CHAPTER 2

Conceptual Framework

LEARNING OBJECTIVES

After reading this chapter, you should be able to

- *describe the significance of conceptual framework.*
- *explain ASB's framework for preparation and presentation of financial statements.*
- *describe the framework laid down by IASB and FASB.*

CONCEPT

A conceptual framework establishes the concepts that underlie financial reporting. The Financial Accounting Standards Board (USA) has defined a conceptual framework, as a constitution, a coherent system of interrelated objectives and fundamentals that can lead to consistent standard and that prescribes the nature, function and limit of financial accounting and financial statements.

A conceptual framework of financial reporting defines fundamental issues including objectives, users of financial statements, qualitative characteristics, elements of financial statements, and concepts for recognizing and measuring these elements in the financial statements. This framework is usually set up by standard setting bodies to use it to resolve accounting issues and problems objectively and satisfactorily.

A conceptual framework primarily comprises of:

- Objectives of financial reporting
- Qualitative characteristics of accounting information
- Elements of financial statements
- Recognition and measurement in financial statements: Assumptions, principles and constraints

It 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:

- Identifying the boundaries of financial reporting
- Selecting the transactions, other events, and circumstances to be represented

- How they should be recognized and measured
- How they should be summarized and reported

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."[3]

In other words, standard-setting that is based on personal conceptual frameworks will lead to different conclusions about identical or similar issues that 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 enhance comparability among companies' financial statements.

Second, as a result of a soundly developed conceptual framework, the profession should be able to make quickly solve new and emerging practica problems by referring to an existing framework of basic theory.

It is difficult, if not impossible, for the IASB to prescribe the proper accounting treatment quickly. Practicing accountants, however, must resolve such problems on a daily basis. How? Through good judgement and with the help of a universally accepted conceptual framework, practitioners can quickly focus on an acceptable treatment.

BENEFITS OF CONCEPTUAL FRAMEWORK

The objective of conceptual framework is to help produce a body of standards that is more internally consistent than the *ad hoc* approach thereby enhancing the credibility of accounting information. A conceptual framework is *an priori* theory whose validity depends upon its consistency with stated objectives of accounting and logical structure. The establishment of a conceptual framework provides many benefits that are listed as follows:

1. With a conceptual framework, the standard setter is in a better position to assess the usefulness of alternative methods in accounting.
2. A conceptual framework will help produce a body of accounting principles and standards which can be used for preparing financial statements and other accounting statements and will further enhance the credibility and reliability of these statements.
3. A conceptual framework will help to reduce personal biases, subjectivity and political pressures in making decisions in accounting. As there are found diverse (conflicting) interests in the information market, conceptual framework will help encourage a common attitude towards accounting issues. This may require preparers and users to subordinate their individual preferences and interests in the knowledge that they will in the long run gain more than lose.
4. A well-developed conceptual framework would serve as basic theory for financial statement preparers to address and resolve emerging practical problems.

DEVELOPMENTS ON CONCEPTUAL FRAMEWORK

Some standards setting bodies such as ICAI (India) IASB, FASB (USA) have developed Conceptual Frameworks. The ICAI has developed Conceptual Framework titled as "Framework for the Preparation and Presentation of Financial Statements" which was issued by ASB in July 2002.

The IASB's conceptual framework is described in the document, "Framework for Preparation and Presentation of Financial Statements." The FASB's conceptual framework is developed in a series of concept statements, which is generally referred to as the Conceptual Framework. The IASB and the FASB are now working towards developing an improved common conceptual framework that provides a sound foundation for developing future accounting standards. Such a framework is essential to fulfilling the Boards' goal of developing standards that are principles-based, internally consistent, and internationalyy converged, and that lead to financial reporting that provides the information investors need to make sound and effective decisions.

ASB'S FRAMEWORK FOR PREPARATION AND PRESENTATION OF FINANCIAL STATEMENTS

The framework issued by Accounting Standards Board of the Institute of Chartered Accountants of India in July 2002 is currently in force. It puts across the purpose and scope of framework followed by users of financial information. It clearly states that financial statements should aim at fulfilling diverse information needs of different users. Accrual basis, going concern and consistency are the underlying assumptions followed by qualitative characteristics. It also enlists the elements of financial statements and their recognition and measurement.

The ASB's Framework issued in July 2000, has dealt with the following aspects of financial reporting:[4]

1. Purpose and Status

The purpose of the Framework is to

(a) assist preparers of financial statements in applying Accounting Standards and in dealing with topics that have yet to form the subject of an Accounting Standard;

(b) assist the Accounting Standards Board in the development of future Accounting Standards and in its review of existing Accounting Standards;

(c) assist the Accounting Standards Board in promoting harmonization of regulations, accounting standards and procedures relating to the preparation and presentation of financial statements by providing a basis for reducing the number of alternative accounting treatments permitted by Accounting Standards;

(d) assist auditors in forming an opinion as to whether financial statements conform with Accounting Standards;

(e) assist users of financial statements in interpreting the information contained in financial statements prepared in conformity with Accounting Standards; and

(f) provide those who are interested in the work of the Accounting Standards Board with information about its approach to the formulation of Accounting Standards.

This Framework is not an Accounting Standard and nothing in this Framework overrides any specific Accounting Standard.

The Accounting Standards Board recognises that in a limited number of cases there may be a conflict between the Framework and an Accounting Standard. In those cases where there is a conflict, the requirements of the Accounting Standard prevail over those of the Framework. As, however, the Accounting Standards Boards will be guided by the Framework in the development of future Standards and in its review of existing Standards, the number of cases of conflict between the Framework and Accounting Standards will diminish through time.

2. Scope

The Framework deals with:

(a) the objective of financial statements;

(b) the qualitative characteristics that determine the usefulness of information provided in financial statements

(c) definition, recognition and measurement of the elements from which financial statements are constructed; and

(d) concepts of capital and capital maintenance.

The Framework is concerned with general purpose financial state...

their requirements permit.

Financial Statements form part of the process of financial reporting. A complete set of financial statements normally includes a balance sheet, a statement of profit and loss (also known as 'income statement'), a cash flow statement and those notes and other statements and explanatory material that are an integral part of the financial statements. They may also include supplementary schedules and information based on or derived from, and expected to be read with, such statements. Such schedules and supplementary information may deal, for example, with financial information about business and geographical segments, and disclosures about the effects of changing prices. Financial statements do not, however, include such items as reports by directors, statements by the chairman, discussion and analysis by management and similar items that may be included in a financial or annual report.

The Framework applies to the financial statements of all reporting enterprises engaged in commercial, industrial and business activities, whether in the public or in the private sector.

3. Users and Their Information Needs

The users of financial statements include present and potential investors, employees, lenders, suppliers and other trade creditors, customers, governments and their agencies and the public, they use financial statements in order to satisfy some of their information needs. These needs include the following:

(a) ***Investors.*** The providers of risk capital are concerned with the risk inherent in, and return provided by, their investments. They need information to help them determine whether they should buy, hold or sell. They are also interested in information that enables them to assess the ability of the enterprise to pay dividends.

