

## CHAPTER 2

## CONCEPTUAL FRAMEWORK FOR FINANCIAL REPORTING

This IFRS Supplement provides expanded discussions of accounting guidance under International Financial Reporting Standards (IFRS) for the topics in Intermediate Accounting. The discussions are organized according to the chapters in *Intermediate Accounting* (13<sup>th</sup> or 14<sup>th</sup> Editions) and therefore can be used to supplement the U.S. GAAP requirements as presented in the textbook. Assignment material is provided for each supplement chapter, which can be used to assess and reinforce student understanding of IFRS.

## CONCEPTUAL FRAMEWORK

A **conceptual framework** establishes the concepts that underlie financial reporting. A conceptual framework is a coherent system of concepts that flow from an objective. The objective identifies the purpose of financial reporting. The other concepts provide guidance on (1) identifying the boundaries of financial reporting; (2) selecting the transactions, other events, and circumstances to be represented; (3) how they should be recognized and measured; and (4) how they should be summarized and reported.<sup>1</sup>

### Need for a Conceptual Framework

Why do we need a conceptual framework? First, to be useful, rule-making should build on and relate to an established body of concepts. A soundly developed conceptual framework thus enables the IASB to issue **more useful and consistent pronouncements over time**, and a coherent set of standards should result. Indeed, without the guidance provided by a soundly developed framework, standard-setting ends up being based on individual concepts developed by each member of the standard-setting body. The following observation by a former standard-setter highlights the problem.

“As our professional careers unfold, each of us develops a technical conceptual framework. Some individual frameworks are sharply defined and firmly held; others are vague and weakly held; still others are vague and firmly held. . . . At one time or another, most of us have felt the discomfort of listening to somebody buttress a preconceived conclusion by building a convoluted chain of shaky reasoning. Indeed, perhaps on occasion we have voiced such thinking ourselves. . . . My experience . . . taught me many lessons. A major one was that most of us have a natural tendency and an incredible talent for processing new facts in such a way that our prior conclusions remain intact.”<sup>2</sup>

In other words, standard-setting that is based on personal conceptual frameworks will lead to different conclusions about identical or similar issues than it did previously. As a result, standards will not be consistent with one another, and past decisions may not be indicative of future ones. Furthermore, the framework should increase financial statement users’ understanding of and confidence in financial reporting. It should enhance comparability among companies’ financial statements.

Second, as a result of a soundly developed conceptual framework, the profession should be able to more quickly solve new and emerging **practical problems by referring**

<sup>1</sup>*Proposed Conceptual Framework for Financial Reporting: Objective of Financial Reporting and Qualitative Characteristics of Decision-Useful Financial Reporting Information* (Norwalk, Conn.: FASB, May 29, 2008), page ix. Recall from our discussion in Chapter 1 that while the conceptual framework and any changes to it pass through the same due process (discussion paper, public hearing, exposure draft, etc.) as do the IFRSs, the framework is not an IFRS. That is, the framework does not define standards for any particular measurement or disclosure issue, and nothing in the framework overrides any specific IFRS.

<sup>2</sup>C. Horngren, “Uses and Limitations of a Conceptual Framework,” *Journal of Accountancy* (April 1981), p. 90.

to an existing framework of basic theory. For example, **Sunshine Mining** (USA) sold two issues of bonds. It can redeem them either with \$1,000 in cash or with 50 ounces of silver, whichever is worth more at maturity. Both bond issues have a stated interest rate of 8.5 percent. At what amounts should Sunshine or the buyers of the bonds record them? What is the amount of the premium or discount on the bonds? And how should Sunshine amortize this amount, if the bond redemption payments are to be made in silver (the future value of which is unknown at the date of issuance)? Consider that Sunshine cannot know, at the date of issuance, the value of future silver bond redemption payments.

It is difficult, if not impossible, for the IASB to prescribe the proper accounting treatment quickly for situations like this or like those represented in our opening story. Practicing accountants, however, must resolve such problems on a daily basis. How? Through good judgment and with the help of a universally accepted conceptual framework, practitioners can quickly focus on an acceptable treatment.

## Development of a Conceptual Framework

Both the IASB and the FASB have a conceptual framework. The IASB's conceptual framework is described in the document, "Framework for Preparation and Presentation of Financial Statements." The FASB's conceptual framework is developed in a series of concept statements, which is generally referred to as the Conceptual Framework. The IASB and the FASB are now working on a joint project to develop an improved common conceptual framework that provides a sound foundation for developing future accounting standards. **[1]**<sup>3</sup> Such a framework is essential to fulfilling the Boards' goal of developing standards that are principles-based, internally consistent, and internationally converged, and that lead to financial reporting that provides the information investors need to make sound and effective decisions.

The new framework will build on the existing IASB and FASB frameworks, and consider developments subsequent to the issuance of these frameworks. To date, the project has identified the objective of financial reporting (discussed in Chapter 1) and the qualitative characteristics of decision-useful financial reporting information.

## Overview of the Conceptual Framework

Illustration 2-1 provides an overview of the IASB's conceptual framework, also referred to as the Framework.

The first level identifies the **objective of financial reporting**—that is, the purpose of financial reporting. The second level provides the **qualitative characteristics** that make accounting information useful and the **elements of financial statements** (assets, liabilities, and so on). The third level identifies the **recognition, measurement, and disclosure** concepts used in establishing and applying accounting standards and the specific concepts to implement the objective. These concepts include assumptions, principles, and constraints that describe the present reporting environment. We examine these three levels of the Framework next.

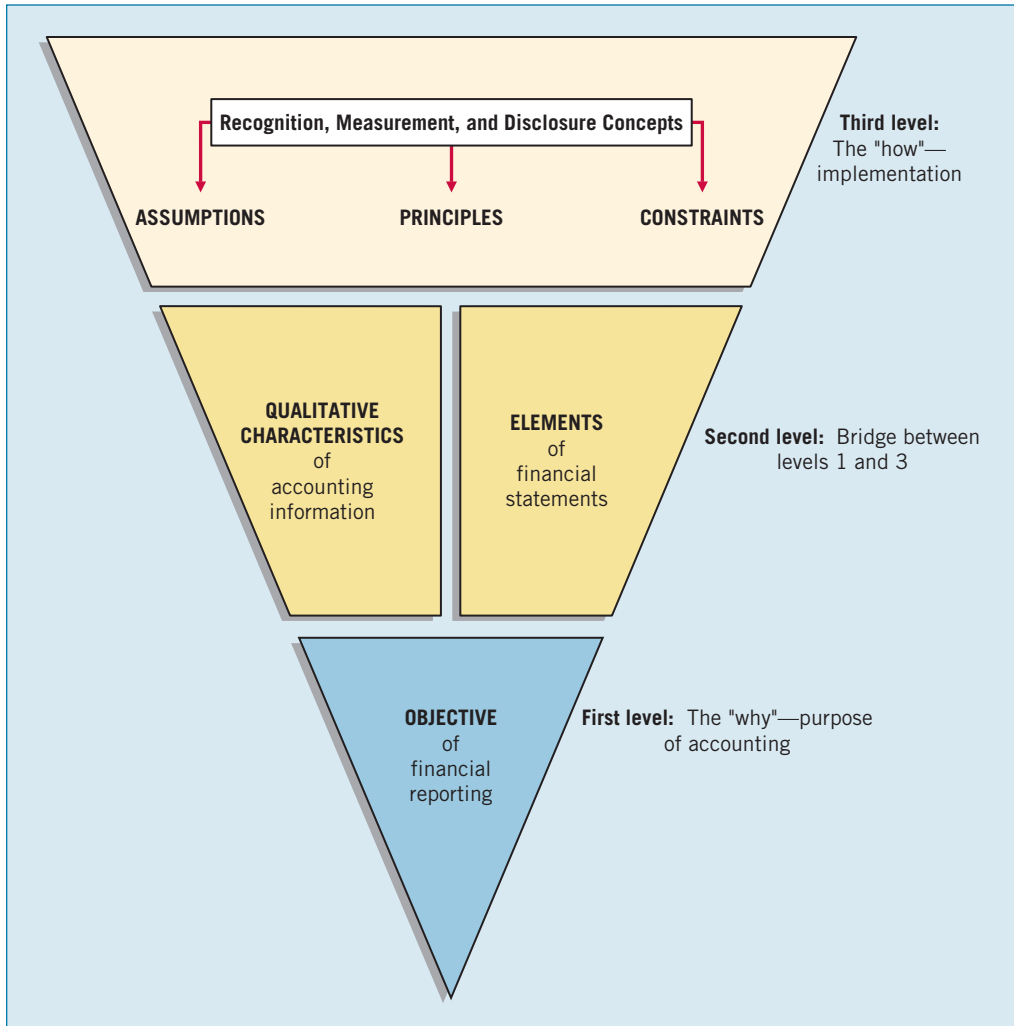
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## FIRST LEVEL: BASIC OBJECTIVE

The **objective of financial reporting** is the foundation of the Framework. Other aspects of the Framework—qualitative characteristics, elements of financial statements, recognition, measurement, and disclosure—flow logically from the objective. Those aspects of the Framework help to ensure that financial reporting achieves its objective.

