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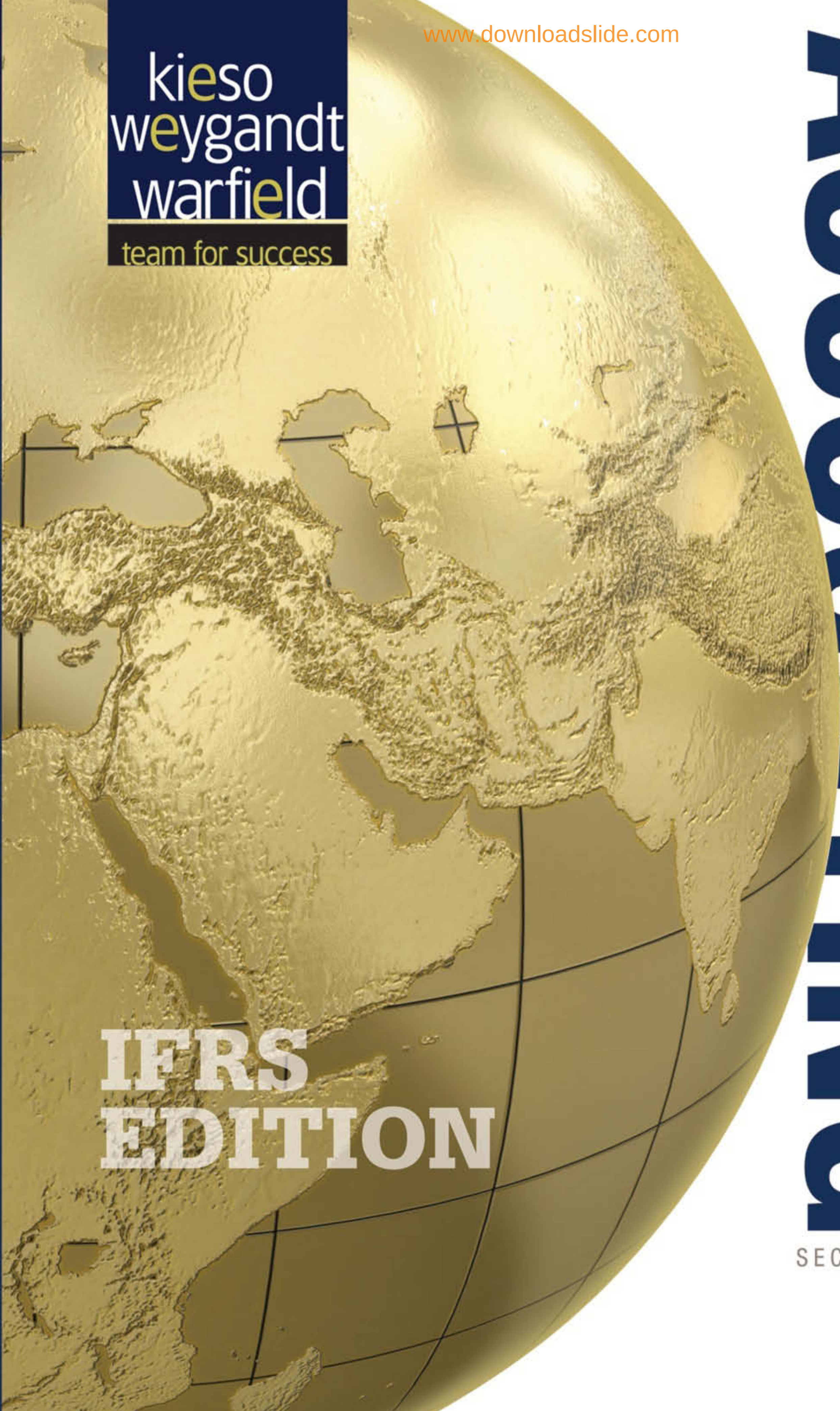