(b) ***Employees.*** Employees and their representative groups are interested in information about the stability and profitability of their employers. They are also interested in information that enables them to assess the ability of the enterprise to provide remuneration, retirement benefits and employment opportunities.

(c) *Lenders.* Lenders are interested in information that enables them to determine whether their loans, and the interest attaching to them, will be paid when due.

(d) ***Suppliers and other trade creditors.*** Suppliers and other creditors are interested in information that enables them to determine whether amounts owing to them will be paid when due. Trade creditors are likely to be interested in an enterprise over a shorter period than lenders unless they are dependent upon the continuance of the enterprise as a major customer.

(e) ***Customers.*** Customers have an interest in information about the continuance of an enterprise, especially when they have a long-term involvement with, or are dependent on, the enterprise.

(f) ***Governments and their agencies.*** Governments and their agencies are interested in the allocation of resources and, therefore, the activities of enterprises. They also require information in order to regulate the activities of enterprises and determine taxation policies, and to serve as the basis for determination of national income and similar statistics.

(g) ***Public.*** Enterprises affect members of the public in a variety of ways, for example, enterprises may make a substantial contribution to the local economy in many ways including the number of people they employ and their patronage of local suppliers. Financial statements may assist the public by providing information about the trends and recent developments in the prosperity of the enterprise and the range of its activities.

While financial statements cannot meet all of the information needs of these users, there are needs that are common to all users. As providers of risk capital to the enterprise, investors need more comprehensive information than other users. The provision of financial statements that meet their needs will also meet most of the needs of other users that financial statements can satisfy.

The management of an enterprise has the responsibility for the preparation and presentation of the financial statements of the enterprise. Management is also interested in the information contained in the financial statements even though it has additional access to additional information to perform planning, decision-making and control responsibilities.

4. The Objective of Financial Statements

The objective of financial statements is to provide information about the financial position, performance and cash flows of an enterprise that is useful to a wide range of users in making economic decisions.

Financial statements prepared for this purpose meet the common needs of most users. However, financial statements do not provide all the information that users may need to make economic decisions since (a) they largely portray the financial effects of past events, and (b) do not necessarily provide non-financial information. Financial statements also show the results of the stewardship of management, or the accountability of management for the resources entrusted to it. Those users who wish to assess the stewardship or accountability of management do so in order that they may make economic decisions; these decisions may include, for example, whether to hold or sell their investment in the enterprise or whether to reappoint or replace the management.

5. Financial Position, Performance and Cash Flows

The economic decisions that are taken by users of financial statements require an evaluation of the ability of an enterprise to generate cash and cash equivalents and of the timing and certainty of their generation. Users are better able to evaluate this ability to generate cash and cash equivalents if they are provided with information that focuses on the financial position, performance and cash flows of an enterprise.

Financial Position

The economic resources it controls, its financial structure, its liquidity and solvency, and its capacity to adapt to changes in the environment in which it operates affect the financial position of an enterprise. Information about the economic resources controlled by the enterprise and its capacity in the past to alter these resources is useful in predicting the ability of the enterprise to generate cash and cash equivalents in the future.

Information about financial structure is useful in predicting future borrowing needs and how future profits and cash flows will be distributed among those with an interest in the enterprise; it is also useful in predicting, how successful the enterprise is likely to be in raising further finance. Information about liquidity and solvency is useful in predicting the ability of the enterprise to meet its financial commitments as they fall due. Liquidity refers to the availability of cash in the near future to meet financial commitments over this period. Solvency refers to the availability of cash over the longer term to meet financial commitments as they fall due.

Performance

Information about the performance of an enterprise, in particular its profitability is required in order to assess potential changes in the economic resources that it is likely to control in the future. Information about variability of performance is important in this respect. Information about performance is useful in predicting the capacity of the enterprise to generate cash flows from its existing resource base. It is also useful in forming judgments about the effectiveness with which the enterprise might employ additional resources.

Cash Flows

Information concerning cash flows of an enterprise is useful in order to evaluate its investing, financing and operating activities during the reporting period. This information is useful in providing the users with a basis to assess the ability of the enterprise to generate cash and cash equivalents and the needs of the enterprise to utilize those cash flows.

Information about financial position is primarily provided in a balance sheet. Information about performance is primarily provided in a statement of profit and loss. Information about cash flows is provided in the financial statements by means of a cash flow statement.

The component parts of the financial statements are interrelated because they reflect different aspects of the same transactions or other events. Although each statement provides information that is different from the others, none is likely to serve only a single purpose nor to provide all the information necessary for particular needs of users.

Notes and Supplementary Schedules

The financial statements also contain notes and supplementary schedules and other information. For example, they may contain additional information that is relevant to the needs of users about the items in the balance sheet and statement of profit and loss. They may include disclosures about the risks and uncertainties affecting the enterprise and any resources and obligations not recognized in the balance sheet (such as mineral reserves). Information about business and geographical segments and the effect of changing prices on the enterprise may also be provided in the form of supplementary information.

6. Underlying Assumptions

Accrual Basis

In order to meet their objectives, financial statements are prepared on the accrual basis of accounting. Under this basis, the effects of transactions and other events are recognized when they occur (and not as cash or a cash equivalent is received or paid) and they are recorded in the accounting records and reported in the financial statements of the periods to which they relate. Financial statements prepared on the accrual basis inform users not only of past events 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 to users in making economic decisions.

Going Concern

The financial statements are normally prepared on the assumption that an enterprise is a going concern and will continue in operation for the foreseeable future. Hence, it is assumed that the enterprise has neither the intention nor the need to liquidate or curtail materially the scale of its operations; if such an intention or need exists, the financial statements may have to be prepared on a different basis and, if so, the basis used is disclosed.

Consistency

In order to achieve comparability of the financial statements of an enterprise through time, the accounting policies are followed consistently from one period to another; a change in an accounting policy is made only in certain exceptional circumstances.

7. Qualitative Characteristics of Financial Statements

Qualitative characteristics are the attributes that make the information provided in financial statements useful to users. The four principal qualitative characteristics are understandability, relevance, reliability and comparability.

Understandability

An essential quality of the information provided in financial statements is that it must be readily understandable by users. For this purpose, it is assumed that users have a reasonable knowledge of business and economic activities and accounting and study the information with reasonable diligence. Information about complex matters that should be included in the financial statements because of its relevance to the economic decision making needs of users should not be excluded merely on the ground that it may be too difficult for certain users to understand.

Relevance

To be useful, information must be relevant to the decision making needs of users. Information has the quality of relevance when it influences the economic decisions of users by helping them evaluate past, present or future events or confirming, or correcting, their past evaluations.

