

The Environment and Conceptual Framework of Financial Reporting

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

1. Describe the global financial markets, major standard-setting bodies, and the meaning of International Financial Reporting Standards (IFRS).
2. Describe the components and usefulness of the conceptual framework, and identify the qualitative characteristics of accounting information and the basic elements of financial statements.
3. Discuss the basic assumptions and principles of accounting.
4. Identify the major challenges in the financial reporting environment.

PREVIEW OF CHAPTER 1 As the following opening story indicates, countries are moving quickly to adopt International Financial Reporting Standards (IFRS). It is estimated that over 300 of the 500 largest global companies are using IFRS. However, the accounting profession faces many challenges in establishing these standards, such as developing a sound conceptual framework, use of fair value measurements, proper consolidation of financial results, off-balance-sheet financing, and proper accounting for leases and pensions. This chapter discusses the international financial reporting environment and the conceptual framework as follows.

This chapter also includes numerous conceptual discussions that are integral to the topics presented here.

THE ENVIRONMENT AND CONCEPTUAL FRAMEWORK OF FINANCIAL REPORTING

Financial Reporting Environment

- Financial statements and financial reporting
- Accounting and capital allocation
- The Need to develop high-quality standards
- International Organization of Securities Commissions (IOSCO)
- International Accounting Standards Board (IASB)
- Hierarchy of IFRS

Conceptual Framework

- Need for a conceptual framework
- Development of a conceptual framework
- Overview of the conceptual framework
- Objective of financial reporting
- Qualitative characteristics of accounting information
- Elements of financial statements

Assumptions and Principles

- Assumptions
- Principles of accounting
- Cost constraint
- Summary of the structure

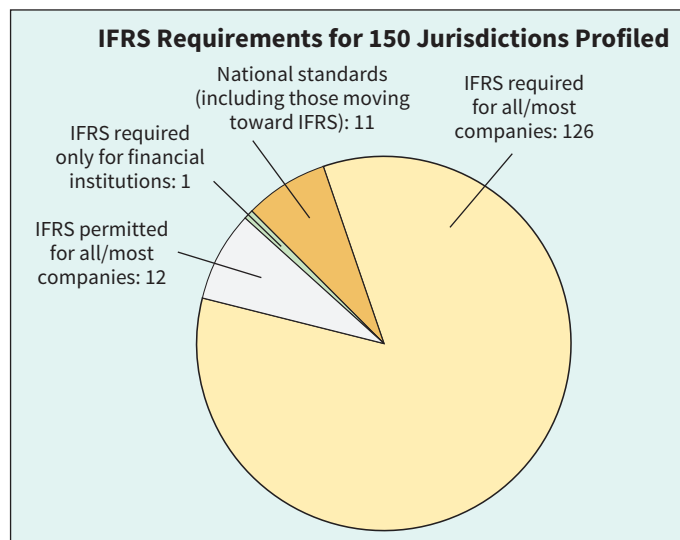
Major Challenges in Financial Reporting

- IFRS in a political environment
- The expectations gap
- Financial reporting issues
- Ethics in the environment of financial accounting
- International convergence
- Conclusion

Continuing Evolution of International Financial Reporting

The age of international trade and the interdependence of national economies continue to evolve. Many of the largest companies in the world often do more of their business in foreign lands than in their home countries. Companies now access not only their home country capital markets for financing, but others as well. With this globalization, companies are recognizing the need to have one set of financial reporting standards. For globalization of capital markets to be efficient, what is reported for a transaction in Beijing should be reported the same way in Paris, New York, or London.

In the past, many countries used their own sets of accounting standards or followed standards set by larger countries, such as those used in Europe or in the United States. That protocol has changed through the adoption of a single set of rules, called International Financial Reporting Standards (IFRS). As indicated in the following chart, there is broad acceptance of IFRS around the world.



As indicated, 126 jurisdictions require the use of IFRS by all or most public companies, with most of the remaining jurisdictions permitting their use. Indeed, 27,000 of the 49,000 companies listed on the 88 largest securities exchanges in the world use IFRS. IFRS also has appeal for non-public companies; since its publication, the *IFRS for SMEs* (small and medium-sized entities) is required or permitted in 57%, or 85 of 150, profiled jurisdictions, while a further 11 jurisdictions are also considering adopting IFRS.

Changing to IFRS does not come without cost and effort. However, academic research and studies by adopting jurisdictions provide overwhelming evidence that the use of IFRS has brought the following net benefits to capital markets.

- IFRS was successful in creating a common accounting language for capital markets (European Commission, 2015).
- Evidence suggests that IFRS adoption was largely positive for listed companies in Australia (Australian Accounting Standards Board, 2016).
- IFRS adoption helped to reduce investment risk in domestic firms, mitigate the “Korea discount,” and attract foreign capital via overseas shares listing, bond issuance, or mergers and acquisitions (Korean Accounting Standards Board, 2016).

Some companies also report benefits from being able to use IFRS in their internal reporting. This improves their ability to compare operating units in different jurisdictions by reducing the number of different reporting systems. In Japan, where the use of IFRS has been voluntary since 2010, business efficiency, enhanced comparability, and better communications with international investors have been identified as the main reasons why many Japanese companies made the choice to adopt IFRS (Japanese Financial Services Agency). Thus, the international financial

reporting environment has and is continuing to evolve. With these changes, it is hoped that a more effective system of reporting will develop, which will benefit all.

Sources: Adapted from P. Pacter, *Pocket Guide to IFRS® Standards—The Global Financial Reporting Language* (2017); www.ifrs.org/use-around-the-world/why-global-accounting-standards; and www.fsa.go.jp/en/news/2015/20151113-1/01.pdf

Review and Practice

Go to the **Review and Practice** section at the end of the chapter for a targeted summary review and practice problems with solutions. Multiple-choice questions with annotated solutions, as well as additional exercises and practice problems with solutions, are also available online.

Financial Reporting Environment

LEARNING OBJECTIVE 1

Describe the global financial markets, major standard-setting bodies, and the meaning of International Financial Reporting Standards (IFRS).

World markets are increasingly intertwined. International consumers drive Japanese cars, wear Italian shoes and Scottish woollens, drink Brazilian coffee and Indian tea, eat Swiss chocolate bars, sit on Danish furniture, watch U.S. movies, and use Arabian oil. The tremendous variety and volume of both exported and imported goods indicates the extensive involvement in international trade—for many companies, the world is their market.

To provide some indication of the extent of globalization of economic activity, **Illustration 1.1** provides a listing of the top 20 global companies in terms of sales.

Rank	Company	Country	Revenues (\$ millions)
1	Walmart	USA	500,343
2	State Grid	China	348,903
3	Sinopec Group	China	326,953
4	China National Petroleum	China	326,008
5	Royal Dutch Shell	Netherlands	311,870
6	Toyota Motor	Japan	265,172
7	Volkswagen	Germany	260,028
8	BP	Britain	244,582
9	ExxonMobil	USA	244,363
10	Berkshire Hathaway	USA	242,137
11	Apple	USA	229,234
12	Samsung Electronics	South Korea	211,940
13	McKesson	USA	208,357
14	Glencore	Switzerland	205,476
15	UnitedHealth Group	USA	201,159
16	Daimler	Germany	185,235
17	CVS Health	USA	184,765
18	Amazon.com	USA	177,866
19	EXOR Group	Italy	161,677
20	AT&T	USA	160,546

Source: Data from Global Fortune 500, 2018. www.fortune.com/global500/2018/search/?revenues=desc

Illustration 1.1 Top 20 Global Companies in Terms of Sales

In addition, due to technological advances and less onerous regulatory requirements, investors are able to engage in financial transactions across national borders and to make investment, capital

allocation, and financing decisions involving many foreign companies. Also, many investors, in attempts to diversify their portfolio risk, have invested more heavily in international markets. As a result, an increasing number of investors are holding securities of foreign companies.

An indication of the significance of these international investment opportunities can be found when examining the number of foreign registrations on various securities exchanges. As shown in **Illustration 1.2**, a significant number of foreign companies are found on national exchanges.

As indicated, capital markets are increasingly integrated and companies have greater flexibility in deciding where to raise capital. In the absence of market integration, there can be company-specific factors that make it cheaper to raise capital and list/trade securities in one location versus another. With the integration of capital markets, the automatic linkage between the location of the company and the location of the capital market is loosening. As a result, companies have expanded choices of where to raise capital, either equity or debt. The move toward adoption of global accounting standards has and will continue to facilitate this trend.

Exchange	Market Capitalization (\$ millions)	Total Listings	Domestic Listings	Foreign Listings	Foreign %
NYSE	24,230,840	2,335	1,832	503	21.5
Nasdaq	11,658,201	3,080	2,637	443	14.4
Japan Exchange Group	5,614,217	3,677	3,672	5	0.1
Euronext	4,418,229	1,239	1,087	152	12.3
Hong Kong Exchanges and Clearing	4,189,279	2,382	2,218	164	6.9
LSE Group	3,934,491	2,450	2,049	401	16.4
TMX Group	2,286,818	3,408	3,354	54	1.6
National Stock Exchange of India Limited	2,183,847	1,945	1,944	1	0.1
Deutsche Boerse AG	1,949,134	519	469	50	9.6
SIX Swiss Exchange	1,711,019	274	240	34	12.4
Nasdaq Nordic and Baltics	1,484,297	1,029	986	43	4.2
ASX Australian Securities Exchange	1,454,171	2,124	1,983	141	6.6
Korea Exchange	1,432,601	2,221	2,200	21	0.9
Taiwan Stock Exchange	1,046,389	948	858	90	9.5
B3 (Brasil Bolsa Balcao)	1,045,210	330	325	5	1.5
Johannesburg Stock Exchange	977,496	349	280	69	19.8
BME Spanish Exchanges	774,947	2,937	2,910	27	0.9
Singapore Exchange	725,887	738	478	260	35.2

Source: Data from Market Statistics, October 2019, The WFE Statistics Team. The World Federation of Exchanges.

Illustration 1.2 International Exchange Statistics

Financial Statements and Financial Reporting

Accounting is the universal language of business. One noted economist and politician indicated that the single most important innovation shaping capital markets was the development of sound accounting principles. The essential characteristics of accounting are (1) the identification, measurement, and communication of financial information about (2) economic entities to (3) interested parties. **Financial accounting** is the process that culminates in the preparation of financial reports on the enterprise for use by both internal and external parties. Users of these financial reports include investors, creditors, managers, unions, and government agencies. In contrast, **managerial accounting** is the process of identifying, measuring, analyzing, and communicating financial information needed by management to plan, control, and evaluate a company's operations.

Financial statements are the principal means through which a company communicates its financial information to those outside the business. These statements provide a company's history quantified in money terms. The **financial statements** most frequently provided are (1) the statement of financial position, (2) the income statement (or statement of comprehensive income), (3) the statement of cash flows, and (4) the statement of changes in equity. Note disclosures are an integral part of each financial statement.

Some financial information is better provided, or can be provided only, by means of **financial reporting** other than formal financial statements. Examples include the president's letter or supplementary schedules in the company annual report, prospectuses, reports filed with government agencies, news releases, management's forecasts, and social or environmental impact statements. Companies may need to provide such information because of authoritative pronouncements and regulatory rules, or custom. Or, they may supply it because management wishes to disclose it voluntarily.

In this textbook, we focus on the development of two types of financial information: (1) the basic financial statements and (2) related disclosures.

Accounting and Capital Allocation

Resources are limited. As a result, people try to conserve them and ensure that they are used effectively. Efficient use of resources often determines whether a business thrives. This fact places a substantial burden on the accounting profession.

Accountants must measure performance accurately and fairly on a timely basis, so that the right managers and companies are able to attract investment capital. For example, relevant financial information that faithfully represents financial results allows investors and creditors to compare the income and assets employed by such companies as **Nokia** (FIN), **McDonald's** (USA), **Air China Ltd.** (CHN), and **Toyota Motor Company** (JPN). Because these users can assess the relative return and risks associated with investment opportunities, they channel resources more effectively. **Illustration 1.3** shows how this process of capital allocation works.

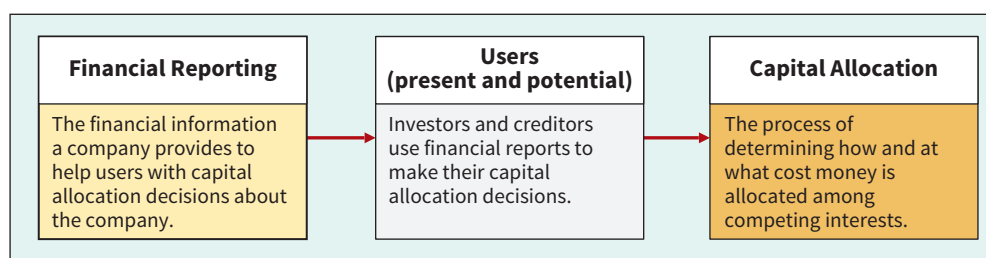


Illustration 1.3 Capital Allocation Process

An effective process of capital allocation is critical to a healthy economy. It promotes productivity, encourages innovation, and provides an efficient and liquid market for buying and selling securities and obtaining and granting credit. Unreliable and irrelevant information leads to poor capital allocation, which adversely affects the securities markets.

The Need to Develop High-Quality Standards

To facilitate efficient capital allocation, investors need relevant information and a faithful representation of that information to enable them to make comparisons across borders. For example, assume that you were interested in investing in the telecommunications industry. Four of the largest telecommunications companies in the world are **Nippon Telegraph and Telephone** (JPN), **Deutsche Telekom** (DEU), **Telefonica** (ESP), and **AT&T** (USA). How do you decide in which of these telecommunications companies to invest, if any? How do you compare, for example, a Japanese company like Nippon Telegraph and Telephone with a German company like Deutsche Telekom?

A single, widely accepted set of high-quality accounting standards is a necessity to ensure adequate comparability. Investors are able to make better investment decisions if they receive financial information from Nippon Telegraph and Telephone that is comparable to information from Deutsche Telekom. Globalization demands a single set of high-quality international accounting standards. But how is this to be achieved? Here are some elements:

1. Single set of high-quality accounting standards established by a single standard-setting body.
2. Consistency in application and interpretation.
3. Common disclosures.

4. Common high-quality auditing standards and practices.
5. Common approach to regulatory review and enforcement.
6. Education and training of market participants.
7. Common delivery systems (e.g., eXtensible Business Reporting Language—XBRL).
8. Common approach to company governance and legal frameworks around the world.¹

Fortunately, as indicated in the opening story, significant changes in the financial reporting environment are taking place, which hopefully will lead to a single, widely accepted set of high-quality accounting standards. The major standard-setters of the world, coupled with regulatory authorities, now recognize that capital formation and investor understanding are enhanced if a single set of high-quality accounting standards is developed.

For many years, many nations have relied on their own standard-setting organizations. For example, Canada has the Accounting Standards Board, Japan has the Accounting Standards Board of Japan, Germany has the German Accounting Standards Committee, and the United States has the Financial Accounting Standards Board (FASB). The standards issued by these organizations are sometimes principles-based, rules-based, tax-oriented, or business-based. In other words, they often differ in concept and objective.

The main international standard-setting organization is based in London, England, and is called the **International Accounting Standards Board (IASB)**. The IASB issues **International Financial Reporting Standards (IFRS)**, which are used on most foreign exchanges. As indicated earlier, IFRS is presently used or permitted in over 149 jurisdictions (similar to countries) and is rapidly gaining acceptance in other jurisdictions as well.

IFRS has the best potential to provide a common platform on which companies can report, resulting in financial statements investors can use to compare financial information. As a result, our discussion focuses on IFRS and the organization involved in developing these standards—the International Accounting Standards Board (IASB). The two organizations that have a role in international standard-setting are the **International Organization of Securities Commissions (IOSCO)** and the IASB.

International Organization of Securities Commissions (IOSCO)

The **International Organization of Securities Commissions (IOSCO)** is an association of organizations that regulate the world's securities and futures markets. Members are generally the main financial regulator for a given country. IOSCO does not set accounting standards. Instead, this organization is dedicated to ensuring that the global markets can operate in an efficient and effective basis. The member agencies (such as from France, Germany, New Zealand, and the United States) have resolved to:

- Cooperate to promote high standards of regulation in order to maintain just, efficient, and sound markets.
- Exchange information on their respective experiences in order to promote the development of domestic markets.
- Unite their efforts to establish standards and an effective surveillance of international securities transactions.
- Provide mutual assistance to promote the integrity of the markets by a rigorous application of the standards and by effective enforcement against offenses.

IOSCO supports the development and use of IFRS as the single set of high-quality international standards in cross-border offerings and listings. It recommends that its members allow multinational issuers to use IFRS in cross-border offerings and listings, as supplemented by reconciliation, disclosure, and interpretation where necessary to address outstanding substantive issues at a national or regional level. (For more information, go to the IOSCO website.)

¹Robert H. Herz, "Towards a Global Reporting System: Where Are We and Where Are We Going?" *AICPA National Conference on SEC and PCAOB Reporting Developments* (December 10, 2007).

Accounting Matters What About the Little Guy?

As discussed in the opening story, IFRS has gained acceptance, especially for publicly traded companies that wish to access international capital markets. What about non-public companies? Well, IFRS has a financial reporting answer for these “SMEs” (small and medium-sized entities).

The 250-page *IFRS for SMEs* focuses on the information needs of lenders, creditors, and other users of SME financial statements, who are primarily interested in information about cash flows, liquidity, and solvency. It also takes into account the costs to SMEs and the capabilities of SMEs to prepare financial information. While based on the full-IFRS principles, the *IFRS for SMEs* is considerably less complex. It reflects five types of simplifications from full IFRS:

1. Some full-IFRS topics are omitted because they are not relevant to typical SMEs.
2. Some full-IFRS accounting policy options are not allowed because a more simplified method is available to SMEs.
3. Many of the full-IFRS recognition and measurement principles have been simplified.
4. Substantially fewer disclosures are required.
5. The full-IFRS text has been redrafted in “plain English” for increased understandability and translation.