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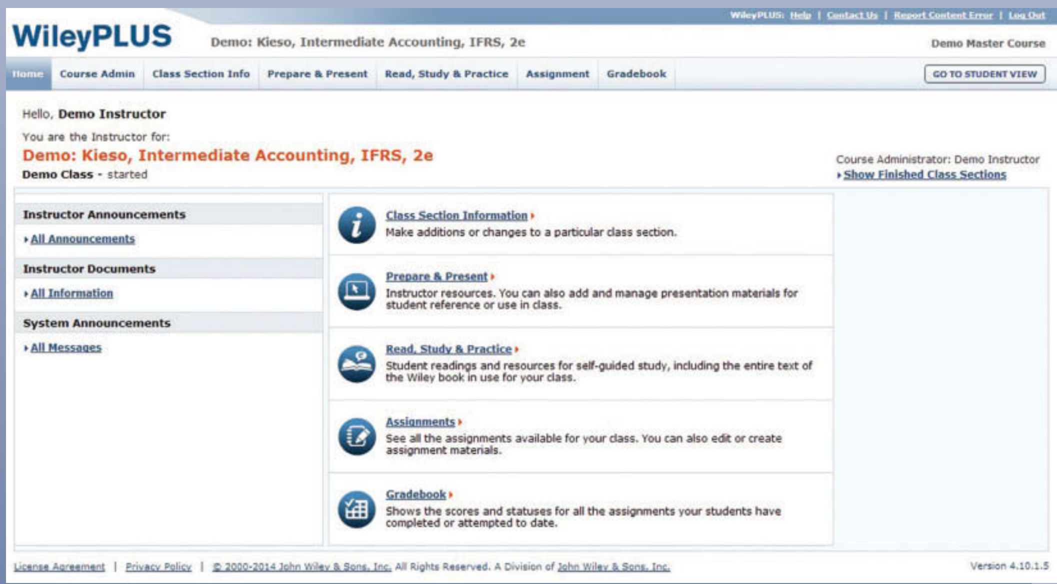


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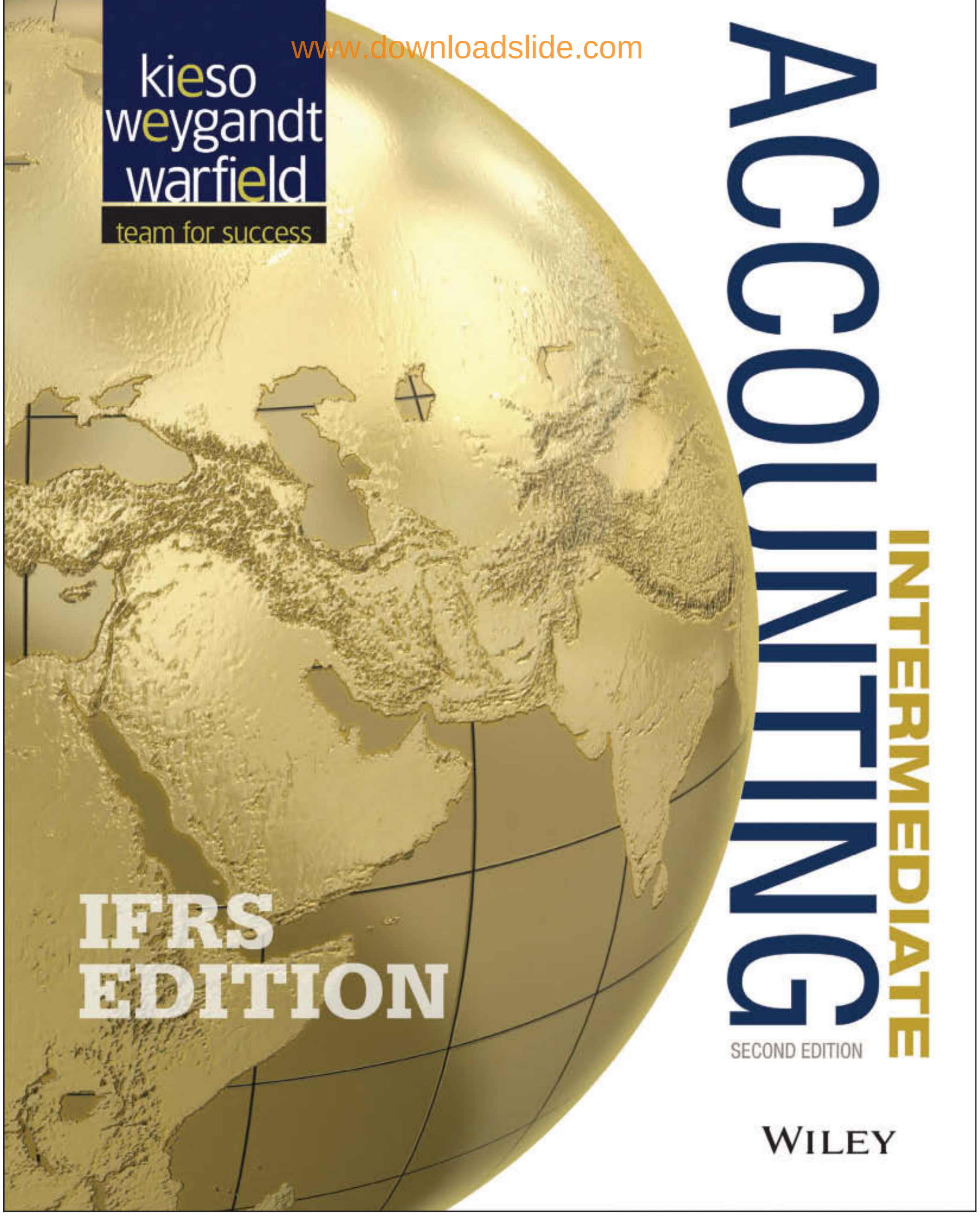