The predictive and confirmatory roles of information are interrelated. For example, information about the current level and structure of asset holdings has value to users when they endeavour to predict the ability of the enterprise to take advantage of opportunities and its ability to react to adverse situations. The same information plays a confirmatory role in respect of past predictions about, for example, the way in which the enterprise would be structured or the outcome of planned operations.

Information about financial position and past performance is frequently used as the basis for predicting future financial position and performance and other matters in which users are directly interested, such as dividend and wage payments, share price movements and the ability of the enterprise to meet its commitments as they fall due. To have predictive value, information need not be in the form of an explicit forecast. The ability to make predictions from financial statements is enhanced, however, by the manner in which information on past transactions and events is displayed. For example, the predictive value of the statement of profit and loss is enhanced if unusual, abnormal and infrequent items of income and expense are separately disclosed.

Materiality

The relevance of information is affected by its materiality. Information is material if its misstatement (*i.e.*, omission or erroneous statement) could influence the economic decisions of users taken on the basis of the financial information. Materiality depends on the size and nature of the item or error, judged in the particular circumstances of its misstatement. Materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic that the information must have if it is to be useful.

Reliability

To be useful, information must also be reliable. Information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully that which it either purports to represent or could reasonably be expected to represent.

Information may be relevant but so unreliable in nature or representation that its recognition may be potentially misleading. For example, if the validity and amount of a claim for damages under a legal action against the enterprise are highly uncertain, it may be inappropriate for the enterprise to recognize the amount of the claim in the balance sheet, although it may be appropriate to disclose the amount and circumstances of the claim.

Faithful Representation

To be reliable, information must represent faithfully the transactions and other events it either purports to represent or could reasonably be expected to represent. Thus, for example, a balance sheet should represent faithfully the transactions and other events that result in assets, liabilities and equity of the enterprise at the reporting date which meet the recognition criteria.

Most financial information is subject to some risk of being less than a faithful representation of that which it purports to portray. This is not due to bias, but rather to inherent difficulties either in identifying the transactions and other events to be measured or in devising and applying measurement and presentation techniques that can convey messages that correspond with those transactions and events. In certain cases, the measurement of the financial effects of items could be so uncertain that enterprises generally would not recognise them in the financial statements; for example, although most enterprises generate goodwill internally over time, it is usually difficult to identify or measure that goodwill reliably. In other cases, however, it may be relevant to recognise items and to disclose the risk of error surrounding their recognition and measurement.

Substance Over Form

If information is to represent faithfully the transactions and other events that it purports to represent, it is necessary that they are accounted for and presented in accordance with their substance and economic reality and not merely their legal form. The substance of transactions or other events is not always consistent with that which is apparent from their legal or contrived form. For example, where rights and beneficial interest in an immovable property are transferred but the documentation and legal formalities are pending, the recording of acquisition/disposal (by the transferee and transferor respectively) would in substance represent the transaction entered into.

Neutrality

To be reliable, the information contained in financial statements must be neutral, that is, free from bias. Financial statements are not neutral if, by the selection or presentation of information, they influence the making of a decision or judgement in order to achieve a predetermined result or outcome.

Prudence

The preparers of financial statements have to contend with the uncertainties that inevitably surround many events and circumstances, such as the collectability of receivables, the probable useful life of plant and machinery, and the warranty claims that may occur. Such uncertainties are recognised by the disclosure of their nature and extent and by the exercise of prudence in the preparation of the financial statements. Prudence is the inclusion of a degree of caution in the exercise of the judgments needed in making the estimates required under conditions of uncertainty, such that assets or income are not overstated and liabilities or expenses are not understated.

However, the exercise of prudence does not allow, for example, the creation of hidden reserves or excessive provisions, the deliberate understatement of assets or income, or the deliberate overstatement of liabilities or expenses, because the financial statements would then not be neutral and, therefore, not have the quality of reliability.

Completeness

To be reliable, the information in financial statements must be complete within the bounds of materiality and cost. An omission can cause information to be false or misleading and thus, unreliable and deficient in terms of its relevance.

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Comparability

Users must be able to compare the financial statements of an enterprise through time in order to identify trends in its financial position, performance and cash flows. Users must also be able to compare the financial statements of different enterprises in order to evaluate their relative financial position, performance and cash flows. Hence, the measurement and display of the financial effects of like transactions and other events must be carried out in a consistent way throughout an enterprise and over time for that enterprise and in a consistent way for different enterprises.

An important implication of the qualitative characteristic of comparability is that users be informed of the accounting policies employed in the preparation of the financial statements, any changes in those policies and the effects of such changes. Users need to be able to identify differences between the accounting policies for like transactions and other events used by the same enterprise from period to period and by different enterprises. Compliance with Accounting Standards, including the disclosure of the accounting policies used by the enterprise, helps to achieve comparability.

The need for comparability should not be confused with mere uniformity and should not be allowed to become an impediment to the introduction of improved accounting standards. It is not appropriate for an enterprise to continue accounting in the same manner for a transaction or other event if the policy adopted is not in keeping with the qualitative characteristics of relevance and reliability. It is also inappropriate for an enterprise to leave its accounting policies unchanged when more relevant and reliable alternatives exist.

Users wish to compare the financial position, performance and cash flows of an enterprise over time. Hence, it is important that the financial statements show corresponding information for the preceding period(s).

Constraints on Relevant and Reliable Information

Timeliness

If there is undue delay in the reporting of information it may lose its relevance. Management may need to balance the relative merits of timely reporting and the provision of reliable information. To provide information on a timely basis it may often be necessary to report before all aspects of a transaction or other event are known, thus impairing reliability. Conversely, if reporting is delayed until all aspects are known, the information may be highly reliable but of little use to users who have had to make decisions in the interim. In achieving a balance between relevance and reliability, the overriding consideration is how best to satisfy the information needs of users.

Balance between Benefit and Cost

The balance between benefit and cost is a pervasive constraint rather than a qualitative characteristic. The benefits derived from information should exceed the cost of providing it. The evaluation of benefits and costs is, however, substantially a judgmental process. Furthermore, the costs do not necessarily fall on those users who enjoy the benefits. Users other than those for whom the information is prepared may also enjoy benefits. For these reasons, it is difficult to apply a cost benefit test in any particular case.

Nevertheless, standard-setters in particular, as well as the preparers and users of financial statements, should be aware of this constraint.

Balance between Qualitative Characteristics

In practice, a balancing, or trade-off, between qualitative characteristics is often necessary. Generally the aim is to achieve an appropriate balance among the characteristics in order to meet the objective of financial statements. The relative importance of the characteristics in different cases is a matter of professional judgment.

8. True and Fair View

Financial statements are frequently described as showing a true and fair view of the financial position, performance and cash flows of an enterprise. Although this Framework does not deal directly with such concepts, the application of the principal qualitative characteristics and of appropriate accounting standards normally results in financial statements that convey what is generally understood as a true and fair view of such information.

