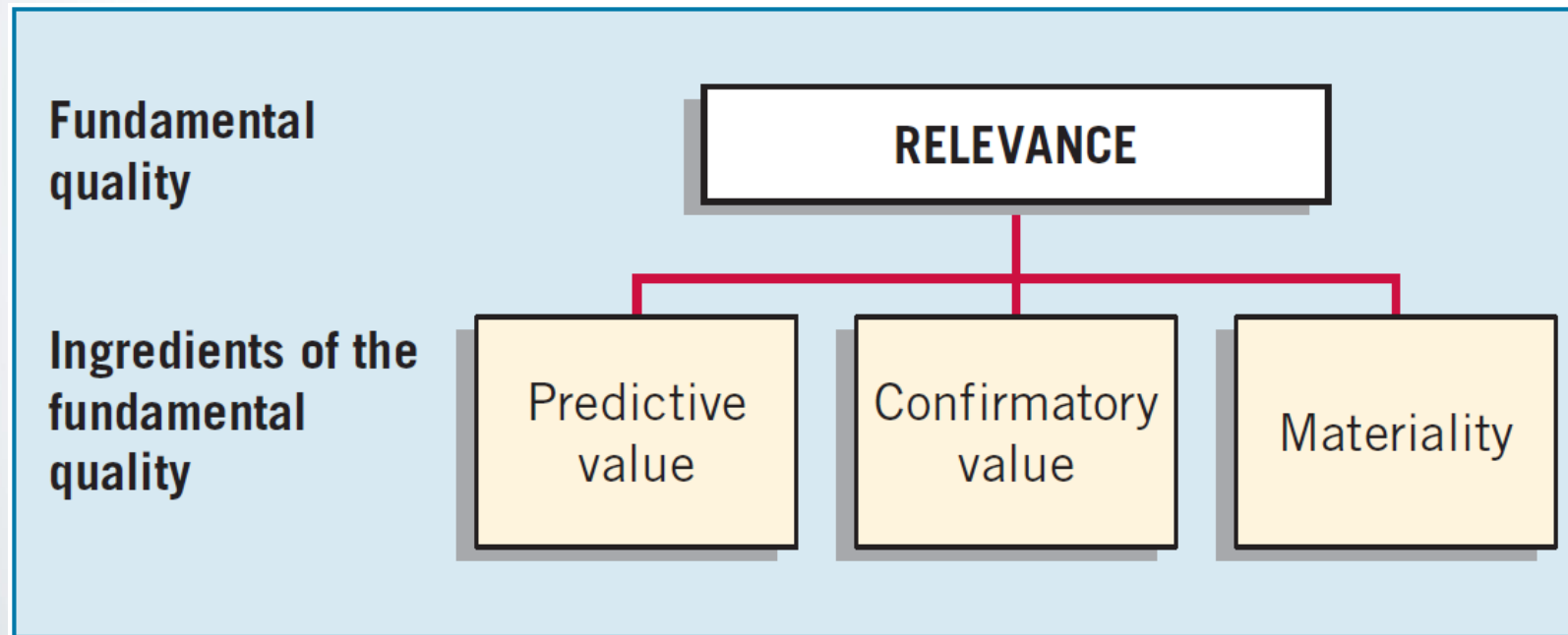
IASB identified the **Qualitative Characteristics** of accounting information that distinguish better (more useful) information from inferior (less useful) information for decision-making purposes.

There are two groups of qualitative characteristics

- ▶ **Fundamental** Characteristics
- ▶ **Enhancing** Characteristics

Learning Objective 2: Identify the qualitative characteristics of accounting information

