Chapter 1+2

Financial Reporting And Accounting Standards

Conceptual Framework For Financial Reporting

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After studying this chapter, you should be able to:

1. **Explain what accounting is.**
2. **Identify users and uses of accounting.**
3. **Explain the meaning of generally accepted accounting principles and the cost principle.**
4. **Explain the meaning of the monetary unit assumption and the economic entity assumption.**
5. **State the basic accounting equation and explain the meaning of assets, liabilities, and owner’s equity.**
6. **Analyze the effect of business transactions on the basic accounting equation.**
7. **Understand what the four financial statements are and how they are prepared.**

WHAT IS ACCOUNTING?

The essential characteristics of accounting are:

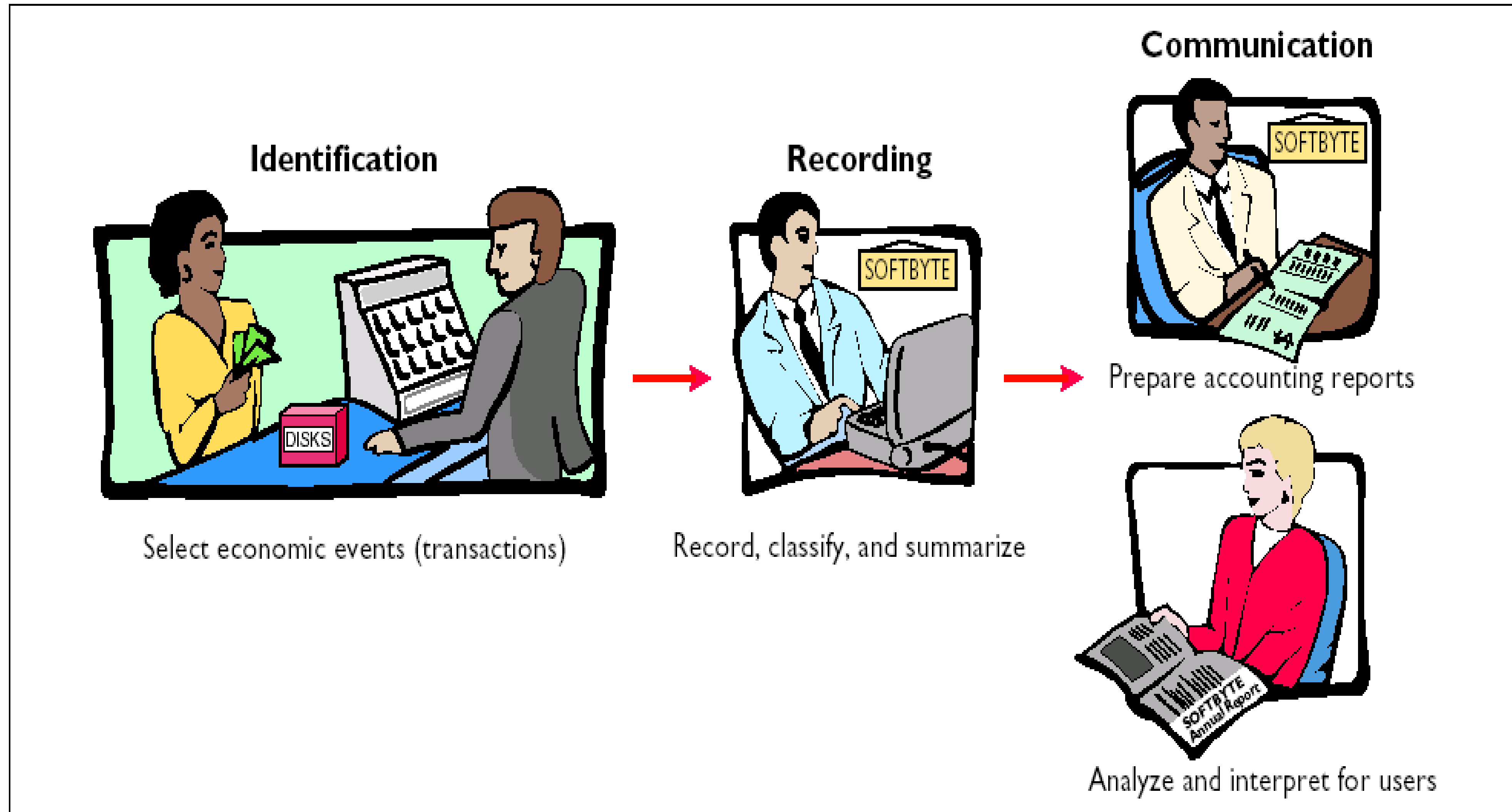
(1) the identification, measurement, and communication of financial information about (2) economic entities to (3) interested Parties

