MODUL-1  FINANCIAL ACCOUNTING

CONCEPTUAL FRAMEWORK FOR FINANCIAL REPORTING

BY:
MUH. ARIEF EFFENDI, SE, MSI, AK, QIA, CPMA.CA

MAGISTER ACCOUNTING PROGRAM (MAKSI)
PASCA SARJANA UNIVERSITAS BUDI LUHUR
JAKARTA
2nd REVISED- SEPTEMBER 2013
Conceptual Framework For Financial Reporting

After studying this topic, students should be able to:

1. Describe the usefulness of a conceptual framework.
2. Describe the Financial Accounting Standard Boards (FASB’s) efforts to construct a conceptual framework.
3. Understand the objectives of financial reporting.
4. Understanding conceptual framework for financial reporting US GAAP VS IFRS.
5. Identify the qualitative characteristics of accounting information.
6. Define the basic elements of financial statements.
7. Describe the basic assumptions of accounting.
8. Explain the applications of the basic principles of accounting.
9. Describe the impact that constraints have on reporting accounting information.
1. Users of financial statements need relevant and reliable information.

2. To provide such information, the profession has developed a set of principles and guidelines.

3. These principles and guidelines are collectively called the Conceptual Framework.

4. In short, the Framework is like a constitution for the profession.
US GAAP Hierarchy

- SFAC
- FAS & FIN, APB Opinion, ARB Bulletin
- FASB Tech Bulletin, AICPA guides, SOP (AICPA)
- AICPA AcSEC Practice Bulletins (FASB Cleared), FASB EIFT Consensus Positions
- AICPA Accounting interpretation, FASB Q&A,
- other Industry literature and Practices

GASB
1. Under US GAAP, detailed framework for pronouncing accounting standards are contained in Statement of Financial Accounting Concepts (SFAC). Total seven (7) SFAC have been issued, out of which SFAC-3 is replaced.

2. SFAC forms the basis of pronouncement of FAS. SFAC is not authoritative GAAP, but can be used if no GAAP exists. There are 6 SFAC in force on Objective, Quality Characteristics, Recognition and measurement, Elements and Cash flow.

3. GAAP /SFAC pronouncement are made by Financial Accounting Standard Board (FASB) which is not an accounting Body like ICAI. AICPA does not pronounce GAAP.

4. Over 150 Financial Accounting Standard (FAS) announced till date, many of which are amendment / replacement.

5. Separate Accounting Board for Government Companies called Government Accounting Standard Board (GASB)
1. IFRS framework was issued in April, 1989. This Framework deals with Objective of Financial statement, Qualitative characteristics, elements of financial statement, Concept of Capital and capital maintenance.

2. Qualitative characteristics- Understandability, Relevance, materiality, Reliability, faithful representation, substance over form, neutrality, prudence, completeness, Comparability and true and fair view
3. Measurement criteria includes Present Value in addition to Historical Cost, Current cost and Realizable Value.

4. IFRS is required or permitted for use in over 90 Countries for Financial reporting, European Union (EU) has recently mandated application of IFRS for all listed Companies affecting over 7,000 companies.
Role of Conceptual Framework

- *Conceptual Framework* sets out agreed concepts that underlie financial reporting
  - objective, qualitative characteristics, element definitions, …
- IASB uses *Conceptual Framework* to set standards
  - enhances consistency across standards
  - enhances consistency over time as Board members change
  - provides benchmark for judgments
Conceptual framework

- **Recognition and Measurement Concepts**
  - ASSUMPTIONS
  - PRINCIPLES
  - CONSTRAINTS

- **First level:**
  - Objectives of financial reporting

- **Second level:**
  - Qualitative characteristics of accounting information
  - Elements of financial statements

- **Third level:**
  - The "how"—implementation

Bridge between levels 1 and 3

- The "why"—goals and purposes of accounting.
Conceptual framework

**Users of accounting information**

- **DECISION MAKERS AND THEIR CHARACTERISTICS**
  - **COST < BENEFITS** (Pervasive constraint)
  - **MATERIALITY** (Threshold for recognition)

**Constraints**

- **UNDERSTANDABILITY**

**User-specific qualities**

**Pervasive criterion**

**Primary qualities**

- **RELEVANCE**
  - Predictive value
  - Feedback value
  - Timeliness

- **RELIABILITY**
  - Verifiability
  - Representational faithfulness
  - Neutrality

**Ingredients of primary qualities**

- Comparability
- Consistency
Objectives of the Conceptual Framework

1. The Framework is to be the *foundation* for building a set of coherent accounting standards and rules.

2. The Framework is to be a *reference of basic accounting theory* for solving emerging practical problems of reporting.
Conceptual framework