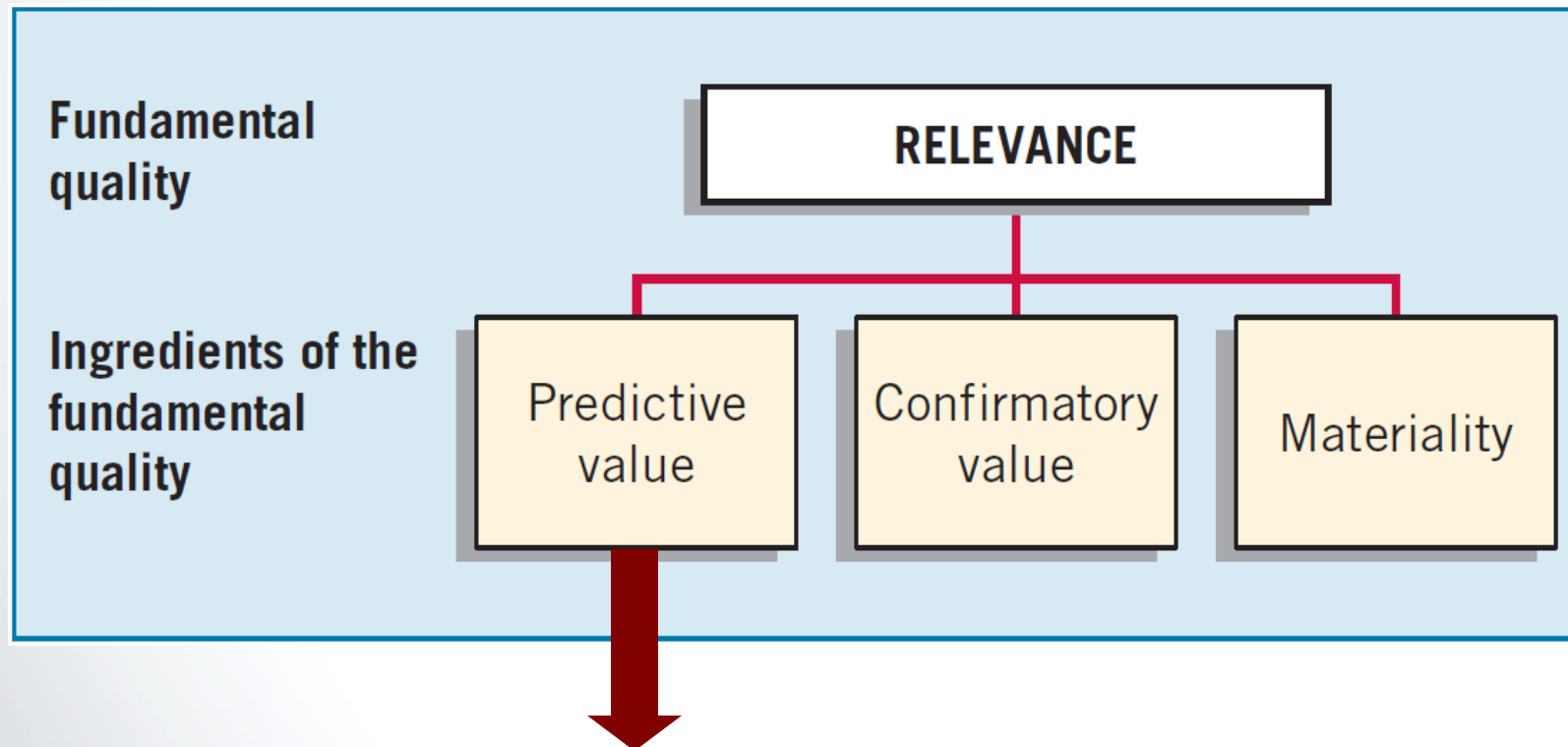
Fundamental Quality — **Relevance**



To be **relevant**, accounting information must be capable of **making a difference in a decision**.

Learning Objective 2: Identify the qualitative characteristics of accounting information

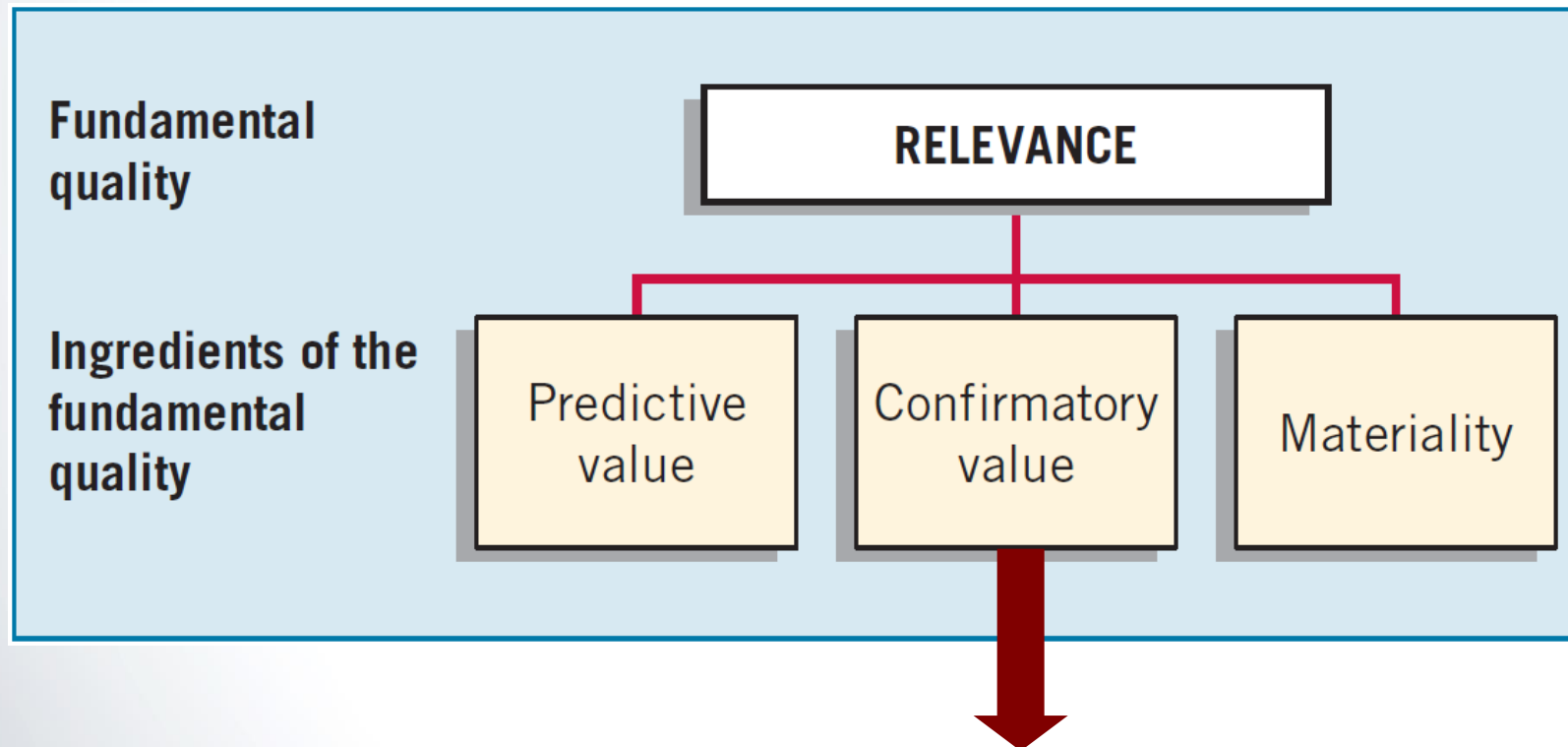
Fundamental Quality — **Relevance**



Financial information has **predictive value** if it has value as an input to predictive processes used by investors to form their own expectations about the future.

Learning Objective 2: Identify the qualitative characteristics of accounting information