The objective of general-purpose financial reporting is to provide financial information about the reporting entity that is **useful to present and potential equity investors**,

<sup>3</sup>The FASB Conceptual Framework is contained in seven concepts statements, which are accessible at the FASB website (<http://www.fasb.org/st/#cons>). Information on the joint conceptual framework project can be found at [http://www.fasb.org/project/conceptual\\_framework.shtml](http://www.fasb.org/project/conceptual_framework.shtml).



**ILLUSTRATION 2-1**  
Framework for Financial Reporting

lenders, and other creditors in making decisions in their capacity as capital providers. Information that is **decision-useful** to capital providers may also be useful to other users of financial reporting, who are not capital providers.<sup>4</sup>

As indicated in Chapter 1, to provide information to decision-makers, companies prepare general-purpose financial statements. **General-purpose financial reporting** helps users who lack the ability to demand all the financial information they need from an entity and therefore must rely, at least partly, on the information provided in financial reports. However, an implicit assumption is that users need reasonable knowledge of business and financial accounting matters to understand the information contained in financial statements. This point is important. It means that financial statement preparers assume a level of competence on the part of users. This assumption impacts the way and the extent to which companies report information.

## SECOND LEVEL: FUNDAMENTAL CONCEPTS

The objective (first level) focuses on the purpose of financial reporting. Later, we will discuss the ways in which this purpose is implemented (third level). What, then, is the purpose of the second level? The second level provides conceptual building blocks

<sup>4</sup>“Chapter 1, The Objective of Financial Reporting,” *Proposed Conceptual Framework for Financial Reporting: Objective of Financial Reporting and Qualitative Characteristics of Decision-Useful Financial Reporting Information* (Norwalk, Conn.: FASB, May 2008).

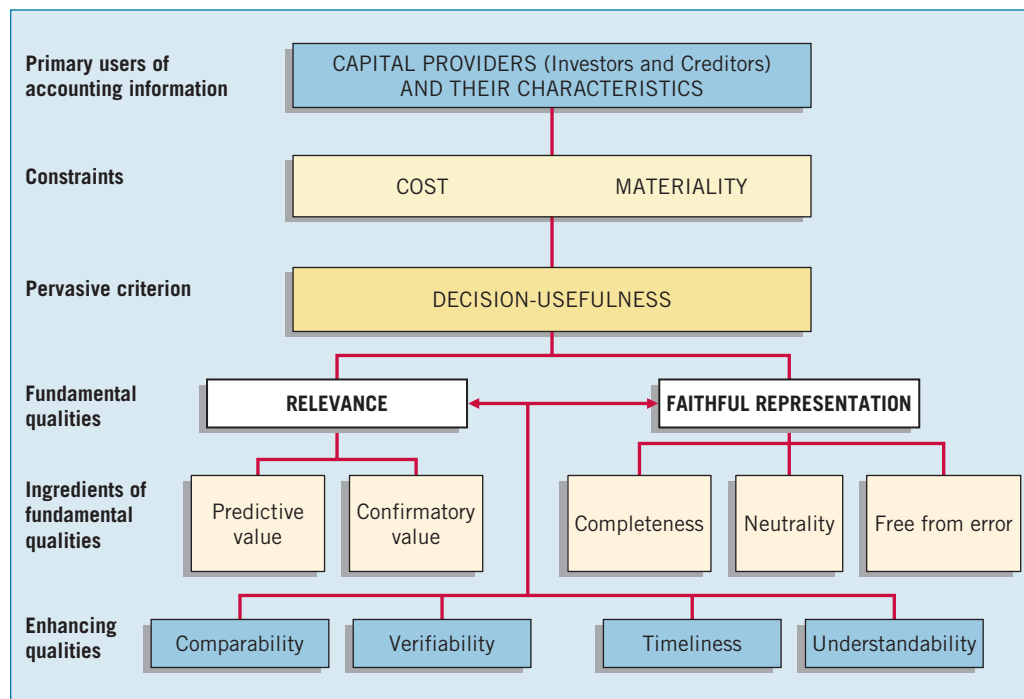
that explain the qualitative characteristics of accounting information and define the elements of financial statements.<sup>5</sup> That is, the second level forms a bridge between the **why** of accounting (the objective) and the **how** of accounting (recognition, measurement, and financial statement presentation).

## Qualitative Characteristics of Accounting Information

Should companies like **Cathay Pacific Airways Ltd.** (HKG) or **Nippon Steel** (JPN) provide information in their financial statements on how much it costs them to acquire their assets (historical cost basis) or how much the assets are currently worth (fair value basis)? Should **PepsiCo** (USA) combine and show as one company the four main segments of its business, or should it report PepsiCo Beverages, Frito Lay, Quaker Foods, and PepsiCo International as four separate segments?

How does a company choose an acceptable accounting method, the amount and types of information to disclose, and the format in which to present it? The answer: By determining **which alternative provides the most useful information for decision-making purposes (decision-usefulness)**. The IASB identified the **qualitative characteristics** of accounting information that distinguish better (more useful) information from inferior (less useful) information for decision-making purposes. In addition, the IASB identified certain constraints (cost and materiality) as part of the conceptual framework (discussed later in the chapter). As Illustration 2-2 shows, the characteristics may be viewed as a hierarchy.

**ILLUSTRATION 2-2**  
Hierarchy of Accounting  
Qualities



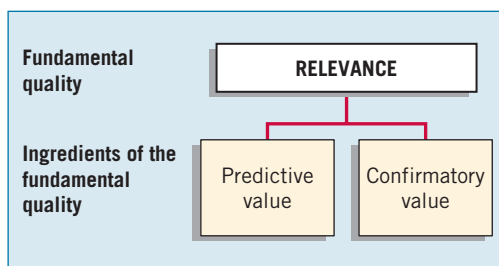
As indicated by Illustration 2-2, qualitative characteristics are either fundamental or enhancing characteristics, depending on how they affect the decision-usefulness of information. Regardless of classification, each qualitative characteristic contributes to the decision-usefulness of financial reporting information. However, providing useful

<sup>5</sup>"Chapter 2, Qualitative Characteristics and Constraints of Decision-Useful Financial Reporting Information," *Proposed Conceptual Framework for Financial Reporting: The Objective of Financial Reporting and Qualitative Characteristics and Constraints of Decision-Useful Financial Reporting Information* (Norwalk, Conn.: FASB, May 2008), paras. QC7–QC38.

financial information is limited by two pervasive constraints on financial reporting—cost and materiality.

### Fundamental Quality—Relevance

Relevance is one of the two fundamental qualities that make accounting information useful for decision-making. Relevance and related ingredients of this fundamental quality are shown below.



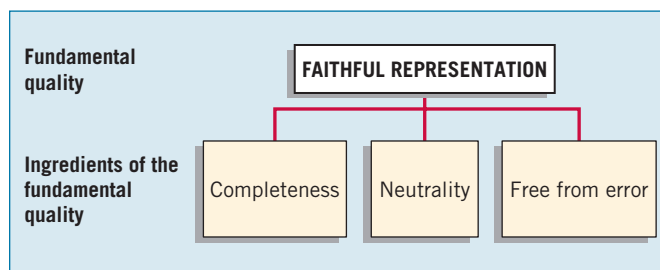
To be **relevant**, accounting information must be **capable of making a difference in a decision**. Information with no bearing on a decision is irrelevant. Financial information is capable of making a difference when it has predictive value, confirmatory value, or both.

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. For example, if potential investors are interested in purchasing ordinary shares in **Stora Enso** (NLD), they may analyze its current resources and claims to those resources, its dividend payments, and its past income performance to predict the amount, timing, and uncertainty of Stora Enso's future cash flows.

Relevant information also helps users confirm or correct prior expectations; it has **confirmatory value**. For example, when Stora Enso issues its year-end financial statements, it confirms or changes past (or present) expectations based on previous evaluations. It follows that predictive value and confirmatory value are interrelated. For example, information about the current level and structure of Stora Enso's assets and liabilities helps users predict its ability to take advantage of opportunities and to react to adverse situations. The same information helps to confirm or correct users' past predictions about that ability.

### Fundamental Quality—Faithful Representation

Faithful representation is the second fundamental quality that makes accounting information useful for decision-making. Faithful representation and related ingredients of this fundamental quality are shown below.



**Faithful representation** means that the numbers and descriptions match what really existed or happened. Faithful representation is a necessity because most users have neither the time nor the expertise to evaluate the factual content of the information. For example, if **Siemens AG's** (DEU) income statement reports sales of €60,510 million

when it had sales of €40,510 million, then the statement fails to faithfully represent the proper sales amount. To be a faithful representation, information must be complete, neutral, and free of material error.

**Completeness.** **Completeness** means that all the information that is necessary for faithful representation is provided. An omission can cause information to be false or misleading and thus not be helpful to the users of financial reports. For example, when **Citigroup** (USA) fails to provide information needed to assess the value of its subprime loan receivables (toxic assets), the information is not complete and therefore not a faithful representation of their values.