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# Brief Contents

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# Author Commitment

## Don Kieso

Donald E. Kieso, PhD, CPA, received his bachelor's degree from Aurora University and his doctorate in accounting from the University of Illinois. He has served as chairman of the Department of Accountancy and is currently the KPMG Emeritus Professor of Accountancy at Northern Illinois University. He has public accounting experience with Price Waterhouse & Co. (San Francisco and Chicago) and Arthur Andersen & Co. (Chicago) and research experience with the Research Division of the American Institute of Certified Public Accountants (New York). He has done post-doctorate work as a Visiting Scholar at the University of California at Berkeley and is a recipient of NIU's Teaching Excellence Award and four Golden Apple Teaching Awards. Professor Kieso is the author of other accounting and business books and is a member of the American Accounting Association, the American Institute of Certified Public Accountants, and the Illinois CPA Society. He has served as a member of the Board of Directors of the Illinois CPA Society, then AACSB's Accounting Accreditation Committees, the State of Illinois Comptroller's Commission, as Secretary-Treasurer of the Federation of Schools of Accountancy, and as Secretary-Treasurer of the American Accounting Association. Professor Kieso is currently serving on the Board of Trustees and Executive Committee of Aurora University, as a member of the Board of Directors of Kishwaukee Community Hospital, and as Treasurer and Director of Valley West Community Hospital. From 1989 to 1993, he served as a charter member of the National Accounting Education Change Commission. He is the recipient of the Outstanding Accounting Educator Award from the Illinois CPA Society, the FSA's Joseph A. Silvoso Award of Merit, the NIU Foundation's Humanitarian Award for Service to Higher Education, a Distinguished Service Award from the Illinois CPA Society, and in 2003 an honorary doctorate from Aurora University.

## Jerry Weygandt

Jerry J. Weygandt, PhD, CPA, is Arthur Andersen Alumni Emeritus Professor of Accounting at the University of Wisconsin—Madison. He holds a Ph.D. in accounting from the University of Illinois. Articles by Professor Weygandt have appeared in the *Accounting Review, Journal of Accounting Research, Accounting Horizons, Journal of Accountancy,* and other academic and professional journals. These articles have examined such financial reporting issues as accounting for price-level adjustments, pensions, convertible securities, stock option contracts, and interim reports. Professor Weygandt is author of other accounting and financial reporting books and is a member of the American Accounting Association, the American Institute of Certified Public Accountants, and the Wisconsin Society of Certified Public Accountants. He has served on numerous committees of the American Accounting Association and as a member of the editorial board of the Accounting Review; he also has served as President and Secretary-Treasurer of the American Accounting Association. In addition, he has been actively involved with the American Institute of Certified Public Accountants and has been a member of the Accounting Standards Executive Committee (AcSEC) of that organization. He has served on the FASB task force that examined the reporting issues related to accounting for income taxes and served as a trustee of the Financial Accounting Foundation. Professor Weygandt has received the Chancellor's Award for Excellence in Teaching and the Beta Gamma Sigma Dean's Teaching Award. He is on the board of directors of M & I Bank of Southern Wisconsin. He is the recipient of the Wisconsin Institute of CPA's Outstanding Educator's Award and the Lifetime Achievement Award. In 2001, he received the American Accounting Association's Outstanding Educator Award.