To date, 85 of the 150 jurisdictions whose profiles are followed by the IASB require or permit the *IFRS for SMEs*. It is also currently under consideration in a further 11 jurisdictions. So IFRS is gaining traction with both public and non-public companies.

International Accounting Standards Board (IASB)

The standard-setting structure internationally is composed of the following four organizations.

1. The **IFRS Foundation** provides oversight to the IASB, IFRS Advisory Council, and IFRS Interpretations Committee. In this role, it appoints members, reviews effectiveness, and helps in the fundraising efforts for these organizations.
2. The **International Accounting Standards Board (IASB)** develops, in the public interest, a single set of high-quality, enforceable, and global international financial reporting standards for general-purpose financial statements.²
3. The **IFRS Advisory Council** (the Advisory Council) provides advice and counsel to the IASB on major policies and technical issues.
4. The **IFRS Interpretations Committee** assists the IASB through the timely identification, discussion, and resolution of financial reporting issues within the framework of IFRS.

In addition, as part of the governance structure, a **Monitoring Board** was created. The purpose of this board is to establish a link between accounting standard-setters and those public authorities (e.g., IOSCO) that generally oversee them. The Monitoring Board also provides political legitimacy to the overall organization. **Illustration 1.4** shows the organizational structure for the setting of international accounting standards.

Due Process

In establishing financial accounting standards, the IASB has a thorough, open, and transparent **due process**. The IASB due process has the following elements.

1. An independent standard-setting board overseen by a geographically and professionally diverse body of trustees.
2. A thorough and systematic process for developing standards.

²The IASB was preceded by the International Accounting Standards Committee (IASC), which came into existence on June 29, 1973, as a result of an agreement by professional accountancy bodies in Australia, Canada, France, Germany, Japan, Mexico, the Netherlands, the United Kingdom and Ireland, and the United States. A revised agreement and constitution was signed in November 1982 and was updated most recently in 2009. The constitution mandates that all standards and interpretations issued under previous constitutions continue to be applicable unless and until they are amended or withdrawn. When the term *IFRS* is used in this textbook, it includes standards and interpretations approved by the IASB, and International Accounting Standards (IAS) and Standards Interpretations Committee (SIC) interpretations issued under previous constitutions.

3. Engagement with investors, regulators, business leaders, and the global accountancy profession at every stage of the process.
4. Collaborative efforts with the worldwide standard-setting community.

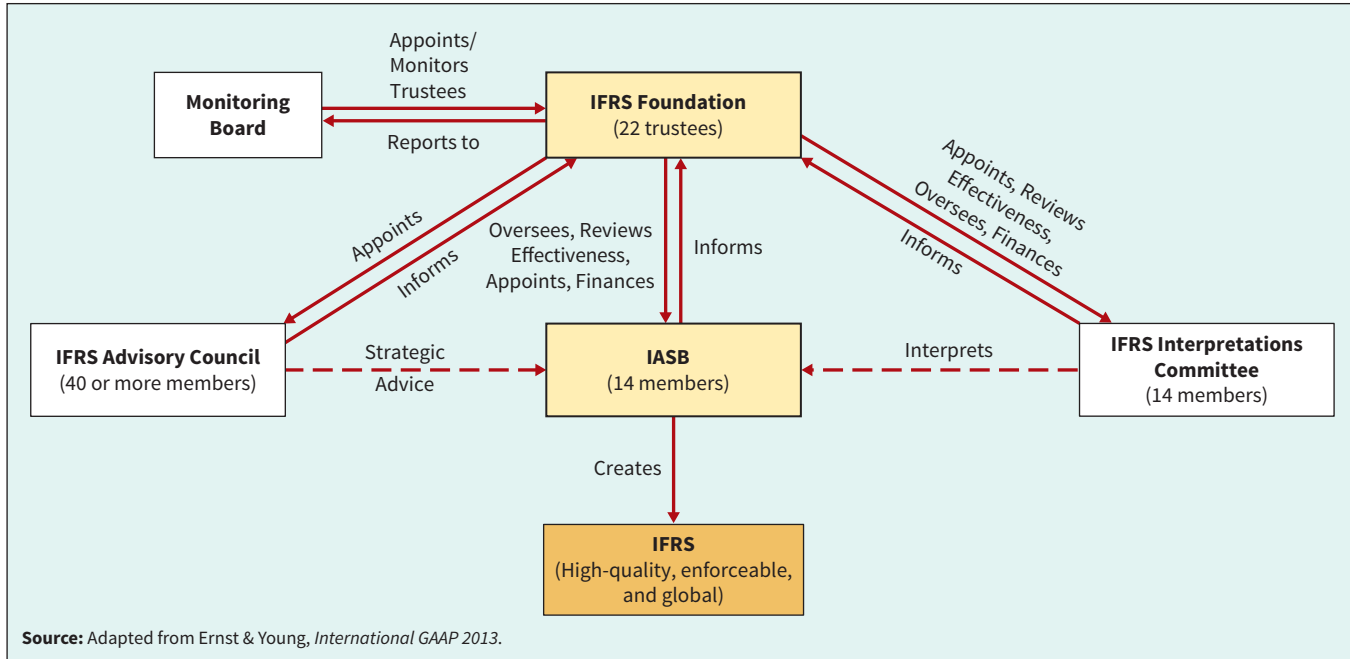


Illustration 1.4 International Standard-Setting Structure

To implement its due process, the IASB follows specific steps to develop a typical IFRS, as **Illustration 1.5** shows.

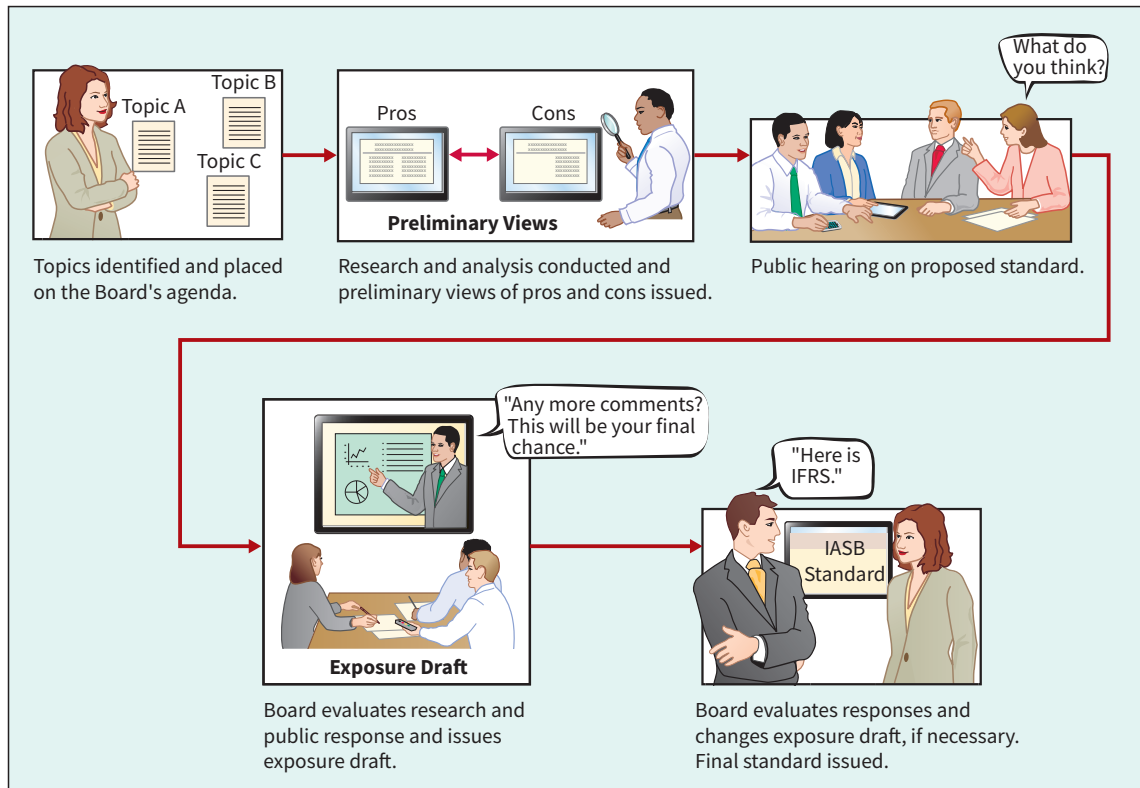


Illustration 1.5 IASB Due Process

Furthermore, the characteristics of the IASB, as shown below, reinforce the importance of an open, transparent, and independent due process.

- **Membership.** The Board consists of 14 full-time members. Members are well-paid, appointed for five-year renewable terms, and come from different countries.³
- **Autonomy.** The IASB is not part of any other professional organization. It is appointed by and answerable only to the IFRS Foundation.
- **Independence.** Full-time IASB members must sever all ties from their past employer. The members are selected for their expertise in standard-setting rather than to represent a given country.
- **Voting.** A majority of votes are needed to issue a new IFRS. In the event of a tie, the chairperson is granted an additional vote.

With these characteristics, the IASB and its members will be insulated as much as possible from the political process, favored industries, and national or cultural bias.

Types of Pronouncements

The IASB issues three major types of pronouncements:

1. International Financial Reporting Standards.
2. Conceptual Framework for Financial Reporting.
3. International Financial Reporting Standards Interpretations.

International Financial Reporting Standards Financial accounting standards issued by the IASB are referred to as International Financial Reporting Standards (IFRS). The IASB has issued 17 of these standards to date, covering such subjects as business combinations, share-based payments, and leases.

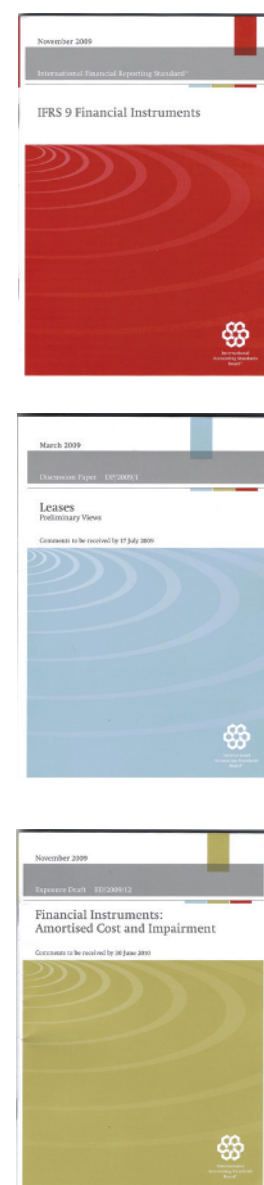
Prior to the IASB (formed in 2001), standard-setting on the international level was done by the International Accounting Standards Committee, which issued International Accounting Standards (IAS). The committee issued 41 IASs, many of which have been amended or superseded by the IASB. Those still remaining are considered under the umbrella of IFRS.

Conceptual Framework for Financial Reporting As part of a long-range effort to move away from the problem-by-problem approach, the IASB uses an IFRS conceptual framework. This **Conceptual Framework for Financial Reporting** sets forth the fundamental objective and concepts that the Board uses in developing future standards of financial reporting. The intent of the document is to form a cohesive set of interrelated concepts—a conceptual framework—that will serve as tools for solving existing and emerging problems in a consistent manner. For example, the objective of general-purpose financial reporting discussed earlier is part of this Conceptual Framework. The Conceptual Framework and any changes to it pass through the same due process (preliminary views, public hearing, exposure draft, etc.) as an IFRS. However, this Conceptual Framework is not an IFRS and hence does not define standards for any particular measurement or disclosure issue. Nothing in this Conceptual Framework overrides any specific international accounting standard.

International Financial Reporting Standards Interpretations **Interpretations** issued by the **IFRS Interpretations Committee** are also considered authoritative and must be followed. These interpretations cover (1) newly identified financial reporting issues not specifically dealt with in IFRS and (2) issues where unsatisfactory or conflicting interpretations have developed, or seem likely to develop, in the absence of authoritative guidance. The IFRS Interpretations Committee has issued over 20 of these interpretations to date.

In keeping with the IASB's own approach to setting standards, the IFRS Interpretations Committee applies a principles-based approach in providing interpretative guidance. To this end, the IFRS Interpretations Committee looks first to the Conceptual Framework as the foundation for formulating a consensus. It then looks to the principles articulated in the applicable standard, if any, to develop its interpretative guidance and to determine that the proposed guidance does not conflict with provisions in IFRS.

³IASB membership reflects geographic representation, generally with members from Europe, the Americas, Asia–Oceania, and Africa.



The IFRS Interpretations Committee helps the IASB in many ways. For example, emerging issues often attract public attention. If not resolved quickly, these issues can lead to financial crises and scandals. They can also undercut public confidence in current reporting practices. The next step, possible governmental intervention, would threaten the continuance of standard-setting in the private sector. The IFRS Interpretations Committee can address controversial accounting problems as they arise. It determines whether it can resolve them or whether to involve the IASB in solving them. In essence, it becomes a “problem filter” for the IASB. Thus, the IASB will hopefully work on more pervasive long-term problems, while the IFRS Interpretations Committee deals with short-term emerging issues.

Hierarchy of IFRS

Because it is a private organization, the IASB has no regulatory mandate and therefore no enforcement mechanism. As a result, the Board relies on other regulators to enforce the use of its standards. For example, the European Union requires publicly traded member country companies to use IFRS.

Any company indicating that it is preparing its financial statements in conformity with IFRS must use all of the standards and interpretations. The following **hierarchy** is used to determine what recognition, valuation, and disclosure requirements should be used. Companies first look to:

1. International Financial Reporting Standards, International Accounting Standards (issued by the predecessor to the IASB), and IFRS interpretations originated by the IFRS Interpretations Committee (and its predecessor, the IAS Interpretations Committee).
2. The Conceptual Framework for Financial Reporting.
3. Pronouncements of other standard-setting bodies that use a similar conceptual framework (e.g., U.S. GAAP).

In the absence of a standard or an interpretation in item 1 above, companies look to the Conceptual Framework for Financial Reporting and then to most recent pronouncements of other standard-setting bodies that use a similar conceptual framework to develop accounting standards (or other accounting literature and accepted industry practices to the extent they do not conflict with the above). The overriding requirement of IFRS is that the financial statements provide a fair presentation (often referred to as a “true and fair view”). Fair representation is assumed to occur if a company follows the guidelines established in IFRS.⁴ [1] (See the Authoritative Literature References section near the end of the chapter.)

Conceptual Framework

LEARNING OBJECTIVE 2

Describe the components and usefulness of the conceptual framework, and identify the qualitative characteristics of accounting information and the basic elements of financial statements.

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;

⁴In rare cases, compliance with a standard or interpretation is judged to be misleading when it conflicts with the objective of financial reporting. In this case, it is possible to have what is referred to as a “true and fair override.” If this occurs, extensive disclosure is required to explain the rationale for this unusual exception.

3. how they should be recognized and measured; and
4. how they should be summarized and reported.⁵

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.”⁶

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 also 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 to an existing framework of basic theory**. For example, assume that **Aphrodite Gold Ltd.** (AUS) issued bonds with two payment options. It can redeem them either with \$2,000 in cash or with 5 ounces of gold, whichever is worth more at maturity. The bonds have a stated interest rate of 8.5%. At what amounts should Aphrodite or the buyers of the bonds record them? What is the amount of the premium or discount on the bonds? And how should Aphrodite amortize this amount, if the bond redemption payments are to be made in gold (the future value of which is unknown at the date of issuance)? Consider that Aphrodite cannot know, at the date of issuance, the value of future gold 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.

⁵Recall from our earlier discussion that while the IASB’s Conceptual Framework and any changes to it pass through the same due process (discussion paper, preliminary views, public hearing, exposure draft, etc.) as do the IFRSs, the Conceptual Framework is not an IFRS. That is, the Conceptual Framework does not define standards for any particular measurement or disclosure issue, and nothing in the Conceptual Framework overrides any specific IFRS. [2]

⁶C. Horngren, “Uses and Limitations of a Conceptual Framework,” *Journal of Accountancy* (April 1981), p. 90.

Accounting Matters What's Your Principle?

The need for a conceptual framework is highlighted by accounting scandals such as those at **Royal Ahold** (NLD), **Enron** (USA), **Satyam Computer Services** (IND), and, most recently, **Carillion** (GBR). To restore public confidence in the financial reporting process, many have argued that regulators should move toward principles-based rules. They believe that companies exploited the detailed provisions in rules-based pronouncements to manage accounting reports, rather than report the economic substance of transactions.

For example, many of the off-balance-sheet arrangements of Enron avoided transparent reporting by barely achieving 3% outside equity ownership, a requirement in an obscure accounting rule interpretation. Enron's financial engineers were able to structure transactions to achieve a desired accounting treatment, even if that accounting treatment did not reflect the transaction's true nature. Under principles-based rules, hopefully top management's financial reporting focus will shift from demonstrating compliance with rules to demonstrating that a company has attained financial reporting objectives.

Development of a Conceptual Framework

In 2018, the IASB published the *Conceptual Framework for Financial Reporting* (the Conceptual Framework). This fully revised document replaced the section of the 2010 version of the Conceptual Framework that had been carried forward from the 1989 version, as well as addressed some changes introduced in 2010. The Conceptual Framework comprises eight chapters, as follows.

- Chapter 1, The Objective of General Purpose Financial Statements.
- Chapter 2, Qualitative Characteristics of Useful Financial Information.
- Chapter 3, Financial Statements and the Reporting Entity.
- Chapter 4, The Elements of Financial Statements.
- Chapter 5, Recognition and Derecognition.
- Chapter 6, Measurement.
- Chapter 7, Presentation and Disclosure.
- Chapter 8, Concepts of Capital and Capital Maintenance.