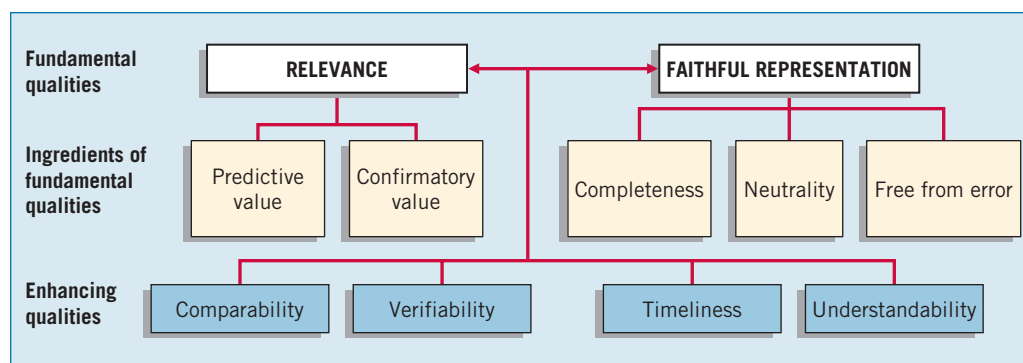
**Neutrality.** **Neutrality** means that a company cannot select information to favor one set of interested parties over another. Unbiased information must be the overriding consideration. For example, in the notes to financial statements, tobacco companies such as **KT & G Corporation** (KOR) should not suppress information about the numerous lawsuits that have been filed because of tobacco-related health concerns—even though such disclosure is damaging to the company.

Neutrality in rule-making has come under increasing attack. Some argue that the IASB should not issue pronouncements that cause undesirable economic effects on an industry or company. We disagree. Accounting rules (and the standard-setting process) must be free from bias, or we will no longer have credible financial statements. Without credible financial statements, individuals will no longer use this information. An analogy demonstrates the point: In the United States, many individuals bet on boxing matches because such contests are assumed not to be fixed. But nobody bets on wrestling matches. Why? Because the public assumes that wrestling matches are rigged. If financial information is biased (rigged), the public will lose confidence and no longer use it.

**Free from Error.** An information item that is **free from error** will be a more accurate (faithful) representation of a financial item. For example, if **UBS** (CHE) misstates its loan losses, its financial statements are misleading and not a faithful representation of its financial results. However, faithful representation does not imply total freedom from error. This is because most financial reporting measures involve estimates of various types that incorporate management's judgment. For example, management must estimate the amount of uncollectible accounts to determine bad debt expense. And determination of depreciation expense requires estimation of useful lives of plant and equipment.

### Enhancing Qualities

Enhancing qualitative characteristics are complementary to the fundamental qualitative characteristics. These characteristics distinguish more-useful information from less-useful information. Enhancing characteristics, shown below, are comparability, verifiability, timeliness, and understandability.



**Comparability.** Information that is measured and reported in a similar manner for different companies is considered comparable. **Comparability** enables users to identify the real

similarities and differences in economic events between companies. For example, historically the accounting for pensions in Japan differs from that in the United States. In Japan, companies generally recorded little or no charge to income for these costs. U.S. companies record pension cost as incurred. As a result, it is difficult to compare and evaluate the financial results of **Toyota** (JPN) or **Honda** (JPN) to **General Motors** (USA) or **Ford** (USA). Investors can only make valid evaluations if comparable information is available.

Another type of comparability, **consistency**, is present when a company applies the same accounting treatment to similar events, from period to period. Through such application, the company shows consistent use of accounting standards. The idea of consistency does not mean, however, that companies cannot switch from one accounting method to another. A company can change methods, but it must first demonstrate that the newly adopted method is preferable to the old. If approved, the company must then disclose the nature and effect of the accounting change, as well as the justification for it, in the financial statements for the period in which it made the change.<sup>6</sup> When a change in accounting principles occurs, the auditor generally refers to it in an explanatory paragraph of the audit report. This paragraph identifies the nature of the change and refers the reader to the note in the financial statements that discusses the change in detail.<sup>7</sup>

**Verifiability.** **Verifiability** occurs when **independent measurers, using the same methods, obtain similar results.** Verifiability occurs in the following situations.

1. Two independent auditors count **Anheuser-Busch InBev NV's** (BEL) inventory and arrive at the same physical quantity amount for inventory. Verification of an amount for an asset therefore can occur by simply counting the inventory (referred to as *direct verification*).
2. Two independent auditors compute **Anheuser-Busch InBev NV's** (BEL) inventory value at the end of the year using the FIFO method of inventory valuation. Verification may occur by checking the inputs (quantity and costs) and recalculating the outputs (ending inventory value) using the same accounting convention or methodology (referred to as *indirect verification*).

**Timeliness.** **Timeliness** means having information available to decision-makers before it loses its capacity to influence decisions. Having relevant information available sooner can enhance its capacity to influence decisions, and a lack of timeliness can rob information of its usefulness. For example, if **Lenovo** (CHN) waited to report its interim results until nine months after the period, the information would be much less useful for decision-making purposes.

**Understandability.** Decision-makers vary widely in the types of decisions they make, how they make decisions, the information they already possess or can obtain from other sources, and their ability to process the information. For information to be useful, there must be a connection (linkage) between these users and the decisions they make. This link, **understandability**, is the quality of information that lets reasonably informed users see its significance. Understandability is enhanced when information is classified, characterized, and presented clearly and concisely.

For example, assume that **Tomkins plc** (GBR) issues a three-months' report that shows interim earnings have declined significantly. This interim report provides relevant and faithfully represented information for decision-making purposes. Some users, upon reading the report, decide to sell their shares. Other users, however, do not understand the report's content and significance. They are surprised when Tomkins

<sup>6</sup>Surveys indicate that users highly value consistency. They note that a change tends to destroy the comparability of data before and after the change. Some companies assist users to understand the pre- and post-change data. Generally, however, users say they lose the ability to analyze over time. IFRS guidelines (discussed in Chapter 22) on accounting changes are designed to improve the comparability of the data before and after the change.

<sup>7</sup>In the United States, these provisions are specified in "Reports on Audited Financial Statements," *Statement on Auditing Standards No. 58* (New York: AICPA, April 1988), par. 34.

declares a smaller year-end dividend and the share price declines. Thus, although Tomkins presented highly relevant information that was a faithful representation, it was useless to those who did not understand it.

Thus, users of financial reports are assumed to have a reasonable knowledge of business and economic activities. In making decisions, users also should review and analyze the information with reasonable diligence. Information that is relevant and faithfully represented should not be excluded from financial reports solely because it is too complex or difficult for some users to understand without assistance.<sup>8</sup>

## Basic Elements

An important aspect of developing any theoretical structure is the body of **basic elements** or definitions to be included in it. Accounting uses many terms with distinctive and specific meanings. These terms constitute the language of business or the jargon of accounting.

One such term is **asset**. Is it merely something we own? Or is an asset something we have the right to use, as in the case of leased equipment? Or is it anything of value used by a company to generate revenues—in which case, should we also consider the managers of a company as an asset?

As this example and the lottery ticket example in the opening story illustrate, it is necessary, therefore, to develop basic definitions for the elements of financial statements. The IASB Framework defines the five interrelated elements that most directly relate to measuring the performance and financial status of a business enterprise. We list them below for review and information purposes; you need not memorize these definitions at this point. We will explain and examine each of these elements in more detail in subsequent chapters.

### U.S. GAAP PERSPECTIVE



The FASB Conceptual Framework has an expanded set of defined elements, including (1) investments by owners, (2) distributions to owners, (3) comprehensive income, (4) gains, and (5) losses.

## ELEMENTS OF FINANCIAL STATEMENTS

The elements directly related to the **measurement of financial position** are assets, liabilities, and equity. These are defined as follows:

**ASSET.** A resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.

**LIABILITY.** A present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

**EQUITY.** The residual interest in the assets of the entity after deducting all its liabilities.

The elements of income and expenses are defined as follows:

**INCOME.** Increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.

**EXPENSES.** Decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants.

As indicated, the IASB classifies the elements into two distinct groups. [2] The first group of three elements—assets, liabilities, and equity—describes amounts of resources

<sup>8</sup>“Chapter 2, Qualitative Characteristics and Constraints of Decision-Useful Financial Reporting Information,” *Proposed Conceptual Framework for Financial Reporting: The Objective of Financial Reporting and Qualitative Characteristics and Constraints of Decision-Useful Financial Reporting Information* (Norwalk, Conn.: FASB, May 2008), paras. QC23–QC24.



and claims to resources at a **moment in time**. The second group of two elements describes transactions, events, and circumstances that affect a company during a **period of time**. The first class, affected by elements of the second class, provides at any time the cumulative result of all changes. This interaction is referred to as “**articulation**.” That is, key figures in one financial statement correspond to balances in another.

## THIRD LEVEL: RECOGNITION, MEASUREMENT, AND DISCLOSURE CONCEPTS

The third level of the framework consists of concepts that implement the basic objectives of level one. These concepts explain how companies should recognize, measure, and report financial elements and events. Here, we identify the concepts as basic assumptions, principles, and constraints. Not everyone uses this classification system, so focus your attention more on **understanding the concepts** than on how we classify and organize them. These concepts serve as guidelines in responding to controversial financial reporting issues.