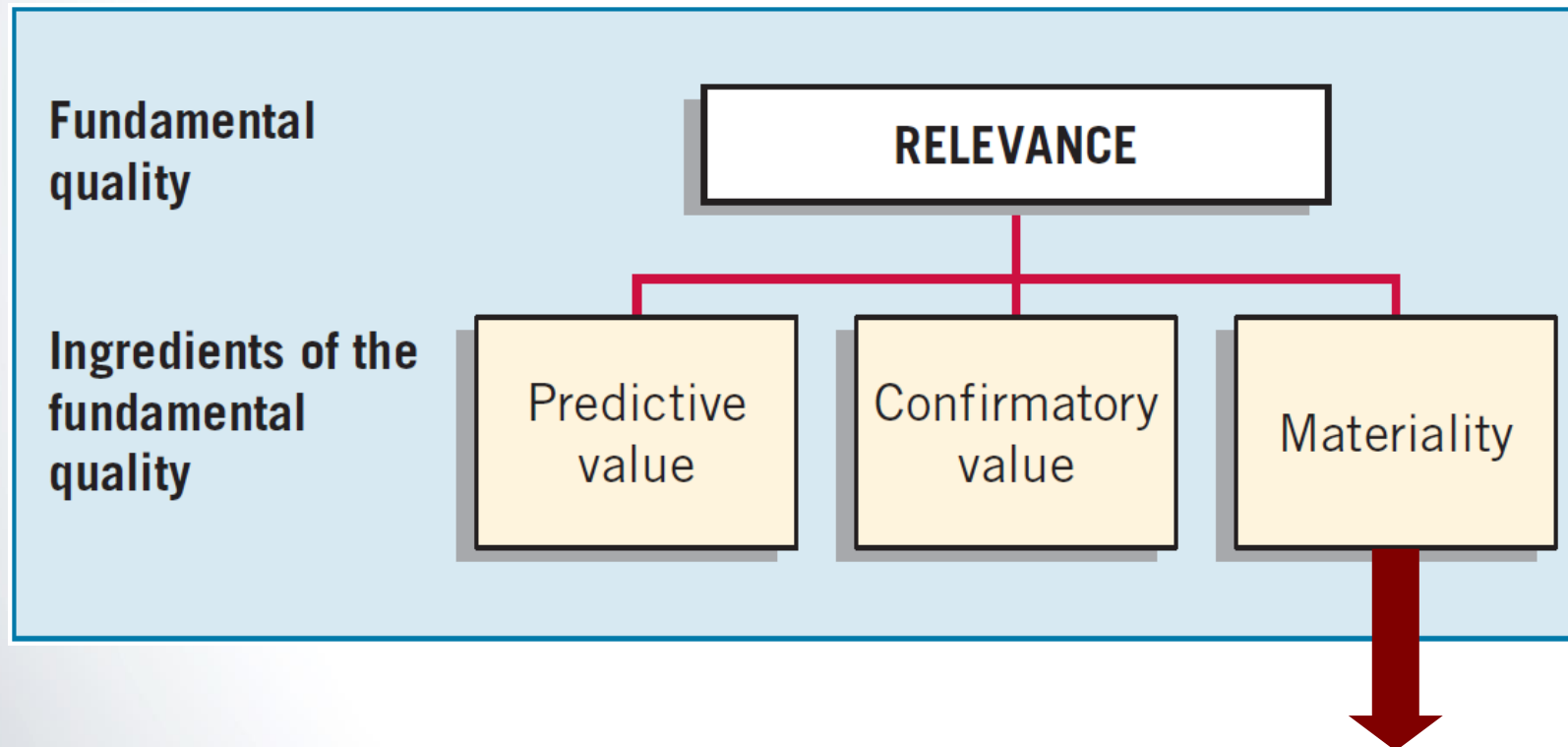
Fundamental Quality — **Relevance**



Relevant information also helps users **confirm** or correct prior expectations.

Learning Objective 2: Identify the qualitative characteristics of accounting information

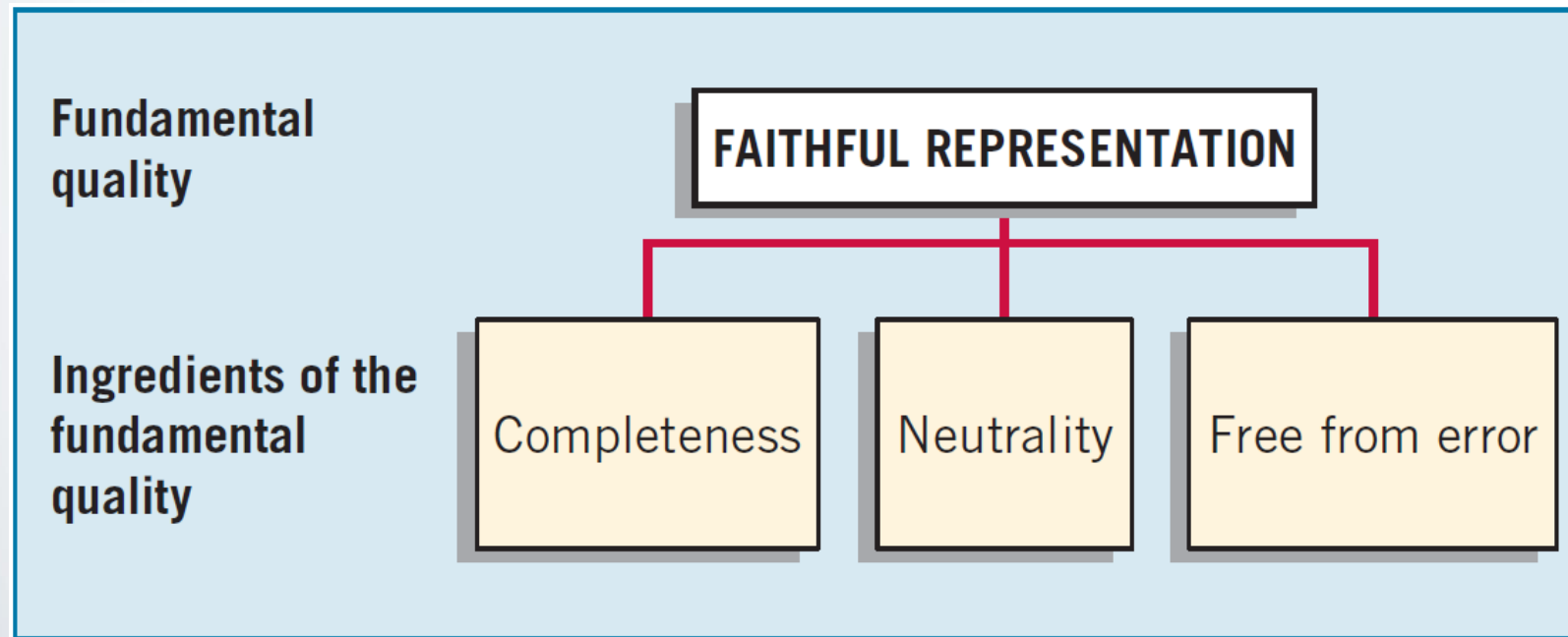
Fundamental Quality — **Relevance**



Information is **material** if omitting it or misstating it could influence decisions that users make on the basis of the reported financial information.