The IASB worked diligently to complete the Conceptual Framework, as the Board recognized the need for such a document to serve its diverse users. It should be emphasized that while the Conceptual Framework is not an IFRS, it is part of the authoritative literature. Thus, the Conceptual Framework can provide guidance in many situations where an IFRS does not cover the issue under consideration.⁷ [3]

Overview of the Conceptual Framework

Illustration 1.6 provides an overview of the IASB's Conceptual Framework for Financial Reporting, also referred to simply as the Conceptual 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 a cost constraint that describe the present reporting environment.

⁷The IASB and the FASB had worked together to develop converged concepts statements on the objective of financial reporting and qualitative characteristics of accounting information, resulting in updated chapters on those elements in 2010. Since 2010, the Boards worked on their own schedules to address the remaining elements of the conceptual framework project. As discussed in the chapter, the IASB issued its updated *Conceptual Framework for Financial Reporting* in 2018. The FASB continues to work on its framework to address concepts related to definitions of assets and liabilities, measurement, and presentation. For more information, go to the FASB website; click on Projects and then Technical Agenda.

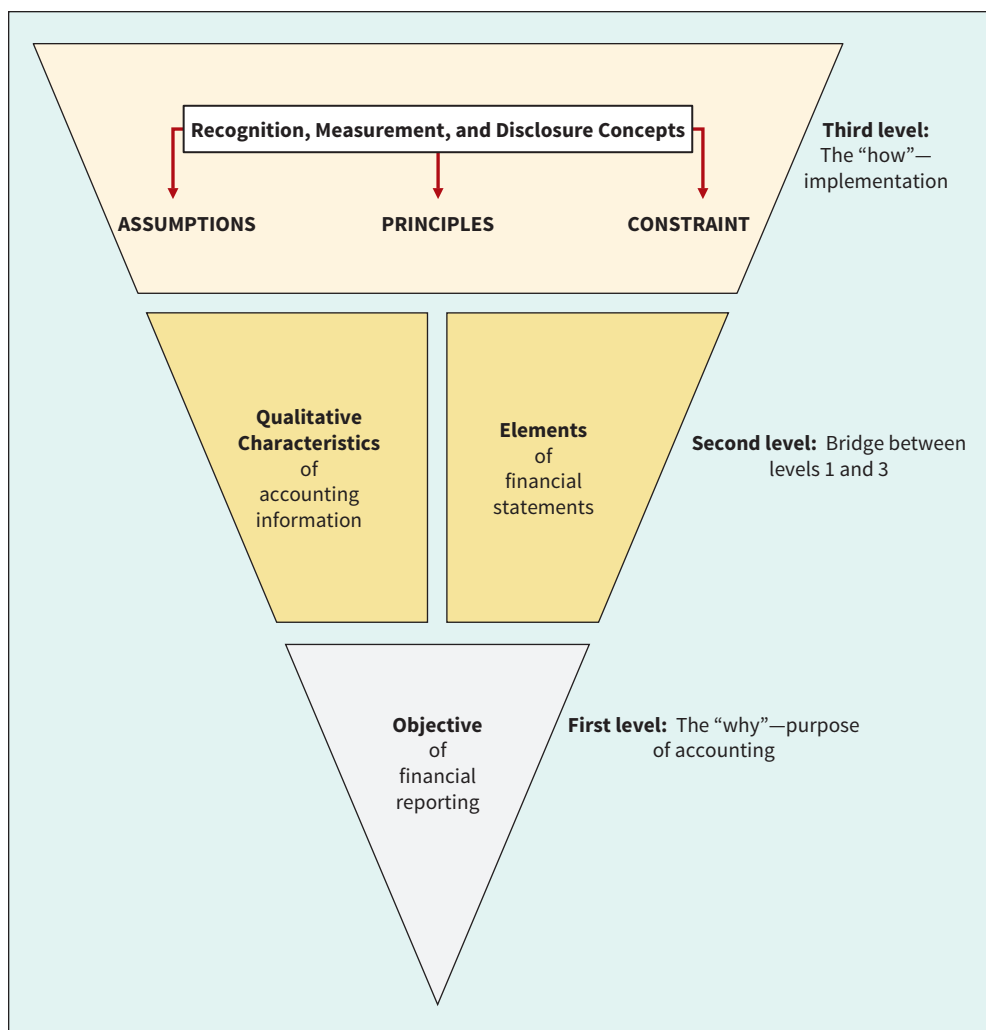


Illustration 1.6 Conceptual Framework for Financial Reporting

Objective of Financial Reporting

The **objective of financial reporting** serves as the foundation of the conceptual framework. What is the objective, or purpose, of financial reporting? It is to provide financial information about the reporting entity that is **useful to present and potential equity investors, lenders, and other creditors in making decisions about providing resources to the entity.**

Think about the types of decisions that investors and lenders are making about companies.

- Investors decide whether to buy, sell, or hold stock in a company.
- Lenders decide whether to lend money to a company and at what interest rate and for how long.

To make effective decisions, these groups need information to help them assess a company's future net cash flows which will support loan payments and/or provide a return to investors.

To provide information to decision-makers, companies prepare general-purpose financial statements. **General-purpose financial statements** help users who lack the ability to demand all the financial information they need from a company and therefore must rely, at least partly, on the information provided in financial statements. However, it's important to note that users need a reasonable knowledge of business and financial accounting matters to understand the information contained in financial statements.

Accounting Matters Don't Forget Management Stewardship

In addition to providing decision-useful information about future cash flows, management is also accountable to investors for the custody and safekeeping of the company's economic resources and for their efficient and profitable use. For example, the management of Nestlé has the responsibility of protecting its economic resources from unfavorable effects of economic factors, such as price changes, and

technological and social changes. Because Nestlé's performance in discharging its responsibilities (referred to as its **management stewardship** responsibilities) usually affects its ability to generate net cash inflows, financial reporting may also provide decision-useful information to assess management performance in this role. [4]

Qualitative Characteristics of Accounting Information

Consider these questions:

- Should a company like **Marks and Spencer plc** (GBR) provide information in its financial statements on how much it costs them to acquire its assets (historical cost basis), or how much the assets are currently worth (fair value basis)?
- Should **Samsung** (KOR) combine and show as one company the main segments of its business, or should it report Consumer Electronics, Information Technology & Mobile Communications, Device Solutions, and Harman as 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 (referred to as decision-usefulness)**. The IASB identified the **qualitative characteristics** of accounting information that distinguish better (more useful) information from inferior (less useful) information for meeting the objective of financial reporting. In addition, the IASB identified a cost constraint as part of the Conceptual Framework (discussed later in the chapter). As **Illustration 1.7** shows, the characteristics may be viewed as a hierarchy.

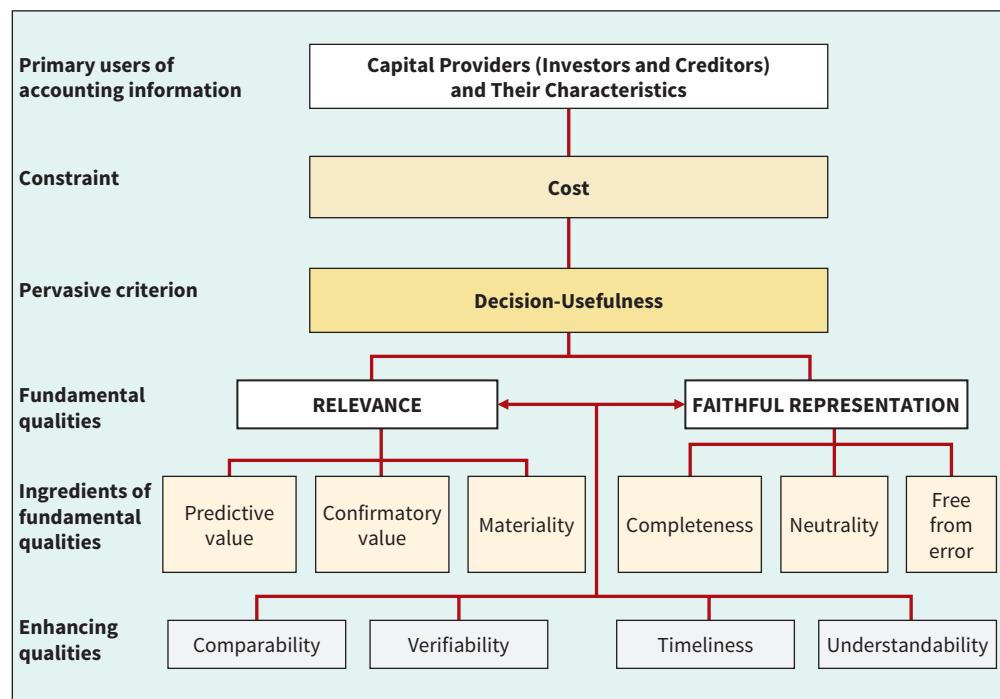
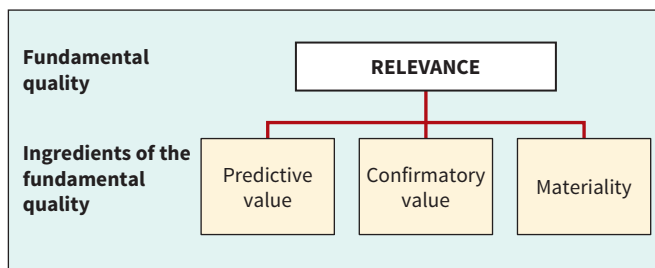


Illustration 1.7 Hierarchy of Accounting Qualities

As indicated by Illustration 1.7, qualitative characteristics are either fundamental, or ingredients of fundamental qualities, and enhancing, 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 financial information is limited by a constraint on financial reporting—cost should not exceed the benefits of a reporting practice.

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.



As indicated, 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 considered relevant when it is material and has predictive value, confirmatory value, or both.

Predictive Value Accounting information has **predictive value** if it helps users form their own expectations about the future. For example, if potential investors are interested in purchasing common shares in **Nippon** (JPN), 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 Nippon’s future cash flows.

Confirmatory Value Accounting information has **confirmatory value** if it helps users confirm or correct prior expectations. For example, when Nippon 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. In this regard, information about the current level and structure of Nippon’s assets and liabilities helps users predict its ability to take advantage of opportunities and react to adverse situations. The same information helps to confirm or correct users’ past predictions about that ability.

Materiality **Materiality** is a company-specific aspect of relevance. Information is material if omitting it or misstating it would influence decisions that users make on the basis of the reported financial information. An individual company determines whether information is material because both the nature and/or magnitude of the item(s) to which the information relates must be considered in the context of an individual company’s financial report. Information 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.

Assessing materiality is one of the more challenging aspects of accounting because it requires evaluating both the **relative size and importance** of an item. For example, let’s consider the two sets of numbers in **Illustration 1.8**, which indicate relative size.

	Company A	Company B
Sales	\$10,000,000	\$100,000
Costs and expenses	9,000,000	90,000
Income from operations	<u>\$ 1,000,000</u>	<u>\$ 10,000</u>
Unusual gain	\$ 20,000	\$ 5,000

Illustration 1.8 Materiality Comparison

During the period under consideration, the revenues and expenses, and therefore the incomes from operations of Company A and Company B, are proportional. Meaning for both companies, income from operations is 10% of sales.

Each reported an unusual gain, but these amounts have different effects for each company.

- For Company A, the gain is only 2% of the operating income ($\$20,000 \div \$1,000,000$); if merged, it would not seriously distort the income figure.
- For Company B, a gain of \$5,000 amounts to 50% of its income from operations; obviously, the inclusion of such an item in 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% of net income is considered immaterial. This may be acceptable for an initial assessment of materiality, but other qualitative factors should also be considered. For example, the relative size of an item might be small, but what if that item:

- Converts a loss to a profit, or vice versa.
- Increases management compensation.
- Hides an illegal transaction, like a bribe.
- Preserves a positive earnings trend.

Ultimately, materiality judgments should be made in the context of the nature and the amount of an item. **Companies must consider both quantitative and qualitative factors in determining whether an item is material.**

Accounting Matters Living in a Material World

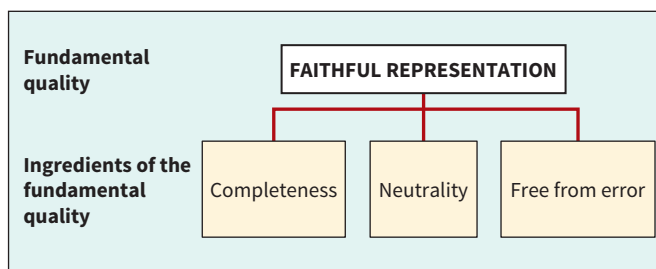
The word “material” can be found 114 times in **Starbucks**’ (USA) recent annual report and 88 times in **Apple**’s (USA). This is not unique to these companies but rather shows the impact that **materiality** has in the financial reporting process. When discussing the judgments and estimates involved in financial reporting, management concedes that actual results could differ materially from the estimates. Apple indicated that the adoption of the new revenue recognition standard did not have a **material** impact on

previously reported amounts. Starbucks adopted new guidance on accounting for hedging relationships and indicated that the adoption of the new guidance did not have a **material** impact on their consolidated financial statements. Materiality is indeed a key ingredient of relevant financial information and one that preparers and auditors alike spend a significant amount of time evaluating.

Source: Apple, Inc. and Starbucks Corporation 10-K annual reports.

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 as follows.



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 €92,403 million when it had sales of

€79,644 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 **Société Générale** (FRA) 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 the value of the receivable.

Neutrality **Neutrality** means that a company cannot select information to favor one set of interested parties over another. Providing neutral or unbiased information must be the overriding consideration. For example, in the notes to financial statements, tobacco companies such as **British American Tobacco** (GBR) 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: 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 or rigged, the public will lose confidence and no longer use it.

The IASB indicates that neutrality is supported by prudence. **Prudence** is the exercise of caution when making judgments under conditions of uncertainty. That is, the exercise of prudence means that assets and income are not overstated, and liabilities and expenses are not understated. Furthermore, exercising prudence does not mean a decision-maker should give primacy to the understatement of assets or income, or the overstatement of liabilities or expenses. Such misstatements can lead to the overstatement or understatement of income or expenses in future periods. Similarly, exercising prudence need not be biased against recognition of assets or income relative to recognition of liabilities or expenses. Such bias is inconsistent with neutrality—the attribute that supports faithful representation and useful information. [5]

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, as well as the residual value of the assets.

Accounting Matters Unfaithful—For 20 Years

The importance of faithful representation is illustrated by the fraud at **Olympus Corporation** (JPN). Here's what happened, as revealed in the report on the fraud by an investigative committee. In transactions dating back nearly 20 years, Olympus was hiding losses related to export sales. The losses arose when the exchange rate between the dollar and yen moved in an unfavorable direction for Olympus, which negatively impacted investments related to the export sales. However, the losses were not reported; that is, the financial statements were not faithful representations.

How could such a loss be hidden? At the time, accounting rules in Japan, as well as in other countries, allowed investments to be carried at cost. Theoretically, there should eventually have

been a write-down, but there never was. Rather, management hoped that with additional risky investments, the losses could somehow be made up. They were not and, eventually, the losses grew to more than \$1 billion. Olympus seems to have been content to sit on the losses until 1997, when accounting rules changed and some investments had to be marked to market.

Olympus then dug the hole deeper; it developed a plan to "sell" the losing investments, at original cost, to shell companies set up by Olympus for that purpose. Under lenient accounting rules, those shell companies would not have to be consolidated with Olympus, so the losses could remain hidden. That all ended when the investigation uncovered the sham adjustments and the losses were finally revealed.

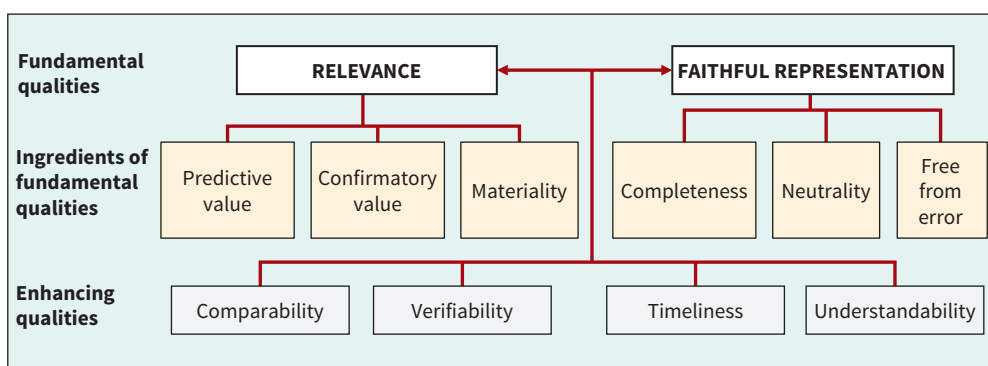
The scandal and the recent case of opaque accounting for goodwill and impairments at **Carillion** (GBR) highlight the importance of accounting rules that result in faithful representation of company performance and financial position. That is, until accounting rule-makers finally started to require fair value accounting for some financial instruments in 1997—seven years after the Olympus fraud began—covering up the losses was easy. Furthermore,

subsequent rule changes (in the wake of the **Enron** (USA) scandal) forced companies to stop hiding losses in off-balance-sheet entities. Indeed, the Olympus scandal might never have occurred if the accounting had kept a focus on faithful representation.

Sources: F. Norris, “Deep Roots of Fraud at Olympus,” *The New York Times* (December 8, 2011); and J. Ford, “Carillion’s Troubles Were Shrouded in a Fog of Goodwill,” *Financial Times* (June 17, 2018).

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 differed from that in the United States. In Japan, companies generally recorded little or no charge to income for these costs. U.S. companies recorded pension cost as incurred. As a result, it is difficult to compare 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 deemed appropriate by the auditor, 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.⁸ 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.

Verifiability **Verifiability** means that different knowledgeable and independent observers could reach consensus, although not necessarily complete agreement, that a particular depiction is a faithful representation. [6] Verifiability occurs in the following situations.