- Provide the structure for building a set of coherent accounting standards.
- Levels:
  - “Why” - Provides objectives of financial reporting
  - “Bridges levels 1 and 3” - Defines qualitative characteristics of accounting information and the elements of financial statements
  - “How/implementation” - Explains recognition and measurement criteria
- US and IFRS similar, but are not exactly the same
- Convergence project underway, not yet approved
General Conceptual framework

- **Recognition and Measurement Concepts**
  - **Assumptions**
  - **Principles**
  - **Constraints**

**First level**: The “why”—goals and purposes of accounting.

**Second level**: Bridge between levels 1 and 3

**Third level**: The “how”—implementation

**Qualitative Characteristics** of accounting information

**Elements** of financial statements
Per SFAC 1-2, 4-7

▪ Provide information that is useful to those making investment & credit decisions.

▪ Helpful to present and potential investors, creditor and other users in assessing the amounts, timing and uncertainty of future cash flows; and

▪ About economic resources, the claims to those resources and the changes in them.

Per IASB Framework (April 1989)

▪ The objective of f/s’s is to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions.

▪ Users are present & potential investors, employees, lenders, suppliers & other trade creditors, customers, gov’ts & their agencies & the general public.
U.S. Conceptual Framework Level 2: Hierarchy of Qualitative Characteristics

- Users of accounting information
- Constraints
  - COST < BENEFITS (Pervasive constraint)
  - MATERIALITY (Threshold for recognition)
- User-specific qualities
- Pervasive criterion
- Primary qualities
  - RELEVANCE
  - RELIABILITY
- Ingredients of primary qualities
  - Predictive value
  - Feedback value
  - Timeliness
  - Verifiability
  - Representational faithfulness
  - Neutrality
- Secondary qualities
  - Comparability
  - Consistency
Primary characteristics
- Relevance
  - Predictive value
  - Feedback value
  - Timeliness
- Reliability
  - Verifiability
  - Representational faithfulness
  - Neutrality
Secondary Characteristics
- Comparability
- Consistency
- Constraints
  - Cost/Benefit
  - Materiality
  - Industry Practices
  - Conservatism

Understandability
- Relevance
  - Predictive value
  - Confirmatory value
  - Materiality
- Reliability
  - Faithful representation
  - Substance over form
  - Neutrality
  - Prudence
  - Completeness
Comparability
Constraints on relevant & reliable info
  - Timeliness
  - Balance between benefit and cost
  - Balance between qualitative characteristics
Level 2: Elements of Financial Statements

US GAAP

- Assets
- Liabilities
- Equity
- Investment by Owners
- Distributions to Owners
- Comprehensive Income
- Revenues
- Expenses
- Gains
- Losses

IFRS

- Asset
- Liabilities
- Equity
- Income
- Expenses
- Capital Maintenance
- result from revaluation of assets and liabilities
Element Definitions

(a) Arises from peripheral or incidental transactions.
(b) Obligation to transfer resources arising from a past transaction.
(c) Increases ownership interest.
(d) Declares and pays cash dividends to owners.
(e) Increases in net assets in a period from nonowner sources.
(f) Items characterized by future economic benefit.
(g) Equals increase in net assets during the year, after adding distributions to owners and subtracting investments by owners.
(h) Arises from income statement activities that constitute the entity’s ongoing major or central operations.
(i) Residual interest in the net assets of the enterprise.
(j) Increases assets through sale of product.
(k) Decreases assets by purchasing the company’s own stock.
(l) Changes in equity during the period, except those from investments by owners and distributions to owners.
Level 3: Basic Assumptions, Principles

US GAAP

- Assumptions
- Economic Entity
- Going concern
- Monetary Unit
- Periodicity
- Principles
- Measurement
  - Historical Cost
  - Fair value
- Revenue Recognition
- Expense Recognition
- Full disclosure

IFRS

- Underlying Assumptions
- Accrual Basis
- Going concern
- Principles
- Measurement
  - Historical cost
  - Current cost
  - Realizable value
  - Fair value
- Revenue Recognition
- Expense Recognition
- Full disclosure
Matching

- Idea: Record expense in same period as the revenue it helped generate.
- To do:
  - Determine revenue recognition
  - Choices to match expenses
    - Direct (COGS)
    - Rational allocation (rent)
    - Immediate
Full Disclosure – Nature and amount of information included in financial reports reflects a series of judgmental trade-offs (between providing sufficient detail and keeping information understandable).

- Financial statements
- Notes to financial statements
- Supplementary information
1. The FASB has issued *seven Statements* of Financial Accounting Concepts (SFACs) to date.