### Basic Assumptions

Five basic **assumptions** underlie the financial accounting structure: (1) **economic entity**, (2) **going concern**, (3) **monetary unit**, (4) **periodicity**, and (5) **accrual basis**. We’ll look at each in turn.

#### Economic Entity Assumption

The **economic entity assumption** means that economic activity can be identified with a **particular unit of accountability**. In other words, a company keeps its activity separate and distinct from its owners and any other business unit.<sup>9</sup> At the most basic level, the economic entity assumption dictates that **Sappi Limited** (ZAF) record the **company’s financial activities separate from those of its owners and managers**. Equally important, financial statement users need to be able to distinguish the activities and elements of different companies, such as **Volvo** (SWE), **Ford** (USA), and **Volkswagen AG** (DEU). If users could not distinguish the activities of different companies, how would they know which company financially outperformed the other?

The entity concept does not apply solely to the segregation of activities among competing companies, such as **Toyota** (JPN) and **Hyundai** (KOR). An individual, department, division, or an entire industry could be considered a separate entity if we choose to define it in this manner. Thus, **the entity concept does not necessarily refer to a legal entity**. A parent and its subsidiaries are separate **legal entities**, but merging their activities for accounting and reporting purposes does not violate the **economic entity assumption**.<sup>10</sup>

<sup>9</sup>Recently, the IASB has proposed to link the definition of an entity to its financial reporting objective. That is, a reporting entity is described as a circumscribed area of business activity of interest to present and potential equity investors, lenders, and other capital providers. See IASB/FASB *Exposure Draft ED/2010/2: Conceptual Framework for Financial Reporting*, “The Reporting Entity” (March 2010) at <http://www.iasb.org/Current+Projects/IASB+Projects/Conceptual+Framework/Conceptual+Framework.htm>.

<sup>10</sup>The concept of the entity is changing. For example, defining the “outer edges” of companies is now harder. Public companies often consist of multiple public subsidiaries, each with joint ventures, licensing arrangements, and other affiliations. Increasingly, companies form and dissolve joint ventures or customer-supplier relationships in a matter of months or weeks. These “virtual companies” raise accounting issues about how to account for the entity. See Steven H. Wallman, “The Future of Accounting and Disclosure in an Evolving World: The Need for Dramatic Change,” *Accounting Horizons* (September 1995). The IASB is addressing these issues in the entity phase of its conceptual framework project (see <http://www.iasb.org/Current+Projects/IASB+Projects/Conceptual+Framework/Conceptual+Framework.htm>) and in its project on consolidations (see <http://www.iasb.org/Current%20Projects/IASB%20Projects/Consolidation/Consolidation.htm>).

### Going Concern Assumption

Most accounting methods rely on the **going concern assumption**—that the company will have a long life. Despite numerous business failures, most companies have a fairly high continuance rate. As a rule, we expect companies to last long enough to fulfill their objectives and commitments.

This assumption has significant implications. The cost principle would be of limited usefulness if we assume eventual liquidation. Under a liquidation approach, for example, a company would better state asset values at fair value than at acquisition cost. **Depreciation and amortization policies are justifiable and appropriate only if we assume some permanence to the company.** If a company adopts the liquidation approach, the current/non-current classification of assets and liabilities loses much of its significance. Labeling anything a long-lived or non-current asset would be difficult to justify. Indeed, listing liabilities on the basis of priority in liquidation would be more reasonable.

The going concern assumption applies in most business situations. **Only where liquidation appears imminent is the assumption inapplicable.** In these cases a total revaluation of assets and liabilities can provide information that closely approximates the company's fair value. You will learn more about accounting problems related to a company in liquidation in advanced accounting courses.

### Monetary Unit Assumption

The **monetary unit assumption** means that money is the common denominator of economic activity and provides an appropriate basis for accounting measurement and analysis. That is, the monetary unit is the most effective means of expressing to interested parties changes in capital and exchanges of goods and services. **The monetary unit is relevant, simple, universally available, understandable, and useful.** Application of this assumption depends on the even more basic assumption that quantitative data are useful in communicating economic information and in making rational economic decisions.

**Accounting generally ignores price-level changes (inflation and deflation) and assumes that the unit of measure—euros, dollars, or yen—remains reasonably stable.** We therefore use the monetary unit assumption to justify adding 1980 euros to 2011 euros without any adjustment. It is expected that the euro or other currency, unadjusted for inflation or deflation, will continue to be used to measure items recognized in financial statements. Only if circumstances change dramatically (such as high inflation rates similar to that in some South American countries) will “inflation accounting” be considered.<sup>11</sup>

### Periodicity Assumption

To measure the results of a company's activity accurately, we would need to wait until it liquidates. Decision-makers, however, cannot wait that long for such information. Users need to know a company's performance and economic status on a timely basis so that they can evaluate and compare companies, and take appropriate actions. Therefore, companies must report information periodically.

The **periodicity** (or **time period**) **assumption** implies that a company can divide its economic activities into artificial time periods. These time periods vary, but the most common are monthly, quarterly, and yearly.

The shorter the time period, the more difficult it is to determine the proper net income for the period. A month's results usually prove less reliable than a quarter's results, and a **quarter's results are likely to be less reliable than a year's results.** Investors desire and demand that a company quickly process and disseminate information. Yet the quicker a company releases the information, the more likely the information will include errors. **This phenomenon provides an interesting example of the trade-off between relevance and faithful representation in preparing financial data.**

<sup>11</sup>There is a separate IFRS (*IFRS No. 29, “Financial Reporting in Hyperinflationary Economies”*) that provides guidance on how to account for adjustments to the purchasing power of the monetary unit. [3]

The problem of defining the time period becomes more serious as product cycles shorten and products become obsolete more quickly. Many believe that, given technology advances, companies need to provide more online, real-time financial information to ensure the availability of relevant information.

### Accrual Basis of Accounting

Companies prepare financial statements using the accrual basis of accounting. **Accrual-basis accounting** means that **transactions that change a company's financial statements are recorded in the periods in which the events occur**. For example, using the accrual basis means that companies recognize revenues when it is probable that future economic benefits will flow to the company and reliable measurement is possible (the revenue recognition principle). This is in contrast to recognition based on receipt of cash. Likewise, under the accrual basis, companies recognize expenses when incurred (the expense recognition principle) rather than when paid.

An alternative to the accrual basis is the cash basis. Under cash-basis accounting, companies record revenue only when cash is received. They record expenses only when cash is paid. The **cash basis of accounting is prohibited under IFRS**. Why? Because it does not record revenue according to the revenue recognition principle (discussed in the next section). Similarly, it does not record expenses when incurred, which violates the expense recognition principle (discussed in the next section).

Financial statements prepared on the accrual basis inform users not only of past transactions involving the payment and receipt of cash but also of obligations to pay cash in the future and of resources that represent cash to be received in the future. Hence, they provide the type of information about past transactions and other events that is most useful in making economic decisions. [4]

## Basic Principles of Accounting

We generally use four basic **principles of accounting** to record and report transactions: (1) measurement, (2) revenue recognition, (3) expense recognition, and (4) full disclosure. We look at each in turn.

### Measurement Principles

We presently have a “mixed-attribute” system in which one of two measurement principles is used. These two principles are the cost principle and the fair value principle. Selection of which principle to follow generally reflects a trade-off between relevance and faithful representation. Here, we discuss each measurement principle.

**Cost Principle.** IFRS requires that companies account for and report many assets and liabilities on the basis of acquisition price. This is often referred to as the **historical cost principle**. Cost has an important advantage over other valuations: **It is generally thought to be a faithful representation of the amount paid for a given item.**

To illustrate this advantage, consider the problems if companies select current selling price instead. Companies might have difficulty establishing a value for unsold items. Every member of the accounting department might value the assets differently. Further, how often would it be necessary to establish sales value? All companies close their accounts at least annually. But some compute their net income every month. Those companies would have to place a sales value on every asset each time they wished to determine income. Critics raise similar objections against current cost (replacement cost, present value of future cash flows) and any other basis of valuation **except historical cost**.

What about liabilities? Do companies account for them on a cost basis? Yes, they do. Companies issue liabilities, such as bonds, notes, and accounts payable, in exchange for assets (or services), for an agreed-upon price. **This price, established by the exchange transaction, is the “cost” of the liability.** A company uses this amount to record the liability in the accounts and report it in financial statements. Thus, many users prefer historical cost because it provides them with a **verifiable benchmark** for measuring historical trends.

**Fair Value Principle.** **Fair value** is defined as “the amount for which an asset could be exchanged, a liability settled, or an equity instrument granted could be exchanged, between knowledgeable, willing parties in an arm’s length transaction.” Fair value is therefore a market-based measure. IFRS has increasingly called for use of fair value measurements in the financial statements. This is often referred to as the **fair value principle**. Fair value information may be more useful than historical cost for certain types of assets and liabilities and in certain industries.

For example, companies report many financial instruments, including derivatives, at fair value. Certain industries, such as brokerage houses and mutual funds, prepare their basic financial statements on a fair value basis. Similarly, in the agricultural industry, biological assets, such as crops and livestock, are measured on the basis of net realizable value. Net realizable value generally approximates fair value for these assets. In these situations, there is a ready and active market for these assets. Thus, the unique nature of these industries calls for a departure from historical cost in favor of fair value measurement.