⁸Surveys 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 21) on accounting changes are designed to improve the comparability of the data before and after the change.

1. Two independent auditors count **Tata Motors'** (IND) inventory and arrive at the same physical quantity amount for inventory. Verification of an amount for an asset can therefore occur by simply counting the inventory (referred to as *direct verification*).
2. Two independent auditors compute Tata Motors' 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 Group** (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.

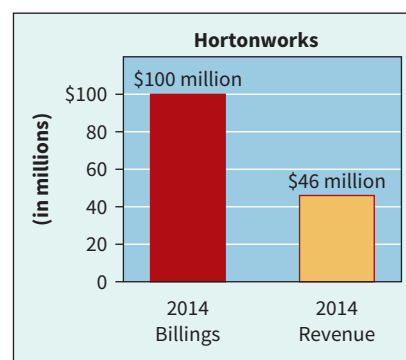
For example, assume that **Tomkins plc** (GBR) issues a three-month report that shows interim earnings have declined significantly. This interim report provides relevant and faithfully represented information for decision-making purposes. Some users, upon reading the report, decide to sell their shares.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

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. [7]

Accounting Matters Show Me the Earnings!

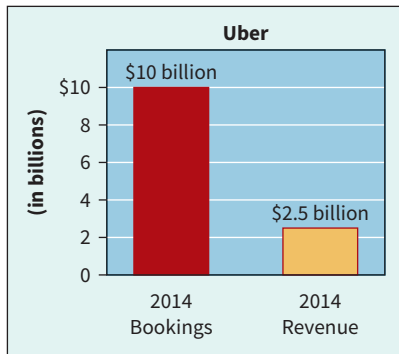
Some young technology companies, in an effort to attract investors who will help them strike it rich, are using unconventional financial terms in their financial reports. As an example, instead of revenue, these privately held companies use terms such as "bookings," annual recurring revenues, or other numbers that often exceed actual revenue.

Hortonworks Inc. (a U.S. software company) is a classic illustration. It forecast in March 2014 that it would have a strong \$100 million in billings by year-end. It turns out the company was not talking about revenues but rather a non-U.S. GAAP number (referred to as an alternative performance measure, or APM) that it uses to gauge future business. This number looked a lot smaller after Hortonworks went public and reported financial results—just \$46 million in revenues, as shown in the following chart.



Another example is **Uber Technologies** (the sometimes controversial U.S. ride service). Uber noted that it was on target to reach \$10 billion in bookings for 2014. Uber defines

bookings as total fares paid by customers. But Uber keeps little of the money from these bookings. As shown in the following chart, Uber gets only 25 cents on each \$1 of bookings.



Now that Uber is a public company, it would report the 25 cents as revenues, not the one dollar. Similar income

reporting disconnects were apparent at **Lululemon** (CAN), which showed gains in its store openings and top line (sales) but not a corresponding increase in profit margin.

Given these examples, it is understandable that standard-setters have increased their scrutiny of the reporting of APMs. The lesson for investors: Keep an eye on verifiable and comparable financial measures of performance and be sure to count expenses and net income according to IFRS. Using gross measures such as billings, recurring revenues, or some non-financial measures, and APMs to determine success may be hazardous to your financial health.

Sources: Telis Demos, Shira Ovide, and Susan Pulliam, “Tech Startups Play Numbers Game,” *Wall Street Journal* (June 10, 2015), pp. A1 and A12; L. Beilfuss, “Lululemon Sales Rise, Gross Margin Declines,” *Wall Street Journal* (September 10, 2015); and PwC, “Alternative Performance Measures—Better Described as ‘Profits Before Unfortunate Debits?’” *IFRS News* (March 2016).

Elements of Financial Statements

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 Conceptual 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.

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 present economic resource controlled by the entity as a result of past events. (An economic resource is a right that has the potential to produce economic benefits.)

Liability. A present obligation of the entity to transfer an economic resource as a result of past events.

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 assets, or decreases in liabilities, that result in increases in equity, other than those relating to contributions from holders of equity claims.

Expenses. Decreases in assets, or increases in liabilities, that result in decreases in equity, other than those relating to distributions to holders of equity claims.

As indicated, the IASB classifies the elements into two distinct groups.

1. The first group of three elements—assets, liabilities, and equity—describes amounts of resources and claims to resources at a **moment in time**.
2. The second group of two elements describes transactions, events, and circumstances that affect a company during a **period of time**.

The first group, affected by elements of the second group, 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.

Assumptions and Principles

LEARNING OBJECTIVE 3

Discuss the basic assumptions and principles of accounting.

The third level of the Conceptual Framework consists of concepts that implement the objective of financial reporting. The **assumptions** and **principles** help to explain how companies should recognize, measure, and report financial elements and events. In addition, you should also recognize the concept of a **cost constraint**, which we will discuss later in the chapter. These concepts serve as guidelines in responding to controversial accounting issues.

Assumptions

As indicated earlier, the Conceptual Framework specifically identifies only one assumption—the going concern assumption. Yet, we believe there are a number of other **assumptions** that are present in the reporting environment. As a result, for completeness, we discuss each of these five basic assumptions in turn: (1) **economic entity**, (2) **going concern**, (3) **monetary unit**, (4) **periodicity**, and (5) **accrual basis**.

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. Consider these examples:

- The economic entity assumption dictates that **Sappi Limited** (ZAF) record the company’s financial activities separate from those of its owners and managers.
- 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 company and its subsidiaries are separate legal entities, but merging their activities for accounting and reporting purposes does not violate the **economic entity** assumption.⁹ [8]

Going Concern Assumption

Most accounting methods rely on the **going concern assumption**—that the company will have a long life. This means for accounting purposes, we expect companies to last long enough

⁹The 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.

to fulfill their objectives and commitments. The going concern assumption has three significant implications:

1. The historical cost principle is of limited usefulness if we assumed eventual liquidation. Under a liquidation approach, a company would better state asset values at net realizable value (sales price less costs of disposal).
2. Depreciation and amortization approaches would not be needed given a liquidation approach.
3. Current and non-current classification of assets and liabilities would lose their significance and would be difficult to justify. Also, reporting liabilities based on priority in liquidation would be more reasonable.

Most companies have a high continuance rate and fulfill their objectives and commitments. Recently, however, companies (both large and small) have had to declare bankruptcy due to the COVID-19 pandemic. **Only where liquidation appears imminent is the assumption inapplicable.** In these cases, when it is known that a company is going out of business or liquidating, we apply a different type of accounting method, called **liquidation accounting**. Under such circumstances, 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. [9]

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. Furthermore, 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 1985 pounds to 2015 pounds sterling without any adjustment. It is expected that the pound 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.¹⁰

Periodicity Assumption

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. [12] 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 verifiable than a quarter's results, and a quarter's results are likely to be less verifiable 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 timeliness and accuracy (free from error) in preparing financial data.**

¹⁰This approach reflects adoption of a financial capital approach to capital maintenance under which the change in capital or a company's net assets is measured in nominal monetary units without adjusting for changes in prices. [10] 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. [11]

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. [13] For example, using the accrual basis means that companies recognize revenues when they satisfy a performance obligation (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, under the cash basis companies do 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.

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.

Measurement Principle

We presently have a “mixed-attribute” system that permits the use of various measurement bases. The most commonly used measurements are based on historical cost and fair value.

Historical Cost 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**. Historical cost has an important advantage over other valuations: **It is generally thought to be verifiable.**

Suppose a company buys a piece of land in the year 2010 paying \$100,000 cash.

- The transaction is **verifiable** because there are documents, such as a title deed, confirming the purchase and the payment.
- The land would be recorded in the company's accounting records at the historical cost of \$100,000.
- Now fast forward to the year 2025—is the land still worth \$100,000?

Most likely, the land has increased in value. That raises two important questions:

1. Should the company adjust the recorded amount for the land to its current sales value?
2. If so, how would the company determine the current sales value of the land?

One way to determine current sales value is to have the land appraised, but this is merely an estimate of the land's value and is subjective. The only way to truly know the value of the land is to sell it. You can see that if companies were required to adjust assets to current sales value, it could lead to highly subjective valuations that would have low verifiability. Plus, it would be a burden for companies to go through this process every time they want to prepare financial statements.

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. [14]

Current Value **Current value** measures provide monetary information about assets, liabilities, and related income and expenses, using information updated to reflect conditions at the measurement date. Because of the updating, current values of assets and liabilities reflect changes in amounts since the previous measurement date. Current value bases include:

1. Fair value.
2. Value in use for assets and fulfillment value for liabilities.
3. Current cost. [15]

Fair value **Fair value** is defined as “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.” Fair value is therefore a market-based measure. [16] Recently, IFRS has increasingly called for the 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:

- If long-lived assets such as buildings or equipment decline in value, a fair value measure determines any impairment loss.
- If inventories decline in value, a fair value measure is used to determine the amount of the loss.
- If equity investments and certain types of debt investments either increase or decrease in value, a fair value measure is used to determine the gain or loss.
- If a company chooses, it can use a fair value option to measure its financial assets and financial liabilities (referred to as the **fair value option**), including items such as receivables and debt securities.

The IASB believes that fair value information in some circumstances is more relevant to users than historical cost. In these cases, fair value measurement provides better insight into the value of a company’s assets and liabilities (its financial position) and a better basis for assessing future cash flow prospects. The IASB provides an option to use fair value (referred to as the fair value option) as the basis for measurement of financial assets and financial liabilities. [17] The primary purpose of this option is to increase the relevance of the accounting information by eliminating cases where an accounting mismatch is created by using a different measurement method. 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, and debt securities.

Use of fair value in financial reporting is increasing. However, measurement based on fair value introduces increased subjectivity into accounting reports when fair value information is not readily available. To increase consistency and comparability in fair value measures, the IASB established a fair value hierarchy that provides insight into the priority of valuation techniques to use to determine fair value. As shown in **Illustration 1.9**, the fair value hierarchy is divided into three broad levels.

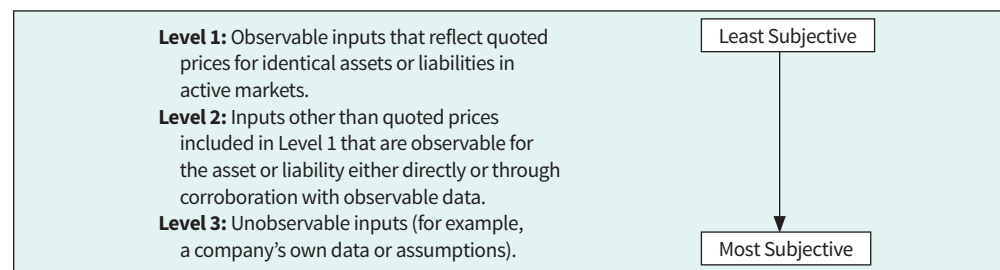


Illustration 1.9 Fair Value Hierarchy

As Illustration 1.9 indicates, Level 1 is the least subjective because it is based on quoted prices, like a closing share price in the *Financial Times*. Level 2 is more subjective and would rely on evaluating similar assets or liabilities in active markets. At the most subjective level, Level 3, much judgment is needed, based on the best information available, to arrive at a relevant and representationally faithful fair value measurement.¹¹

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 assets of a subprime lender such as **New Century** (USA) given that the market for these securities has essentially disappeared? A great deal of expertise and sound judgment will be needed to arrive at appropriate answers. IFRS also provides guidance on estimating fair values when market-related data are not available. In general, these valuation issues relate to Level 3 fair value measurements. These measurements may be developed using expected cash flow and present value techniques, as described in Chapter 5.

Value in use / fulfillment value **Value in use** is the present value of the cash flows, or other economic benefits that a company expects to derive **from the use of an asset** and from its ultimate disposal. **Fulfillment value** is the present value of the cash, or other economic resources that a company expects to be **obliged to transfer as it fulfills a liability**. Value in use and fulfillment value cannot be observed directly and are determined using cash-flow-based measurement techniques. Value in use and fulfillment value reflect the same factors described for fair value but from a company-specific perspective rather than from a market-participant perspective.

Current cost The **current cost** of an asset is the cost of an equivalent asset at the measurement date, comprising the consideration that would be paid at the measurement date plus the transaction costs that would be incurred at that date. The current cost of a liability is the consideration that would be received for an equivalent liability at the measurement date minus the transaction costs that would be incurred at that date. Similar to historical cost, current cost is an entry value: It reflects prices in the market in which the company would acquire the asset or would incur the liability. As a result, current cost is distinguished from fair value, value in use, and fulfillment value, which are exit values.

However, unlike historical cost, current cost reflects conditions at the measurement date. Current cost frequently cannot be determined directly by observing prices in an active market and must be determined indirectly by other means. For example, if prices are available only for new assets, the current cost of a used asset might need to be estimated by adjusting the current price of a new asset to reflect the current age and condition of the asset held by the entity.¹²

Summary As indicated above, we presently have a “mixed-attribute” system that permits the use of both historical cost and current value. Although the historical cost principle continues to be an important basis for valuation, recording and reporting of current (fair value) information is increasing. How do we determine which measurement basis should be used? In many cases, IFRSs specify which basis should be used. For instance, inventory is generally recorded at cost unless it is obsolete or the value is impaired. As a general principle, the choice should result in the most useful information. That is, the measurement basis selected should provide relevant information that faithfully represents the event or transaction. The recent measurement and disclosure guidance should increase consistency and comparability when current (fair) value measurements are used in the financial statements and related notes.¹³

¹¹For major groups of assets and liabilities, companies must disclose (1) the fair value measurement and (2) the fair value hierarchy level of the measurements as a whole, classified by Level 1, 2, or 3. Given the judgment involved, it follows that the more a company depends on Level 3 to determine fair values, the more information about the valuation process the company will need to disclose. Thus, additional disclosures are required for Level 3 measurements; we discuss these disclosures in more detail in subsequent chapters.

¹²Detailed discussion on measurement bases was not included in the pre-2018 Conceptual Framework. However, these current value measurement bases are reflected in certain IFRS. By including them in the Conceptual Framework, the IASB, when establishing new standards, can be guided by this Framework to ensure consistency. Indeed, while current cost is not often used in IFRS, value in use and fulfillment costs will be discussed in subsequent chapters in this text.

¹³The IFRS Conceptual Framework provides significant guidance on selecting a measurement basis that provides the most useful information. The optimal choice depends on the facts and circumstances of the company. [18]

Revenue Recognition Principle

For an item to be recognized in the financial statements, it must meet the definition of an element, be measurable with sufficient certainty, and be relevant and reliable. Two key recognition concepts are the revenue recognition principle and the expense recognition principle. When a company agrees to perform a service or sell a product to a customer, it has a **performance obligation**. The **revenue recognition principle** requires that companies recognize revenue in the accounting period in which the performance obligation is satisfied.

For example, assume that **Klinke Cleaners** (USA) cleans clothing on June 30, but customers do not claim and pay for their clothes until the first week of July. Klinke should record revenue in June when it performed the service (satisfied the performance obligation) rather than in July when it received the cash. At June 30, Klinke would report a receivable on its balance sheet and revenue in its income statement for the service performed.

To illustrate the revenue recognition principle in more detail, assume that **Airbus** (DEU) signs a contract to sell airplanes to **British Airways** (GBR) for €100 million. To determine when to recognize revenue, Airbus uses the five steps shown in **Illustration 1.10**.¹⁴

Many revenue transactions pose few problems because the transaction is initiated and completed at the same time. However, when to recognize revenue in other situations is often

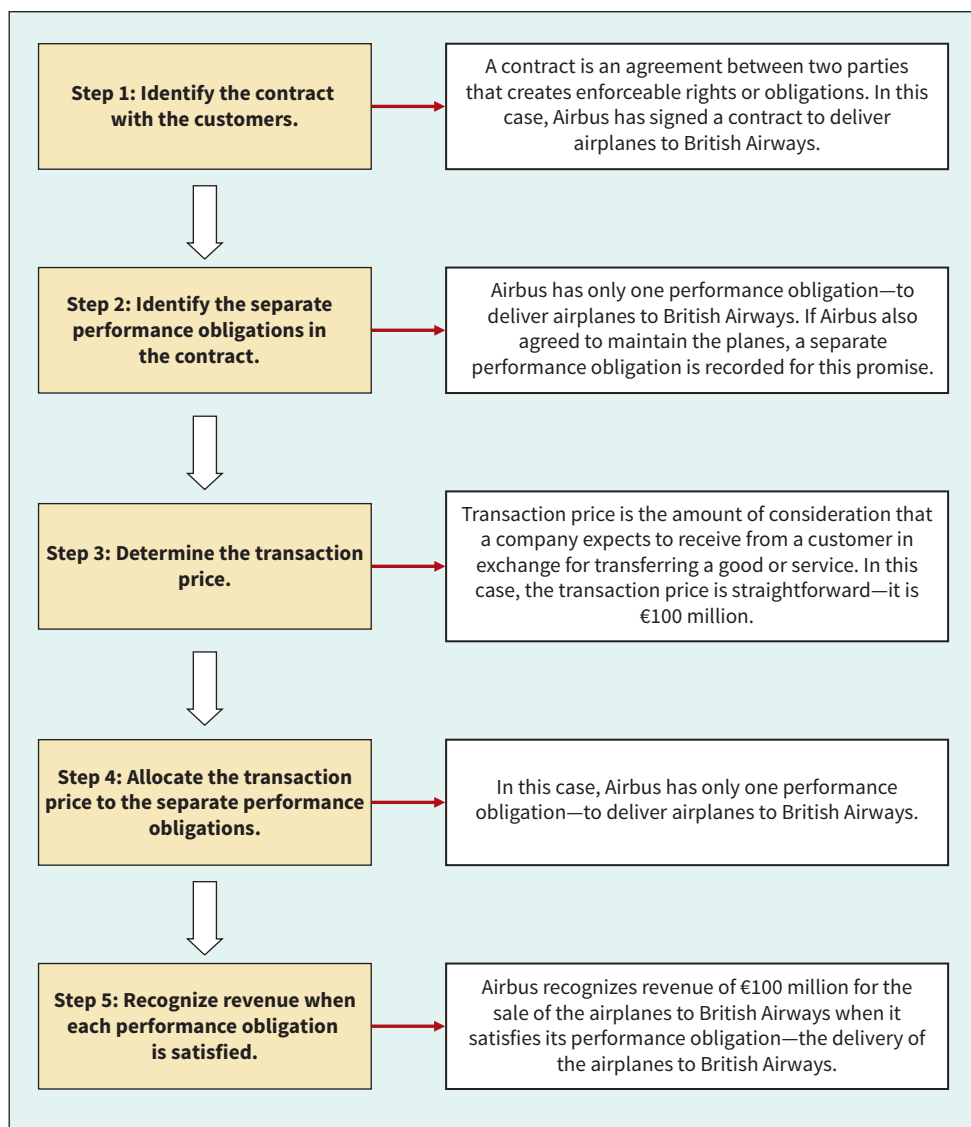


Illustration 1.10 The Five Steps of Revenue Recognition

¹⁴The framework shown in Illustration 1.10 is based on the recent standard on revenue recognition. The new guidance establishes the principles to report useful information about the nature, timing, and uncertainty of revenue from contracts with customers.

more difficult, as when a performance obligation is satisfied over time or multiple performance obligations are involved. We will revisit the five steps of revenue recognition in more detail in Chapters 3, 6, 7, 12, and 17.