## Terry Warfield

Terry D. Warfield, PhD, is the PwC Professor in Accounting at the University of Wisconsin—Madison. He received a B.S. and M.B.A. from Indiana University and a Ph.D. in accounting from the University of Iowa. Professor Warfield's area of expertise is financial reporting, and prior to his academic career, he worked for five years in the banking industry. He served as the Academic Accounting Fellow in the Office of the Chief Accountant at the U.S. Securities and Exchange Commission in Washington, D.C. from 1995–1996. Professor Warfield's primary research interests concern financial accounting standards and disclosure policies. He has published scholarly articles in *The Accounting Review, Journal of Accounting and Economics, Research in Accounting Regulation,* and *Accounting Horizons,* and he has served on the editorial boards of *The Accounting Review, Accounting Horizons,* and *Issues in Accounting Education*. He has served as president of the Financial Accounting and Reporting Section, the Financial Accounting Standards Committee of the American Accounting Association (Chair 1995–1996), and on the AAA-FASB Research Conference Committee. He also served on the Financial Accounting Standards Advisory Council of the Financial Accounting Standards Board. He currently serves as a trustee on the Financial Accounting Foundation. Professor Warfield has received teaching awards at both the University of Iowa and the University of Wisconsin, and he was named to the Teaching Academy at the University of Wisconsin in 1995. Professor Warfield has developed and published several case studies based on his research for use in accounting classes. These cases have been selected for the AICPA Professor-Practitioner Case Development Program and have been published in *Issues in Accounting Education*.

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# From the Authors

Globalization is occurring rapidly. As economic and other interactions increase among countries, capital markets must provide high-quality financial information. A need therefore exists for high-quality financial reporting standards that meet this objective. Fortunately, **International Financial Reporting Standards (IFRS)** has broad international acceptance, being used in some form by more than 115 countries around the world. One securities regulator noted that IFRS is best positioned to serve as the single set of high-quality accounting standards.

## Change Is the Only Constant

Most countries want rapid action related to the acceptance of IFRS. A number of countries have already switched from their own version of accounting standards to IFRS. Students and instructors need educational materials related to IFRS in order to meet this new challenge. Our objective in revising *Intermediate Accounting*, IFRS Edition, was therefore to continue to provide the tools needed to understand what IFRS is and how it is applied in practice. The emphasis on fair value, the proper accounting for financial instruments, and the new developments related to leasing, revenue recognition, and financial statement presentation are examined in light of current practice. In addition, given the rapid changes taking place, we provide and discuss the new Conceptual Framework to understand how these issues will likely be resolved in the future.

> "If this textbook helps you appreciate the challenges, worth, and limitations of financial reporting, if it encourages you to evaluate critically and understand financial accounting concepts and practice, and if it prepares you for advanced study, professional examinations, and the successful and ethical pursuit of your career in accounting or business in a global economy, then we will have attained our objectives."

## A Look at Global Accounting

While IFRS has achieved broad acceptance, not all countries have adopted it. For example, U.S. companies still follow U.S. generally accepted accounting principles (U.S. GAAP) in preparing their financial statements. In fact, the differences between IFRS and U.S. GAAP may provide certain companies with a competitive advantage, so understanding these differences may be important in analyzing company performance. In addition, the IASB and the FASB are working together to converge their standards as appropriate. Accordingly, we have included a **Global Accounting Insights** section at the end of selected chapters, to highlight the important differences that remain between IFRS and U.S. GAAP, as well as the ongoing joint convergence efforts to resolve them. As a result, students truly gain a global accounting education by studying this textbook.

## *Intermediate Accounting* Works

*Intermediate Accounting,* Fifteenth Edition (based on U.S. GAAP) is the market-leading textbook in providing the tools needed to understand what U.S. GAAP is and how it is applied in practice. With this IFRS Second Edition, we strive to continue to provide the material needed to understand this subject area using IFRS. The book is comprehensive and up-to-date, and provides the instructor with flexibility in the topics to cover. We also include proven pedagogical tools, designed to help students learn more effectively and to answer the changing needs of this course.