Accounting is an information system that:

1. **Identifies**
2. **Records**
3. **Communicates the economic events of an organization to interested users.**

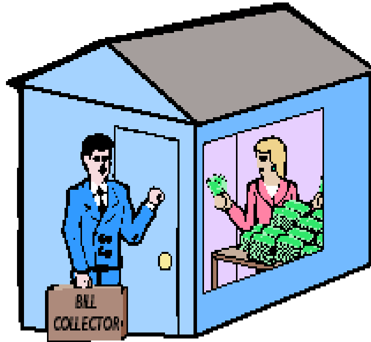
- **Financial accounting is the process that culminates in the preparation of financial reports on the enterprise for use by both internal and external parties.**

THE ACCOUNTING PROCESS

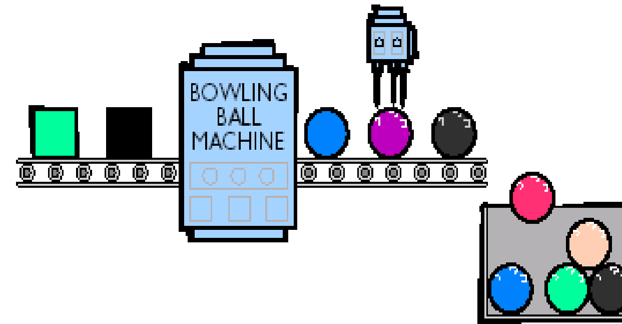


QUESTIONS ASKED BY INTERNAL USERS

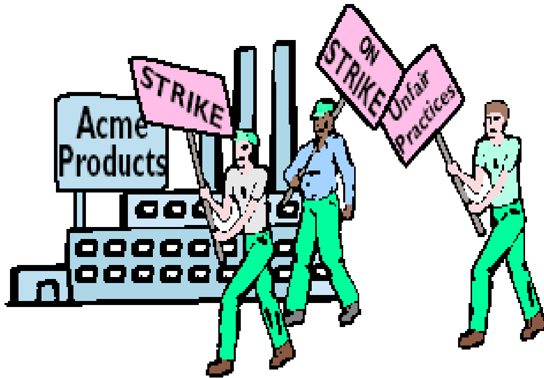
Questions Asked by Internal Users



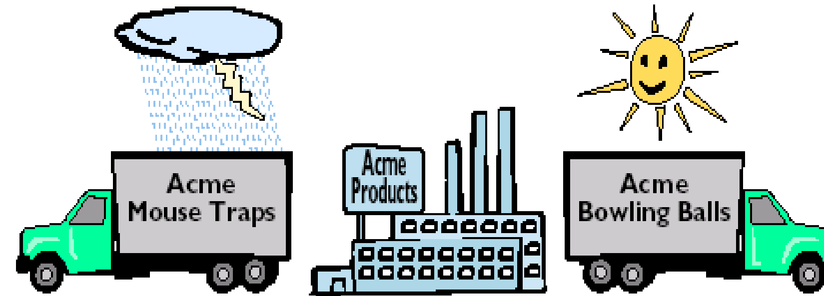
Is cash sufficient to pay bills?



What is the cost of manufacturing each unit of product?



Can we afford to give employee pay raises this year?

