# PRINCIPLES
of
# ACCOUNTING

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# PREVIEW OF CHAPTER 1

**Conceptual Framework for Financial Reporting**

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  - Development
  - Overview
- **First Level: Basic Objective**
- **Second Level: Fundamental Concepts**
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  - Basic elements
- **Third Level: Recognition and Measurement Concepts**
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  - Basic principles
  - Cost constraint
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# Conceptual Framework

## The Need for a Conceptual Framework

- To develop a coherent set of standards and rules.
- To solve new and emerging practical problems.



*LO 1 Describe the usefulness of a conceptual framework.*

# Development of Conceptual Framework

The **FASB** has issued seven **Statements of Financial Accounting Concepts** (SFAC) for business enterprises.

**SFAC No.1** - Objectives of Financial Reporting (superseded by SFAC No. 8)

**SFAC No.2** - Qualitative Characteristics of Accounting Information. (superseded by SFAC No. 8)

**SFAC No.3** - Elements of Financial Statements. (superseded by SFAC No. 6)

**SFAC No.5** - Recognition and Measurement in Financial Statements.

**SFAC No.6** - Elements of Financial Statements (replaces SFAC No. 3).

**SFAC No.7** - Using Cash Flow Information and Present Value in Accounting Measurements.

**SFAC No.8** - The Objective of General Purpose Financial Reporting and Qualitative Characteristics of Useful Financial Information (replaces SFAC No. 1 and No. 2)

# Conceptual Framework

## Overview of the Conceptual Framework

- **First Level** = Basic Objectives
- **Second Level** = Qualitative Characteristics and Elements
- **Third Level** = Recognition, Measurement, and Disclosure Concepts.

# First Level: Basic Objectives

## Objective of financial reporting:

To provide financial information about the reporting entity that is **useful to present and potential equity investors, lenders, and other creditors in making decisions about providing resources to the entity**.