We are excited about *Intermediate Accounting,* IFRS Second Edition. We believe it meets an important objective of providing useful information to educators and students interested in learning about IFRS. Suggestions and comments from users of this textbook will be appreciated. Please feel free to e-mail any one of us at *AccountingAuthors@yahoo.com*.

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# What's New?

The Second Edition expands our emphasis on student learning and improves upon a teaching and learning package that instructors and students have rated the highest in customer satisfaction. We have developed a number of new pedagogical features and content changes, designed both to help students learn more effectively and to answer the changing needs of the course.

## Evolving Issues

As we continue to strive to reflect the constant changes in the accounting environment, we have added a new feature to the Second Edition, **Evolving Issue** boxes, which highlight and discuss areas in which the profession may be encountering controversy or nearing resolution. Our hope is that these high-interest boxes will increase student engagement, as well as serve as classroom discussion points. For another source of high-interest material, see the **What Do the Numbers Mean?** boxes, most of which are new to this edition.

## Global Accounting Insights

We have updated the end-of-chapter section, **Global Accounting Insights** (previously known as the Convergence Corner), throughout the textbook. In addition, we now present *Similarities* as well as *Differences* between U.S. GAAP and IFRS to increase student understanding.

## Major Content Revisions

In response to the changing environment, we have significantly revised several chapters.

### Chapter 2 Conceptual Framework for Financial Reporting

- Updated discussion on the IASB's guidance related to the use of fair value in financial statements, including the establishment of the fair value hierarchy.
- New illustration on the five steps of revenue recognition.
- Revised Constraints section, as now only cost constraint is included in the Conceptual Framework.

### Chapter 4 Income Statement and Related Information

- New sections on the one statement and two statement formats for reporting components of other comprehensive income.
- Rewrote the Allocating to Non-Controlling Interest section to increase student understanding.

### Chapter 18 Revenue Recognition

- Completely new chapter reflecting the very recent IFRS on revenue recognition.
- Numerous new illustrations providing case examples for correctly applying the new IFRS on revenue recognition.

### Chapter 20 Accounting for Pensions and Postretirement Benefits

- New sections on the net defined benefit obligations and how to report changes for it.
- Updated section on past service cost, including discussion of curtailments.

### Chapter 23 Statement of Cash Flows

- Reorganized chapter, to present the indirect method through preparation of the statement of cash flows first, followed by the discussion of the direct method as well as the advantages and disadvantages of both methods.
- New Evolving Issue, "Direct versus Indirect Controversy," on the arguments in favor of each method.

See the next two pages for a complete list of content revisions by chapter.

## Supplementary Materials

The Solutions Manual, Test Bank, PowerPoint, Instructor's Manual, and all other materials were updated to reflect changes in the Second Edition. Instructor resources and additional student resources, such as online self-tests, are available at **www.wiley.com/college/kieso**. Supplementary materials are also available in *WileyPLUS* where additional resources can help instructors create assignments and track student progress. Additional Course Management Resources are available.

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# Content Changes by Chapter

**Chapter 1 Financial Accounting and Accounting Standards**
- Revised opening story, to include more recent commentaries on IFRS.
- New WDNM box, on recent progress toward global adoption of IFRS.
- Updated and expanded discussion of the IASB's standard-setting structure.
- Revised International Convergence section, to include recent developments.
- Moved Appendix 1A, The U.S. Standard-Setting Environment, to book's companion website.

**Chapter 2 Conceptual Framework for Financial Reporting**
- Updated Conceptual Framework discussion to reflect recent IASB discussion paper, e.g., materiality no longer considered a separate constraint.
- Updated discussion on fair value, including the establishment of the fair value hierarchy, and the revenue recognition principle.
- New WDNM boxes, on the importance of faithful representation, as exemplified by the scandal at **Olympus Corp.**, and the concept of prudence.
- Updated discussion plus added an illustration on the five steps of revenue recognition.
- Updated Constraints section as now only cost constraint is included in the Conceptual Framework.

**Chapter 3 The Accounting Information System**
- New opening story on impact of global economic crime.
- Enhanced Adjusting Entries section, to provide additional explanation and visuals to students.
- New WDNM box, on companies' need to update their accounting information systems yet unwillingness to interrupt their operations to do so.