**At initial acquisition, historical cost equals fair value.** In subsequent periods, as market and economic conditions change, historical cost and fair value often diverge. Thus, fair value measures or estimates often provide more relevant information about the expected future cash flows related to the asset or liability. For example, when long-lived assets decline in value, a fair value measure determines any impairment loss. In this case, fair value measurement, it is argued, provides better insight into the value of a company’s asset and liabilities (its financial position) and a better basis for assessing future cash flow prospects.

The IASB has also taken the additional step of giving companies the option to use fair value (referred to as the **fair value option**) as the basis for measurement of financial assets and financial liabilities. [5] The Board considers fair value more relevant than historical cost in these situations because it reflects the current cash equivalent value of financial instruments. As a result companies now have the option to record fair value in their accounts for most financial instruments, including such items as receivables, investments, debt securities, and financial liabilities.

Some oppose the movement to fair value measurement. They argue that measurement based on fair value introduces increased subjectivity into accounting reports, when fair value information is not readily available. For example, it is easy to arrive at fair values when markets are liquid with many traders, but fair value answers are not readily available in other situations. For example, how do you value the mortgage-backed assets held by **Société Générale** (FRA) and **Barclays** (GBR) if the market for these securities essentially disappears? In these situations, companies may rely on valuation models based on discounted expected cash flows to arrive at fair value measurements. Obviously, a great deal of expertise and sound judgment is needed to arrive at measures that are representationally faithful.<sup>12</sup>

As indicated above, we presently have a “mixed-attribute” system that permits the use of historical cost and fair value. Although the historical cost principle continues to be an important basis for valuation, recording and reporting of fair value information is increasing.

### Revenue Recognition Principle

As discussed earlier, the **revenue recognition principle** indicates that revenue is to be recognized when it is **probable that future economic benefits will flow to the company and reliable measurement of the amount** of revenue is possible. Based on these fundamental concepts of revenue recognition, criteria are then established for various kinds of revenue transactions through the development of related IFRSs. For example, there is a **standard on revenue that identifies the circumstances in which revenue recognition criteria are met for various revenue transactions.** [6]

<sup>12</sup>The IASB is considering a proposal to provide guidance on estimating fair values when market-related data is not available. Similar to fair value guidance in U.S. GAAP, these measurements may be developed using expected cash flow and present value techniques. See IASB *Exposure Draft ED/2009/5, “Fair Value Measurement”* (London, U.K.: IASB, May 2009).

#### U.S. GAAP PERSPECTIVE



Both the IASB and FASB have similar measurement principles, based on historical cost and fair value. However, U.S. GAAP has a concept statement to guide estimation of fair values when market-related data is not available (*Statement of Financial Accounting Concepts No. 7, “Using Cash Flow Information and Present Value in Accounting”*). The IASB is considering a proposal to provide expanded guidance on estimating fair values when market-related data is not available.

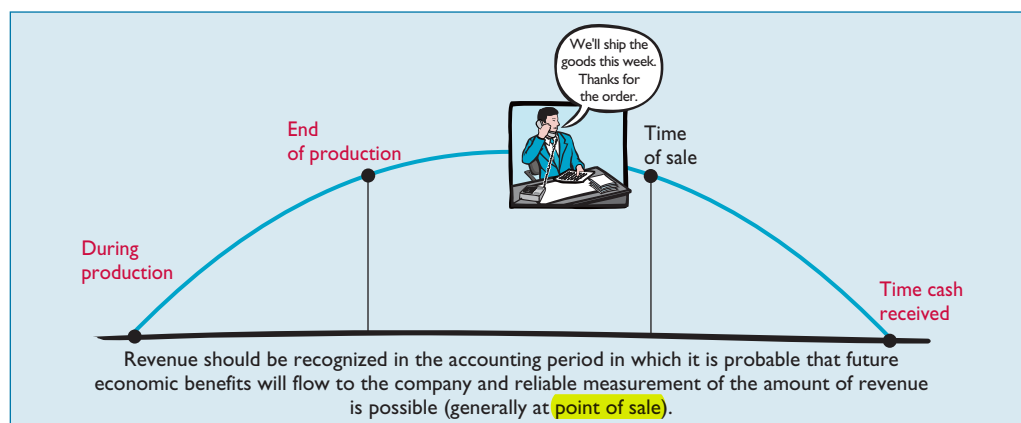
#### U.S. GAAP PERSPECTIVE



Under U.S. GAAP, revenue is recognized when realized (when the company receives cash or claims to cash) and earned (when the company substantially accomplishes what it must do to be entitled to the benefits represented by the revenues).

Generally, an objective test, such as a sale, indicates the point at which a company recognizes revenue. The sale provides an objective and verifiable measure of revenue—the sales price. Any basis for revenue recognition short of actual sale opens the door to wide variations in practice. **Recognition at the time of sale provides a uniform and reasonable test.**<sup>13</sup>

However, as Illustration 2-3 shows, exceptions to the rule exist. We discuss these exceptions in the following sections.



**ILLUSTRATION 2-3**  
Timing of Revenue  
Recognition

**During Production.** A company can recognize revenue **before** it completes the job in certain long-term construction contracts. In this method, a company recognizes revenue periodically, based on the percentage of the job it has completed. Although technically a transfer of ownership has not occurred, it is probable that future economic benefits will flow to the company. If it is not possible to obtain dependable estimates of cost and progress, then a company delays revenue recognition until it completes the job.

**At End of Production.** At times, a company may recognize revenue **after completion of the production cycle but before the sale takes place.** This occurs if products or other assets are salable in an active market at readily determinable prices without significant additional cost. An example is the mining of certain minerals. Once a company mines the mineral, a ready market at a quoted price exists. The same holds true for harvested assets in the agricultural industry.

**Upon Receipt of Cash.** Receipt of cash is another basis for revenue recognition. Companies use the cash-basis approach only when collection is uncertain at the time of sale.

One form of the cash basis is the **installment-sales method.** Here, a company requires payment in periodic installments over a long period of time. Its most common use is in retail, such as for farm and home equipment and furnishings. Companies frequently justify the installment-sales method based on the high risk of not collecting an account receivable. In some instances, this reasoning may be valid. Generally, though, if a sale has been completed, the company should recognize the sale; **if bad debts are expected, the company should record them as separate estimates.**

To summarize, a company records revenue in the period in which it is probable that future economic benefits will flow to the company and reliable measurement of the amount of revenue is possible. Normally, this is the date of sale. But circumstances may dictate application of the percentage-of-completion approach, the end-of-production approach, or the receipt-of-cash approach.

<sup>13</sup>The FASB and IASB are working on a joint revenue recognition project, which will likely change from revenue recognition criteria based on completing the earnings process to criteria more aligned with changes in assets and liabilities. See [http://www.fasb.org/project/revenue\\_recognition.shtml](http://www.fasb.org/project/revenue_recognition.shtml).

### Expense Recognition Principle

Expenses are defined as outflows or other “using up” of assets or incurring of liabilities (or a combination of both) during a period as a result of delivering or producing goods and/or rendering services. It follows then that recognition of expenses is related to net changes in assets and earning revenues. In practice, the approach for recognizing expenses is, “Let the expense follow the revenues.” This approach is the **expense recognition principle**.

To illustrate, companies recognize expenses not when they pay wages or make a product, but when the work (service) or the product actually contributes to revenue. Thus, companies tie expense recognition to revenue recognition. That is, by matching efforts (expenses) with accomplishment (revenues), the expense recognition principle is implemented in accordance with the definition of expense (outflows or other using up of assets or incurring of liabilities).<sup>14</sup>

Some costs, however, are difficult to associate with revenue. As a result, some other approach must be developed. Often, companies use a “rational and systematic” allocation policy that will approximate the expense recognition principle. This type of expense recognition involves assumptions about the benefits that a company receives as well as the cost associated with those benefits. For example, a company like Intel (USA) or Nokia (FIN) allocates the cost of equipment over all of the accounting periods during which it uses the asset because the asset contributes to the generation of revenue throughout its useful life.

Companies charge some costs to the current period as expenses (or losses) simply because they cannot determine a connection with revenue. Examples of these types of costs are officers’ salaries and other administrative expenses.

Costs are generally classified into two groups: **product costs** and **period costs**. **Product costs**, such as material, labor, and overhead, attach to the product. Companies carry these costs into future periods if they recognize the revenue from the product in subsequent periods. **Period costs**, such as officers’ salaries and other administrative expenses, attach to the period. Companies charge off such costs in the immediate period, even though benefits associated with these costs may occur in the future. Why? Because companies cannot determine a direct relationship between period costs and revenue. Illustration 2-4 summarizes these expense recognition procedures.