Expense Recognition Principle

Expenses are defined as outflows or other “using up” of assets or incurring of liabilities during a period as a result of delivering or producing goods and/or performing 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**.

- 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 an expense.¹⁵

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 to apply 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 **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 1.11 summarizes these expense recognition procedures.

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

Illustration 1.11 Expense Recognition Procedures for Product and Period Costs

Full Disclosure Principle

Consider the following questions.

- Should a company have to disclose that its CEO has the coronavirus?
- Should a company be required to disclose its level of political spending?
- Should a company be required to disclose its level of diversity in its board of directors?

¹⁵This approach is commonly referred to as the matching principle. However, there is much 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 balance sheet. In fact, these costs may not have future benefits. If abused, this principle permits the balance sheet to become a “dumping ground” for unmatched costs.

Answers to questions like these are difficult as they do not directly affect a specific asset, liability, revenue, or expense. But non-disclosure may have a significant effect on the financial reports from a longer-term point of view.

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**, this practice 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.

Disclosure is not a substitute for proper accounting. As a former chief accountant of the U.S. SEC noted, “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.”

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.
3. As supplementary information.

Financial Statements As we discussed earlier, the financial statements are the balance sheet, income statement, statement of cash flows, and statement of stockholders’ equity. They are a structured means of communicating financial information. To be recognized in the main body of financial statements, **an item should meet the definition of an element, be measurable with sufficient certainty, and be relevant and reliable.**

Notes to the Financial Statements **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 financial statements. The notes can be essential to understanding the company’s performance and position.

Supplementary Information **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.¹⁶

¹⁶To provide guidance for management disclosures, the IASB issued an IFRS practice statement entitled “Management Commentary—A Framework for Presentation.” The IASB notes that this practice statement is neither an IFRS nor part of the Conceptual Framework. However, the guidance is issued on the basis that management commentary meets the definition of other financial reporting as referenced in the Conceptual Framework.

Cost Constraint

In providing information with the qualitative characteristics that make it useful, companies must consider an overriding factor that limits (constrains) the reporting. This is referred to as the **cost constraint**. That is, companies 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. [19]

A company 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.”¹⁷ Although extreme, this remark indicates the frustration expressed by members of the business community about accounting standard-setting, 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. There are several types of costs associated with providing information:

- Collecting, processing, and disseminating information.
- Auditing information.
- Potential litigation caused by disclosure.
- Disclosure to competitors.
- Analyzing and interpreting information.

However, 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.”¹⁸

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 the overall benefits of the resulting information. In addition, they seek input on costs and benefits as part of their due process.

Accounting Matters Let’s Be Prudent

Historically, it has been an acceptable practice to invoke the additional constraint of prudence or conservatism as a justification for an accounting treatment under conditions of uncertainty. **Prudence** or **conservatism** means the exercise of caution when making decisions under conditions of uncertainty. However, the Conceptual Framework, when updated in 2010, indicated that prudence or conservatism is generally in conflict with the quality of neutrality. This is because being prudent or conservative can lead to 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 Conceptual Framework issued in 2010 did not include prudence or conservatism as desirable qualities of financial reporting information.

¹⁷“Decision-Usefulness: The Overriding Objective,” *FASB Viewpoints* (October 19, 1983), p. 4.

¹⁸Charles 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 U.S. SEC (April 11, 2005).

The IASB heard many calls to bring prudence back into the Conceptual Framework, arguing that prudence is one of the most important tenets of accounting. The IASB was persuaded by arguments that prudence can actually help achieve neutrality when selecting and applying accounting policies. As a result, the IASB reintroduced the term “prudence,” describing it in the 2018 Conceptual Framework as “cautious prudence,” which it says is “the exercise of caution when making judgments under conditions of uncertainty.”

The Board hoped that would satisfy stakeholders. “The previous conceptual framework led a lot of people to believe that the Board did not think prudence to be important,” said Hans Hoogervorst, IASB Chair. “And I think in the new conceptual framework, that confusion will be gone.”

Sources: Peter Hogarth, “Dear Prudence,” PricewaterhouseCoopers blog, pwc.blogs.com/ifrs/2015/06/dear-prudence.html (June 3, 2015); and H. Hoogervorst, “IASB Completes Revisions to Its Conceptual Framework,” (IASB, March 29, 2018).

Summary of the Structure

Illustration 1.12 presents the Conceptual Framework for Financial Reporting discussed in this chapter. It is similar to Illustration 1.6 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.

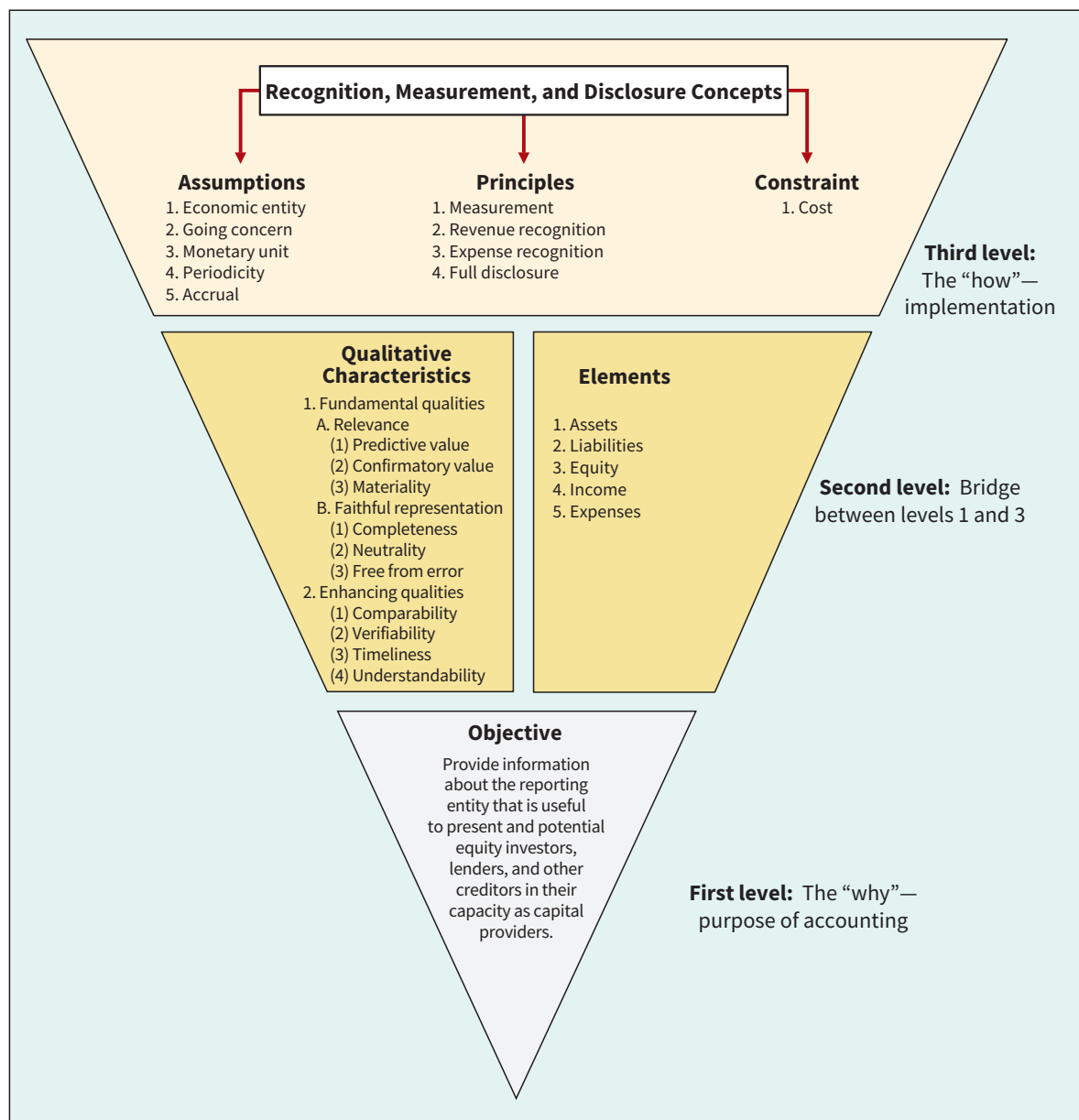


Illustration 1.12 Conceptual Framework for Financial Reporting

Accounting Matters Be Responsible

Kellogg's (USA) issues an annual corporate responsibility report, and **Patagonia** (USA) devotes substantial space on its website to articulate its views on social responsibility, its initiatives, and its progress toward its goals. Evidence shows financial performance corresponds to how well companies contend with **environmental, social and governance (ESG) issues**, and investors have taken note.

Unlike financial information, however, sustainability disclosures do not need to conform to a set of shared standards. Kellogg's and Patagonia may focus their reporting on vastly different metrics. With over a dozen major reporting

frameworks and standards, businesses can apply the standards they see fit, making it challenging for investors to compare among companies.

Establishing some uniformity in ESG reporting took a big step forward in 2020 when the Big Four public accounting firms developed an international set of metrics for companies to use. They aim to provide a common set of existing disclosures that lead toward a more coherent, comprehensive global corporate reporting system. This emphasizes the need and desire for a uniform set of standards, both for financial and non-financial reporting.

Major Challenges in Financial Reporting

LEARNING OBJECTIVE 4

Identify the major challenges in the financial reporting environment.

Much is right about international financial reporting. One reason for this success is that financial statements and related disclosures capture and organize financial information in a useful and reliable fashion. However, much still needs to be done. Here are some of the major challenges.

IFRS in a Political Environment

User groups are possibly the most powerful force influencing the development of IFRS. User groups consist of those most interested in or affected by accounting rules. **IFRS is as much a product of political action as it is of careful logic or empirical findings.**

- Various participants in the financial reporting environment may want particular economic events accounted for or reported in a particular way, and they fight hard to get what they want. They know that the most effective way to influence IFRS is to participate in the formulation of these rules or to try to influence or persuade the formulators of them.¹⁹
- These user groups often target the IASB, to pressure it to change the existing rules and develop new ones.
- In fact, these pressures have been multiplying. Some influential groups demand that the accounting profession act more quickly and decisively to solve its problems. Other groups resist such action, preferring to implement change more slowly, if at all.

Illustration 1.13 shows the various user groups that apply pressure.

Should there be politics in establishing IFRS for financial accounting and reporting? Why not? Politics is everywhere: at the office, home, school, church, temple, and mosque. IFRS is part of the real world, and it cannot escape political pressures.

¹⁹However, as IASB chairperson Hans Hoogervorst noted, "It is not always obvious what is lobbying by vested interests and what is public interest feedback whose purpose is to help us deliver a high quality standard. More often than not the vested interest is packaged in public interest arguments. Sometimes even users do not want change. Analysts are so much in love with their own models that they do not want our standards to shed light on complex issues." See "Strengthening Institutional Relationships," www.ifrs.org//media/feature/news/speeches/2013/hans-hoogervorst-wss-september-2013.pdf

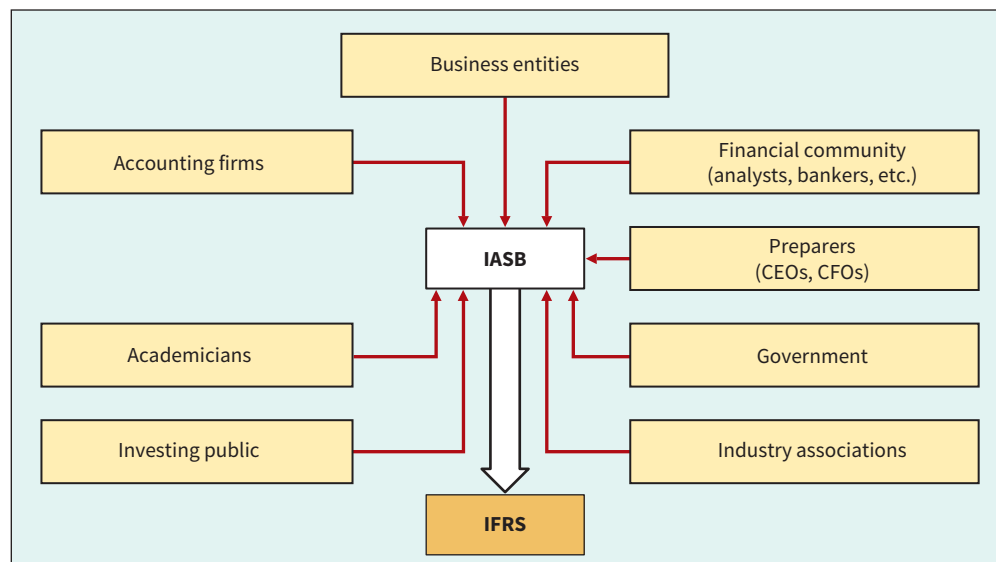


Illustration 1.13 User Groups That Influence the Formulation of Accounting Standards

That is not to say that politics in establishing IFRS is a negative force. Considering the **economic consequences** of many accounting rules, special interest groups are expected to vocalize their reactions to proposed rules.²⁰ What the Board should *not* do is issue standards that are primarily politically motivated. While paying attention to its constituencies, the Board should base IFRS on sound research and a conceptual framework that has its foundation in economic reality.

Accounting Matters Fair Consequences?

No accounting issue better illustrates the economic consequences of accounting than the current debate over the use of fair value accounting for financial assets. The IASB has had long-standing standards requiring the use of fair value accounting for financial assets, such as investments and other financial instruments. Fair value provides the most relevant and reliable information for investors about these assets and liabilities. However, in the wake of the credit crisis of 2008, some countries, their central banks, and bank regulators wanted to suspend fair value accounting based on concerns that use of fair value accounting, which calls for recording significant losses on poorly performing loans and investments, would scare investors and depositors and lead to a “run on the bank.”

Most notable was the lobbying of then French President Nicolas Sarkozy in urging his European Union counterparts to back changes to accounting rules and give banks and insurers some breathing space amid the market turmoil.

Mr. Sarkozy sought agreement to the new regulations, including changes to the mark-to-market accounting rules that have been blamed for aggravating the crisis. International regulators also have conducted studies of fair value accounting and its role in the credit crisis. It is clear that political pressure affected the final standard on financial instruments. The standard (issued in 2016) permits companies to use amortized cost instead of fair value for held-for-collection financial assets. The amortized cost approach was favored by financial institutions with substantial portfolios of held-for-collection financial assets. These financial institutions applied much pressure on regulators, noting the dire economic consequences that might follow if they had to use fair value in reporting on these financial assets. In short, numbers have consequences.

Source: Adapted from Ben Hall and Nikki Tait, “Sarkozy Seeks EU Accounting Change,” *The Financial Times Limited* (September 30, 2008).

²⁰*Economic consequences* means the impact of accounting reports on the wealth positions of issuers and users of financial information and the decision-making behavior resulting from that impact. The resulting behavior of these individuals and groups could have detrimental financial effects on the providers of the financial information. See Stephen A. Zeff, “The Rise of ‘Economic Consequences,’” *Journal of Accountancy* (December 1978), pp. 56–63.

The Expectations Gap

Accounting scandals at companies like **Parmalat** (ITA), **Siemens** (DEU), and **Carillion** (GBR) have attracted the attention of regulators, investors, and the general public. Due to the size and the number of fraudulent reporting cases, some question whether the accounting profession is doing enough. The **expectations gap**—what the public thinks accountants should do and what accountants think they can do—is difficult to close.

Although the profession can argue rightfully that accounting cannot be responsible for every financial catastrophe, it must continue to strive to meet the needs of society. However, efforts to meet these needs will become more costly to society. The development of highly transparent, clear, and reliable systems to meet public expectations requires considerable resources.

Financial Reporting Issues

While our reporting model has worked well in capturing and organizing financial information in a useful and reliable fashion, much still needs to be done, as shown in **Illustration 1.14**.

Challenge	Issue to Be Addressed
Non-financial measurements	Financial reports fail to provide some key performance measures widely used by management, such as customer satisfaction indexes, backlog information, reject rates on goods purchased, as well as the results of companies' sustainability efforts.
Forward-looking information	Financial reports fail to provide forward-looking information needed by present and potential investors and creditors. One individual noted that financial statements in 2020 should have started with the phrase, "Once upon a time," to signify their use of historical cost and accumulation of past events.
Soft assets	Financial reports are focused on hard assets (inventory, plant assets) but fail to provide much information about a company's soft assets (intangibles). The best assets are often intangible. Consider Microsoft's (USA) know-how and market dominance, Walmart's (USA) expertise in supply chain management, and Procter & Gamble's (USA) brand image.
Timeliness	Companies only prepare financial statements quarterly and provide audited financials annually. Little to no real-time financial statement information is available.
Understandability	Investors and market regulators are raising concerns about the complexity and lack of understandability of financial reports.