Learning Objective 2: Identify the qualitative characteristics of accounting information

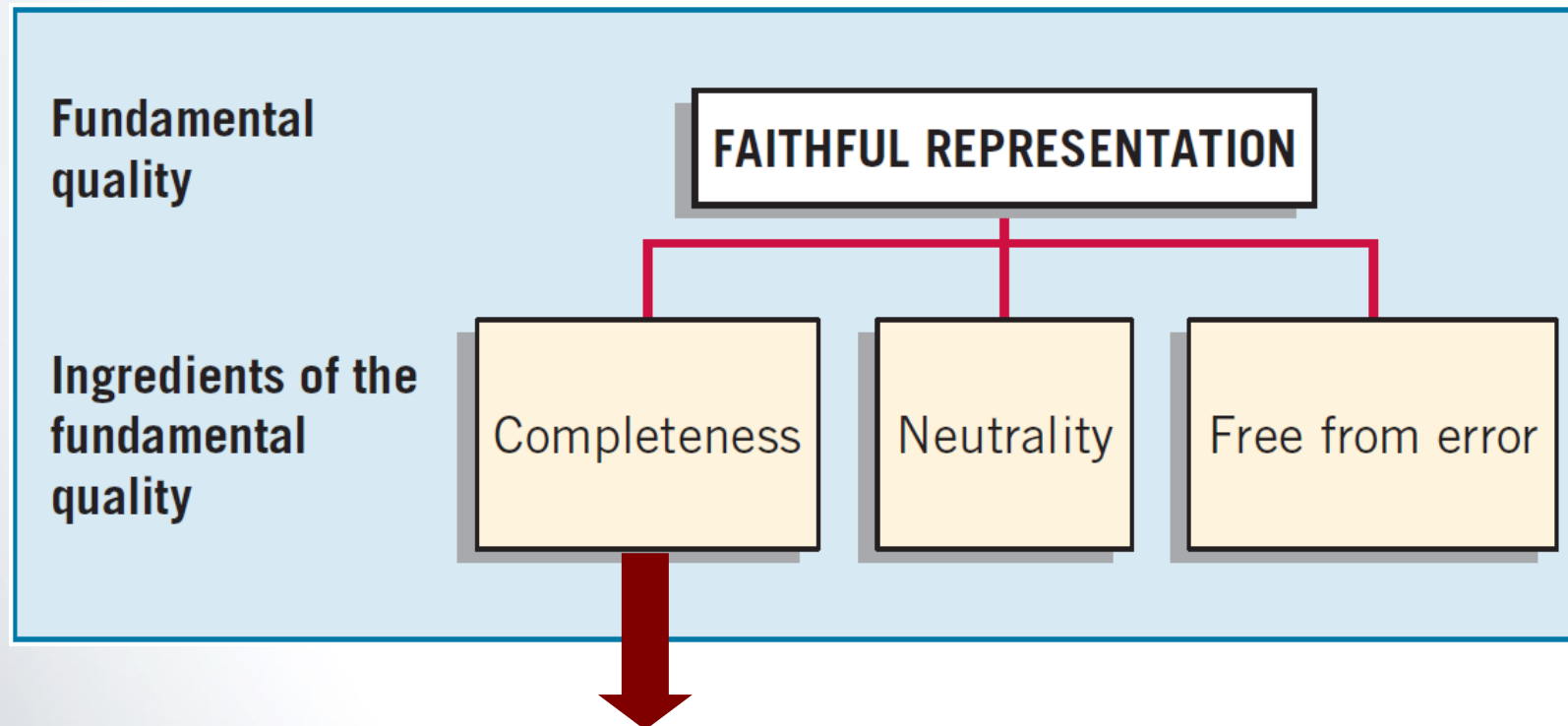
Fundamental Quality — Faithful Representation



Faithful representation means that the numbers and descriptions match what really existed or happened.

Learning Objective 2: Identify the qualitative characteristics of accounting information

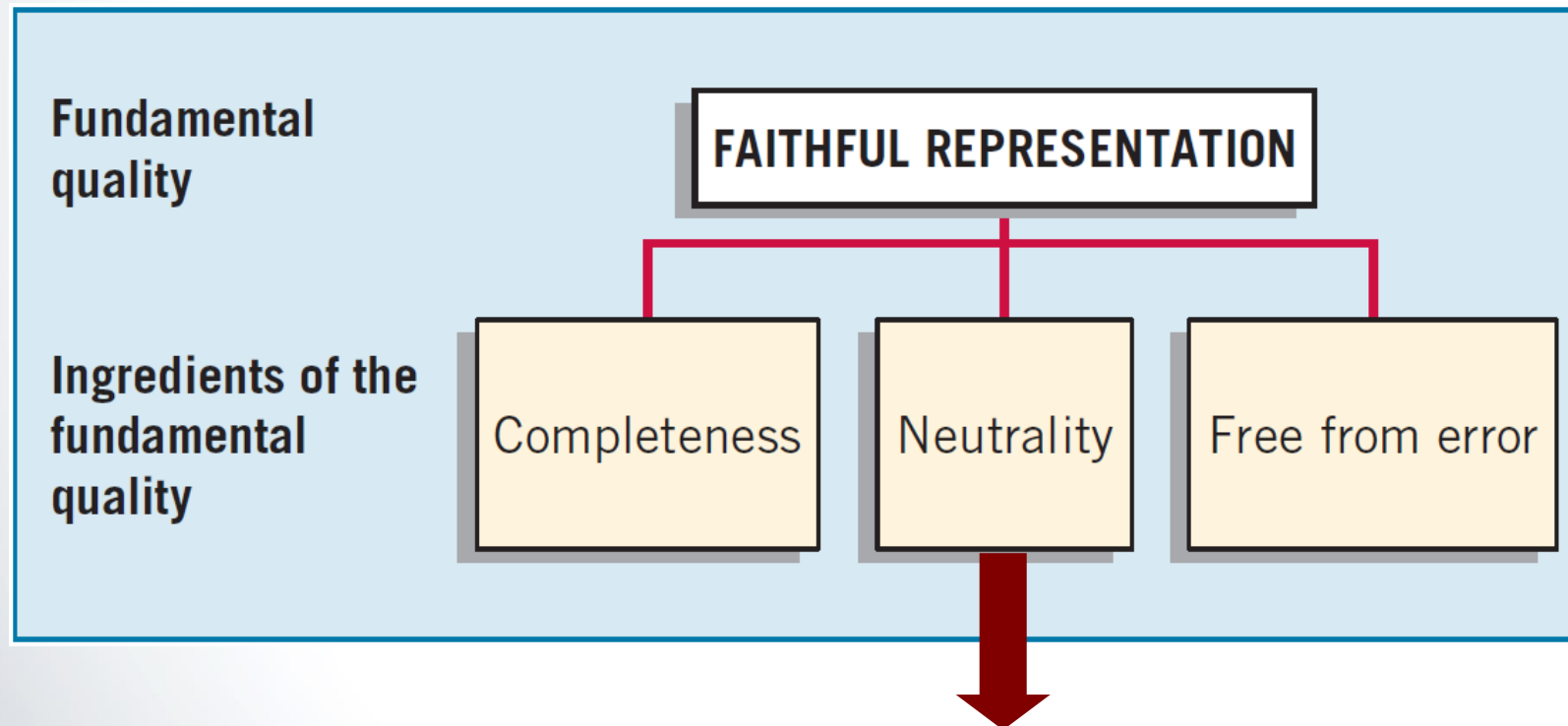
Fundamental Quality — Faithful Representation



Completeness means that **all the information** that is necessary for faithful representation is provided.