#### ILLUSTRATION 2-4 Expense Recognition

| Type of Cost  | Relationship                                     | Recognition                                |
|---|--|--|
| <b>Product costs:</b> <ul style="list-style-type: none"> <li>• Material</li> <li>• Labor</li> <li>• Overhead</li> </ul> | Direct relationship between cost and revenue.    | Recognize in period of revenue (matching). |
| <b>Period costs:</b> <ul style="list-style-type: none"> <li>• Salaries</li> <li>• Administrative costs</li> </ul>       | No direct relationship between cost and revenue. | Expense as incurred.                       |

### Full Disclosure Principle

In deciding what information to report, companies follow the general practice of providing information that is of sufficient importance to influence the judgment and decisions of an informed user. Often referred to as the **full disclosure principle**, it recognizes that the nature and amount of information included in financial reports reflects a series of judgmental trade-offs. These trade-offs strive for (1) sufficient detail to disclose matters that **make a difference** to users, yet (2) sufficient condensation to make the **information understandable**, keeping in mind costs of preparing and using it.

<sup>14</sup>This approach is commonly referred to as the **matching principle**. However, there is some debate about the conceptual validity of the matching principle. A major concern is that matching permits companies to defer certain costs and treat them as assets on the statement of financial position. In fact, these costs may not have future benefits. If abused, this principle permits the statement of financial position to become a “dumping ground” for unmatched costs.

Users find information about financial position, income, cash flows, and investments in one of three places: (1) within the main body of financial statements, (2) in the notes to those statements, or (3) as supplementary information.

As discussed in Chapter 1, the **financial statements** are the statement of financial position, income statement or statement of comprehensive income, statement of cash flows, and statement of changes in equity. They are a structured means of communicating financial information. An item that meets the definition of an element should be recognized if: (a) it is probable that any future economic benefit associated with the item will flow to or from the entity; and (b) the item has a cost or value that can be measured with reliability. [7]

Disclosure is not a substitute for proper accounting. As a noted accountant indicated, “Good disclosure does not cure bad accounting any more than an adjective or adverb can be used without, or in place of, a noun or verb.” Thus, for example, cash-basis accounting for cost of goods sold is misleading, even if a company discloses accrual-basis amounts in the notes to the financial statements.

The **notes to financial statements** generally amplify or explain the items presented in the main body of the statements. If the main body of the financial statements gives an incomplete picture of the performance and position of the company, the notes should provide the additional information needed. Information in the notes does not have to be quantifiable, nor does it need to qualify as an element. Notes can be partially or totally narrative. Examples of notes include descriptions of the accounting policies and methods used in measuring the elements reported in the statements, explanations of uncertainties and contingencies, and statistics and details too voluminous for presentation in the statements. The notes can be essential to understanding the company’s performance and position.

**Supplementary information** may include details or amounts that present a different perspective from that adopted in the financial statements. It may be quantifiable information that is high in relevance but low in reliability. For example, oil and gas companies typically provide information on proven reserves as well as the related discounted cash flows.

Supplementary information may also include management’s explanation of the financial information and its discussion of the significance of that information. For example, many business combinations have produced financing arrangements that demand new accounting and reporting practices and principles. In each of these situations, the same problem must be faced: making sure the company presents enough information to ensure that the **reasonably prudent investor** will not be misled.

We discuss the content, arrangement, and display of financial statements, along with other facets of full disclosure, in Chapters 4, 5, and 24.

## Constraints

In providing information with the qualitative characteristics that make it useful, companies must consider two overriding factors that limit (constrain) the reporting. These **constraints** are: (1) **cost** and (2) **materiality**.

### Cost Constraint

Too often, users assume that information is free. But preparers and providers of accounting information know that it is not. Therefore, companies must consider the **cost constraint**: They must weigh the costs of providing the information against the benefits that can be derived from using it. Rule-making bodies and governmental agencies use cost-benefit analysis before making final their informational requirements. In order to justify requiring a particular measurement or disclosure, the benefits perceived to be derived from it must exceed the costs perceived to be associated with it.

A corporate executive made the following remark to a standard-setter about a proposed rule: “In all my years in the financial arena, I have never seen such an absolutely ridiculous proposal. . . . To dignify these ‘actuarial’ estimates by recording them as

assets and liabilities would be virtually unthinkable except for the fact that the FASB has done equally stupid things in the past. . . . For God's sake, use common sense just this once."<sup>15</sup> Although extreme, this remark indicates the frustration expressed by members of the business community about rule-making, and whether the benefits of a given pronouncement exceed the costs.

The difficulty in cost-benefit analysis is that the costs and especially the benefits are not always evident or measurable. The costs are of several kinds: costs of collecting and processing, of disseminating, of auditing, of potential litigation, of disclosure to competitors, and of analysis and interpretation. Benefits to preparers may include greater management control and access to capital at a lower cost. Users may receive better information for allocation of resources, tax assessment, and rate regulation. As noted earlier, benefits are generally more difficult to quantify than are costs.

The implementation of the provisions of the Sarbanes-Oxley Act in the United States illustrates the challenges in assessing costs and benefits of standards. One study estimated the increased costs of complying with the new internal-control standards related to the financial reporting process to be an average of \$7.8 million per company. However, the study concluded that ". . . quantifying the benefits of improved more reliable financial reporting is not fully possible."<sup>16</sup>

Despite the difficulty in assessing the costs and benefits of its rules, the IASB attempts to determine that each proposed pronouncement will fill a significant need and that the costs imposed to meet the standard are justified in relation to overall benefits of the resulting information. In addition, they seek input on costs and benefits as part of their due process.

### Materiality Constraint

The **materiality constraint** concerns an item's impact on a company's overall financial operations. An item is **material** if its inclusion or omission would influence or change the judgment of a reasonable person. As noted in the IASB Framework: "Information is material if its omission or misstatement could influence the decisions that users make on the basis of an entity's financial information. . . . When considering whether financial information is a faithful representation of what it purports to represent, it is important to take into account materiality because material omissions or misstatements will result in information that is incomplete, biased, or not free from error."<sup>17</sup> It is *immaterial*, and therefore irrelevant, if it would have no impact on a decision-maker. In short, **it must make a difference** or a company need not disclose it.

The point involved here is of **relative size and importance**. If the amount involved is significant when compared with the other revenues and expenses, assets and liabilities, or net income of the company, sound and acceptable standards should be followed in reporting it. If the amount is so small that it is unimportant when compared with other items, applying a particular standard may be considered of less importance.

It is difficult to provide firm guidelines in judging when a given item is or is not material. Materiality varies both with relative amount and with relative importance. For example, the two sets of numbers in Illustration 2-5 indicate relative size.

During the period in question, the revenues and expenses, and therefore the net incomes of Company A and Company B, are proportional. Each reported an unusual gain. In looking at the abbreviated income figures for Company A, it appears insignificant whether the amount of the unusual gain is set out separately or merged with the regular

<sup>15</sup>"Decision-Usefulness: The Overriding Objective," *FASB Viewpoints* (October 19, 1983), p. 4.

<sup>16</sup>Charles Rivers and Associates, "Sarbanes-Oxley Section 404: Costs and Remediation of Deficiencies," letter from Deloitte and Touche, Ernst and Young, KPMG, and PricewaterhouseCoopers to the SEC (April 11, 2005).

<sup>17</sup>"Chapter 2, Qualitative Characteristics and Constraints of Decision-Useful Financial Reporting Information," *Proposed Conceptual Framework for Financial Reporting* (Norwalk, Conn.: FASB, May 2008), par. S14. The auditing profession also adopted this same concept of materiality. See "Audit Risk and Materiality in Conducting an Audit," *Statement on Auditing Standards No. 47* (New York: AICPA, 1983), par. 6.



|                        | Company A   | Company B |
|------------------------|-------------|-----------|
| Sales                  | €10,000,000 | €100,000  |
| Costs and expenses     | 9,000,000   | 90,000    |
| Income from operations | € 1,000,000 | € 10,000  |
| Unusual gain           | € 20,000    | € 5,000   |

**ILLUSTRATION 2-5**  
Materiality Comparison

operating income. The gain is only 2 percent of the net income. If merged, it would not seriously distort the net income figure. Company B has had an unusual gain of only €5,000. However, it is relatively much more significant than the larger gain realized by A. For Company B, an item of €5,000 amounts to 50 percent of its income from operations. Obviously, the inclusion of such an item in ordinary operating income would affect the amount of that income materially. Thus we see the importance of the **relative size** of an item in determining its materiality.

Companies and their auditors generally adopt the rule of thumb that anything under 5 percent of net income is considered immaterial. However, much can depend on specific rules. For example, one market regulator indicates that a company may use this percentage for an initial assessment of materiality, but it must also consider other factors.<sup>18</sup> For example, companies can no longer fail to record items in order to meet consensus analysts' earnings numbers, preserve a positive earnings trend, convert a loss to a profit or vice versa, increase management compensation, or hide an illegal transaction like a bribe. In other words, **companies must consider both quantitative and qualitative factors in determining whether an item is material.**

Thus, it is generally not feasible to specify uniform quantitative thresholds at which an item becomes material. Rather, materiality judgments should be made in the context of the nature and the amount of an item. Additional examples are provided in Illustration 2-6.