Illustration 1.14 Financial Reporting Challenges

We believe each of these challenges must be met for the accounting profession to provide the type of information needed for an efficient capital allocation process. We are confident that changes will occur, based on these positive signs:

- **Companies are voluntarily disclosing information deemed relevant to investors.** Often, such information is non-financial. For example, banking companies now disclose data on loan growth, credit quality, fee income, operating efficiency, capital management, and management strategy. Increasingly, companies are preparing reports on their sustainability efforts by reporting such information as water use and conservation, carbon impacts, and labor practices. In some cases, "integrated reports" are provided, which incorporate sustainability reports into the traditional annual report, leading some to call for standards for sustainability reporting.
- **Most companies publish their annual reports in several formats on the Internet.** The most innovative companies offer sections of their annual reports in a format that the user can readily manipulate, such as in an electronic spreadsheet format. Companies also format their financial reports using eXtensible Business Reporting Language (XBRL), which permits quicker and lower-cost access to their financial information.
- **More accounting standards now require the recording or disclosing of fair value information.** For example, companies either record investments in shares and bonds, debt obligations, and derivatives at fair value, or companies show information related to fair values in the notes to the financial statements.

Changes in these directions will enhance the relevance of financial reporting and provide useful information to financial statement readers.

Analytics in Action

Big Data for Big Decisions

Accounting software systems collect vast amounts of data about a company's economic events as well as its suppliers and customers. With financial information delivered in a fully digital format, decision-makers are taking advantage of this wealth of information (big data) by using data analytics.

- **Data analytics** involves analyzing data, often employing both software and statistics, to draw inferences.
- As both data access and analytical software improve, the use of data analytics to support decisions is

becoming increasingly common at virtually all types of companies.

Data analytics often employs software and statistics to make inferences and make more informed business decisions.

Visit the Analytics in Action Activities section given in the book's product page on www.wiley.com, which includes Excel-based problems with data sets, to see the relevance and application of data analytics to intermediate accounting topics.

Ethics in the Environment of Financial Accounting

A noted commentator on the subject of accounting ethics observed, "Based on my experience, new graduates tend to be idealistic . . . thank goodness for that! Still it is very dangerous to think that your armor is all in place and say to yourself, 'I would have never given in to that.' The pressures don't explode on us; they build, and we often don't recognize them until they have us."

These observations are particularly appropriate for anyone entering the business world. In accounting, as in other areas of business, we frequently encounter ethical dilemmas. Some of these dilemmas are simple and easy to resolve. However, many are not, requiring difficult choices among allowable alternatives. Consider these examples:

- Companies that concentrate on "maximizing the bottom line," "facing the challenges of competition," and "stressing short-term results" place accountants in an environment of conflict and pressure.
- Basic questions such as, "Is this way of communicating financial information good or bad?" "Is it right or wrong?" and "What should I do in the circumstance?" cannot always be answered by simply adhering to IFRS or following the rules of the profession.
- Technical competence is not enough when encountering ethical decisions.

Doing the right thing is not always easy or obvious. The pressures "to bend the rules," "to play the game," or "to just ignore it" can be considerable. For example, "Will my decision affect my job performance negatively?" "Will my superiors be upset?" and "Will my colleagues be unhappy with me?" are often questions businesspeople face while making a tough ethical decision. The decision is more difficult because there is no comprehensive ethical system to provide guidelines.

Time, job, client, personal, and peer pressures can complicate the process of ethical sensitivity and selection among alternatives. *Throughout this text, we present ethical considerations to help sensitize you to the type of situations you may encounter in the performance of your professional responsibility.* As Warren Buffet noted, "A word of caution as you go through life—It takes 20 years to build a reputation and five minutes to lose it. If you think about that, you will do things differently."

International Convergence

As discussed in the opening story, convergence to a single set of high-quality financial reporting standards is desirable. Here are some examples of how convergence is occurring:

1. China is reforming its financial reporting system through an approach called a continuous convergence process. The goal is to eliminate differences between its standards and IFRS.

2. Japan now permits the use of IFRS for domestic companies. The number of companies electing to use IFRS is expected to increase substantially in the near future.
3. The IASB and the FASB (of the United States) worked together for years to converge their standards. The two Boards issued standards on revenue recognition, financial instruments, and lease accounting, which mark the end of the Boards' formal convergence project. Although the IASB and FASB standards in these three areas are similar, there are significant differences as well.²¹
4. Recently, Malaysia was instrumental in helping to amend the accounting for agricultural assets.
5. Italy's standard-setting group has provided advice and counsel on the accounting for business combinations under common control.

In addition, U.S. and European regulators have agreed to recognize each other's standards for listing on the various world securities exchanges. As a result, costly reconciliation requirements have been eliminated, which should lead to greater comparability and transparency. Because international accounting issues are so important, we provide in each chapter of this textbook **Global Accounting Insights**, which highlight non-IFRS standards, mostly those from the United States. This feature will help you to understand the changes that are taking place in the financial reporting area as we move toward converged global accounting standards.

Accounting Matters Can You Do That?

One of the more difficult issues related to convergence and international accounting standards is that countries have different cultures and customs. For example, the former chair of the IASB explained it this way regarding Europe:

“In the U.K. everything is permitted unless it is prohibited. In Germany, it is the other way around; everything is prohibited unless it is permitted. In the Netherlands, everything is prohibited even if it is permitted. And in France,

everything is permitted even if it is prohibited. Add in countries like Japan, the United States, and China, it becomes very difficult to meet the needs of each of these countries.”

With this diversity of thinking around the world, it is understandable why accounting convergence has been so elusive.

Source: Sir D. Tweedie, “Remarks at the Robert P. Maxon Lectureship,” George Washington University (April 7, 2010).

Conclusion

International financial reporting continues to evolve. A number of convergence projects are already completed and differences eliminated. However, as one international regulator indicates, “the ultimate question remains whether IFRS will in fact function as the single set of high-quality, global accounting standards that the world has been seeking for so long. At least, when it comes to satisfying investors' concerns, there is no question of the attractiveness of the promise of a truly global accounting standard. The only real question is not whether this is good for investors, but how quickly both the accounting standards and the process by which they are established and developed can be globally recognized as world-class.”

²¹The chairperson of the IASB recently noted that the notion of the United States embracing IFRS is politically dead. The IASB is now taking the position that it will attempt both to avoid divergence and to favor convergence between IFRS and U.S. GAAP wherever possible. Staying converged can be challenging, as illustrated by the Boards' deliberations on sustainability reporting and the accounting for goodwill. In the case of goodwill, the FASB has floated the idea of allowing companies to amortize goodwill (and avoid the cost of annual impairment testing). The IASB has been opposed to such an approach. See M. Cohn, “Sustainability Standards Seen as Too Fragmented,” www.accountingtoday.com/news/sustainability-standards-seen-as-too-fragmented (October 17, 2019); and M. Mauer, “U.S., International Accounting Rule Makers Differ on Goodwill Amortization,” *Wall Street Journal* (October 17, 2019).

Review and Practice

Key Terms Review

accrual-basis accounting 1-23	faithful representation 1-16	materiality 1-15
assumptions 1-21	financial accounting 1-4	monetary unit assumption 1-22
comparability 1-18	financial reporting 1-5	Monitoring Board 1-7
completeness 1-17	financial statements 1-4	neutrality 1-17
conceptual framework 1-10	fulfillment value 1-25	note to financial statements 1-28
Conceptual Framework for Financial Reporting 1-9	full disclosure principle 1-28	objective of financial reporting 1-13
confirmatory value 1-15	general-purpose financial statements 1-13	performance obligation 1-26
conservatism 1-29	going concern assumption 1-21	period costs 1-27
consistency 1-18	hierarchy (of IFRS) 1-10	periodicity (or time period) assumption 1-22
cost constraint 1-29	historical cost principle 1-23	predictive value 1-15
current cost 1-25	IFRS Advisory Council 1-7	principles 1-21
current value 1-24	IFRS Foundation 1-7	product costs 1-27
decision-usefulness 1-14	IFRS Interpretations Committee 1-7	prudence 1-29
due process 1-7	International Accounting Standards Board (IASB) 1-6, 1-7	qualitative characteristics 1-14
economic consequences 1-32	International Financial Reporting Standards (IFRS) 1-6	revenue recognition principle 1-26
elements 1-20	International Organization of Securities Commissions (IOSCO) 1-6	supplementary information 1-28
expectations gap 1-21	interpretations 1-9	timeliness 1-19
expense recognition principle 1-27	managerial accounting 1-4	understandability 1-19
fair value 1-24	management stewardship 1-14	value in use 1-25
fair value option 1-24		verifiability 1-18
fair value principle 1-24		

Learning Objectives Review

1 Describe the global financial markets, major standard-setting bodies, and the meaning of International Financial Reporting Standards (IFRS).

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, lenders, and other creditors in decisions about providing resources to the entity through equity investments and loans or other forms of credit. Information that is decision-useful to investors may also be helpful to other users of financial reporting who are not investors.

To achieve this objective, the accounting profession has attempted to **develop a set of standards that is generally accepted** and universally practiced. Without this set of standards, each company would have to develop its own standards. Readers of financial statements would have to familiarize themselves with every company's peculiar accounting and reporting practices. As a result, it would be almost impossible to prepare statements that could be compared.

The **International Organization of Securities Commissions (IOSCO)** does not set accounting standards but is dedicated to ensuring that the global markets can operate in an efficient and effective manner. The **International Accounting Standards Board (IASB)** is the leading international accounting standard-setting organization. Its mission is to develop, in the public interest, a single set of high-quality and understandable **International Financial Reporting Standards (IFRS)** for general-purpose financial statements. Standards issued by the IASB have been adopted by over 149 jurisdictions (similar to countries) worldwide, and all publicly traded European companies must use IFRS.

IFRS is comprised of (a) International Financial Reporting Standards, (b) International Accounting Standards, and (c) interpretations issued by the IFRS Interpretations Committee or the former Standing Interpretations Committee (SIC). In the absence of a

standard or an interpretation, other accounting literature, including that contained in the Conceptual Framework for Financial Reporting and recent pronouncements of other standard-setting bodies that use a similar conceptual framework, can be applied.

2 Describe the components and usefulness of the conceptual framework, and identify the qualitative characteristics of accounting information and the basic elements of financial statements.

The accounting profession needs a conceptual framework to (1) build on and relate to an established body of concepts and objectives, (2) provide a framework for solving new and emerging practical problems, (3) increase financial statement users' understanding of and confidence in financial reporting, and (4) enhance comparability among companies' financial statements. Concepts that relate to financial reporting for business enterprises provide the basis for the conceptual framework. They include objectives, qualitative characteristics, and elements. In addition, measurement and recognition concepts are developed.

Objective of financial reporting. 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, lenders, and other creditors** in making decisions about providing resources to the entity. Those decisions involve buying, selling, or holding equity and debt instruments, and providing or settling loans and other forms of credit. Information that is decision-useful to capital providers may also be helpful to other users of financial reporting who are not capital providers.

The overriding criterion by which accounting choices can be judged is decision-usefulness—that is, providing information that is most useful for decision-making. Relevance and faithful representation are the two fundamental qualities that make information decision-useful.

Relevant information makes a difference in a decision by having predictive or confirmatory value and is material. Faithful representation is characterized by completeness, neutrality, and being free from error.

Enhancing qualities of useful information are (1) comparability, (2) verifiability, (3) timeliness, and (4) understandability.

Elements of financial statements. The basic elements of financial statements are (1) assets, (2) liabilities, (3) equity, (4) income, and (5) expenses. We define these elements in the “Elements of Financial Statements” box in the chapter.

3 Discuss the basic assumptions and principles of accounting.

Five basic assumptions underlying financial accounting are as follows. (1) **Economic entity:** The activity of a company can be kept separate and distinct from its owners and any other business unit. (2) **Going concern:** Without information to the contrary, the company will have a long life. (3) **Monetary unit:** Money is the common denominator by which economic activity is conducted, and the monetary unit provides an appropriate basis for measurement and analysis. (4) **Periodicity:** The economic activities of a company can be divided into artificial time periods. (5) **Accrual basis:** Transactions that change a company’s financial statements are recorded in the periods in which the events occur, rather than when cash is paid or received.

The principles underlying accounting are as follows. (1) **Measurement principle:** IFRS permits the use of historical cost, fair value, and other valuation bases. Although the historical cost principle (measurement based on acquisition price) continues to be an important basis for valuation, recording and reporting of fair value

information is increasing. (2) **Revenue recognition principle:** A company generally recognizes revenue when it satisfies a performance obligation. (3) **Expense recognition principle:** As a general rule, companies recognize expenses when the service or the product actually makes its contribution to revenue (commonly referred to as **matching**). (4) **Full disclosure principle:** Companies generally provide information that is of sufficient importance to influence the judgment and decisions of an informed user. (5) **Cost constraint:** The cost of providing the information must be weighed against the benefits that can be derived from using the information.

4 Identify the major challenges in the financial reporting environment.

Challenges include (1) the development of IFRS in a political environment; (2) the expectations gap; (3) financial reporting issues related to key performance measures widely used by management, forward-looking information needed by investors and creditors, sufficient information on a company’s soft assets (intangibles), real-time financial information, including fair values, and easy-to-comprehend information; (4) ethics in accounting; and (5) international convergence.

Enhanced Review and Practice

Go online for multiple-choice questions with solutions, review exercises with solutions, and a full glossary of all key terms.

Practice Problems

- At the completion of Teo NV’s audit, the president, Judy Teo, asks about the meaning of the phrase “in conformity with IFRS” that appears in your audit report on the management’s financial statements. Judy observes that the meaning of the phrase must include something more and different than what she thinks of as “standards.” Judy is curious about the pronouncements that are encompassed in IFRS and wonders, if there are different types of pronouncements, which are more authoritative than others?

Instructions

- Describe the pronouncements that comprise IFRS.
- Explain to Judy how a company determines which type of pronouncement takes precedence when deciding the recognition, valuation, and disclosure related to a particular transaction.

Solution

- The IASB issues three major types of pronouncements:

- International Financial Reporting Standards.
- Conceptual Framework for Financial Reporting.
- International Financial Reporting Standards Interpretations.

IASB standards are financial accounting standards issued by the IASB and are referred to as International Financial Reporting Standards (IFRS). The Conceptual Framework for Financial Reporting sets forth the fundamental objective and concepts that the Board uses in developing accounting standards that will serve as tools for solving existing and emerging problems in a consistent manner.

- The hierarchy of IFRS to determine what recognition, valuation, and disclosure requirements should be used is:
 - International Financial Reporting Standards, including International Accounting Standards, and interpretations from the International Financial Reporting Standards Interpretations Committee.

2. If not addressed in 1., refer to IFRS Concepts Statements.
3. If not addressed in 1. and 2., refer to pronouncements of other standard-setting bodies that use a similar conceptual framework (e.g. U.S. GAAP).

Any company indicating that it is preparing its financial statements in conformity with IFRS must comply with the standards and interpretations.

2. Meadow plc has hired you to review its accounting records prior to the closing of the revenue and expense accounts as of December 31, the end of the current fiscal year. The following information comes to your attention.
 1. During the current year, Meadow plc changed its policy in regard to expensing purchases of small tools. In the past, it had expensed these purchases because they amounted to less than 2% of net income. Now, the president has decided that the company should follow a policy of capitalization and subsequent depreciation. It is expected that purchases of small tools will not fluctuate greatly from year to year.
 2. The company constructed a warehouse at a cost of £1,000,000. It had been depreciating the asset on a straight-line basis over 10 years. In the current year, the controller doubled depreciation expense because the replacement cost of the warehouse had increased significantly.
 3. When the statement of financial position was prepared, the preparer omitted detailed information as to the amount of cash on deposit in each of several banks. Only the total amount of cash under the caption "Cash in banks" was presented.
 4. On July 15 of the current year, Meadow plc purchased an undeveloped tract of land at a cost of £320,000. The company spent £80,000 in subdividing the land and getting it ready for sale. An appraisal of the property at the end of the year indicated that the land was now worth £500,000. Although none of the lots were sold, the company recognized revenue of £180,000, less related expenses of £80,000, for a net income on the project of £100,000.
 5. For a number of years, the company used the FIFO method for inventory valuation purposes. During the current year, the president noted that all the other companies in the industry had switched to the average-cost method. The company decided not to switch to average-cost because net income would decrease £830,000.

Instructions

State whether or not you agree with the decisions made by Meadow plc. Support your answers with reference, whenever possible, to the generally accepted principles, assumptions, and cost constraint applicable in the circumstances.

Solution

1. From the facts, it is difficult to determine whether to agree or disagree. Consistency, of course, is violated in this situation although its violation may not be material. Furthermore, the change of accounting policies regarding the treatment of small tools cannot be judged good or bad but would depend on the circumstances. In this case, it seems that the result will be approximately the same whether the company capitalizes and expenses, or simply expenses each period, since the purchases are fairly uniform. Perhaps from a cost standpoint (expediency), it might be best to continue the present policy rather than become involved in detailed depreciation schedules, assuming that purchases remain fairly uniform. On the other hand, the president may believe there is a significant unrecorded asset that should be shown on the statement of financial position. If such is the case, capitalization and subsequent depreciation would be more appropriate.
2. Disagree. At the present time, accountants do not recognize price level or current value adjustments in the accounts. Hence, unless the controller is proposing use of revaluation accounting for all warehouses, it is misleading to deviate from the historical cost principle because conjecture or opinion can take place. Also, depreciation is not so much a matter of valuation as it is a means of cost allocation. Assets are not depreciated on the basis of a decline in their fair value. Rather, they are depreciated on the basis of a systematic charge of expired cost against revenues.
3. Agree. The full disclosure principle recognizes that reasonable condensation and summarization of the details of a company's operations and financial position are essential to readability and comprehension. Thus, in determining what is full disclosure, the accountant must decide whether omission will mislead readers of the financial statements. Generally, companies present only the total amount of cash on a statement of financial position unless some special circumstance is involved (such as a possible restriction on the use of the cash). In most cases, however, the company's presentation would be considered appropriate and in accordance with the full disclosure principle.