Learning Objective 2: Identify the qualitative characteristics of accounting information

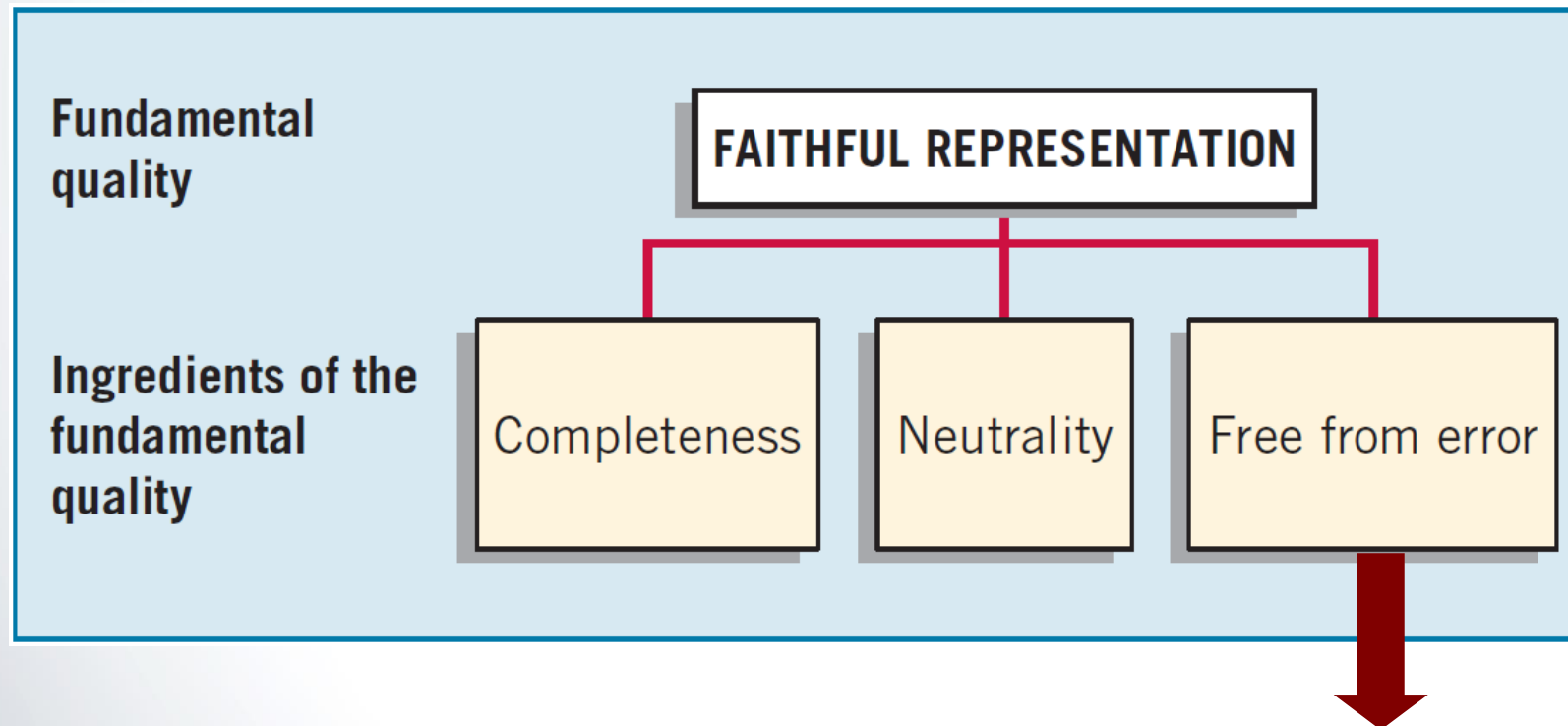
Fundamental Quality — Faithful Representation



Neutrality means that a company cannot select information to favor one set of interested parties over another.

Learning Objective 2: Identify the qualitative characteristics of accounting information

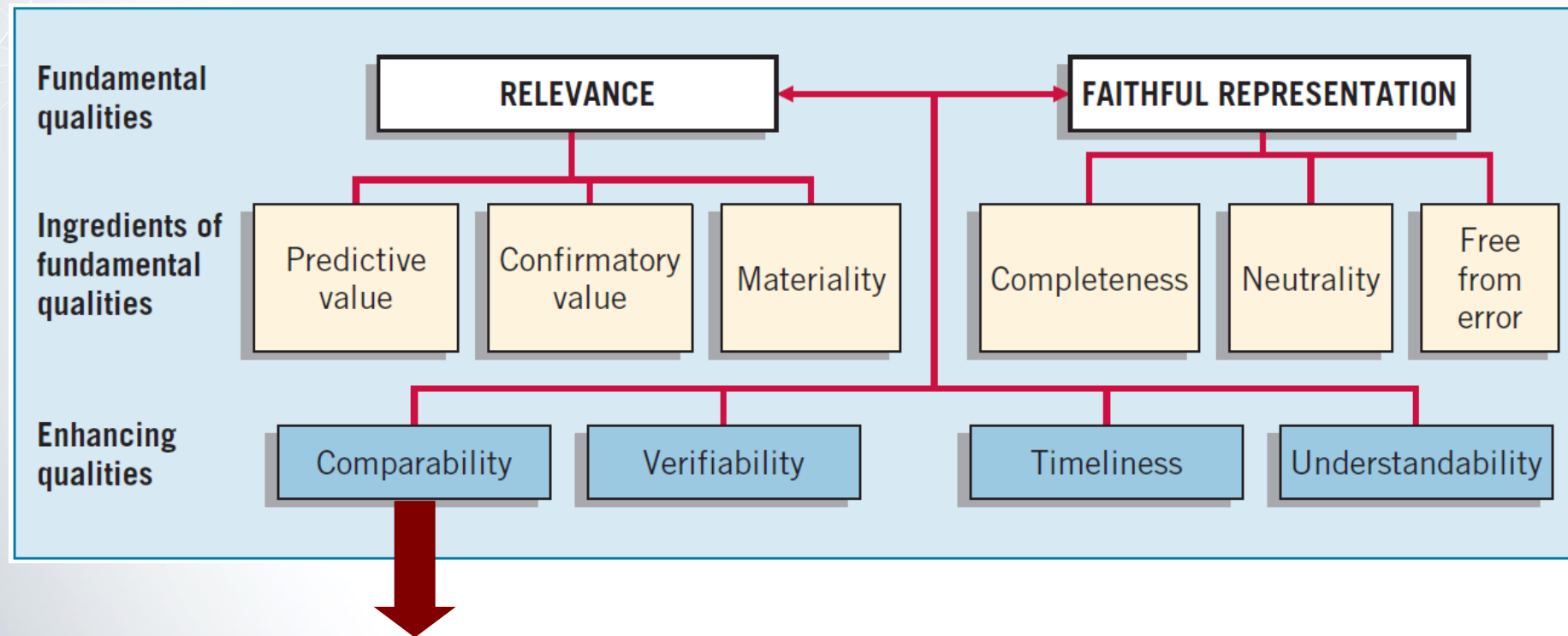
Fundamental Quality — Faithful Representation