1. Disclosure of the effects of an accounting change might lead to a company violating a debt covenant, even though the amount is small in magnitude. Such a situation may justify a lower materiality threshold than if the company's financial condition were stronger.
2. A misclassification of an asset as equipment that should have been classified as plant may not be material because it does not affect classification on the statement of financial position (that is, the line item "plant and equipment" is the same regardless of the misclassification). However, a misclassification of the same amount might be material if it changed the classification of an asset from plant or equipment to inventory.
3. Similar to the example above, an error of £10,000 in the amount of uncollectible receivables is more likely to be material if the total amount of receivables is £100,000 than if it is £1,000,000. In addition, even though an individual item may be immaterial, it may be considered material when added to other immaterial items.
4. Amounts too small to warrant disclosure or correction in normal circumstances may be considered material if they arise from abnormal or unusual transactions or events, or if they involve related parties. Similarly, the amount of a misstatement that would be immaterial if it results from an unintentional error might be considered material if it results from an intentional misstatement.<sup>19</sup>

**ILLUSTRATION 2-6**  
Materiality Examples

Materiality factors into a great many internal accounting decisions, too. Examples of such judgments that companies must make include: the amount of classification required in a subsidiary expense ledger, the degree of accuracy required in allocating expenses among the departments of a company, and the extent to which adjustments should be made for accrued and deferred items. Only by **the exercise of good judgment**

<sup>18</sup>"Materiality," *SEC Staff Accounting Bulletin No. 99* (Washington, D.C.: SEC, 1999).

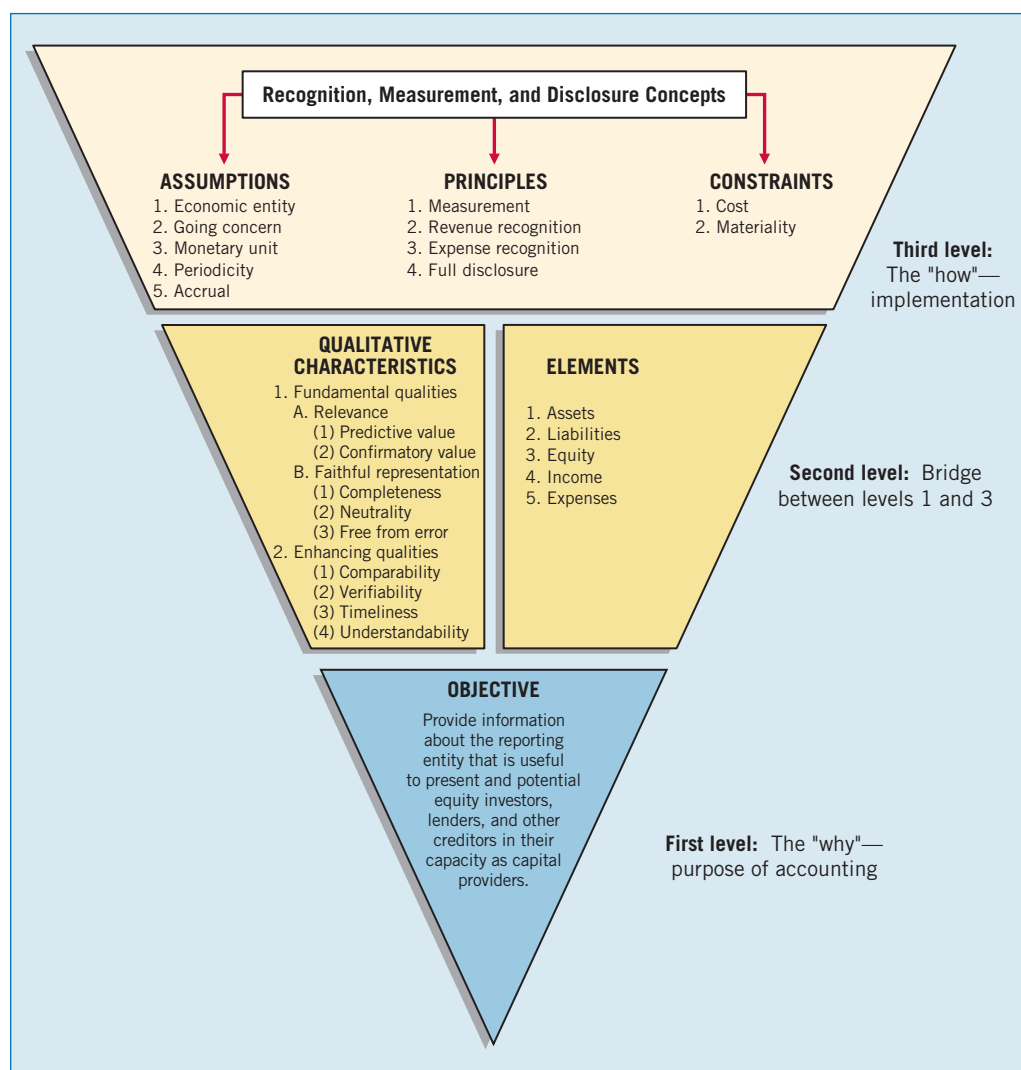
<sup>19</sup>"Chapter 2, Qualitative Characteristics and Constraints of Decision-Useful Financial Reporting Information," *Proposed Conceptual Framework for Financial Reporting* (Norwalk, Conn.: FASB, May 2008), par. QC51.

and professional expertise can reasonable and appropriate answers be found, which is the materiality constraint sensibly applied.<sup>20</sup>

## Summary of the Structure

Illustration 2-7 presents the conceptual framework for financial reporting discussed in this chapter. It is similar to Illustration 2-1, except that it provides additional information for each level. We cannot overemphasize the usefulness of this conceptual framework in helping to understand many of the problem areas that we examine in later chapters.

**ILLUSTRATION 2-7**  
Framework for Financial Reporting



<sup>20</sup>Sometimes, in practice, it has been acceptable to invoke prudence or conservatism as a justification for an accounting treatment under conditions of uncertainty. **Prudence** or **conservatism** means when in doubt, choose the solution that will be least likely to overstate assets or income and/or understate liabilities or expenses. The Framework indicates that prudence or conservatism generally is in conflict with the quality of neutrality. This is because being prudent or conservative likely leads to a bias in the reported financial position and financial performance. In fact, introducing biased understatement of assets (or overstatement of liabilities) in one period frequently leads to overstating financial performance in later periods—a result that cannot be described as prudent. This is inconsistent with neutrality, which encompasses freedom from bias. Accordingly, the Framework does not include prudence or conservatism as desirable qualities of financial reporting information. See “Chapter 2, Qualitative Characteristics and Constraints of Decision-Useful Financial Reporting Information,” *Proposed Conceptual Framework for Financial Reporting* (Norwalk, Conn.: FASB, May 2008), paras. BC2.20–21.

## AUTHORITATIVE LITERATURE

### Authoritative Literature References

- [1] “Framework for the Preparation and Presentation of Financial Statements” (London, U.K.: IASB, 2001).
- [2] “Framework for the Preparation and Presentation of Financial Statements” (London, U.K.: IASB, 2001), paras. 49, 70.
- [3] International Accounting Standard No. 29, *Financial Reporting in Hyperinflationary Economies* (London, U.K.: IASB, 2001).
- [4] “Framework for the Preparation and Presentation of Financial Statements” (London, U.K.: IASB, 2001), par. 22.
- [5] International Accounting Standard 39, *Financial Instruments: Recognition and Measurement* (London, U.K.: International Accounting Standards Committee Foundation, March 1999), par. 9.
- [6] International Accounting Standard 18, *Revenue* (London, U.K.: International Accounting Standards Committee Foundation, 2001), par. 1.
- [7] “Framework for the Preparation and Presentation of Financial Statements” (London, U.K.: IASB, 2001), paras. 83–88.

## QUESTIONS

1. Briefly describe the two fundamental qualities of useful accounting information.
2. What is the distinction between comparability and consistency?
3. What are the basic elements of the Framework? Briefly describe the relationship between the “moment in time” and “period of time” elements.
4. What are the five basic assumptions that underlie the financial accounting structure?

## BRIEF EXERCISES

**BE2-1** Match the qualitative characteristics below with the following statements.

- |                            |                  |
|----------------------------|------------------|
| 1. Relevance               | 5. Comparability |
| 2. Faithful representation | 6. Completeness  |
| 3. Predictive value        | 7. Neutrality    |
| 4. Confirmatory value      | 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.

**BE2-2** Match the qualitative characteristics below with the following statements.

- |                      |                            |
|----------------------|----------------------------|
| 1. Timeliness        | 5. Faithful representation |
| 2. Completeness      | 6. Relevance               |
| 3. Free from error   | 7. Neutrality              |
| 4. Understandability | 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.

**BE2-3** Identify which qualitative characteristic of accounting information is best described in each item below. (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.

**BE2-4** What accounting assumption, principle, or constraint would **Marks and Spencer plc (M&S)** (GBR) use in each of the situations below?

- (a) M&S records expenses when incurred, rather than when cash is paid.
- (b) M&S was involved in litigation over the last year. This litigation is disclosed in the financial statements.
- (c) M&S allocates the cost of its depreciable assets over the life it expects to receive revenue from these assets.
- (d) M&S records the purchase of a new **Dell** (USA) PC at its cash equivalent price.