4. Disagree. The historical cost principle indicates that companies account for assets and liabilities on the basis of cost. If sales value were selected, for example, it would be extremely difficult to establish an appraisal value for the given item without selling it. Note, too, that the revenue recognition principle provides guidance on when revenue should be recognized. Revenue should be recognized when the performance obligation is satisfied. In this case, the revenue was not recognized because the critical event for satisfying the performance obligation, “sale of the land with transfer to the buyer,” had not occurred.
5. From the facts, it is difficult to determine whether to agree or disagree with the president. The president’s approach is not a violation of any principle. Consistency requires that accounting entities give accountable events the same accounting treatment from period to period for a given business enterprise. It says nothing concerning consistency of accounting principles among business enterprises. From a comparability viewpoint, it might be useful to report the information on an average-cost basis. But, as indicated above, there is no requirement to do so.

Questions

1. What is happening to world markets, and what are the implications for financial reporting?
2. Differentiate broadly between financial accounting and managerial accounting.
3. What are the major financial statements, and what is the difference between financial statements and financial reporting?
4. How does accounting help in the capital allocation process?
5. What is the benefit of a single set of high-quality accounting standards?
6. What are the two key organizations in the development of international accounting standards? Explain their role.
7. What is IOSCO?
8. What is the mission of the IASB?
9. What is the purpose of the Monitoring Board?
10. How are IASB preliminary views and IASB exposure drafts related to IASB standards?
11. What is a conceptual framework? Why is a conceptual framework necessary in financial accounting?
12. What is the primary objective of financial reporting?
13. Does management stewardship have a role in the objective of financial reporting? Explain.
14. What is meant by the term “qualitative characteristics of accounting information”?
15. Briefly describe the two fundamental qualities of useful accounting information.
16. How are materiality (and immateriality) related to the proper presentation of financial statements? What factors and measures should be considered in assessing the materiality of a misstatement in the presentation of a financial statement?
17. Your friend (not an accounting major) thinks that prudence in the Conceptual Framework means being conservative. Do you agree? Explain.
18. What are the enhancing qualities of the qualitative characteristics? What is the role of enhancing qualities in the Conceptual Framework?
19. According to the Conceptual Framework, the objective of financial reporting for business enterprises is based on the needs of the users of financial statements. Explain the level of sophistication that the IASB assumes about the users of financial statements.
20. What is the distinction between comparability and consistency?
21. Why is it necessary to develop a definitional framework for the basic elements of accounting?
22. What are the basic elements of the Conceptual Framework? Briefly describe the relationship between the “moment in time” and “period of time” elements.
23. What are the five basic assumptions that underlie the financial accounting structure?
24. The life of a business is divided into specific time periods, usually a year, to measure results of operations for each such time period and to portray financial conditions at the end of each period.
 - a. This practice is based on the accounting assumption that the life of the business consists of a series of time periods and that it is possible to measure accurately the results of operations for each period. Comment on the validity and necessity of this assumption.
 - b. What has been the effect of this practice on accounting? What is its relation to the accrual basis of accounting? What influence has it had on accounting entries and practices?
25. What is the basic accounting problem created by the monetary unit assumption when there is significant inflation? What appears to be the IASB position on a stable monetary unit?
26. The chairman of the board of directors of the company for which you are the chief accountant has told you that he has little use for accounting figures based on historical cost. He believes that fair values are of far more significance to the board of directors than “out-of-date costs.” Present some arguments to convince him that accounting data should still be based on historical cost.
27. Briefly describe the three bases for measuring current value.
28. What is the definition of fair value?
29. What is the fair value option? Explain how use of the fair value option reflects application of the fair value principle.
30. Briefly describe the fair value hierarchy.
31. Explain the revenue recognition principle.
32. What is a performance obligation, and how is it used to determine when revenue should be recognized?
33. What are the five steps used to determine the proper time to recognize revenue?
34. Selane Eatery operates a catering service specializing in business luncheons for large companies. Selane requires customers to place their orders 2 weeks in advance of the scheduled events. Selane bills its customers on the 10th day of the month following the date of

service and requires that payment be made within 30 days of the billing date. Conceptually, when should Selane recognize revenue related to its catering service?

- 35.** Mogilny Company paid \$135,000 for a machine. The Accumulated Depreciation account has a balance of \$46,500 at the present time. The company could sell the machine today for \$150,000. The company president believes that the company has a “right to this gain.” What does the president mean by this statement? Do you agree?
- 36.** Three expense recognition methods (associating cause and effect, systematic and rational allocation, and immediate recognition) were discussed in the chapter under the expense recognition principle. Indicate the basic nature of each of these expense recognition methods and give two examples of each.
- 37.** Under what conditions should an item be recognized in the financial statements?
- 38.** Briefly describe the types of information concerning financial position, income, and cash flows that might be provided (a) within the main body of the financial statements, (b) in the notes to the financial statements, or (c) as supplementary information.
- 39.** In January 2026, Janeway AG doubled the amount of its outstanding shares by selling an additional 10,000 shares to finance an expansion of the business. You propose that this information be shown by a footnote to the statement of financial position as of December 31, 2025. The president objects, claiming that this sale took place after December 31, 2025, and, therefore, should not be shown. Explain your position.
- 40.** Describe the major constraint inherent in the presentation of accounting information.
- 41.** What are some of the costs of providing accounting information? What are some of the benefits of accounting information? Describe the cost-benefit factors that should be considered when new accounting standards are being proposed.
- 42.** The treasurer of Landowska Co. has heard that conservatism is a doctrine that is followed in accounting and, therefore, proposes that several policies be followed that are conservative in nature. State your opinion with respect to each of the policies listed.
- The company gives a 2-year warranty to its customers on all products sold. The estimated warranty costs incurred from this year’s sales should be entered as an expense this year instead of an expense in the period in the future when the warranty is made good.
 - When sales are made on account, there is always uncertainty about whether the accounts are collectible. Therefore, the treasurer recommends recording the sale when the cash is received from the customers.
 - A personal liability lawsuit is pending against the company. The treasurer believes there is an even chance that the company will lose the suit and have to pay damages of \$200,000 to \$300,000. The treasurer recommends that a loss be recorded and a liability created in the amount of \$300,000.
- 43.** What is the “expectations gap”? What is the profession doing to try to close this gap?
- 44.** What are some of the major challenges facing the accounting profession?

Exercises

E1.1 (LO 2) (Usefulness, Objective of Financial Reporting) Indicate whether the following statements about the Conceptual Framework are true or false. If false, provide a brief explanation supporting your position.

- Accounting rule-making that relies on a body of concepts will result in useful and consistent pronouncements.
- General-purpose financial reports are most useful to company insiders in making strategic business decisions.
- Accounting standards based on individual conceptual frameworks generally will result in consistent and comparable accounting reports.
- Capital providers are the only users who benefit from general-purpose financial reporting.
- Accounting reports should be developed so that users without knowledge of economics and business can become informed about the financial results of a company.
- The objective of financial reporting is the foundation from which the other aspects of the framework logically result.

E1.2 (LO 2) (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.

- The fundamental qualitative characteristics that make accounting information useful are relevance and verifiability.
- Relevant information has predictive value, confirmatory value, or both.
- Conservatism, a prudent reaction to uncertainty, is considered a constraint of financial reporting.
- Information that is a faithful representation is characterized as having predictive or confirmatory value.
- Comparability pertains only to the reporting of information in a similar manner for different companies.
- Verifiability is solely an enhancing characteristic for faithful representation.

7. In preparing financial reports, it is assumed that users of the reports have reasonable knowledge of business and economic activities.

E1.3 (LO 2) Groupwork (Qualitative Characteristics) The Conceptual Framework identifies the qualitative characteristics that make accounting information useful. Presented below are a number of questions related to these qualitative characteristics and underlying constraint.

1. What is the quality of information that enables users to confirm or correct prior expectations?
2. Identify the overall or pervasive constraint developed in the Conceptual Framework.
3. 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.)
4. Muruyama Group 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?
5. 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.)
6. What are the two fundamental qualities that make accounting information useful for decision-making?
7. 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.)
8. Predictive value is an ingredient of which of the two fundamental qualities that make accounting information useful for decision-making purposes?
9. 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 present?
10. 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.)

E1.4 (LO 2) (Qualitative Characteristics) The qualitative characteristics that make accounting information useful for decision-making purposes are as follows.

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

Instructions

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

- a. Qualitative characteristic being displayed 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. Four qualitative characteristics that enhance both relevance and faithful representation.
- h. An item is not reported because its effect on income would not change a decision.
- i. Neutrality is a key ingredient of this fundamental quality of accounting information.
- j. Two fundamental qualities that make accounting information useful for decision-making purposes.
- k. Issuance of interim reports is an example of what enhancing ingredient?

E1.5 (LO 2) (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 following nine items.

- Obligation to transfer resources arising from a past transaction.
- Increases ownership interest by issuance of shares.
- Declares and pays cash dividends to owners.
- Increases in net assets in a period from non-owner sources.
- Items characterized by service potential or future economic benefit.
- Equals increase in assets less liabilities during the year, after adding distributions to owners and subtracting investments by owners.
- Residual interest in the assets of the enterprise after deducting its liabilities.
- Increases assets during a period through sale of product.
- Decreases assets during the period by purchasing the company's own shares.

E1.6 (LO 3) (Assumptions, Principles, and Constraint) Presented below are the assumptions, principles, and constraint used in this chapter.

- Economic entity assumption
- Going concern assumption
- Monetary unit assumption
- Periodicity assumption
- Accrual-basis assumption
- Historical cost principle
- Fair value principle
- Expense recognition principle
- Full disclosure principle
- Revenue recognition principle
- Cost constraint

Instructions

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

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

E1.7 (LO 3) (Assumptions, Principles, and Constraint) Presented below are a number of operational guidelines and practices that have developed over time.

Instructions

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

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

E1.8 (LO 3) (Full Disclosure Principle) The following facts relate to Weller AG. Assume that no mention of these facts was made in the financial statements and the related notes.

Instructions

Assume that you are the auditor of Weller AG and that you have been asked to explain the appropriate accounting and related disclosure necessary for each of these items.

- a. The company decided that, for the sake of conciseness, only net income should be reported on the income statement. Details as to revenues, cost of goods sold, and expenses were omitted.
- b. Equipment purchases of €170,000 were partly financed during the year through the issuance of a €110,000 notes payable. The company offset the equipment against the notes payable and reported plant assets at €60,000.
- c. Weller has reported its ending inventory at €2,100,000 in the financial statements. No other information related to inventories is presented in the financial statements and related notes.
- d. The company changed its method of valuing inventories from weighted-average to FIFO. No mention of this change was made in the financial statements.

E1.9 (LO 3) Groupwork (Accounting Principles—Comprehensive) Presented below are a number of business transactions that occurred during the current year for Gonzales SpA.

Instructions

In each of the situations, discuss the appropriateness of the journal entries.

- a. The president of Gonzales SpA used his expense account to purchase a new Suburban solely for personal use. The following journal entry was made.

Miscellaneous Expense	29,000	
Cash		29,000

- b. Merchandise inventory that cost €620,000 is reported on the statement of financial position at €690,000, the expected selling price less estimated selling costs. The following entry was made to record this increase in value.

Inventory	70,000	
Sales Revenue		70,000

- c. The company is being sued for €500,000 by a customer who claims damages for personal injury apparently caused by a defective product. Company attorneys feel extremely confident that the company will have no liability for damages resulting from the situation. Nevertheless, the company decides to make the following entry.

Loss from Lawsuit	500,000	
Liability for Lawsuit		500,000

- d. Because the general level of prices increased during the current year, Gonzales SpA determined that there was a €16,000 understatement of depreciation expense on its equipment and decided to record it in its accounts. The following entry was made.

Depreciation Expense	16,000	
Accumulated Depreciation—Equipment		16,000

- e. Gonzales SpA has been concerned about whether intangible assets could generate cash in case of liquidation. As a consequence, goodwill arising from a purchase transaction during the current year and recorded at €800,000 was written off as follows.

Retained Earnings	800,000	
Goodwill		800,000

- f. Because of a “fire sale,” equipment obviously worth €200,000 was acquired at a cost of €155,000. The following entry was made.

Equipment	200,000	
Cash		155,000
Sales Revenue		45,000

E1.10 (LO 3) Groupwork (Accounting Principles—Comprehensive) The following information relates to Wang Group.

Instructions

Comment on the appropriateness of the accounting procedures followed by Wang Group.

- a. Depreciation expense on the building for the year was ¥60,000. Because the building was increasing in value during the year, the controller decided to charge the depreciation expense to retained earnings instead of to net income. The following entry is recorded.

Retained Earnings	60,000	
Accumulated Depreciation—Buildings		60,000

- b. Materials were purchased on January 1, 2025, for ¥120,000 and this amount was entered in the Materials account. On December 31, 2025, the materials would have cost ¥141,000, so the following entry is made.

Inventory	21,000	
Gain on Inventories		21,000

- c. During the year, the company purchased equipment through the issuance of ordinary shares. The shares had a par value of ¥135,000 and a fair value of ¥450,000. The fair value of the equipment was not easily determinable. The company recorded this transaction as follows.

Equipment	135,000	
Share Capital		135,000

- d. During the year, the company sold certain equipment for ¥285,000, recognizing a gain of ¥69,000. Because the controller believed that new equipment would be needed in the near future, she decided to defer the gain and amortize it over the life of any new equipment purchased.

- e. An order for ¥61,500 has been received from a customer for products on hand. This order was shipped on January 9, 2025. The company made the following entry in 2024.

Accounts Receivable	61,500	
Sales Revenue		61,500

E1.11 (LO 1 2, 3, 4) (Financial Reporting and Accounting Standards) Answer the following multiple-choice questions.

1. IFRS stands for:

- a. International Federation of Reporting Services. b. Independent Financial Reporting Standards.
c. International Financial Reporting Standards. d. Integrated Financial Reporting Services.

2. The major key organizations on the international side are the:
 - a. IASB and IFRS Advisory Council.
 - b. IOSCO and the U.S. SEC.
 - c. London Stock Exchange and International Securities Exchange.
 - d. IASB and IOSCO.
3. Which governmental body is most influential in enforcing IFRS?
 - a. Monitoring Board.
 - b. IOSCO.
 - c. IFRS Advisory Council.
 - d. IFRS Foundation.
4. Accounting standard-setters use the following process in establishing international standards:
 - a. Research, exposure draft, discussion paper, standard.
 - b. Discussion paper, research, exposure draft, standard.
 - c. Research, preliminary views, discussion paper, standard.
 - d. Research, preliminary views, exposure draft, standard.
5. IFRS is comprised of:
 - a. International Financial Reporting Standards and FASB financial reporting standards.
 - b. International Financial Reporting Standards, International Accounting Standards, and International Accounting Standards Interpretations.
 - c. International Accounting Standards and International Accounting Standards Interpretations.
 - d. FASB financial reporting standards and International Accounting Standards.
6. The authoritative status of the Conceptual Framework for Financial Reporting is as follows:
 - a. It is used when there is no standard or interpretation related to the reporting issues under consideration.
 - b. It is not as authoritative as a standard but takes precedence over any interpretation related to the reporting issue.
 - c. It takes precedence over all other authoritative literature.
 - d. It has no authoritative status.
7. The objective of financial reporting places most emphasis on:
 - a. reporting to capital providers.
 - b. reporting on stewardship.
 - c. providing specific guidance related to specific needs.
 - d. providing information to individuals who are experts in the field.
8. General-purpose financial statements are prepared primarily for:
 - a. internal users.
 - b. auditors.
 - c. external users.
 - d. government regulators.
9. Economic consequences of accounting standard-setting means:
 - a. standard-setters must give first priority to ensuring that companies do not suffer any adverse effect as a result of a new standard.
 - b. standard-setters must ensure that no new costs are incurred when a new standard is issued.
 - c. the objective of financial reporting should be politically motivated to ensure acceptance by the general public.
 - d. accounting standards can have detrimental impacts on the wealth levels of the providers of financial information.
10. The expectations gap is the difference between:
 - a. what financial information management provides and what users want.
 - b. what the public thinks accountants should do and what accountants think they can do.
 - c. what the governmental agencies want from standard-setting and what the standard-setters provide.
 - d. what the users of financial statements want from the government and what is provided.

Concepts for Analysis

CA1.1 (LO 1) (IFRS and Standard-Setting) Presented below are five statements to identify as true or false. If false, explain why the statement is incorrect.

1. IFRS is the term used to indicate the whole body of IASB authoritative literature.
2. Any company claiming compliance with IFRS must follow most standards and interpretations but not the disclosure requirements.
3. The primary governmental body that has influence over the IASB is the IFRS Advisory Council.
4. The overriding requirement of IFRS is for the financial statements to give a fair presentation (or true and fair view).
5. The IASB has a government mandate and therefore does not have to follow due process in issuing an IFRS.

CA1.2 (LO 1) (IFRS and Standard-Setting) Presented below are four statements to identify as true or false. If false, explain why the statement is incorrect.

1. The objective of financial statements emphasizes a stewardship approach for reporting financial information.
2. The objective of financial reporting is to prepare a statement of financial position, a statement of comprehensive income, a statement of cash flows, and a statement of changes in equity.
3. The difference between International Accounting Standards and IFRS is that International Accounting Standards are more authoritative.
4. The objective of financial reporting uses an entity rather than a proprietary approach in determining what information to report.