**Chapter 4 Income Statement and Related Information**
- Updated opening story, to discuss recent IASB project on financial statement presentation.
- New sections on the one statement and two statement formats for reporting components of other comprehensive income.
- Rewrote Allocation to Non-Controlling Interest section, to increase student understanding.
- New WDNM boxes, on a recent study that reinforces concerns about earnings management and the use of pro forma earnings measures.
- New Evolving Issue on income reporting.

**Chapter 5 Statement of Financial Position and Statement of Cash Flows**
- New WDNM box, on presentation order of assets on the statement of financial position.
- New Evolving Issue, on statement of financial position reporting.
- Moved **M&S**'s financial statements from Appendix 5B to Appendix A at end of textbook.

**Chapter 6 Accounting and the Time Value of Money**
- New opening story, about developing fair value estimates and applying fair value guidance to specific examples.

**Chapter 7 Cash and Receivables**
- Revised opening story, about banks' bad debt allowances.
- New WDNM box, on consequences of requiring companies to value their securities at fair value.
- New Evolving Issue, on the three-bucket approach of classifying loans and impairment stages.

**Chapter 8 Valuation of Inventories: A Cost-Basis Approach**
- New opening story, about the difficulties in determining the point at which inventory is considered to be sold.
- Moved Appendix 8B (Special Issues Related to LIFO) and related assignment material to book's companion website.
- Deleted material on sales on installment in Special Sales Agreements section.

**Chapter 9 Inventories: Additional Valuation Issues**
- New opening story, about why investors need comparable information about inventory when evaluating retailers' financial statements.

**Chapter 10 Acquisition and Disposition of Property, Plant, and Equipment**
- New opening story, about importance of capital expenditures and how they can affect a company's income.

**Chapter 11 Depreciation, Impairments, and Depletion**
- New WDNM box, on why some companies do not use revaluation accounting.

**Chapter 12 Intangible Assets**
- New opening story, on increasing amount of sustainable information provided by companies.
- New Underlying Concepts note about surrounding controversy for R&D accounting.
- New WDNM boxes: (1) how companies protect their intangible assets, (2) the patent battles between e-tailers and cell phone companies, and (3) global R&D incentives.
- New Evolving Issue, on the recognition of R&D and internally generated intangibles.

**Chapter 13 Current Liabilities, Provisions, and Contingencies**
- Revised Unearned Revenues section, to correspond to recent revenue recognition standard.
- New section on value-added tax (VAT).
- New sections on assurance-type and service-type warranties.
- New Evolving Issue, on how to account for greenhouse gases.

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**Chapter 14 Non-Current Liabilities**

- New opening story, about the impact of long-term debt on governments and companies.
- New WDNM box, on why companies issue 100-year bonds.
- Updated Fair Value Option section, on how to treat changes in liability value due to credit risk changes.
- New footnote on IASB consolidation guidance for whether an off-balance-sheet entity should be on-balance-sheet.

**Chapter 15 Equity**

- Updated opening story, on the global IPO market.
- New WDNM boxes, on whether buybacks signal good or bad news about companies, and an analysis of recent company dividend payouts.
- Significantly enhanced Share Dividends and Share Splits sections to reflect recent information and pronouncements.

**Chapter 16 Dilutive Securities and Earnings per Share**

- Updated WDNM box on convertible bonds, to include more recent offerings from Asian companies.
- New illustration on company equity grants.

**Chapter 17 Investments**

- Revised WDNM box on fair value, to discuss controversial valuation of Greek government bond holdings.
- New illustration to clarify how to determine the adjustment to the carrying value of an investment.
- New Evolving Issue, on fair value controversy.
- New Appendix 17B on required fair value disclosures; deleted discussion of reclassification adjustments (old Appendix 17A).

**Chapter 18 Revenue Recognition**

- Completely rewritten chapter to reflect recently issued revenue recognition standard, including an overview and discussion of the five-step process.
- New opening story, featuring **Rolls-Royce**, **Qwest Communications**, **Sinovel Wind Group**, and **iGo**, to demonstrate challenges of recognizing revenue properly.
- New Evolving Issue, on the implementation of the recently issued revenue recognition standard.