9. The Elements of Financial Statements

Financial statements portray the financial effects of transactions and other events by grouping them into broad classes according to their economic characteristics. These broad classes are termed the elements of financial statements. The elements directly related to the measurement of financial position in the balance sheet are assets, liabilities and equity. The elements directly related to the measurement of performance in the statement of profit and loss are income and expenses. The cash flow statement usually reflects elements of statement of profit and loss and changes in balance sheet elements; accordingly, this Framework identifies no elements that are unique to this statement.

The presentation of these elements in the balance sheet and the statement of profit and loss involve a process of subclassification. For example, assets and liabilities may be classified by their nature or function in the business of the enterprise in order to display information in the manner most useful to users for purposes of making economic decisions.

***Financial Position*: Assets, Liabilities, Equity**

The elements directly related to the measurement of financial position are assets, liabilities and equity. These are defined as follows:

(a) An asset is a resource controlled by the enterprise as a result of past events from which future economic benefits are expected to flow to the enterprise.

(b) A liability is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits.

(c) Equity is the residual interest in the assets of the enterprise after deducting all its liabilities.

Assets

The future economic benefit embodied in an asset is the potential to contribute, directly or indirectly, to the flow of cash and cash equivalents to the enterprise. The potential may be a productive one that is part of the operating activities of the enterprise. It may also take the form of convertibility into cash or cash equivalents or a capability to reduce cash outflows, such as when an alternative manufacturing process lowers the costs of production.

An enterprise usually employs its assets to produce goods or services capable of satisfying the wants or needs of customers; because these goods or services can satisfy these wants or needs, customers are prepared to pay for them and hence contribute to the cash flows of the enterprise. Cash itself renders a service to the enterprise because of its command over other resources.

The future economic benefits embodied in an asset may flow to the enterprise in a number of ways. For example, an asset may be

(a) used singly or in combination with other assets in the production of goods or services to be sold by the enterprise,

(b) exchanged for other assets,

(c) used to settle a liability, or

(d) distributed to the owners of the enterprise.

Many assets, for example, plant and machinery, have a physical form. However, physical form is not essential to the existence of an asset; hence patents and copyrights, for example, are assets if future economic benefits are expected to flow from them and if they are controlled by the enterprise.

Many assets, for example, receivables and property, are associated with legal rights, including the right of ownership. In determining the existence of an asset, the right of ownership is not essential; thus, for example, an item held under a hire purchase is an asset of the hire purchaser since the hire purchaser controls the benefits that are expected to flow from the item. Although the capacity of an enterprise to control benefits is usually the result of legal rights, an item may nonetheless satisfy the definition of an asset even when there is no legal control. For example, know-how obtained from a development activity may meet the definite of an asset when, by keeping that know-how secret, an enterprise controls the benefits that are expected to flow from it.

The assets of an enterprise result from past transactions or other past events. Enterprises normally obtain assets by purchasing or producing them, but other transactions or events may also generate assets; examples include land received by an enterprise from government as part of a programme to encourage economic growth in an area and the discovery of mineral deposits. Transactions or events expected to occur in the future do not in themselves give rise to assets, hence, for example, an intention to purchase inventory does not, of itself, meet the definition of an asset.

There is a close association between incurring expenditure and obtaining assets but the two do not necessarily coincide. Hence, when an enterprise incurs expenditure this may provide evidence that future economic benefits were sought but is not conclusive proof that an item satisfying the definition of an asset has been obtained.

Liabilities

An essential characteristic of a liability is that the enterprise has a present obligation. An obligation is a duty or responsibility to act or perform in a certain way. Obligations may be legally enforceable as a consequence of a binding contract or statutory requirement. This is normally the case, for example, with amounts payable for goods and services received. Obligations also arise, however, from normal business practice, custom and a desire to maintain good business relations or act in an equitable manner. If, for example, an enterprise decides as a matter of policy to rectify faults in its products even when these become apparent after the warranty period has expired, the amount expected to be spent in respect of goods already sold are liabilities.

A distinction needs to be drawn between a present obligation and a future commitment. A decision by the management of an enterprise to acquire assets in the future does not, of itself, give rise to a present obligation.

An obligation normally arises only when the asset is delivered or the enterprise enters into an irrevocable agreement to acquire the asset. In the latter case, the irrevocable nature of the agreement means that the economic consequences of failing to honour the obligation, for example, because of the existence of a substantial penalty, leave the enterprise with little, if any, discretion to avoid the outflow of resources to another party.

The settlement of a present obligation usually involves the enterprise giving up resources embodying economic benefits in order to satisfy the claim of the other party. Settlement of a present obligation may occur in a number of ways, for example, by

(a) payment of cash;

(b) transfer of other assets;

(c) provision of services;

(d) replacement of that obligation with another obligation; or

(e) conversion of the obligation to equity.

An obligation may also be extinguished by other means, such as a creditor waiving or forfeiting its rights.

Liabilities result from past transactions or other past events. Thus, for example, the acquisition of goods and the use of services give rise to trade creditors (unless paid for in advance or on delivery) and the receipt of a bank loan results in an obligation to repay the loan. An enterprise may also recognize future rebates based on annual purchases by customers as liabilities; in this case, the sale of the goods in the past is the transaction that gives rise to the liability.

Some liabilities can be measured only by using a substantial degree of estimation. Such liabilities are commonly described as 'provisions'. Examples include provisions for payments to be made under existing warranties and provisions to cover pension obligations.

Equity

Although equity is defined as a residual, it may be subclassified in the balance sheet. For example, funds contributed by owners, reserves representing appropriations of retained earnings, unappropriated retained earnings and reserves representing capital maintenance adjustments may be shown separately. Such classifications can be relevant to the decision making needs of the users of financial statements when they indicate legal or other restrictions on the ability of the enterprise to distribute or otherwise apply its equity. They may also reflect the fact that parties with ownership interests in an enterprise have differing rights in relation to the receipt of dividends or the repayment of capital.

The creation of reserves is sometimes required by law in order to give the enterprise and its creditors an added measure of protection from the effects of losses. Reserves may also be created when tax laws grant exemptions from, or reductions in, taxation liabilities if transfers to such reserves are made. The existence and size of such reserves is information that can be relevant to the decision-making needs of users. Transfers to such reserves are appropriations of retained earnings rather than expenses.

The amount at which equity is shown in the balance sheet is dependent on the measurement of assets and liabilities. Normally, the aggregate amount of equity only by coincidence corresponds with the aggregate market value of the shares of the enterprise or the sum that could be raised by disposing of either the net assets on a piecemeal basis or the enterprise as a whole on a going concern basis.