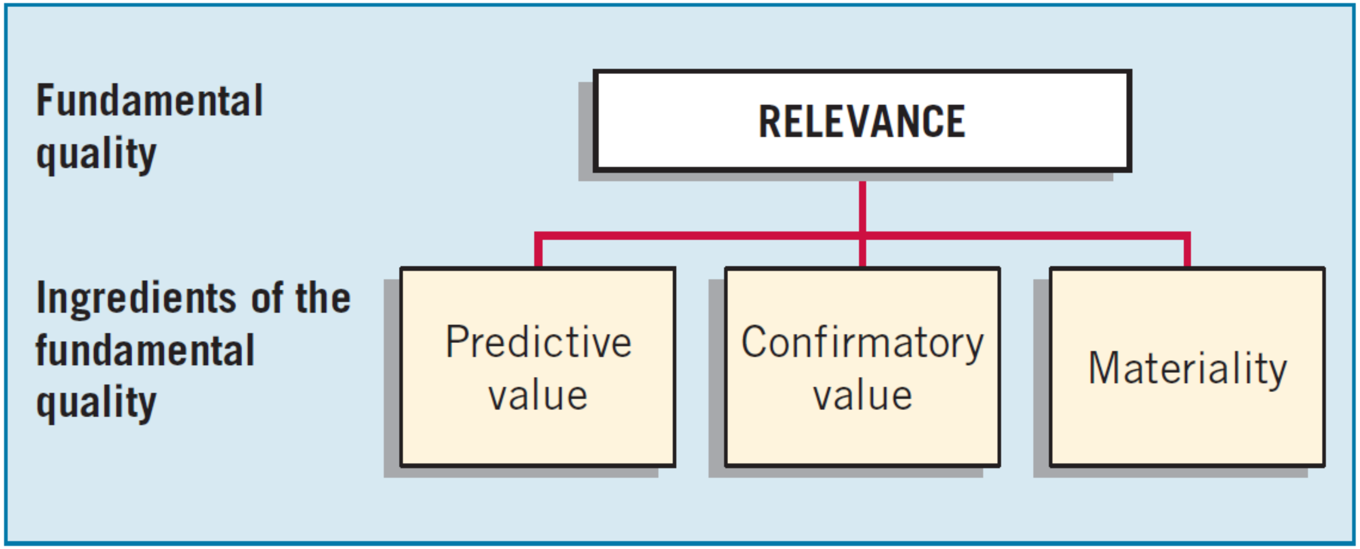
# Second Level: Fundamental Concepts

## 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."

# Second Level: Fundamental Concepts

## Fundamental Quality—Relevance



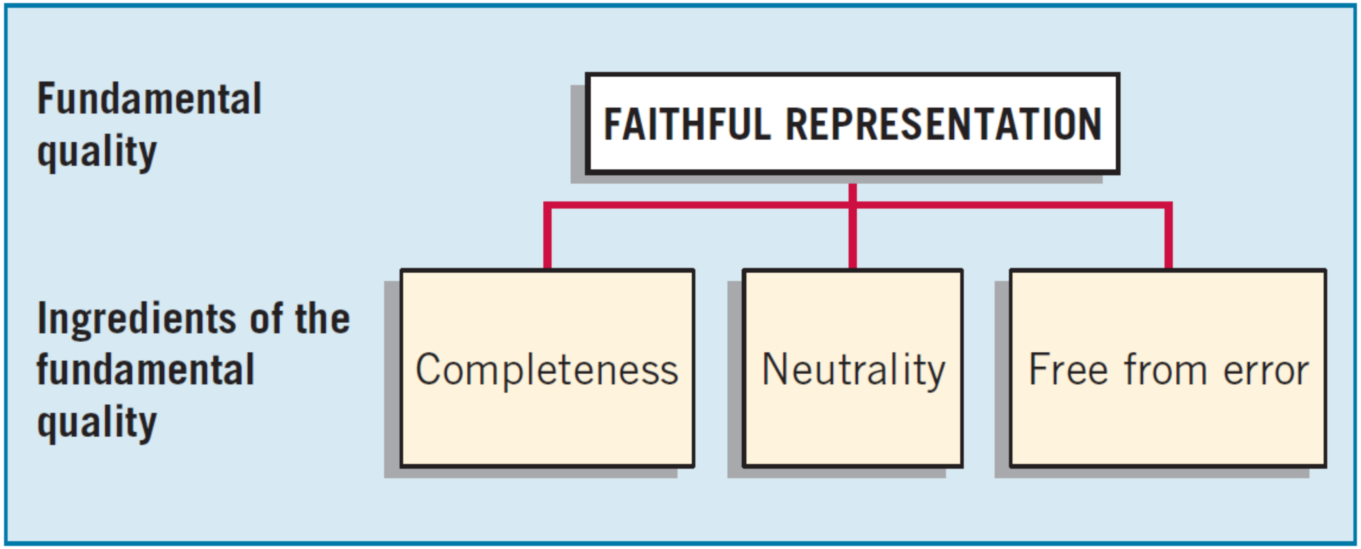

To be **relevant**, accounting information must be capable of **making a difference in a decision**.