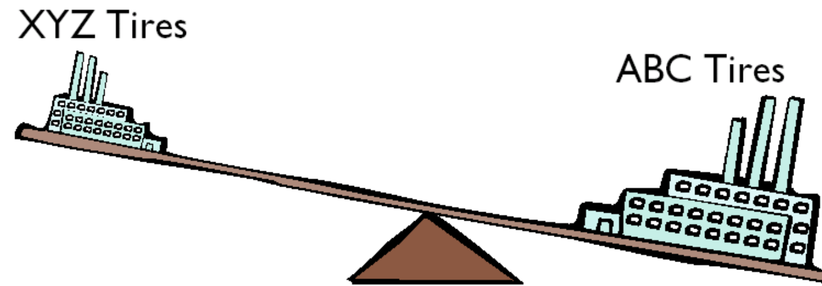


Which product line is the most profitable?

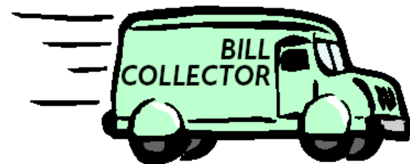
QUESTIONS ASKED BY EXTERNAL USERS

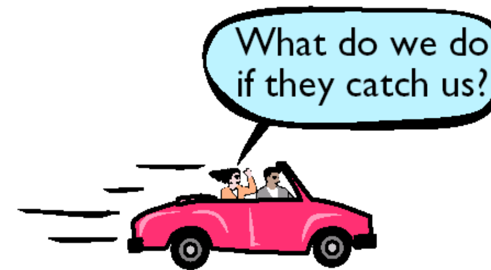
Questions Asked by External Users

Is the company earning satisfactory income?



How does the company compare in size and profitability with competitors?





Will the company be able to pay its debts as they come due?

Parties Involved In Standard-setting

Three organizations are instrumental in the development of financial accounting standards (GAAP) in the United States:

1. Securities and Exchange Commission (SEC)

2. American Institute of Certified Public Accountants (AICPA)

3. Financial Accounting Standards Board (FASB)

Financial Reporting Challenges

1. ***Nonfinancial measurements.*** Financial reports failed to provide some key performance measures widely used by management, such as customer satisfaction indexes, backlog information, and reject rates on goods purchased.
2. ***Forward-looking information.*** Financial reports failed to provide forward-looking information needed by present and potential investors and creditors.
3. ***Soft assets.*** Financial reports focused on hard assets (inventory, plant assets) but failed to provide much information about a company's soft assets (intangibles). The best assets are often intangible. Consider **Microsoft**'s know-how
4. ***Timeliness.*** Companies only prepared financial statements quarterly and provided audited financials annually. Little to no real-time financial statement information was available.

CONCEPTUAL FRAMEWORK

A **conceptual framework** establishes the concepts that underlie financial reporting. A conceptual framework is a coherent system of concepts that flow from an objective. The objective identifies the purpose of financial reporting. The other concepts provide guidance on:

1. identifying the boundaries of financial reporting;
2. selecting the transactions, other events, and circumstances to be represented;
3. how they should be recognized and measured;
4. how they should be summarized and reported.

CONCEPTUAL FRAMEWORK OF ACCOUNTING:

Objective, Usefulness, and Limitations of General Purpose Financial Reporting

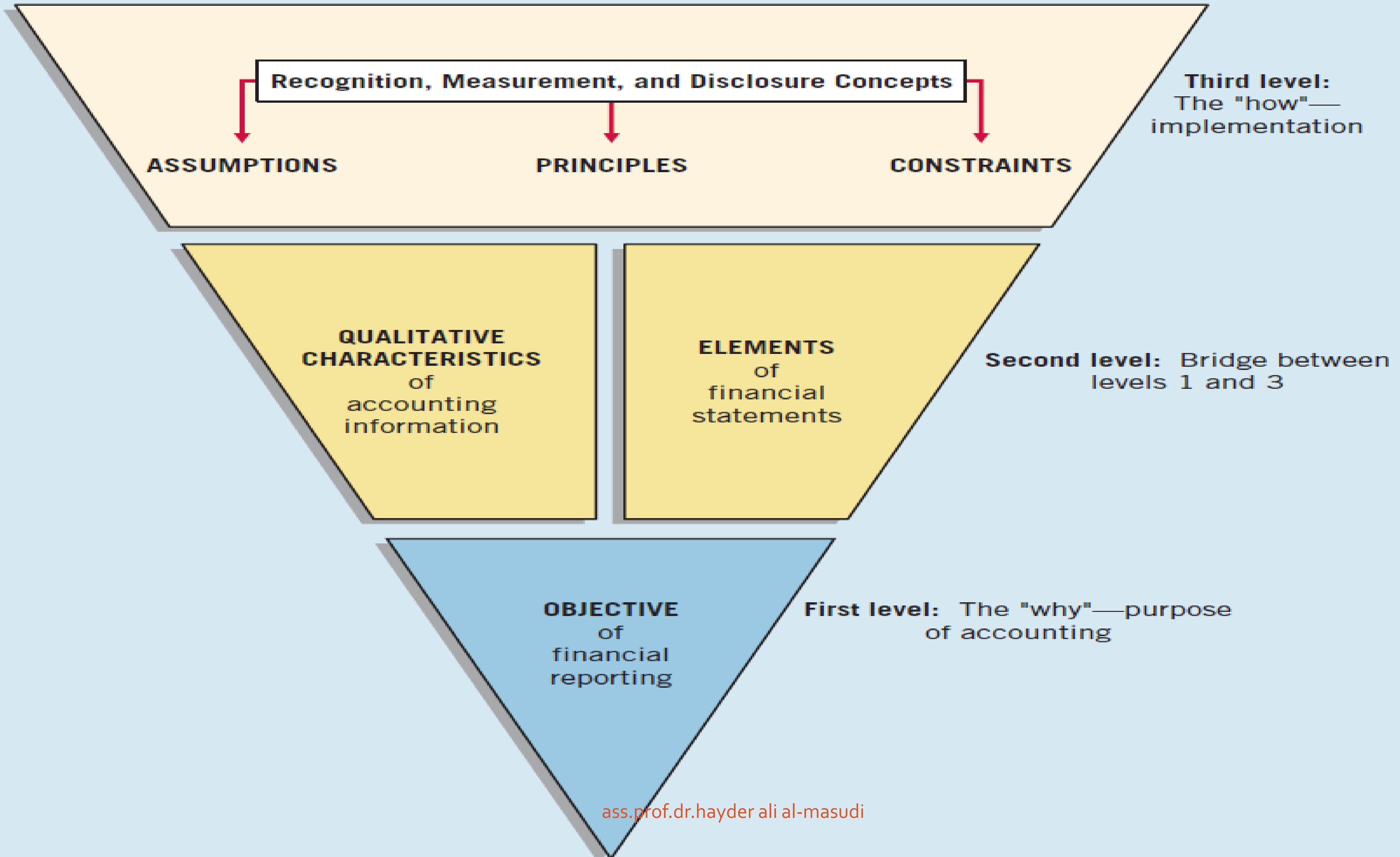
- The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity. Those decisions involve buying, selling, or holding equity and debt instruments and providing or settling loans and other forms of credit.

FASB'S CONCEPTUAL FRAMEWORK :

The conceptual framework developed by the FASB serves as the basis for resolving accounting and reporting problems.

- The conceptual framework consists of:

1. objectives of financial reporting;
2. qualitative characteristics of accounting information;
3. elements of financial statements; and
4. operating guidelines (assumptions, principles, and constraints).



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FIRST LEVEL: BASIC OBJECTIVE

The **objective of financial reporting** is the foundation of the conceptual framework. Other aspects of the framework—qualitative characteristics, elements of financial statements, recognition, measurement, and disclosure—flow logically from the objective.

Those aspects of the framework help to ensure that financial reporting achieves its objective.

The objective of general-purpose financial reporting is to provide financial information about the reporting entity that is **useful to present and potential equity investors, lenders, and other creditors in making decisions about providing resources to the entity**.

Second Level: Fundamental Concepts:

The second level forms a bridge between the **why** of accounting (the objective) and the **how** of accounting (recognition, measurement, and financial statement presentation).:

1. **Qualitative Characteristics of Accounting Information:** The FASB identified the **qualitative characteristics** of accounting information that distinguish better (more useful) information from inferior (less useful) information for decision-making purposes.