Commercial, industrial and business activities are often undertaken by means of enterprises such as sole proprietorships, partnerships and trusts and various types of government business undertakings. The legal and regulatory framework for such enterprises is often different from that applicable to corporate enterprises. For example, unlike corporate enterprises, in the case of such enterprises, there may be few, if any, restrictions on the distribution to owners or other beneficiaries of amounts included in equity. Nevertheless, the definition of equity and the other aspects of this Framework that deal with equity are appropriate for such enterprises.

Performance : Income and Expenses

Profit is frequently used as a measure of performance or as the basis for other measures, such as return on investment or earnings per share. The elements directly related to the measurement of profit are income and expenses. The recognition and measurement of income and expenses, and hence profit, depends in part on the concepts of capital and capital maintenance used by the enterprise in preparing its financial statements.

Income and expenses are defined as follows:

(a) Income is increase in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.

(b) Expenses are decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants.

The definitions of income and expenses identify their essential features but do not attempt to specify the criteria that need to be met before they are recognised in the statement of profit and loss. Income and expenses may be presented in the statement of profit and loss in different ways so as to provide information that is relevant for economic decision making. For example, it is a common practice to distinguish between those items of income and expenses that arise in the course of the ordinary activities of the enterprise and those that do not. This distinction is made on the basis that the source of an item is relevant in evaluating the ability of the enterprise to generate cash and cash equivalents in the future. When distinguishing between items in this way, consideration needs to be given to the nature of the enterprise and its operations. Items that arise from the ordinary activities of one enterprise may be extraordinary in respect of another.

Distinguishing between items of income and expense and combining them in different ways also permits several measures of enterprise performance to be displayed. These have differing degrees of inclusiveness. For example, the statement of profit and loss could display gross margin, profit from ordinary activities before taxation, profit from ordinary activities after taxation, and net profit.

Income

The definition of income encompasses both revenue and gains. Revenue arises in the course of the ordinary activities of an enterprise and is referred to by a variety of different names including sales, fees, interest, dividends, royalties and rent.

Gains represent other items that meet the definition of income and may, or may not, arise in the course of the ordinary activities of an enterprise. Gains represent increases in economic benefits and as such are no different in nature from revenue. Hence, they are not regarded as a separate element in this Framework.

The definition of income includes unrealised gains. Gains also include, for example, those arising on the disposal of fixed assets. When gains are recognised in the statement of profit and loss, they are usually displayed separately because knowledge of them is useful for the purpose of making economic decisions.

Various kinds of assets may be received or enhanced by income; examples include cash, receivables and goods and services received in exchange for goods and services supplied. Income may also result in the settlement of liabilities. For example, an enterprise may provide goods and services to a lender in settlement of an obligation to repay an outstanding loan.

Expenses

The definition of expenses encompasses those expenses that arise in the course of the ordinary activities of the enterprise, as well as losses. Expenses that arise in the course of the ordinary activities of the enterprise include, for example, cost of goods sold, wages, and depreciation. They take the form of an outflow or depletion of assets or enhancement of liabilities.

Losses represent other items that meet the definition of expenses and may, or may not, arise in the course of the ordinary activities of the enterprise. Losses represent decreases in economic benefits and as such they are no different in nature from other expenses. Hence, they are not regarded as a separate element in this Framework.

Losses include, for example, those resulting from disasters such as fire and flood, as well as those arising on the disposal of fixed assets. The definition of expenses also includes unrealised losses. When losses are recognised in the statement of profit and loss, they are usually displayed separately because knowledge of them is useful for the purpose of making economic decisions.

Capital Maintenance Adjustments

The revaluation or restatement of assets and liabilities gives rise to increases or decreases in equity. While these increases or decreases meet the definition of income and expenses, they are not included in the statement of profit and loss under certain concepts of capital maintenance. Instead, these items are included in equity as capital maintenance adjustments or revaluation reserves.

10. Recognition of the Elements of Financial Statements

Recognition is the process of incorporating in the balance sheet or statement of profit and loss an item that meets the definition of an element and satisfies the criteria for recognition. It involves the depiction of the item in words and by a monetary amount and the inclusion of that amount in the totals of balance sheet or statement of profit and loss. Items that satisfy the recognition criteria should be recognised in the balance sheet or statement of profit and loss. The failure to recognise such items is not rectified by disclosure of the accounting policies used nor by notes or explanatory material.

An item that meets the definition of an element should be recognised if:

(a) It is probable that any future economic benefit associated with the item will flow to or from the enterprise; and

(b) The item has a cost or value that can be measured with reliability.

In assessing whether an item meets these criteria and therefore qualifies for recognition in the financial statements, regard needs to be given to the materiality considerations. The interrelationship between the elements means that an item that meets the definition and recognition criteria for a particular element, for example, an asset, automatically requires the recognition of another element, for example, income or a liability.

The Probability of Future Economic Benefits

The concept of probability is used in the recognition criteria to refer to the degree of uncertainty that the future economic benefits associated with the item will flow to or from the enterprise. The concept is in keeping with the uncertainty that characterizes the environment in which an enterprise operates. Assessments of the degree of uncertainty attaching to the flow of future economic benefits are made on the basis of the evidence available when the financial statements are prepared. For example, when it is probable that a receivable will be realized, it is then justifiable, in the absence of any evidence to the contrary, to recognise the receivable as an asset. For a large population of receivables, however, some degree of non payment is normally considered probable; hence, an expense representing, the expected reduction in economic benefits is recognised.

Reliability of Measurement

The second criterion for the recognition of an item is that it possesses a cost or value that can be measured with reliability. In many cases, cost or value must be estimated; the use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability. When, however, a reasonable estimate cannot be made, the item is not recognised in the balance sheet or statement of profit and loss. For example, the damages payable in a lawsuit may meet the definitions of a liability as well as an expense as well as the probability criterion for recognition; however, if it is not possible to measure the claim reliably, it should not be recognised as a liability or as an expense.

An item that, at a particular point in time, fails to meet the recognition criteria may qualify for recognition at a later date as a result of subsequent circumstances or events.

An item that possesses the essential characteristics of an element but fails to meet the criteria for recognition may nonetheless warrant disclosure in the notes, explanatory material or supplementary schedules. This is appropriate when knowledge of the item is considered to be relevant to the evaluation of the financial position, performance and cash flows of an enterprise by the users of financial statements. Thus, in the above example, the existence of the claim would need to be disclosed in the notes, explanatory material or supplementary schedules.

Recognition of Assets

An asset is recognised in the balance sheet when it is probable that the future economic benefits associated with it will flow to the enterprise and the asset has a cost or value that can be measured reliably.

An asset is not recognised in the balance sheet when expenditure has been incurred for which it is considered improbable that economic benefits will flow to the enterprise beyond the current accounting period. Instead, such a transaction results in the recognition of an expense in the statement of profit and loss. This treatment does not imply either that the intention of management in incurring expenditure was other than to generate future economic benefits for the enterprise or that management was misguided.