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

# Second Level: Fundamental Concepts

## Fundamental Quality—Faithful Representation



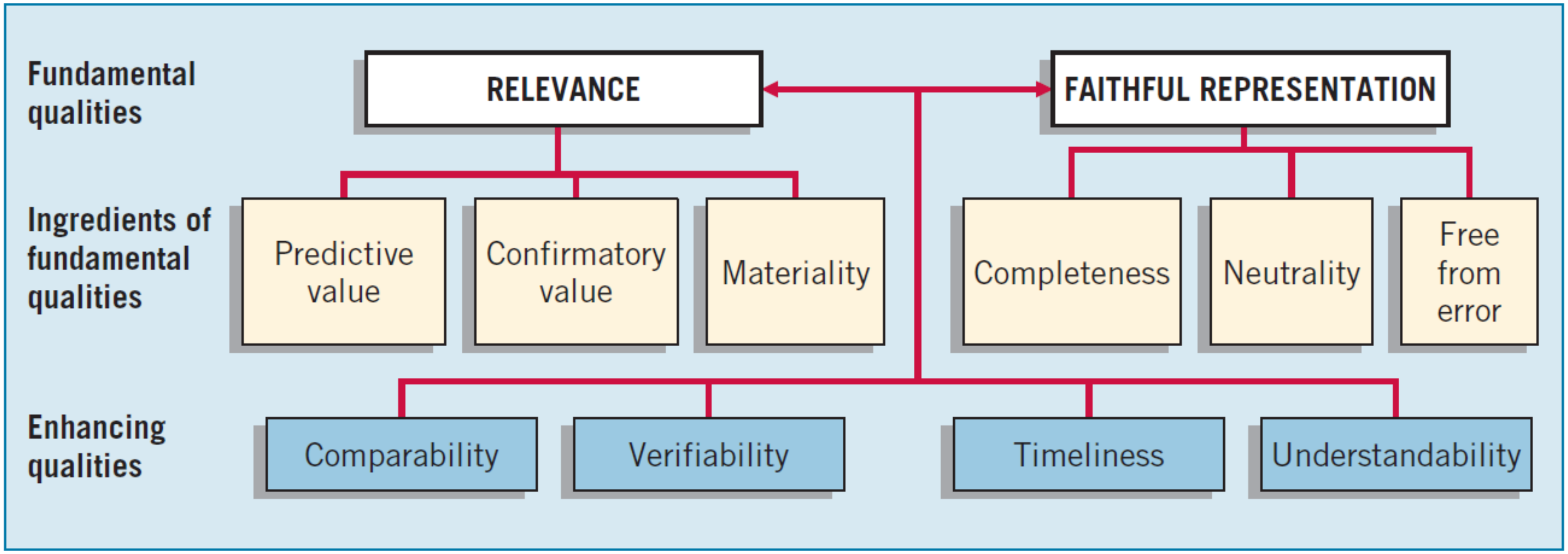

**Faithful representation** means that the numbers and descriptions match what really existed or happened.



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

# Second Level: Fundamental Concepts

## Enhancing Qualities




Information that is measured and reported in a similar manner for different companies is considered **comparable**.



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

# Second Level: Fundamental Concepts

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

**Timeliness** means having information available to decision-makers before it loses its capacity to influence decisions.

**Understandability** is the quality of information that lets reasonably informed users see its significance.

# Third Level:  Basic Assumptions

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

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

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

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

# Third Level: Basic Principles

**Measurement Principle** – The most commonly used measurements are based on **historical cost** and **fair value**.

**Issues:**

- **Historical cost** provides a reliable benchmark for measuring historical trends.
- **Fair value** information may be more useful.
- Recently the FASB has taken the step of giving companies the option to use fair value as the basis for measurement of financial assets and financial liabilities.
- Reporting of fair value information is increasing.

# Third Level:  Basic Principles

**Revenue Recognition** - requires that companies recognize revenue in the accounting period in which the performance obligation is satisfied.

**Expense Recognition** - "Let the expense follow the revenues."

**Illustration 2-6**
Expense Recognition

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



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

# Third Level: Basic Principles

**Full Disclosure** – providing information that is of sufficient importance to influence the judgment and decisions of an informed user.

Provided through:

- Financial Statements
- Notes to the Financial Statements
- Supplementary information

# Third Level: Constraints

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

**Illustration:** The following two situations represent applications of the cost constraint.

(a) Rafael Corporation discloses fair value information on its loans because it already gathers this information internally.