   Qualitative characteristics are either fundamental or enhancing characteristics, depending on how they affect the decision-usefulness of information

Primary users of accounting information

CAPITAL PROVIDERS (Investors and Creditors) AND THEIR CHARACTERISTICS

Constraint

COST

Pervasive criterion

DECISION-USEFULNESS

Fundamental qualities

RELEVANCE

FAITHFUL REPRESENTATION

Ingredients of fundamental qualities

Predictive value

Confirmatory value

Materiality

Completeness

Neutrality

Free from error

Enhancing qualities

Comparability

Verifiability

Timeliness

Understandability

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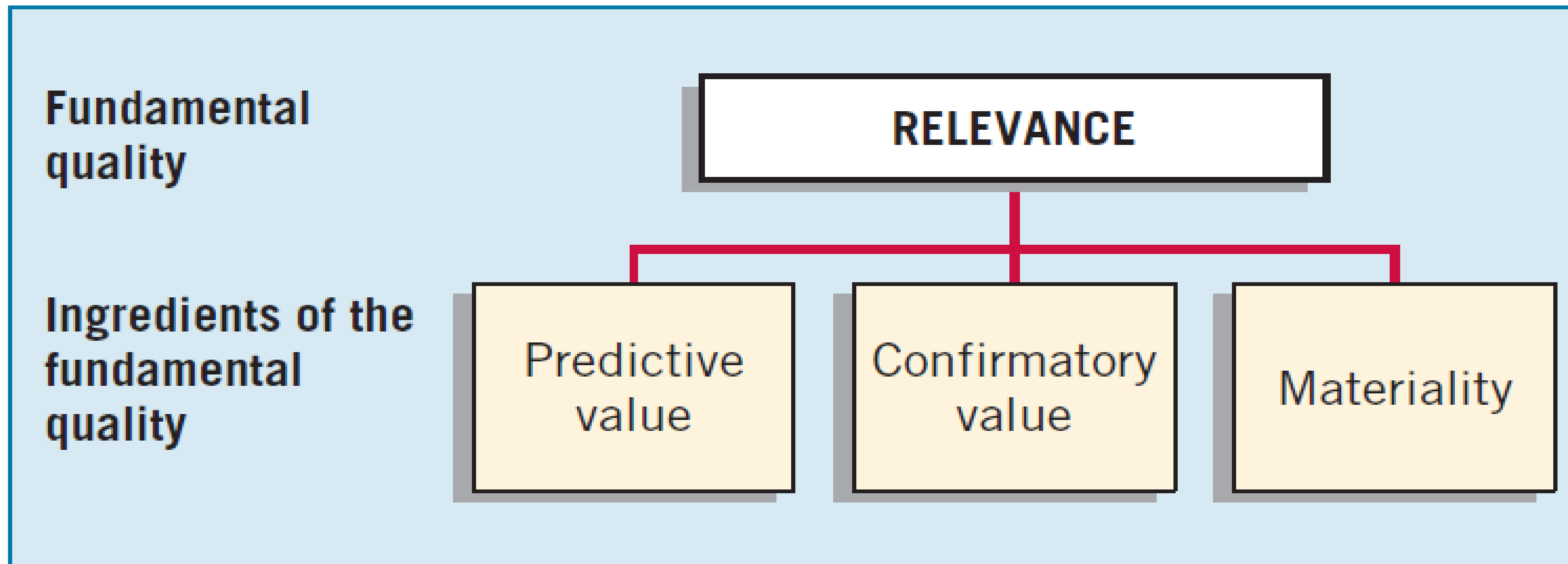
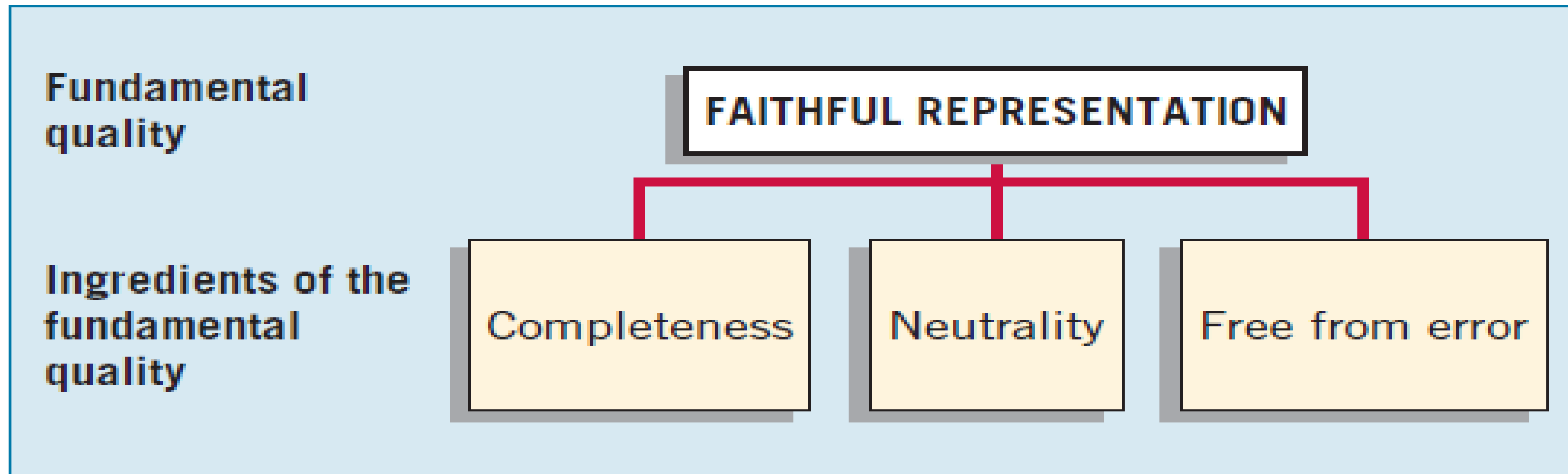
1. Relevance :