The only implication is that the degree of certainty that economic benefits will flow to the enterprise beyond the current accounting period is insufficient to warrant the recognition of an asset.

Recognition of Liabilities

A liability is recognised in the balance sheet when it is probable that an outflow of resources embodying economic benefits will result from the settlement of a present obligation and the amount at which the settlement will take place can be measured reliably. In practice, obligations under contracts that are equally proportionately unperformed (for example, liabilities for inventory ordered but not yet received) are generally not recognised as liabilities in the financial statements. However, such obligations may meet the definition of liabilities and, provided the recognition criteria are met in the particular circumstances, may qualify for recognition. In such circumstances, recognition of liabilities entails recognition of related assets or expenses.

Recognition of Income

Income is recognised in the statement of profit and loss when an increase in future economic benefits related to an increase in an asset or a decrease of a liability has arisen that can be measured reliably. This means, in effect, that recognition of income occurs simultaneously with the recognition of increases in assets or decreases in liabilities (for example, the net increase in assets arising on a sale of goods or services or the decrease in liabilities arising from the waiver of a debt payable).

Recognition of Expenses

Expenses are recognised in the statement of profit and loss when a decrease in future economic benefits related to a decrease in an asset or an increase of a liability has arisen that can be measured reliably. This means, in effect, that recognition of expenses occurs simultaneously with the recognition of an increase of liabilities or a decrease in assets (for example, the accrual of employees' salaries or the depreciation of plant and machinery).

Matching of Costs with Revenues: Many expenses are recognised in the statement of profit and loss on the basis of a direct association between the costs incurred and the earning of specific items of income. This process, commonly referred to as the matching of costs with revenues, involves the simultaneous or combined recognition of revenues and expenses that result directly and jointly from the same transactions or other events; for example, the various components of expense making up the cost of goods sold are recognised at the same time as the income derived from the sale of the goods. However, the application of the matching concept under this Framework does not allow the recognition of items in the balance sheet that do not meet the definition of assets or liabilities.

Systematic and Rational Allocation: When economic benefits are expected to arise over several accounting, periods and the association with income can only be broadly or indirectly determined, expenses are recognised in the statement of profit and loss on the basis of systematic and rational allocation procedures. This is often necessary in recognising the expenses associated with the using up of assets such as plant and machinery, goodwill, patents and trademarks; in such cases, the expense is referred to as depreciation or amortization. These allocation procedures are intended to recognise expenses in the accounting periods in which the economic benefits associated with these items are consumed or expire.

Immediate Recognition: An expense is recognised immediately in the statement of profit and loss when expenditure produces no future economic benefits. An expense is also recognised to the extent that future economic benefits from an expenditure, do not qualify, or cease to qualify, for recognition in the balance sheet as an asset. An expense is recognised in the statement of profit, and loss in those cases also where a liability is incurred without the recognition of an asset, for example, in the case of a liability under a product warranty.

11. Measurement of the Elements of Financial Statements

Measurement is the process of determining the monetary amounts at which the elements of financial statements are to be recognised and carried in the balance sheet and statement of profit and loss. This involves the selection of the particular basis of measurement.

A number of different measurement bases are employed to different degrees and in varying combinations in financial statements, They include the following:

(a) *Historical cost.* Assets are recorded at the amount of cash or cash equivalents paid or the fair value' of the other consideration given to acquire them at the time of their acquisition. Liabilities are recorded at the amount of proceeds received in exchange for the obligation, or in some circumstances (for example, income taxes), at the amounts of cash or cash equivalents expected to be paid to satisfy the liability in the normal course of business.

(b) *Current cost.* Assets are carried at the amount of cash or cash equivalents that would have to be paid if the same or an equivalent asset were acquired currently. Liabilities are carried at the undiscounted amount of cash or cash equivalents that would be required to settle the obligation currently.

(c) *Realisable (settlement) value.* Assets are carried at the amount of cash or cash equivalents that could currently be obtained by selling the asset in an orderly disposal. Liabilities are carried at their settlement values, that is, the undiscounted amounts of cash or cash equivalents expected to be required to settle the liabilities in the normal course of business.

(d) *Present value.* Assets are carried at the present value of the future net cash inflows that the item is expected to generate in the normal course of business. Liabilities are carried at the present value of the future net cash outflows that are expected to be required to settle the liabilities in the normal course of business.

The measurement basis most commonly adopted by enterprises in preparing their financial statements is historical cost. This is usually combined with other measurement bases. For example, inventories are usually carried at the lower of cost and net realisable value and pension liabilities are carried at their present value.

Furthermore, the current cost basis may be used as a response to the inability of the historical cost accounting model to deal with the effects of changing prices of non-monetary assets.

12. Concepts of Capital and Capital Maintenance

Concepts of Capital

Under a financial concept of capital, such as invested money or invested purchasing power, capital is synonymous with the net assets or equity of the enterprise. Under a physical concept of capital, such as operating capability, capital is regarded as the productive capacity of the enterprise based on, for example, units of output per day.

The selection of the appropriate concept of capital by an enterprise should be based on the needs of the users of its financial statements. Thus, a financial concept of capital should be adopted if the users of financial statements are primarily concerned with the maintenance of nominal invested capital or the purchasing power of invested capital. If, however, the main concern of users is with the operating capability of the enterprise, a physical concept of capital should be used. The concept chosen indicates the goal to be attained in determining profit, even though there may be some measurement difficulties in making the concept operational.

Concepts of Capital Maintenance and the Determination of Profit

The concepts of capital described above give rise to the following concepts of capital maintenance:

(a) *Financial capital maintenance:* Under this concept, a profit is earned only if the financial (or money) amount of the net assets at the end of the period exceeds the financial (or money) amount of net assets at the beginning of the period, after excluding any distributions to, and contributions from, owners during the period. Financial capital maintenance can be measured in either nominal monetary units or units of constant purchasing power.

(b) *Physical capital maintenance:* Under this concept, a profit is earned only if the physical productive capacity (or operating capability) of the enterprise at the end of the period exceeds the physical productive capacity at the beginning of the period, after excluding any distributions to, and contributions from, owners during the period.

The concept of capital maintenance is concerned with how an enterprise defines the capital that it seeks to maintain. It provides the linkage between the concepts of capital and the concepts of profit because it provides the point of reference by which profit is measured; it is a prerequisite for distinguishing between an enterprise's return on capital and its return of capital; only inflows of assets in excess of amounts needed to maintain capital can be regarded as profit and therefore as a return on capital. Hence, profit is the residual amount that remains after expenses (including capital maintenance adjustments, where appropriate) have been deducted from income. If expenses exceed income, the residual amount is a net loss

The physical capital maintenance concept requires the adoption of the current cost basis of measurement. The financial capital maintenance concept, however, does not require the use of a particular basis of measurement. Selection of the basis under this concept is dependent on the type of financial capital that the enterprise is seeking to maintain.