**Chapter 19 Accounting for Income Taxes**

- Updated opening story, to include the most recent tax system recommendations by the G20.
- Updated footnotes on determining true cost of taxes and deferred tax assets (**Sony**'s experience in post-quake Japan).
- Expanded discussion of the components of income tax expense on the income statement.
- New WDNM box, on how a reduction in tax rates can be a double-edged sword for companies that have large deferred tax asset balances.

**Chapter 20 Accounting for Pensions and Postretirement Benefits**

- Chapter has been significantly revised to reflect recent IASB standards. Details are given below.
- Updated opening story, to include recent information about swings in pension plans' status.
- Updated WDNM box, to highlight increased popularity of defined contribution plans with employers as well as differences between countries in which plans are offered.
- New section on Net Defined Benefit Obligation (Asset).
- Rewrote Components of Pension Expense as new section, Reporting Changes in the Defined Benefit Obligation (Asset) to reflect recent IFRS.
- Expanded and updated section on Past Service Cost to reflect recent IASB rulings, including discussion of curtailments.
- New section on Remeasurements, replacing outdated discussion of corridor amortization.

**Chapter 21 Accounting for Leases**

- Updated opening story on aircraft leasing data and added information about IASB's work on new lease standard.
- New Evolving Issue, on proposal to address off-balance-sheet reporting of leases.

**Chapter 22 Accounting Changes and Error Analysis**

- New WDNM box, on how accounting changes create comparability challenges.
- Revised WDNM box, on need to protect company statements from negative effects of fraud.
- Reformatted examples of counterbalancing and non-counterbalancing errors as illustrations, for improved student understanding.

**Chapter 23 Statement of Cash Flows**

- Reorganized chapter, to present indirect method through preparation of the statement of cash flows first, followed by discussion of the direct method and advantages and disadvantages of both methods.
- New WDNM box, on COROA (cash operating return on assets), a new measure of profitability.
- Reformatted "Direct versus Indirect Controversy" as new Evolving Issue box, to highlight the arguments in favor of each method.
- New Underlying Concepts, on how statement of cash flows information and disclosures relate to the objective of financial reporting and the full disclosure principle.

**Chapter 24 Presentation and Disclosure in Financial Reporting**

- New opening story, about IASB survey of criticisms of current financial statement disclosures and how the Board plans to respond.
- New WDNM boxes: (1) requirements for disclosing collateral arrangements in repurchase agreements, (2) how note disclosure requirements can positively affect securities markets, and (3) differences in British forecasted information.
- New Evolving Issue, on anticipated increase in note disclosure requirements as IFRS and U.S. GAAP converge.
- New graphs on types and trends of economic crime and fraud.

**Appendices A-C (New!)**

Financial statements for **Marks & Spencer**, **adidas**, and **Puma**.

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# Acknowledgments


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## Practicing Accountants and Business Executives

*From the fields of corporate and public accounting, we owe thanks to the following practitioners for their technical advice and for consenting to interviews.*

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Suggestions and comments from users of this book will be appreciated. Please feel free to e-mail any one of us at *AccountingAuthors@yahoo.com*.


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CHAPTER 1

# Financial Reporting and Accounting Standards

## LEARNING OBJECTIVES

*After studying this chapter, you should be able to:*

1 Describe the growing importance of global financial markets and its relation to financial reporting.

2 Identify the major financial statements and other means of financial reporting.

3 Explain how accounting assists in the efficient use of scarce resources.

4 Explain the need for high-quality standards.

5 Identify the objective of financial reporting.

6 Identify the major policy-setting bodies and their role in the standard-setting process.

7 Explain the meaning of IFRS.

8 Describe the challenges facing financial reporting.

## Revolution in International Financial Reporting

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

A revolution is therefore occurring in financial reporting. In the past, many countries used their own set of standards or followed standards set by larger countries, such as those in Europe or in the United States. However, that situation is changing rapidly. A single set of rules, called International Financial Reporting Standards (IFRS), is now being used by over 115 countries. Here is what some are saying about IFRS.