- Accounting information has relevance if it capable of making a difference in a decision.
- Relevant information helps users forecast future events (predictive value), or it confirms or corrects prior expectations (feedback value).
- Information must be available to decision makers before it loses its capacity to influence their decisions (timeliness).



A. **Predictive Value:** Financial information has **predictive value** if it has value as an input to predictive processes used by investors to form their own expectations about the future.
B. **Confirmatory Value** :Relevant information also helps users confirm or correct prior expectations; it has confirmatory value.
C. **Materiality:** Information is material if omitting it or misstating it could influence decisions that users make on the basis of the reported financial information.

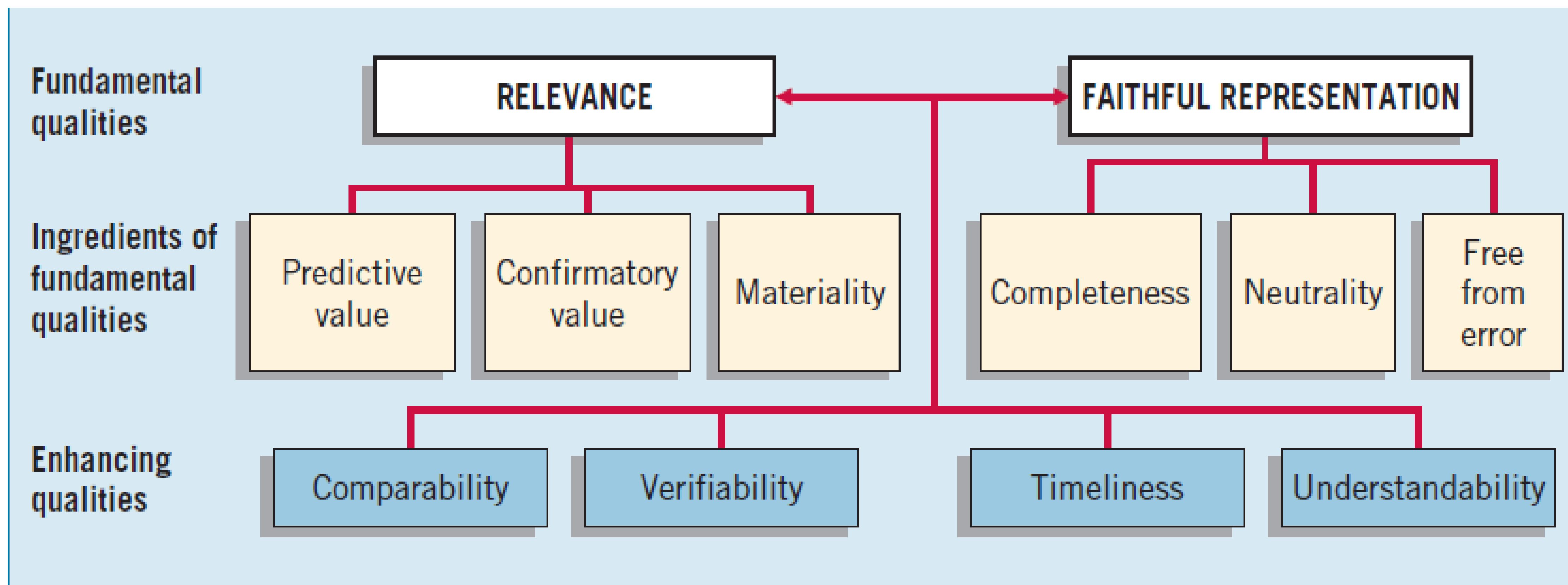
2. Faithful representation: means that the numbers and descriptions match what really existed or happened. Faithful representation is a necessity because most users have neither the time nor the expertise to evaluate the factual content of the information.