The principal difference between the two concepts of capital maintenance is the treatment of the effects of changes in the prices of assets and liabilities of the enterprise. In general terms, an enterprise has maintained its capital if it has as much capital at the end of the period as it had at the beginning of the period. Any amount over and above that required for maintaining the capital at the beginning of the period is profit.

Under the concept of financial capital maintenance where capital is defined in terms of nominal monetary units, profit represents the increase in nominal money capital over the period. Thus, increases in the prices of assets held over the period, conventionally referred to as holding gains, are, conceptually, profits. They may not be recognised as such, however, until the assets are disposed of in an exchange transaction. When the concept of financial capital maintenance is defined in terms of constant purchasing power units, profit represents the increase in invested purchasing power over the period. Thus, only that part of the increase in the prices of assets that exceeds the increase in the general level of prices is regarded as profit. The rest of the increase is treated as a capital maintenance adjustment and, hence, as part of equity.

Under the concept of physical capital maintenance when capital is defined in terms of the physical productive capacity, profit represents the increase in that capital over the period. All price changes affecting the assets and liabilities of the enterprise are viewed as changes in the measurement of the physical productive capacity of the enterprise; hence, they are treated as capital maintenance adjustments that are part of equity and not as profit.

The selection of the measurement bases and concept of capital maintenance will determine the accounting model used in the preparation of the financial statements. Different accounting models exhibit different degrees of relevance and reliability and, as in other areas; management must seek a balance between relevance and reliability. This Framework is applicable to a range of accounting models and provides guidance on preparing and presenting the financial statements under the chosen model.

IASB'S (EARLIER IASC) CONCEPTUAL FRAMEWORK

The International Accounting Standards Committee had issued a conceptual framework for the preparation and presentation of financial statements in July 1989. In 2001, the IASB readopted the framework. The material on the objective of financial reporting and on the qualitative characteristics of financial information was revised by the IASB in 2010 as a result of a joint project with the US-National Standard Letter, the Financial Accounting Standards Board (FASB).

Tho Conceptual Framework describes the objective of, and the concepts for general purpose financial reporting. It is practical tool that

- assists the board to develop IFRS standards that are based on consistent concepts;

- assists preparers to develop consistent accounting policies when no IFRS standard applies to a particular transition or event, or when a standard allows a choice of accounting policy; and
- assist others to understand and interpret the standards.

The objective of Conceptual Framework is to improve financial reporting by providing a more complete, clear and updated set of concepts. To achieve this, the Board is building on the existing Conceptual Framework, updating it, improving it and filling in the gaps instead of fundamentally reconsidering all aspects of the Conceptual Framework.[3]

Figure 2.1 provides an view of the IASB's conceptual framework, also referred to as the Framework. The first level identified 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 statement (assets, liabilities, and so on). The third level identifies the recognition, measurement, and disclosure concepts used in establishing and applying accounting

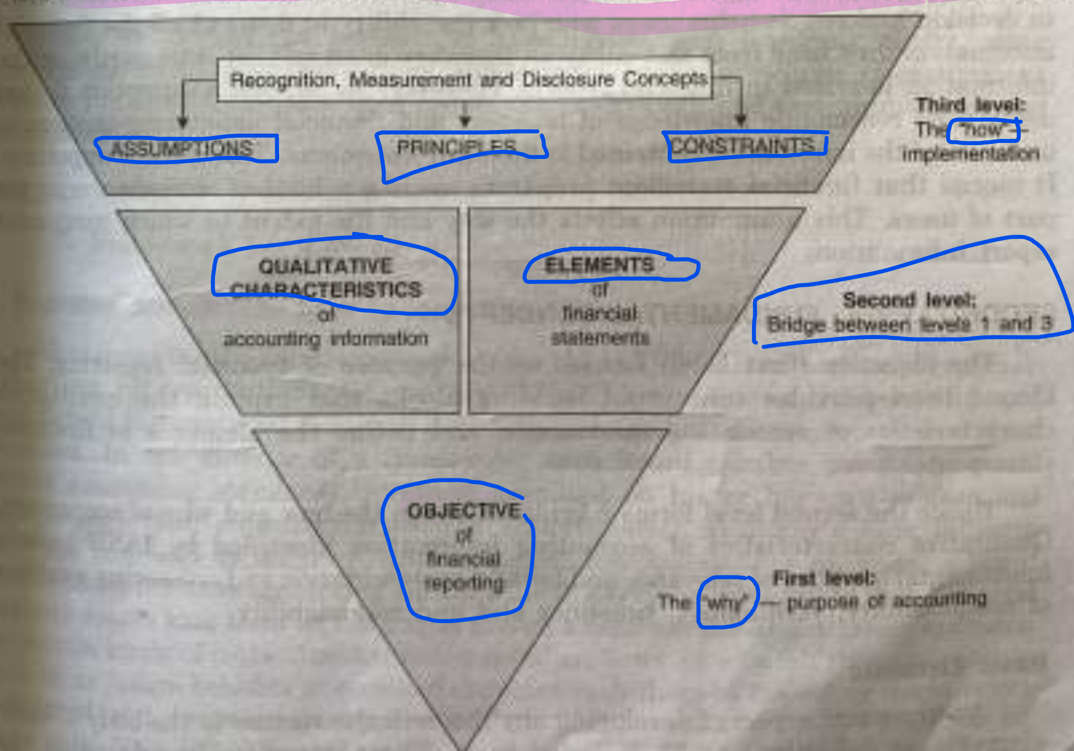

FIG. 2.1: IASB's Framework for Financial Reporting

Source: Donald E. Kiesco, Jerry J. Weygandt, Terry D. Warfield, *Intermediate Accounting, IFRS Edition*, 2nd Edition, Wiley Publishing, pp. 2.2-2.16.

standards and the specific concepts to implement the objective. These concepts include assumptions, principles, and constraints that describe the present reporting environment.[4]

FIRST LEVEL: BASIC OBJECTIVE

The objective of financial reporting is the foundation of the 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 the 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, other creditors in making decisions in their capacity as capital providers.

Companies prepare general purpose financial statements to provide information to decision makers. It helps users who lack the ability to demand all the financial information they need from and entity an therefore must rely, at least partly, on the information provided in financial reports. However, an implicit assumption is that users need reasonable knowledge of business and financial accounting matters to understand the information contained in financial statements. This point is important. It means that financial statement preparers assume a level of competence on the part of users. This assumption affects the way and the extent to which companies report information.

SECOND LEVEL: FUNDAMENTAL CONCEPTS

The objective (first level) focuses on the purpose of financial reporting. The second level provides conceptual building blocks that explain the qualitative characteristics of accounting information and define the elements of financial statements.

Hence the second level forms a bridge between the how and why of accounting. Qualitative characteristics of accounting information identified by IASB include fundamental qualities of relevance and faithful representation and enhancing qualities of comparability, verifiability, timelines and understandability.

