1. Describe the usefulness of a conceptual framework.
2. Describe efforts to construct a conceptual framework.
3. Understand the objective of financial reporting.
4. Identify the qualitative characteristics of accounting information.
5. Define the basic elements of financial statements.
6. Describe the basic assumptions of accounting.
7. Explain the application of the basic principles of accounting.
8. Describe the impact that constraints have on reporting accounting information.
Chapter 2-4

Conceptual Framework For Financial Reporting

Conceptual Framework
- Need
- Development
- Overview

First Level: Basic Objective
- Qualitative characteristics
- Basic elements

Second Level: Fundamental Concepts
- Basic assumptions
- Basic principles
- Constraints
- Summary of the structure

Third Level: Recognition, Measurement, and Disclosure Concepts

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

Need for a Conceptual Framework

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

LO 1 Describe the usefulness of a conceptual framework.
IASB and FASB are working on a joint project to develop a common conceptual framework. Framework will build on existing IASB and FASB frameworks. Project has identified the objective of financial reporting (Chapter 1) and the qualitative characteristics of decision-useful financial reporting information.
Overview of the Conceptual Framework

Three levels:

- **First Level** = Basic objective
- **Second Level** = Qualitative characteristics and elements of financial statements
- **Third Level** = Recognition, measurement, and disclosure concepts

LO 2 Describe efforts to construct a conceptual framework.
Chapter 2-8

LO 2 Describe efforts to construct a conceptual framework.

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

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

CONSTRAINTS
1. Cost
2. Materiality

QUALITATIVE CHARACTERISTICS
1. Fundamental qualities
2. Enhancing qualities

ELEMENTS
1. Assets
2. Liabilities
3. Equity
4. Income
5. Expenses

OBJECTIVE
Provide information about the reporting entity that is useful to present and potential equity investors, lenders, and other creditors in their capacity as capital Providers.

Illustration 2-7
Framework for Financial Reporting
“To provide financial information about the reporting entity that is useful to present and potential equity investors, lenders, and other creditors in making decisions in their capacity as capital providers.”

- Provided by issuing general-purpose financial statements.
- Assumption is that users have reasonable knowledge of business and financial accounting matters to understand the information.
IASB identified the **Qualitative Characteristics** of accounting information that distinguish better (more useful) information from inferior (less useful) information for decision-making purposes.
LO 4 Identify the qualitative characteristics of accounting information.
Second Level: Fundamental Concepts

Fundamental Quality - Relevance

Relevance is one of the two fundamental qualities that make accounting information useful for decision-making.

LO 4 Identify the qualitative characteristics of accounting information.
Fundamental Quality – Faithful Representation

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

**Fundamental quality**

**Ingredients of the fundamental quality**

- Completeness
- Neutrality
- Free from error

**FAITHFUL REPRESENTATION**

*LO 4 Identify the qualitative characteristics of accounting information.*
Enhancing Qualities

Distinguish more-useful information from less-useful information.

**LO 4** Identify the qualitative characteristics of accounting information.
ILLUSTRATION 2-7
Framework for Financial Reporting

Chapter 2-15

LO 4
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.

*LO 5 Define the basic elements of financial statements.*
Exercise 2-4: Identify the qualitative characteristic(s) to be used given the information provided.

(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.

<table>
<thead>
<tr>
<th>Characteristics</th>
<th>LO 5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Relevance</td>
<td></td>
</tr>
<tr>
<td>Faithful representation</td>
<td></td>
</tr>
<tr>
<td>Predictive value</td>
<td></td>
</tr>
<tr>
<td>Confirmatory value</td>
<td></td>
</tr>
<tr>
<td>Neutrality</td>
<td></td>
</tr>
<tr>
<td>Completeness</td>
<td></td>
</tr>
<tr>
<td>Timeliness</td>
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<tr>
<td>Verifiability</td>
<td></td>
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<tr>
<td>Understandability</td>
<td></td>
</tr>
<tr>
<td>Comparability</td>
<td></td>
</tr>
</tbody>
</table>
Exercise 2-4: Identify the qualitative characteristic(s) to be used given the information provided.

(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.
Exercise 2-4: Identify the qualitative characteristic(s) to be used given the information provided.

(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?

**Characteristics**

- Relevance
- Faithful representation
- Predictive value
- Confirmatory value
- Neutrality
- Completeness
- Timeliness
- Verifiability
- Understandability
- Comparability
These concepts explain how companies should recognize, measure, and report financial elements and events.