1. **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.
2. **Neutrality**. means that a company cannot select information to favor one set of interested parties over another. Unbiased information must be the overriding consideration.
3. **Free from Error**. An information item that is free from error will be a more accurate (faithful) representation of a financial item.

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.



1. **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.
2. **Verifiability.** Verifiability occurs when independent measurers, using the same methods, obtain similar results.
3. **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.
4. **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

ELEMENTS OF FINANCIAL STATEMENTS:

1. **ASSETS.** Probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.
2. **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.
3. **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.
4. **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.
5. **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.

6. **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.
7. **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.
8. **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.
9. **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.
10. **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.

Third Level: Recognition And Measurement Concepts:

The third level of the framework consists of concepts that implement the basic objective of level one.

These concepts explain how companies should:

1. Recognize, financial elements and events
2. Measure, financial elements and events
3. Report, financial elements and events.

First: Basic Assumptions

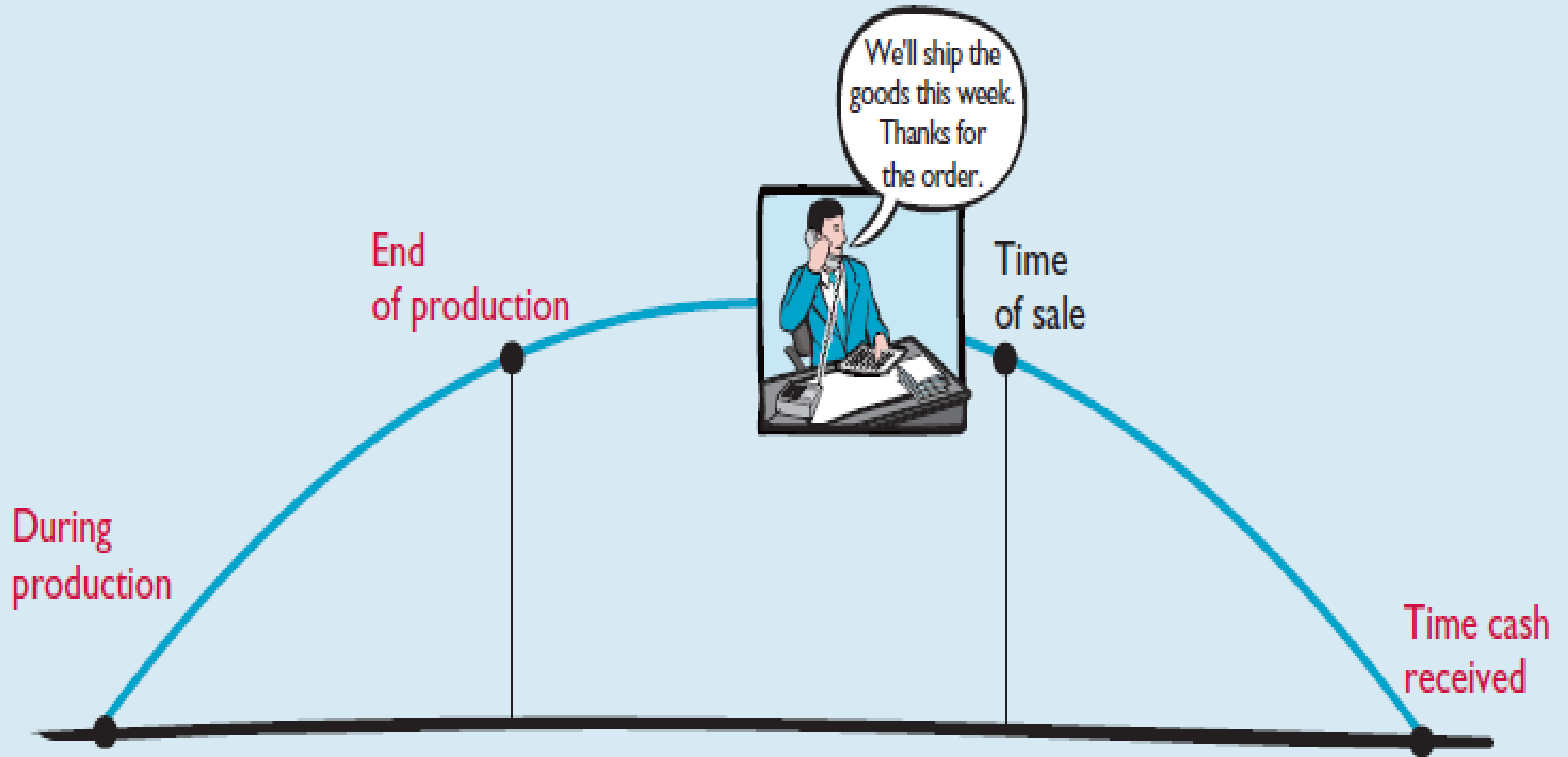
Four basic assumptions underlie the financial accounting structure:

1. **Economic Entity: means that economic activity can be identified with a particular unit of accountability, the entity concept does not necessarily refer to a legal entity.**
2. **Going Concern: the entity concept does not necessarily refer to a legal entity**
3. **Monetary Unit: means that money is the common denominator of economic activity and provides an appropriate basis for accounting measurement and analysis.**