2. These statements set forth major *recognition and reporting* issues.

3. Statement 4 pertains to reporting by *non-business* entities.

4. The other six statements pertain to reporting by *business* enterprises.
Statements of Financial Accounting Concepts

Statement
- Statement 1
- Statement 2
- Statement 6
- Statement 4
- Statement 5
- Statement 7

Brief Title
- Objectives of Financial Reporting (Business)
- Qualitative Characteristics
- Elements of Financial Statements (replaces 3)
- Objectives of Financial Reporting (Non-business)
- Recognition and Measurement Criteria
- Using Cash Flows
1. The Framework has *three levels*: objectives, elements and criteria.
2. The first level consists of *objectives*.
3. The second level explains financial statement *elements* and characteristics of information.
4. The third level incorporates *recognition* and *measurement criteria*. 
Overview of the Conceptual Framework (2 of 2)

- **Level 1**: Objectives of Financial Reporting
- **Level 2**: Elements of Financial Statements and Qualitative Characteristics of Accounting Information
- **Level 3**: Recognition and Measurement Concepts
Basic Objectives of Financial Reporting

Objectives of Financial Reporting
Statement of Financial Accounting Concept (SFAC) No. 1

To provide information:
1. Useful in investment and credit decisions
2. Useful in assessing future cash flows
3. About enterprise resources, claims and changes
Basic Objectives of Financial Reporting

Basic Objectives:

1. Useful for *decision making*
2. Information about *future cash flows*
3. Information about *resources, claims to resources, changes in resources*
   - Liquidity
   - Solvency
   - Flexibility
   - Profitability
1. Primary qualities are *relevance* and *reliability* of accounting information.

2. Secondary qualities are *comparability* and *consistency* of reported information.
Relevance of information means “information capable of making a difference in a decision context.” To be relevant:

- The information must be *timeliness*.
- The information should have *predictive value*: (be helpful in making predictions about ultimate outcomes of past, present and future events).
- The information should have *feedback value* (helps users to *confirm* prior expectations.)
1. Information is *reliable*, when it can be relied on to represent the true, underlying situation.

2. *To be reliable, information must be*:  
   - verifiable  
   - representational faithfulness  
   - neutral
1. Information is *verifiable*, when, given the same information, independent users can arrive at similar conclusions.

2. Information is *faithful*, when it represents what really existed or happened.

3. Information is *neutral*, when it is free from bias.
1. Secondary characteristics are: comparability and consistency of reported information.

2. For information to be comparable, it must be:

- measured and reported in a similar manner for different enterprises.
- useful in the allocation of resources to the areas of greatest benefit.
- useful to users in identifying real differences between enterprises.
1. Accounting information is consistent, if the same accounting principles are applied in a similar manner from one period to the next.

2. Accounting principles may be changed, if the change results in better reporting.

3. If principles are changed, the justification for, and the nature and effect of the change, must be disclosed.
Fundamental qualitative characteristics

- **Relevance**: capable of making a difference in users’ decisions
  - predictive value
  - confirmatory value
  - materiality (entity-specific)
- **Faithful representation**: faithfully represents the phenomena it purports to represent
  - completeness (depiction including numbers and words)
  - neutrality (unbiased)
  - free from error (ideally)

Note: faithful representation replaces reliability
Enhancing qualitative characteristics

- **Comparability**: like things look alike; different things look different

- **Verifiability**: knowledgeable and independent observers could reach consensus, but not necessarily complete agreement, that a depiction is a faithful representation

- **Timeliness**: having information available to decision-makers in time to be capable of influencing their decisions

- **Understandability**: Classify, characterise, and present information clearly and concisely
Reporting financial information imposes costs, and it is important that those costs are justified by the benefits of reporting that information.

In applying the cost constraint, the IASB assesses whether the benefits of reporting particular information are likely to justify the costs incurred to provide and use that information. Those assessments are usually based on a combination of quantitative and qualitative information.
Hierarchy of Accounting Qualities

- Decision Makers
  - What are their characteristics?
- Constraints
  - Cost benefit & Materiality
- User specific Qualities
  - Understandability
- Pervasive Criterion
  - Decision Usefulness
- Primary Qualities
  - Relevance & Reliability
- Secondary Qualities
  - Comparability & Consistency
Ingredients of Primary Qualities

**Relevance**
- Predictive Value
- Feedback Value

**Reliability**
- Verifiability
- Represent. Faithfulness
- Neutrality

Timeliness
Basic Elements of Financial Statements

Elements of Financial Statements
SFAC No. 6

Basic Building Blocks
Recognition and Measurement Criteria

**Basic Assumptions**
1. Economic entity
2. Going concern
3. Monetary Unit
4. Periodicity

**Principles**
1. Historical cost
2. Revenue recognition
3. Matching
4. Full disclosure

**Constraints**
1. Cost Benefit
2. Materiality
3. Industry practices
4. Conservatism
Recognition and Measurement Criteria