Basic Elements

An important aspect of developing any theoretical structure is the body of basic elements or definitions to be included in it. These are directly related to the measurement of financial position and are assets, liabilities, and equity. These are defined as follows:

- ***Asset:*** A resource controlled by entity as a result of past events and from which future economic benefits are expected to flow to the entity.
- ***Liability:*** A present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic liabilities.
- ***Equity:*** The residual interest in the assets of the entity after deducting all its liabilities.

The elements of income and expenses are defined as follows.

- ***Income:*** Increases (in economic benefits during the accounting period) in the form of Inflows or enhancements of assets or decreases of liabilities that result in increase in equity, (other than those relating to contributions from equity participants).
- ***Expense:*** Decrease outflows or depletions of assets or incurrences of liabilities that result in decrease in income.

THIRD LEVEL: RECOGNITION, MEASUREMENT, AND DISCLOSURE CONCEPTS

Here, we identify the concepts as basic assumptions (economic entity, going concern, monetary unit, periodicity and accrual basis), principles (measurement revenue recognition, expense recognition, full disclosure), and constraints (cost and materiality).

USES OF CONCEPTUAL FRAMEWORK

be, financial statements can lose credibility if they lack a conceptual underpinning.

USA'S FASB'S CONCEPTUAL FRAMEWORK

The Financial Accounting Standards Board of USA has identified the following components of conceptual framework for financial accounting and reporting (Figure 2.2). Between 1978 and 1985, the FASB issued six Statements of Financial Accounting Concepts (SFAC).

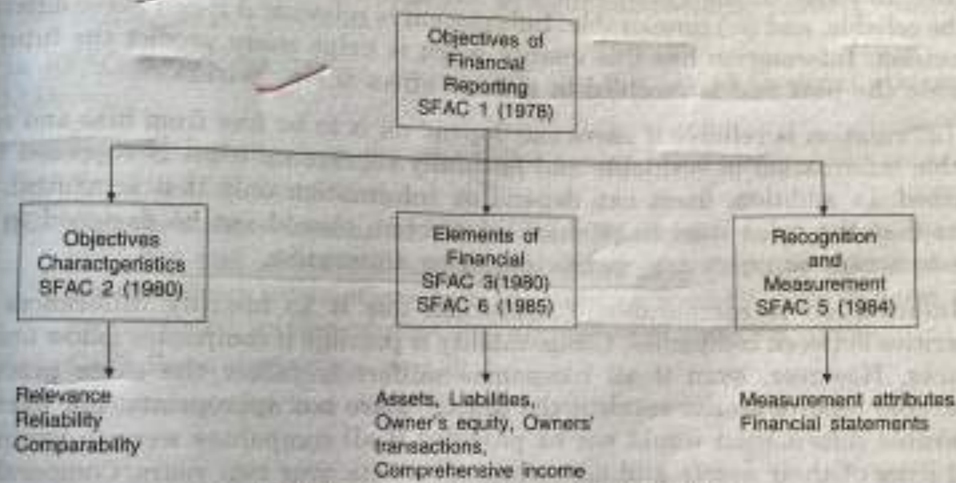

FIG. 2.2. USA's FASB Conceptual framework

These concept statements are not the same as the FASB's Statements of Financial Accounting Standards (SFASs). The SFASs are authoritative statements of generally accepted accounting principles that must be followed. The SFACs are guidelines the Board uses in developing new standards. Accountants are not required to follow the SFACs in practice. The conceptual framework developed by FASB consists of the following components:

1. The Objectives of Financial Reporting

The FASB's first Statement of Financial Accounting Concepts (SFAC 1)(1978) identified the broad objectives of financial reporting. The first and most general objective stated in SFAC 1 is to "provide information that is useful to present and potential investors and creditors and other users in making rational investment credit, and similar decisions. These objectives recognize (i) that financial reporting should help users predict future cash flows, and (ii) that information about a company's resources and obligations is useful in making such predictions. All the concepts in the conceptual framework are intended to be consistent with these general objectives. In USA, present accounting practice already provides information about a company's resources and obligation. Thus, although the conceptual framework is intended to be prescriptive of new and improved practices, the concepts in the framework are also descriptive of many current practices.

2. The Qualities of Useful Information

The next component is the conceptual framework is the qualities (or qualitative characteristics) that financial informant should have if it is to be useful in decisions making. In SFAC 2, the FASB said that information is useful if it is (1) relevant, (ii) the reliable, and (iii) comparable. Information is relevant if it can make difference in decision. Information has this quality when it helps users predict the future or evaluate the past and is received in time to affect their decision.

Information is reliable if users can depend on it to be free from bias and error. Reliable information is verifiable and faithfully represents what is supposed to be described. In addition, users can depend on information only if it is neutral. This means that the rules used to produce information should not be designed to lead users to accept or reject any specific decisions alternative.

Information is comparable if users can use it to identify differences and similarities between companies. Comparability is possible if companies follow uniform practices. However, even if all companies uniformly follow the same practices, comparable reports do not result if the practices are not appropriate. For example, comparable information would not be provided if all companies were to ignore the useful lives of their assets and depreciate all assets ovor two years. Comparability also requires consistency, which means that a company should not changes its accounting practices unless the change is justified as a reporting, improvement. Another important concept discussed in SFAC 2 is materiality.

3. Elements of Financial Statements

Another important step in developing a conceptual framework is to determine the elements of financial statements. This involves defining the categories of information that should be contained in financial reports. The FASB's discussion of financial statement elements includes definitions of important elements such as assets, liabilities, equity, revenues, expenses, gains, and losses. The FASB's pronouncement on financial statement elements was first published in 1980 as SFAC3. SFAC6 replaced it in 1985, which modified the discussion of financial statement elements to include several elements for not for-profit accounting entities.

4. Recognition and Measurement

In SFAC 5, "Recognition and Measurement in Financial Statements of Business Enterprises", the FASB established concepts for deciding (1) when items should be presented (or recognized) in the financial statements, and (2) how to assign numbers to (or measure) those items. In general, the FASB has said that items should be recognized in the Financial Statements if they meet the following, criteria:

(i) Definitions — The item meets the definition of an element of financial statements;

(ii) Measurability — It has a relevant attribute measurable with sufficient reliability;

(iii) Relevance — The information about it is capable of making a difference in user decisions;

(iv) Reliability — The information is representationally faithful, verifiable, and neutral.

In SFAC 5, the FASB has stated that the full set of financial statements should show:

(i) Financial position at the end of the period

(ii) Earnings for the period

(iii) Comprehensive income for the period. (This new concept is broader than earnings and includes all changes in owners' equity other than those that resulted from transactions with the owners. Some changes in asset value are included in this concept but are excluded from earnings).

(iv) Cash flows during the period.

(v) Investments by and distributions to owners during the period.

REFERENCES