An information item that is **free from error** will be a more accurate (faithful) representation of a financial item.

Learning Objective 2: Identify the qualitative characteristics of accounting information

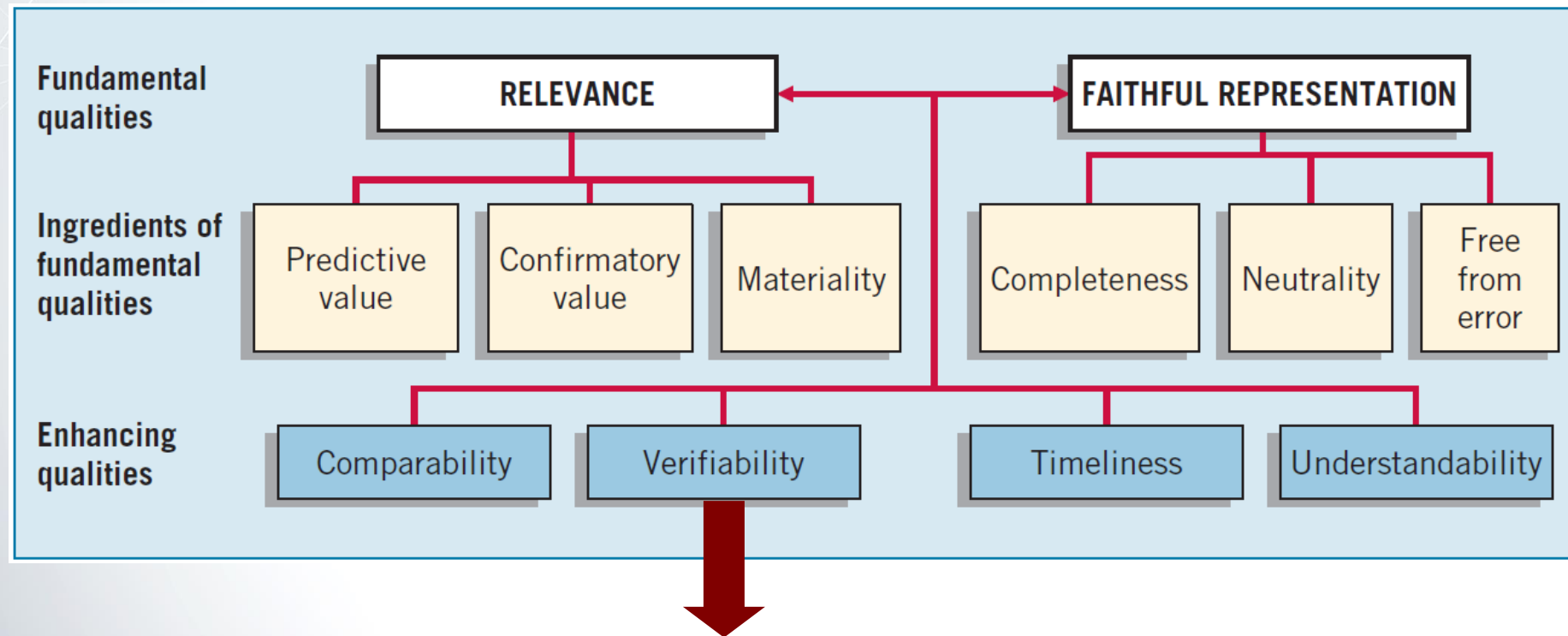
Enhancing Qualities



Information that is **measured and reported in a similar manner** for different companies is considered **comparable**.

Learning Objective 2: Identify the qualitative characteristics of accounting information