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

***LO 8 Describe the impact that the cost constraint has on reporting accounting information.***

# Summary of the Structure

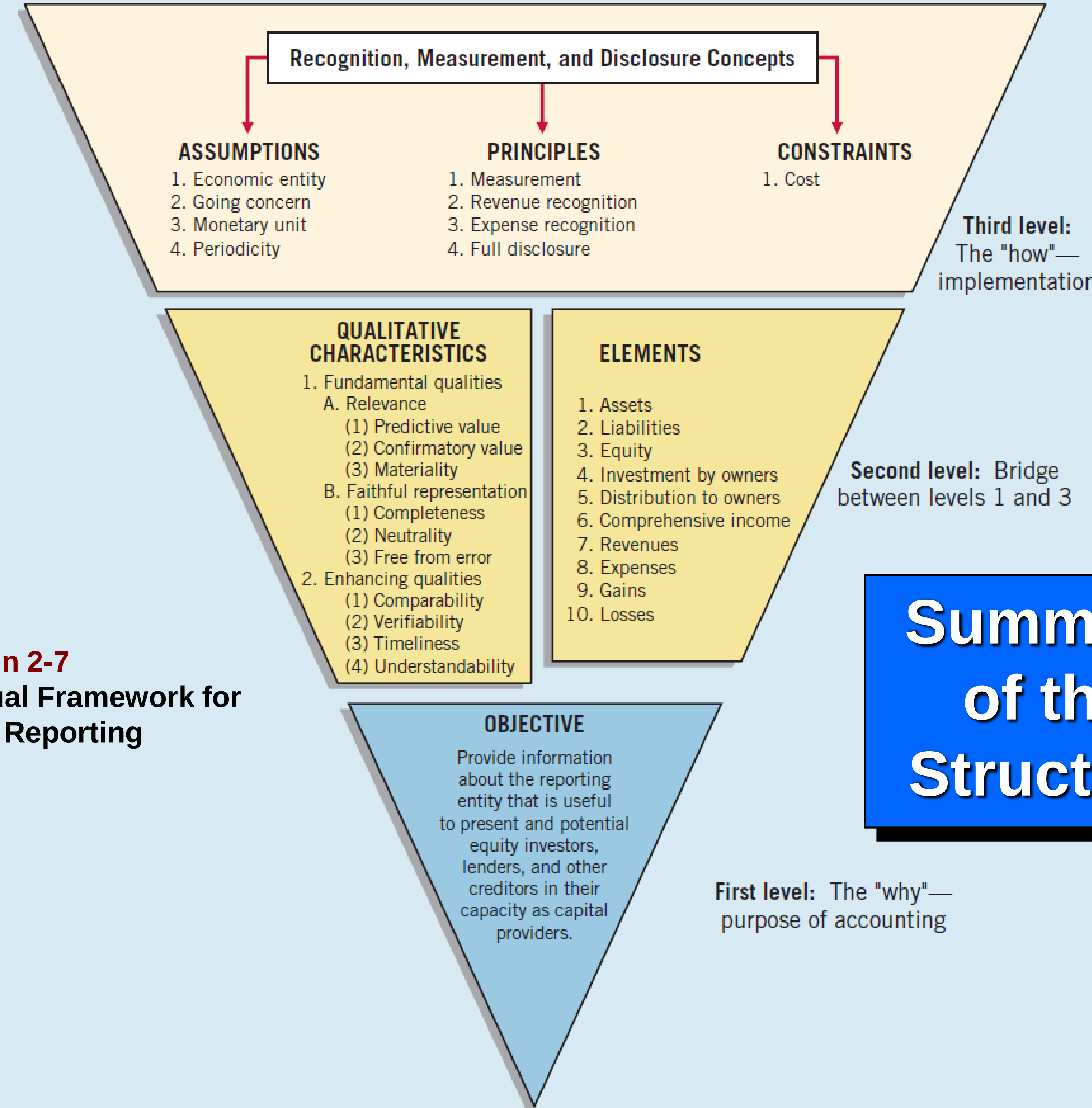



**Illustration 2-7**
**Conceptual Framework for Financial Reporting**

## ABOUT THE NUMBERS

### Financial Statement Elements

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

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

**Liabilities.** A present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits. Liabilities may be legally enforceable via a contract or law, but need not be, i.e., they can arise due to normal business practice or customs.



*LO 9 Compare the conceptual frameworks underlying GAAP and IFRS.*

## ABOUT THE NUMBERS

### Financial Statement Elements

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

**Equity.** A residual interest in the assets of the entity after deducting all its liabilities.

**Income.** Increases in economic benefits that result in increases in equity (other than those related to contributions from shareholders). Income includes both revenues (resulting from ordinary activities) and gains.

**Expenses**. Decreases in economic benefits that result in decreases in equity (other than those related to distributions to shareholders). Expenses includes losses that are not the result of ordinary activities.

## Uses Accounting Data

The information that a user of financial information needs depends upon the kinds of decisions the user makes. There are two broad groups of users of financial information: internal users and external users.

## INTERNAL USERS

Internal users of accounting information are those individuals inside a company who plan, organize, and run the business. These include marketing managers, production supervisors, finance directors, and company officers .Inrunning a business, internal users must answer many important questions

# EXTERNAL USERS

External users are individuals and organizations outside a company who want financial information about the company. The two most common types of external users are investors and creditors .Investors (owners) use accounting information to make decisions to buy, hold, or sell ownership shares of a company. Creditors (such as suppliers and bankers) use accounting information to evaluate the risks of granting credit or lending money.

# Thanks