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

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

**CONSTRAINTS**
1. Cost
2. Materiality

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

*LO 6 Describe the basic assumptions of accounting.*
Chapter 2

Third Level: Assumptions

Basic Assumptions

**Economic Entity** – company keeps its activity separate from its owners and other business unit.

**Going Concern** - company to last long enough to fulfill objectives and commitments.

**Monetary Unit** - money is the common denominator.

**Periodicity** - company can divide its economic activities into time periods.

**Accrual Basis of Accounting** – transactions are recorded in the periods in which the events occur.

*LO 6 Describe the basic assumptions of accounting.*
E2-8: Identify which **basic assumption** of accounting is best described in each item below.

(a) The economic activities of FedEx Corporation (USA) are divided into 12-month periods for the purpose of issuing annual reports.

(b) Total S.A. (FRA) does not adjust amounts in its financial statements for the effects of inflation.

(c) Barclays (GBR) reports current and non-current classifications in its statement of financial position.

(d) The economic activities of Tokai Rubber Industries (JPN) and its subsidiaries are merged for accounting and reporting purposes.

**Periodicity**  
**Monetary Unit**  
**Going Concern**  
**Economic Entity**
Chapter 2-23

**Principles**

**Measurement**

- **Cost** is generally thought to be a faithful representation of the amount paid for a given item.

- **Fair value** is “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.”

- IASB has taken the step of giving companies the option to use fair value as the basis for measurement of financial assets and financial liabilities.

*LO 7 Explain the application of the basic principles of accounting.*
Revenue Recognition - 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.

Illustration 2-3
Timing of Revenue Recognition

Revenue should be recognized in the accounting 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 (generally at point of sale).

LO 7 Explain the application of the basic principles of accounting.
Expense Recognition - outflows or “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.

<table>
<thead>
<tr>
<th>Type of Cost</th>
<th>Relationship</th>
<th>Recognition</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Product costs:</strong></td>
<td>Direct relationship between cost and revenue.</td>
<td>Recognize in period of revenue (matching).</td>
</tr>
<tr>
<td>• Material</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Labor</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Overhead</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Period costs:</strong></td>
<td>No direct relationship between cost and revenue.</td>
<td>Expense as incurred.</td>
</tr>
<tr>
<td>• Salaries</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Administrative costs</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

“Let the expense follow the revenues.”

**Illustration 2-4**
Expense Recognition

**LO 7** Explain the application of the basic principles of accounting.
Full Disclosure – providing information that is of sufficient importance to influence the judgment and decisions of an informed user.

Provided through:

- Financial Statements
- Notes to the Financial Statements
- Supplementary information
Third Level: Principles

**BE2-9:** Identify which basic principle of accounting is best described in each item below.

(a) **Parmalat** (ITA) reports revenue in its income statement when it is earned instead of when the cash is collected.

(b) **Google** (USA) recognizes depreciation expense for a machine over the 2-year period during which that machine helps the company earn revenue.

(c) **KC Corp.** (USA) reports information about pending lawsuits in the notes to its financial statements.

(d) **Fuji Film** (JPN) reports land on its balance sheet at the amount paid to acquire it, even though the estimated fair market value is greater.

---

**LO 7** Explain the application of the basic principles of accounting.
Constraints

**Cost** – the cost of providing the information must be weighed against the benefits that can be derived from using it.

**Materiality** - an item is material if its inclusion or omission would influence or change the judgment of a reasonable person.

**LO 8** Describe the impact that constraints have on reporting accounting information.
E2-11: What accounting constraints are illustrated by the items below?

(a) Willis Company does not disclose any information in the notes to the financial statements unless the value of the information to users exceeds the expense of gathering it.

(b) Beckham Corporation expenses the cost of wastebaskets in the year they are acquired.
Summary of the Structure

Chapter 2-30

Recognition, Measurement, and Disclosure Concepts

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

PRINCIPLES
1. Measurement
2. Revenue recognition
3. Expense recognition
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CONSTRAINTS
1. Cost
2. Materiality

QUALITATIVE CHARACTERISTICS
1. Fundamental qualities
   A. Relevance
      (1) Predictive value
      (2) Confirmatory value
   B. Faithful representation
      (1) Completeness
      (2) Neutrality
      (3) Free from error
2. Enhancing qualities
   (1) Comparability
   (2) Verifiability
   (3) Timeliness
   (4) Understandability

ELEMENTS
1. Assets
2. Liabilities
3. Equity
4. Income
5. Expenses

OBJECTIVE
Provide information about the reporting entity that is useful to present and potential equity investors, lenders, and other creditors in their capacity as capital providers.

Third level: The "how"—implementation

Second level: Bridge between levels 1 and 3

First level: The "why"—purpose of accounting
The existing conceptual frameworks underlying U.S. GAAP and IFRS are very similar.

The converged framework should be a single document, unlike the two conceptual frameworks that presently exist.

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.
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