Recognition and Measurement
SFAC No. 5

Recognition :
Reporting an item in the financial statements

Measurement :
The amount reported for an item in financial statements
Recognition and Measurement Criteria

Recognition Criteria:

1. **Definition**
   Must meet definition of an element of financial statements found in SFAC No. 6

2. **Measurability**
   Must be measurable with sufficient reliability

3. **Relevance**
   Must be capable of making a difference

4. **Reliability**
   Must be representationally faithful, verifiable & neutral
Basic Assumptions
Basic Assumptions

Economic Entity Assumption

1. The economic entity can be identified with a particular unit of accountability.
2. The business is separate and distinct from its owners.
3. Entity’s assets and other financial elements are not commingled with those of the owners.
4. The economic entity assumption is an accounting concept, and not a legal construct.
Basic Assumptions

Going Concern Assumption

1. The business is assumed to continue indefinitely unless terminated by owners.
2. The basis of recording financial elements is historical accounting.
3. Liquidation accounting (based on liquidation values) is not followed unless so indicated.
Going Concern Assumption

4. The financial statements are normally prepared on the assumption that an entity is a going concern and will continue in operation for the foreseeable future.

5. Hence, it is assumed that the entity has neither the intention nor the need to liquidate or curtail materially the scale of its operations; if such an intention or need exists, the financial statements may have to be prepared on a different basis and, if so, the basis used is disclosed.
Basic Assumptions

Monetary Unit

1. Money is the *common unit of measure* of economic transactions.

2. Use of a monetary unit is relevant, simple to understand and universally available.

3. Price level changes are ignored in accounting, leading to the assumption that the dollar remains relatively stable.
Periodicity (Time Period) Assumption

1. Economic activity of an entity may be *artificially* divided into time periods for reporting purposes.
2. Shorter time periods are subject to revisions but may be more timely.
Accrual Basis Assumption

1. In order to meet their objectives, financial statements are prepared on the accrual basis of accounting.

2. Under this basis, the effects of transactions and other events are recognized when they occur (and not as cash or its equivalent is received or paid) and they are recorded in the accounting records and reported in the financial statements of the periods to which they relate.
Basic Assumptions

Accrual Basis Assumption

3. 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.

4. Hence, they provide the type of information about past transactions and other events that is most useful to users in making economic decisions.
Historical Cost Principle

1. Transaction is recorded at its **acquisition price**.
2. It is not changed to reflect **market price**.
3. The principle applies to most assets and liabilities.
4. Users of financial statements may find **fair value** information useful for certain types of assets and liabilities.
5. The current system is a “mixed attribute” incorporating historical cost, **fair value**, and **certain other valuation bases**.
Revenue Recognition Principle

1. Revenue is recognized when it is *realized* or *realizable* and *earned* and the amount can be **objectively** determined.

2. Revenue is recognized *at time of sale*. There are *exceptions*:
   1) **During production**: In long-term construction revenue is recognized periodically based on % of job completed.
   2) **End of production**: Where active markets exist for the product and there are no significant future costs.
   3) **Receipt of cash**: Used when there is uncertainty of collection. In installment sales contracts payment is required in periodic installments.
The Matching Principle

1. Expenses are matched to the revenues they help generate.
2. There should be a logical, *rational association* of revenues and expenses.
3. If a cost does not benefit future periods, it is recorded in *the current period* as an expense.
1. Financial statements must report what a reasonable person would need to know to make an informed decision.

2. Disclosure may be made:
   - within the **body** of the financial statements,
   - as **notes** to those statements, or
   - as **supplementary** information.
The Cost-Benefit Relationship

1. Cost of providing information should not outweigh the benefit derived.

2. Costs and benefits are not always obvious or measurable.

3. Sound judgment must be used in providing information.
Materiality refers to an item’s importance to a firm’s overall financial operations.

- An item must *make a difference* to be material and be disclosed.
- It is a matter of the *relative significance* of the element.
- Both *quantitative and qualitative* factors are to be considered in determining relative significance.
Industry Practices

1. The nature of some industries sometimes require departures from basic accounting theory.

2. If application of accounting theory results in statements that are not comparable or consistent, then industry practices must be examined for possible explanations.
1. Conservatism suggests that the preparer, when in doubt, choose a conservative solution.

2. This solution will be least likely to overstate assets and income.

3. Conservatism does not suggest that net assets or net income be deliberately understated.
1. American Institute of Certified Public Accountants (AICPA), http://www.aicpa.org
4. IFRS, Improving the Conceptual Framework, Joint World Bank and IFRS Foundation ‘train the trainers’ workshop hosted by the ECCB, 30 April to 4 May 2012.