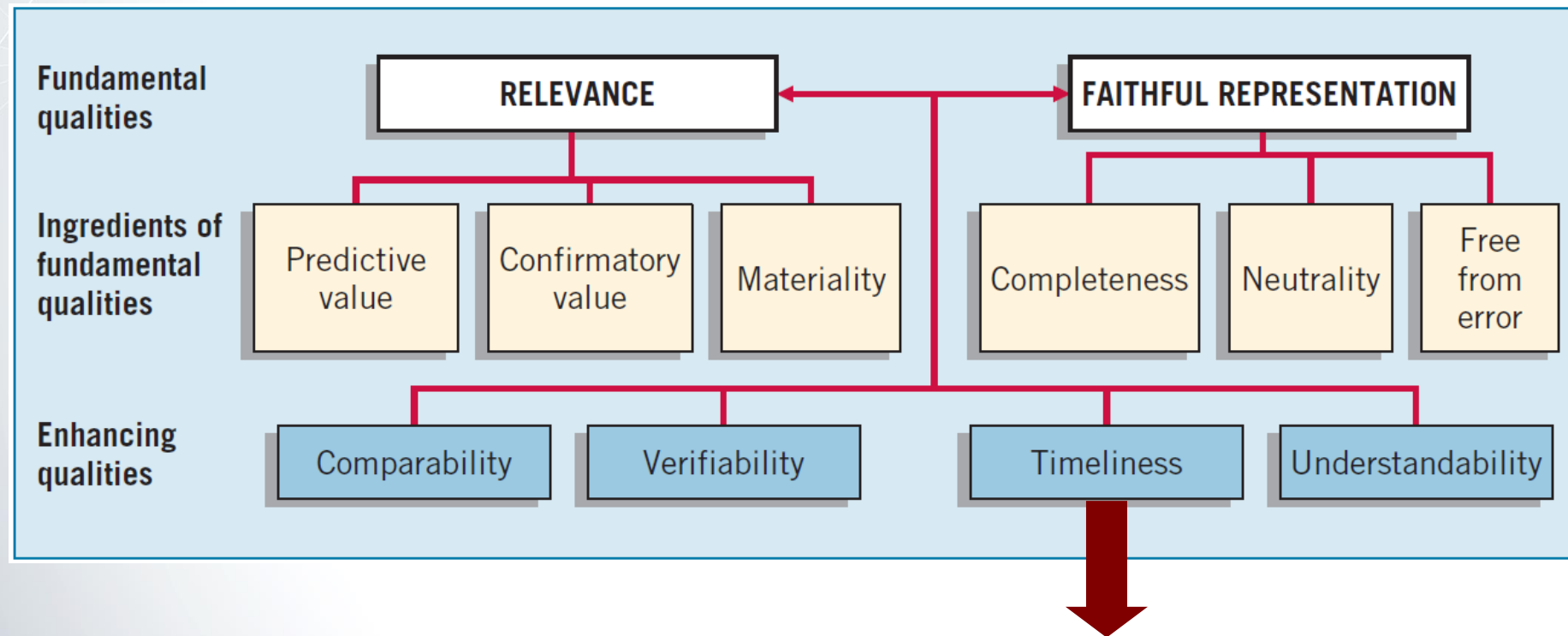
Enhancing Qualities



Verifiability occurs when independent measurers, using the same methods, obtain similar results.

Learning Objective 2: Identify the qualitative characteristics of accounting information

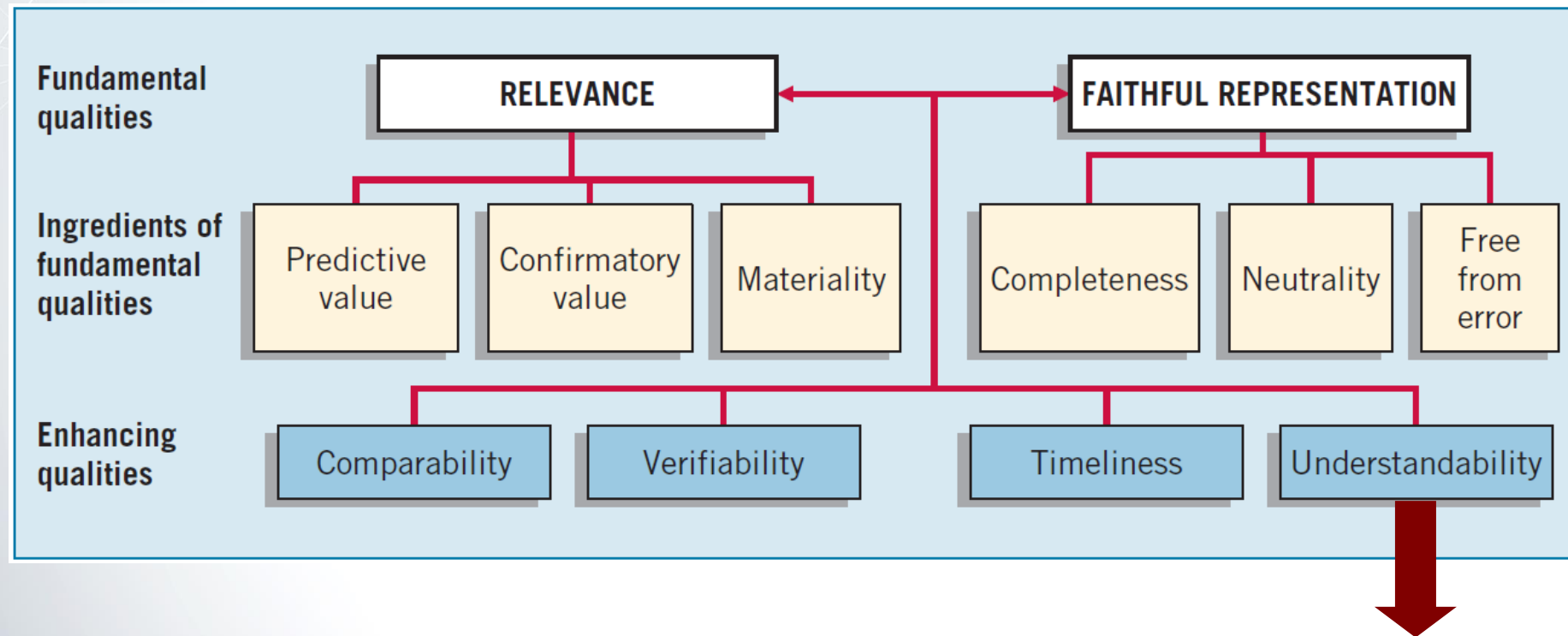
Enhancing Qualities



Timeliness means having information available to decision-makers **before it loses its capacity to influence decisions.**

Learning Objective 2: Identify the qualitative characteristics of accounting information

Enhancing Qualities



Understandability is the quality of information that lets reasonably informed users see its significance.

TEST YOUR KNOWLEDGE

BE2.1 (LO2) Match the qualitative characteristics below with the following statements.

1. Relevance

2. Faithful representation

3. Predictive value

4. Confirmatory value

5. Comparability

6. Completeness

7. Neutrality

8. Timeliness

- a. Quality of information that permits users to identify similarities in and differences between two sets of economic phenomena.
- b. Having information available to users before it loses its capacity to influence decisions.
- c. Information about an economic phenomenon that has value as an input to the processes used by capital providers to form their own expectations about the future.
- d. Information that is capable of making a difference in the decisions of users in their capacity as capital providers.
- e. Absence of bias intended to attain a predetermined result or to induce a particular behavior.

TEST YOUR KNOWLEDGE

BE2.2 (LO2) Match the qualitative characteristics below with the following statements.

1. Timeliness
 2. Completeness
 3. Free from error
 4. Understandability
 5. Faithful representation
 6. Relevance
 7. Neutrality
 8. Confirmatory value
- a. Quality of information that assures users that information represents the economic phenomena that it purports to represent.
 - b. Information about an economic phenomenon that changes past or present expectations based on previous evaluations.
 - c. The extent to which information is accurate in representing the economic substance of a transaction.
 - d. Includes all the information that is necessary for a faithful representation of the economic phenomena that it purports to represent.
 - e. Quality of information that allows users to comprehend its meaning.