**BE2-5** Fill in the blanks related to the following statements.

1. Financial reporting imposes \_\_\_\_; the benefits of financial reporting should justify those \_\_\_\_.
2. The information provided by \_\_\_\_\_ focuses on the needs of all capital providers, not just the needs of a particular group.
3. A depiction of economic phenomena is \_\_\_\_ if it includes all the information that is necessary for faithful representation of the economic phenomena that it purports to represent.
4. \_\_\_\_ is the quality of information that allows users to comprehend its meaning.
5. \_\_\_\_ is the quality of information that permits users to identify similarities in and differences between two sets of economic phenomena.
6. Information about economic phenomena has \_\_\_\_\_ if it changes past or present expectations based on previous evaluations.

## EXERCISES

**E2-1 (Usefulness, Objective of Financial Reporting, Qualitative Characteristics)** Indicate whether the following statements about the conceptual framework are true or false. If false, provide a brief explanation supporting your position.

- (a) The fundamental qualitative characteristics that make accounting information useful are relevance and verifiability.
- (b) Relevant information has predictive value, confirmatory value, or both.
- (c) Conservatism, a prudent reaction to uncertainty, is considered a constraint of financial reporting.
- (d) Information that is a faithful representation is characterized as having predictive or confirmatory value.
- (e) Comparability pertains only to the reporting of information in a similar manner for different companies.
- (f) Verifiability is solely an enhancing characteristic for faithful representation.
- (g) In preparing financial reports, it is assumed that users of the reports have reasonable knowledge of business and economic activities.



**E2-2 (Qualitative Characteristics)** The Framework identifies the qualitative characteristics that make accounting information useful. Presented below are a number of questions related to these qualitative characteristics and underlying constraints.

- (a) What is the quality of information that enables users to confirm or correct prior expectations?
- (b) Identify the two overall or pervasive constraints developed in the Framework.
- (c) A noted accountant once remarked, "If it becomes accepted or expected that accounting principles are determined or modified in order to secure purposes other than economic measurement, we assume a grave risk that confidence in the credibility of our financial information system will be undermined." Which qualitative characteristic of accounting information should ensure that such a situation will not occur? (Do not use faithful representation.)
- (d) Muruyama Corp. switches from FIFO to average cost and then back to FIFO over a 2-year period. Which qualitative characteristic of accounting information is not followed?
- (e) Assume that the profession permits the savings and loan industry to defer losses on investments it sells, because immediate recognition of the loss may have adverse economic consequences on the industry. Which qualitative characteristic of accounting information is not followed? (Do not use relevance or faithful representation.)
- (f) What are the two fundamental qualities that make accounting information useful for decision-making?
- (g) Watteau Inc. does not issue its first-quarter report until after the second quarter's results are reported. Which qualitative characteristic of accounting is not followed? (Do not use relevance.)
- (h) Predictive value is an ingredient of which of the two fundamental qualities that make accounting information useful for decision-making purposes?
- (i) Duggan, Inc. is the only company in its industry to depreciate its plant assets on a straight-line basis. Which qualitative characteristic of accounting information may not be followed?
- (j) Nadal Company has attempted to determine the replacement cost of its inventory. Three different appraisers arrive at substantially different amounts for this value. The president, nevertheless, decides to report the middle value for external reporting purposes. Which qualitative characteristic of information is lacking in these data? (Do not use reliability or representational faithfulness.)

**E2-3 (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      |              |                   |

### Instructions

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

- (a) Qualitative characteristic being employed when companies in the same industry are using the same accounting principles.
- (b) Quality of information that confirms users' earlier expectations.
- (c) Imperative for providing comparisons of a company from period to period.
- (d) Ignores the economic consequences of a standard or rule.
- (e) Requires a high degree of consensus among individuals on a given measurement.
- (f) Predictive value is an ingredient of this fundamental quality of information.
- (g) Qualitative characteristics that enhance both relevance and faithful representation.
- (h) Neutrality and completeness are ingredients of this fundamental quality of accounting information.
- (i) Two fundamental qualities that make accounting information useful for decision-making purposes.
- (j) Issuance of interim reports is an example of what enhancing ingredient?

**E2-4 (Elements of Financial Statements)** Five interrelated elements that are most directly related to measuring the performance and financial status of an enterprise are provided below.

|             |          |
|-------------|----------|
| Assets      | Income   |
| Liabilities | Expenses |
| Equity      |          |

### Instructions

Identify the element or elements associated with the nine items below.

- (a) Obligation to transfer resources arising from a past transaction.
- (b) Increases ownership interest.
- (c) Declares and pays cash dividends to owners.

- (d) Increases in net assets in a period from non-owner sources.
- (e) Items characterized by service potential or future economic benefit.
- (f) Equals increase in assets less liabilities during the year, after adding distributions to owners and subtracting investments by owners.
- (g) Residual interest in the assets of the enterprise after deducting its liabilities.
- (h) Increases assets during a period through sale of product.
- (i) Decreases assets during the period by purchasing the company's own shares.

## CONCEPTS FOR ANALYSIS



**CA2-1 (Conceptual Framework—General)** The IASB has developed a conceptual framework for financial accounting and reporting. The Framework sets forth the objective and fundamentals that will be the basis for developing financial accounting and reporting standards. The objective identifies the purpose of financial reporting. The fundamentals are the underlying concepts of financial accounting that guide the selection of transactions, events, and circumstances to be accounted for; their recognition and measurement; and the means of summarizing and communicating them to interested parties.

The characteristics or qualities of information discussed in the Framework are the concepts that make information useful and the qualities to be sought when accounting choices are made.

### Instructions

- (a) Identify and discuss the benefits that can be expected to be derived from the IASB's Framework.
- (b) What is the most important quality for accounting information as identified in the Framework? Explain why it is the most important.
- (c) Briefly discuss the importance of any three of the fundamental characteristics or enhancing qualities of accounting information.

**CA2-2 (Objective of Financial Reporting)** Homer Winslow and Jane Alexander are discussing various aspects of the "conceptual framework." Homer indicates that this pronouncement provides little, if any, guidance to the practicing professional in resolving accounting controversies. He believes that the Framework provides such broad guidelines that it would be impossible to apply the objective(s) to present-day reporting problems. Jane concedes this point but indicates that objective(s) are still needed to provide a starting point for the IASB in helping to improve financial reporting.

### Instructions

- (a) Indicate the basic objective established in the Conceptual Framework.
- (b) What do you think is the meaning of Jane's statement that the IASB needs a starting point to resolve accounting controversies about how to improve financial reporting?



**CA2-3 (Qualitative Characteristics)** Accounting information provides useful information about business transactions and events. Those who provide and use financial reports must often select and evaluate accounting alternatives. The IASB Framework examines the characteristics of accounting information that make it useful for decision-making. It also points out that various limitations inherent in the measurement and reporting process may necessitate trade-offs or sacrifices among the characteristics of useful information.

### Instructions

- (a) Describe briefly the following characteristics of useful accounting information.
 

|                             |                   |
|-----------------------------|-------------------|
| (1) Relevance               | (4) Comparability |
| (2) Faithful representation | (5) Neutrality    |
| (3) Understandability       |                   |
- (b) For each of the following pairs of information characteristics, give an example of a situation in which one of the characteristics may be sacrificed in return for a gain in the other.
 

|  |                                      |
|--|--------------------------------------|
| (1) Relevance and faithful representation. | (3) Comparability and consistency.   |
| (2) Relevance and consistency.             | (4) Relevance and understandability. |
- (c) What criterion should be used to evaluate trade-offs between information characteristics?

## USING YOUR JUDGMENT

### FINANCIAL REPORTING

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#### Financial Reporting Problem

##### Marks and Spencer plc (M&S)

The financial statements of M&S (GBR) can be accessed at the book's companion website, [www.wiley.com/college/kiesoifrs](http://www.wiley.com/college/kiesoifrs).

##### Instructions

Refer to M&S's financial statements and the accompanying notes to answer the following questions.

- (a) Using the notes to the consolidated financial statements, determine M&S's revenue recognition policies.
- (b) Give two examples of where historical cost information is reported in M&S's financial statements and related notes. Give two examples of the use of fair value information reported in either the financial statements or related notes.
- (c) How can we determine that the accounting principles used by M&S are prepared on a basis consistent with those of last year?
- (d) What is M&S's accounting policy related to Refunds and loyalty schemes? Why does M&S include the accounting for Refunds and loyalty schemes in its Critical accounting estimates and judgements?



### IFRS BRIDGE TO THE PROFESSION

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#### Professional Research

Your aunt recently received the annual report for a company in which she has invested. The report notes that the statements have been prepared in accordance with IFRS. She has also heard that certain terms have special meanings in accounting relative to everyday use. She would like you to explain the meaning of terms she has come across related to accounting.

##### Instructions

Access the IASB Framework at the IASB website (<http://ifrs.iasb.org/>). When you have accessed the documents, you can use the search tool in your Internet browser to prepare responses to the following items. (Provide paragraph citations.)

- (a) How is "materiality" defined in the Framework?
- (b) Briefly discuss how materiality relates to (1) the relevance of financial information, and (2) completeness.
- (c) Your aunt observes that under IFRS, the financial statements are prepared on the accrual basis. According to the Framework, what does the "accrual basis" mean?