CA1.3 (LO 2) Groupwork (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 Conceptual 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.
 2. Faithful representation.
 3. Understandability.
 4. Comparability (consistency).
 5. Neutrality.
- 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.
 2. Relevance and consistency.
 3. Comparability and consistency.
 4. Relevance and understandability.
- c. What criterion should be used to evaluate trade-offs between information characteristics?

CA1.4 (LO 3) (Revenue Recognition Principle) After the presentation of your report on the examination of the financial statements to the board of directors of Piper Publishing, one of the new directors expresses surprise that the income statement assumes that an equal proportion of the revenue is earned with the publication of every issue of the company's magazine. She feels that the "crucial event" in the process of recognizing revenue in the magazine business is the cash sale of the subscription. She says that she does not understand why most of the revenue cannot be recognized in the period of the sale.

Instructions

Discuss the propriety of timing the recognition of revenue in Piper Publishing's accounts with respect to the following.

- a. The cash sale of the magazine subscription.
- b. The publication of the magazine every month.
- c. Both events, by recognizing a portion of the revenue with the cash sale of the magazine subscription and a portion of the revenue with the publication of the magazine every month.

CA1.5 (LO 3) (Expense Recognition Principle) An accountant must be familiar with the concepts involved in determining earnings of a business entity. The amount of earnings reported for a business

entity is dependent on the proper recognition, in general, of revenue and expense for a given time period. In some situations, costs are recognized as expenses at the time of product sale. In other situations, guidelines have been developed for recognizing costs as expenses or losses by other criteria.

Instructions

- Explain the rationale for recognizing costs as expenses at the time of product sale.
- What is the rationale underlying the appropriateness of treating costs as expenses of a period instead of assigning the costs to an asset? Explain.
- In what general circumstances would it be appropriate to treat a cost as an asset instead of as an expense? Explain.
- Some expenses are assigned to specific accounting periods on the basis of systematic and rational allocation of asset cost. Explain the underlying rationale for recognizing expenses on the basis of systematic and rational allocation of asset cost.
- Identify the conditions under which it would be appropriate to treat a cost as a loss.

CA1.6 (LO 4) Writing (Politicization of IFRS) Some accountants have said that politicization in the development and acceptance of International Financial Reporting Standards (IFRS) is taking place. Some use the term “politicization” in a narrow sense to mean the influence by governmental agencies, such as the European Union and the U.S. Securities and Exchange Commission, on the development of IFRS. Others use it more broadly to mean the compromise that results when the bodies responsible for developing IFRS are pressured by interest groups, businesses through their various organizations, financial analysts, bankers, lawyers, academics, auditors, and so on.

Instructions

- What arguments can be raised to support the “politicization” of accounting rule-making?
- What arguments can be raised against the “politicization” of accounting rule-making?

CA1.7 (LO 3) Ethics (Expense Recognition Principle) Anderson Nuclear Power Plant will be “mothballed” at the end of its useful life (approximately 20 years) at great expense. Accountants Ana Alicia and Ed Bradley argue whether it is better to allocate the expense of mothballing over the next 20 years or ignore it until mothballing occurs.

Instructions

Answer the following questions.

- What stakeholders should be considered?
- What ethical issue, if any, underlies the dispute?
- What alternatives should be considered?
- Assess the consequences of the alternatives.
- What decision would you recommend?

CA1.8 (LO 3) (Cost Constraint) A Special Committee on Financial Reporting proposed the following constraints related to financial reporting.

- Business reporting should exclude information outside of management’s expertise or for which management is not the best source, such as information about competitors.
- Management should not be required to report information that would significantly harm the company’s competitive position.
- Management should not be required to provide forecasted financial statements. Rather, management should provide information that helps users forecast for themselves the company’s financial future.
- Other than for financial statements, management need report only the information it knows. That is, management should be under no obligation to gather information it does not have or does not need to manage the business.
- Companies should present certain elements of business reporting only if users and management agree they should be reported—a concept of flexible reporting.
- Companies should not have to report forward-looking information unless there are effective deterrents to unwarranted litigation that discourages companies from doing so.

Instructions

For each item, briefly discuss how the proposed constraint addresses concerns about the costs and benefits of financial reporting.

Using Your Judgment

Financial Reporting Problem

Marks and Spencer plc (M&S)

The financial statements of **M&S** (GBR) are presented in Appendix A. The company's complete annual report, including the notes to the financial statements, is available online.

Instructions

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

- Using the notes to the consolidated financial statements, determine M&S's revenue recognition policies.
- 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.
- How can we determine that the accounting principles used by M&S are prepared on a basis consistent with those of last year?
- What is M&S's accounting policy related to volume-based rebates? How is uncollected supplier income classified in the financial statements?

Comparative Analysis Case

adidas and Puma

The financial statements of **adidas** (DEU) and **Puma** (DEU) are presented in Appendices B and C, respectively. The complete annual reports, including the notes to the financial statements, are available online.

Instructions

Use the companies' financial information to answer the following questions.

- Briefly discuss the currency used by each company in its financial statements. Does the currency used affect the comparability of their reports? Briefly explain.
- What are the primary segments or product groups of these two companies as shown in their notes to the financial statements?
- How are inventories for these two companies valued? How does their accounting for inventories affect comparability between the two companies?
- Which company changed its accounting policies, which could affect the consistency of the financial results from the previous year? What were these changes?

Financial Statement Analysis Case

Nokia (FIN) provided the following disclosure in a recent annual report.

Use of Estimates (Partial)

The preparation of financial statements in conformity with IFRS requires the application of judgment by management in selecting appropriate assumptions for calculating financial estimates, which inherently contain some degree of uncertainty . . . are areas requiring significant judgment and estimation that may have an impact on reported results and the financial position.

Revenue Recognition

Sales from the majority of the Group are recognized when the significant risks and rewards of ownership have transferred to the buyer, continuing managerial involvement usually associated with ownership and effective control have ceased, the amount of revenue can be measured reliably, it is probable that economic benefits associated with the transaction will flow to the Group and the costs incurred or to be incurred in respect of the transaction can be measured reliably. Sales may materially change if management's assessment of such criteria was determined to be inaccurate. The Group makes price protection adjustments based on estimates of future price reductions and certain agreed customer inventories at the date of the price adjustment. Possible changes in these estimates could result in revisions to the sales in future periods.

Revenue from contracts involving solutions achieved through modification of complex telecommunications equipment is recognized on the percentage of completion basis when the outcome of the contract can be estimated reliably. Recognized revenues and profits are subject to revisions during the project in the event that the assumptions regarding the overall project outcome are revised. Current sales and profit estimates for projects may materially change due to the early stage of a long-term project, new technology, changes in the project scope, changes in costs, changes in timing, changes in customers' plans, realization of penalties, and other corresponding factors.

Instructions

- a. Briefly discuss how Nokia's revenue recognition policies are consistent with the revenue recognition principle. Evaluate both:
 1. Sales.
 2. Revenue from contracts.
- b. Briefly discuss how estimates inherent in Nokia's revenue recognition policies can result in reported revenue numbers that are not relevant and faithful representations.
- c. Assume that Nokia's competitors use similar revenue recognition policies for their sales. What are some of the judgments inherent in applying those policies that could raise concerns with respect to the qualitative characteristic of comparability?

Accounting, Analysis, and Principles

William Koh achieved one of his life-long dreams by opening his own business, The Caddie Shack Driving Range, on May 1, 2025. He invested A\$20,000 of his own savings in the business. He paid A\$6,000 cash to have a small building constructed to house the operations and spent A\$800 on golf clubs, golf balls, and yardage signs. Koh leased 4 acres of land at a cost of A\$1,000 per month. (He paid the first month's rent in cash.) During the first month, advertising costs totaled A\$750, of which A\$150 was unpaid at the end of the month. Koh paid his three nephews A\$400 for retrieving golf balls. He deposited in the company's bank account all revenues from customers (A\$4,700). On May 15, Koh withdrew A\$800 in cash for personal use. On May 31, the company received a utility bill for A\$100 but did not immediately pay it. On May 31, the balance in the company bank account was A\$15,100.

Koh is feeling pretty good about results for the first month, but his estimate of profitability ranges from a loss of A\$4,900 to a profit of A\$2,450.

Accounting

Prepare a statement of financial position at May 31, 2025. (Koh appropriately records any depreciation expense on a quarterly basis.) How could Koh have determined that the business operated at a profit of A\$2,450? How could Koh conclude that the business operated at a loss of A\$4,900?

Analysis

Assume Koh has asked you to become a partner in his business. Under the partnership agreement, after paying him A\$10,000, you would share equally in all future profits. Which of the two income measures above would be more useful in deciding whether to become a partner? Explain.

Principles

What is income according to IFRS? What concepts do the differences in income measures for The Caddie Shack Driving Range illustrate?

Bridge to the Profession

Authoritative Literature References

- [1] International Accounting Standard 8, *Accounting Policies, Changes in Accounting Estimates and Errors* (London, U.K.: IASB, 1993), par. 12.
- [2] International Accounting Standard 8, *Accounting Policies, Changes in Accounting Estimates, and Errors* (London, U.K.: International Accounting Standards Committee Foundation, 2001).
- [3] *Conceptual Framework for Financial Reporting* (London, U.K.: IASB, 2018).
- [4] *The Conceptual Framework for Financial Reporting*, "Chapter 1, The Objective of General Purpose Financial Reporting" (London, U.K.: IASB, 2018), paras. 3–4.
- [5] *Conceptual Framework for Financial Reporting*, "Chapter 2, Qualitative Characteristics of Useful Financial Information" (London, U.K.: IASB, 2018), paras. 2.16–2.17.
- [6] *Conceptual Framework for Financial Reporting*, "Chapter 2, Qualitative Characteristics of Useful Financial Information" (London, U.K.: IASB, 2018), par. 2.30.

- [7] *Conceptual Framework for Financial Reporting*, “Chapter 2, Qualitative Characteristics of Useful Financial Information” (London, U.K.: IASB, 2018), par. 2.36.
- [8] *Conceptual Framework for Financial Reporting*, “Chapter 3, Financial Statements and the Reporting Entity” (London, U.K.: IASB, 2018), paras. 3.10–3.14.
- [9] *Conceptual Framework for Financial Reporting*, “Chapter 3, Financial Statements and the Reporting Entity” (London, U.K.: IASB, 2018), par. 3.9.
- [10] *Conceptual Framework for Financial Reporting*, “Chapter 8, Concepts of Capital and Capital Maintenance” (London, U.K.: IASB, 2018), par. 8.3.
- [11] International Accounting Standard No. 29, *Financial Reporting in Hyperinflationary Economies* (London, U.K.: IASB, 2001).
- [12] *Conceptual Framework for Financial Reporting*, “Chapter 3, Financial Statements and the Reporting Entity” (London, U.K.: IASB, 2018), paras. 3.4–3.7.
- [13] *Conceptual Framework for Financial Reporting*, “Chapter 1, The Objective of General Purpose Financial Reporting” (London, U.K.: IASB, 2018), par. 1.17.
- [14] *Conceptual Framework for Financial Reporting*, “Chapter 6, Measurement” (London, U.K.: IASB, 2018), paras. 6.4–6.8.
- [15] *Conceptual Framework for Financial Reporting*, “Chapter 6, Measurement” (London, U.K.: IASB, 2018), paras. 6.10–6.22.
- [16] *Conceptual Framework for Financial Reporting*, “Chapter 6, Measurement” (London, U.K.: IASB, 2018), par. 6.12.
- [17] International Financial Reporting Standard 9, “Financial Instruments, Chapter 4: Classification” (London, U.K.: IASB 2014), paras. 4.1.5 and 4.2.2.
- [18] *Conceptual Framework for Financial Reporting*, “Chapter 6, Measurement” (London, U.K.: IASB, 2018), paras. 6.43–6.76.
- [19] *Conceptual Framework for Financial Reporting*, “Chapter 2, Qualitative Characteristics of Useful Financial Information” (London, U.K.: IASB, 2018), paras. 2.39–2.43.

Research Case

As a newly enrolled accounting major, you are anxious to better understand accounting institutions and sources of accounting literature. As a first step, you decide to explore the IASB’s Conceptual Framework for Financial Reporting.

Instructions

Access the Conceptual Framework at the IFRS website (you may register for free IFRS access at this site). When you have accessed the document, you can use the search tool in your Internet browser to respond to the following items. (Provide paragraph citations.)

- What is the objective of financial reporting?
- Explain the role of presentation and disclosure principles to facilitate communication in financial statements.
- Indicate some of the users and the information they are most directly concerned with in economic decision-making.

Global Accounting Insights

LEARNING OBJECTIVE 5

Compare the conceptual frameworks underlying IFRS and U.S. GAAP.

The IASB and the FASB originally planned to develop a common conceptual framework. The Boards converged on two subjects: *Objectives of Financial Reporting* and *Qualitative Characteristics of Accounting Information*. However, the IASB decided it was important to move forward and complete other parts of the conceptual framework. The IASB issued its updated conceptual framework in 2018. The FASB did not join this effort although it now appears likely it will start soon on adding to and modifying its existing conceptual framework as well. Both Boards have that same objective, that is, to develop a conceptual framework consisting of standards that are principles-based and internally consistent, thereby leading to the most useful financial reporting. Hopefully, the two Boards will eventually agree on the key components of a common conceptual framework.

Relevant Facts

Following are the key similarities and differences between U.S. GAAP and IFRS related to the Conceptual Framework for Financial Reporting.

Similarities

- In 2010, the IASB and FASB completed the first phase of a jointly created conceptual framework. In this first phase, they agreed on the objective of financial reporting and a common set of desired qualitative characteristics. These were presented in the discussion in text. Note that prior to this converged phase, the Conceptual Framework gave more emphasis to the objective of providing information on management’s performance (stewardship).
- The existing conceptual frameworks underlying U.S. GAAP and IFRS are very similar. That is, they are organized in a similar manner (objective, elements, qualitative characteristics, etc.). There is no real need to change many aspects of the existing frameworks other than to converge different ways of discussing essentially the same concepts.

- Both the IASB and FASB have similar measurement principles, based on historical cost and fair value. In 2011, the Boards issued a converged standard on fair value measurement so that the definition of fair value, measurement techniques, and disclosures are the same between U.S. GAAP and IFRS when fair value is used in financial statements.

Differences

- Under the 2018 update to the IASB Conceptual Framework, there are now some subtle differences between the frameworks related to definitions of assets and liabilities (see the following “About the Numbers” discussion), measurement, and presentation.
- The updated IASB Conceptual Framework makes explicit a role for management stewardship in the objective of financial reporting, and prudence (a form of conservatism) is a dimension of the qualitative characteristic of faithful representation (neutrality).
- Although both U.S. GAAP and IFRS are increasing the use of fair value to report assets, at this point IFRS has adopted it more broadly. As examples, under IFRS, companies can apply fair value to property, plant, and equipment; natural resources; and, in some cases, intangible assets.
- U.S. GAAP has a concept statement to guide the estimation of fair values when market-related data are not available (*Statement of Financial Accounting Concepts No. 7*, “Using Cash Flow Information and Present Value in Accounting”). The IASB has not issued a similar concept statement; it has issued a fair value standard (*IFRS 13*) that is converged with U.S. GAAP.
- The monetary unit assumption is part of each framework. However, the unit of measure will vary depending on the currency used in the country in which the company is based (e.g., Chinese yuan, Japanese yen, and British pound).
- The economic entity assumption is also part of each framework, although some cultural differences result in differences in its application. For example, in Japan many companies have formed such strong alliances that they behave more like related divisions in the same company, although they are separate corporations.

About the Numbers

While the conceptual framework that underlies U.S. GAAP is very similar to that used to develop IFRS, the elements identified and their definitions under U.S. GAAP are different. The FASB elements and their definitions are as follows.

Elements of Financial Statements

Asset. Probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.

Liabilities. Probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.

Equity. Residual interest in the assets of an entity that remains after deducting its liabilities. In a business enterprise, the equity is the ownership interest.

Investments by Owners. Increases in net assets of a particular enterprise resulting from transfers to it from other entities of something of value to obtain or increase ownership interests (or equity) in it. Assets are most commonly received as investments by owners, but that which is received may also include services or satisfaction or conversion of liabilities of the enterprise.

Distributions to Owners. Decreases in net assets of a particular enterprise resulting from transferring assets, rendering services, or incurring liabilities by the enterprise to owners. Distributions to owners decrease ownership interests (or equity) in an enterprise.

Comprehensive Income. Change in equity (net assets) of an entity during a period from transactions and other events and circumstances from non-owner sources. It includes all changes in

equity during a period except those resulting from investments by owners and distributions to owners.

Revenues. Inflows or other enhancements of assets of an entity or settlement of its liabilities (or a combination of both) during a period from delivering or producing goods, rendering services, or other activities that constitute the entity’s ongoing major or central operations.

Expenses. Outflows or other using up of assets or incurrences of liabilities (or a combination of both) during a period from delivering or producing goods, rendering services, or carrying out other activities that constitute the entity’s ongoing major or central operations.

Gains. Increases in equity (net assets) from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity during a period except those that result from revenues or investments by owners.

Losses. Decreases in equity (net assets) from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity during a period except those that result from expenses or distributions to owners.

Source: “Elements of Financial Statements,” *Statement of Financial Accounting Concepts No. 6* (Stamford, Conn.: FASB, December 1985), pp. ix and x.

On the Horizon

The Boards have made much progress in updating and converging their conceptual frameworks. The IASB issuance of its updated *Conceptual Framework for Financial Reporting* in 2018 represents an important milestone. The FASB continues to work on its framework to address remaining elements not converged (definitions of assets and liabilities, measurement, and presentation). Progress to date indicates that the FASB's work has been informed by the IASB's updated framework (go to the FASB website; click on Projects and then Technical Agenda). We are optimistic that these efforts will result in substantially converged conceptual frameworks, which will support the development of standards that help financial statement users to make better decisions.