TEST YOUR KNOWLEDGE

BE2.4 (LO2) Identify which qualitative characteristic of accounting information is best described in each of the following items. (Do not use relevance and faithful representation.)

- a. The annual reports of **Best Buy Co.** (USA) are audited by certified public accountants.
- b. **Motorola** (USA) and **Nokia** (FIN) both use the FIFO cost flow assumption.
- c. **Starbucks Corporation** (USA) has used straight-line depreciation since it began operations.
- d. **Heineken Holdings** (NLD) issues its quarterly reports immediately after each quarter ends.

TEST YOUR KNOWLEDGE

E2.4 (LO2) (Qualitative Characteristics) The qualitative characteristics that make accounting information useful for decision-making purposes are as follows.

Relevance	Neutrality	Verifiability
Faithful representation	Completeness	Understandability
Predictive value	Timeliness	Comparability
Confirmatory value	Materiality	Free from error

Instructions

Identify the appropriate qualitative characteristic(s) to be used given the information provided below.

- Qualitative characteristic being displayed when companies in the same industry are using the same accounting principles.
- Quality of information that confirms users' earlier expectations.
- Imperative for providing comparisons of a company from period to period.
- Ignores the economic consequences of a standard or rule.
- Requires a high degree of consensus among individuals on a given measurement.
- Predictive value is an ingredient of this fundamental quality of information.
- Four qualitative characteristics that enhance both relevance and faithful representation.
- An item is not reported because its effect on income would not change a decision.
- Neutrality is a key ingredient of this fundamental quality of accounting information.
- Two fundamental qualities that make accounting information useful for decision-making purposes.
- Issuance of interim reports is an example of what enhancing ingredient?

Learning Objective 3: Describe the basic assumptions of accounting

These concepts explain how companies should **recognize** (record), **measure** (express in terms of money or quantify) , and **report** (present in FS) financial elements and events.

Recognition, Measurement, and Disclosure Concepts

ASSUMPTIONS

1. Economic entity
2. Going concern
3. Monetary unit
4. Periodicity
5. Accrual basis

PRINCIPLES

1. Measurement
2. Revenue recognition
3. Expense recognition
4. Full disclosure

CONSTRAINTS

1. Cost

Basic Assumptions

- ▶ **Economic Entity** – company keeps its activity separate from its owners and other business units.
- ▶ **Going Concern** - company to last long enough to fulfill objectives and commitments.
- ▶ **Monetary Unit** - money is the common denominator.
- ▶ **Periodicity** - company can divide its economic activities into time periods.
- ▶ **Accrual Basis of Accounting** – transactions (revenues & expenses) are recorded in the periods in which the events occur, not when cash is exchanged.

Measurement Principles

- ▶ **Historical Cost** is generally thought to be a faithful representation of the **amount paid for a given item**.
Assume you purchase equipment for \$1,000. We record equipment at \$1,000, and we keep reporting it as \$1,000.
- ▶ **Fair value** is defined as “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.”
- ▶ IASB has given companies the **option** to use fair value as the basis for measurement of **financial assets** and **financial liabilities**.

Learning Objective 4: Explain the application of the basic principles of accounting

Revenue Recognition

Requires that companies **recognize revenue** in the accounting period in which the **performance obligation is satisfied**.

When a company agrees to perform a service or sell a product to a customer, it has a **performance obligation**.

Expense Recognition

Expenses are outflows or “using up” of assets or incurring of liabilities during a period as a result of delivering or producing goods and/or rendering services.

“Let expenses follow the revenues.”

Full Disclosure

Providing all information that is of sufficient importance to influence the judgment and decisions of an informed user.

Provided through:

- ▶ **Financial Statements**
- ▶ **Notes to the Financial Statements**
- ▶ **Supplementary information**

TEST YOUR KNOWLEDGE

E2.6 (LO3,4) (Assumptions, Principles, and Constraint) Presented below are the assumptions, principles, and constraint used in this chapter.

- | | | |
|-------------------------------|----------------------------------|-----------------------------------|
| 1. Economic entity assumption | 5. Accrual-basis assumption | 9. Full disclosure principle |
| 2. Going concern assumption | 6. Historical cost principle | 10. Revenue recognition principle |
| 3. Monetary unit assumption | 7. Fair value principle | 11. Cost constraint |
| 4. Periodicity assumption | 8. Expense recognition principle | |

Instructions

Identify by number the accounting assumption, principle, or constraint that describes each situation below. Do not use a number more than once.

- a. Allocates expenses to revenues in the proper period.
- b. Indicates that fair value changes subsequent to purchase are not recorded in the accounts. (Do not use revenue recognition principle.)
- c. Ensures that all relevant financial information is reported.
- d. Rationale why plant assets are not reported at liquidation value. (Do not use historical cost principle.)
- e. Generally records revenue at the point of sale.
- f. Indicates that personal and business record keeping should be separately maintained.
- g. Separates financial information into time periods for reporting purposes.
- h. Permits the use of fair value valuation in certain situations.
- i. Assumes that the yen is the “measuring stick” used to report on financial performance of a Japanese company.

TEST YOUR KNOWLEDGE

E2.7 (LO3,4) (Assumptions, Principles, and Constraint) Presented below are a number of operational guidelines and practices that have developed over time.

Instructions

Select the assumption, principle, or constraint that most appropriately justifies these procedures and practices. (Do not use qualitative characteristics.)

- a. Fair value changes are not recognized in the accounting records.
- b. Accounts receivable are recorded for sales on account rather than waiting until cash is received.
- c. Financial information is presented so that investors will not be misled.
- d. Intangible assets are capitalized and amortized over periods benefited.
- e. Brokerage companies use fair value for purposes of valuing financial securities.
- f. Each enterprise is kept as a unit distinct from its owner or owners.
- g. All significant post-statement of financial position events are reported.
- h. Revenue is recorded at point of sale.
- i. All important aspects of bond indentures are presented in financial statements.
- j. Rationale for accrual accounting.
- k. The use of consolidated statements is justified.
- l. Reporting must be done at defined time intervals.
- m. An allowance for doubtful accounts is established.
- n. All payments out of petty cash are charged to Miscellaneous Expense.
- o. Goodwill is recorded only at time of purchase.
- p. Cash received and paid is not the basis used to recognize revenues and expenses.
- q. A company charges its sales commission costs to expense.