4. **Periodicity:** 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.

Second: Basic Principles of Accounting

We generally use four basic **principles of accounting** to record and report transactions:

1. **Measurement**:
   a. *Historical Cost: companies account for and report many assets and liabilities on the basis of acquisition price.*
   b. *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*
2. **Revenue Recognition**: This approach has often been referred to as the revenue recognition principle recognize revenue. generally occurs:
   a. when realized or realizable:
   b. when earned.
3. **Expense Recognition**: the approach for recognizing expenses is, "Let the expense follow the revenues." This approach is the expense recognition principle. To illustrate, companies recognize expenses not when they pay wages or make a product, but when the work (service) or the product actually contributes to revenue.
4. **Full Disclosure**: it recognizes that the nature and amount of information included in financial reports reflects a series of judgmental trade-offs. These trade-offs strive for:
   a. sufficient detail to disclose matters that make a difference to users, yet.
   b. sufficient condensation to make the information understandable, keeping in mind costs of preparing and using it.


We'll ship the goods this week. Thanks for the order.
End of production
During production
Time of sale
Time cash received
Revenue should be recognized in the accounting period in which it is earned (generally at point of sale).

Expense Recognition

Type of Cost	Relationship	Recognition
Product costs: • Material • Labor • Overhead	Direct relationship between cost and revenue.	Recognize in period of revenue (matching).
Period costs: • Salaries • Administrative costs	No direct relationship between cost and revenue.	Expense as incurred.

Third: Constraints:

1. **cost constraint (cost-benefit relationship):** Companies must weigh the costs of providing the information against the benefits that can be derived from using it.
2. **industry practices.** The peculiar nature of some industries and business concerns sometimes requires departure from basic theory

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