- "The global financial crisis that began in 2007 and continues today provides a very clear illustration of the globally connected nature of financial markets and the pressing need for a single set of high quality global accounting standards. That is why the G20 . . . has supported the work of the IASB and called for a rapid move towards global accounting." [Michael Prada, chairman of the IFRS Foundation.]
- "Large multi-national companies stand to realize great benefits from a move to a single set of standards. Companies will have more streamlined IT, easier training, and there will be better communication with outside parties. In fact, the move to IFRS is not so much about the accounting but about the economics of a shrinking world." [Sir David Tweedie, former chairman of the IASB.]
- "The added costs from having to use this complex hodgepodge (different country reporting standards) of financial information can run in the tens of millions of dollars annually. In the international arena, they can act as a barrier to forming and allocating capital efficiently. Thus, there are growing demands for the development of a single set of high quality international accounting standards." [Robert Herz, former chairman of the FASB.]

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**INTERNATIONAL FOCUS**

> Read the **Global Accounting Insights** on pages 17–18 for a discussion of international financial reporting.

- "The current and growing breadth of IFRS adoption across the world suggests that IFRS has become the most practical approach to achieving the objective of having a single set of high-quality, generally accepted standards for financial reporting. Those who share this belief are influenced by the fact that the IASB's structure and due-process procedures are open, accessible, responsive, and marked by extensive consultation." [KPMG Defining Issues.]
- "Developments such as the shocks of the Asian financial crisis, the Enron and WorldCom scandals, and Europe's creation of a unified financial market helped build consensus for global accounting standards. Every relevant international organization has expressed its support for our work to develop a global language for financial reporting." [Hans Hoogervorst, chairman of the IASB, June 2013.]

What these statements suggest is that the international standard-setting process is rapidly changing. And with these changes, it is hoped that a more effective system of reporting will develop, which will benefit all.

## PREVIEW OF CHAPTER 1

As the opening story indicates, countries are moving quickly to adopt International Financial Reporting Standards (IFRS). It is estimated that as many as 310 of the 500 largest global companies are using IFRS. However, the accounting profession faces many challenges in establishing these standards, such as developing a sound conceptual framework, use of fair value measurements, proper consolidation of financial results, off-balance-sheet financing, and proper accounting for leases and pensions. This chapter discusses the international financial reporting environment and the many factors affecting it, as follows.

**Financial Reporting and Accounting Standards**

| Global Markets | Objective of Financial Reporting | Standard-Setting Organizations | Financial Reporting Challenges |
|---|---|---|---|
| • Financial statements and financial reporting<br>• Accounting and capital allocation<br>• High-quality standards | • General-purpose financial statements<br>• Equity investors and creditors<br>• Entity perspective<br>• Decision-usefulness | • IOSCO<br>• IASB<br>• Hierarchy of IFRS | • Political environment<br>• Expectations gap<br>• Significant financial reporting issues<br>• Ethics<br>• International convergence |

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# GLOBAL MARKETS

**LEARNING OBJECTIVE 1**
Describe the growing importance of global financial markets and its relation to financial reporting.

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

To provide some indication of the extent of globalization of economic activity, Illustration 1-1 provides a listing of the top 20 global companies in terms of sales.

| Rank | Company | Country | Revenues ($ millions) | Rank | Company | Country | Revenues ($ millions) |
|---|---|---|---|---|---|---|---|
| 1 | **Royal Dutch Shell** | Netherlands | 484,489 | 11 | **Total** | France | 231,580 |
| 2 | **ExxonMobil** | U.S. | 452,926 | 12 | **Volkswagen** | Germany | 221,551 |
| 3 | **Wal-Mart Stores** | U.S. | 446,950 | 13 | **Japan Post Holdings** | Japan | 211,019 |
| 4 | **BP** | U.K. | 386,463 | 14 | **Glencore International** | Switzerland | 186,152 |
| 5 | **Sinopec Group** | China | 375,214 | 15 | **Gazprom** | Russia | 157,831 |
| 6 | **China National Petroleum** | China | 352,338 | 16 | **E.ON** | Germany | 157,057 |
| 7 | **State Grid** | China | 259,142 | 17 | **ENI** | Italy | 153,676 |
| 8 | **Chevron** | U.S. | 245,621 | 18 | **ING Group** | Netherlands | 150,571 |
| 9 | **ConocoPhillips** | U.S. | 237,272 | 19 | **General Motors** | U.S. | 150,276 |
| 10 | **Toyota Motor** | Japan | 235,364 | 20 | **Samsung Electronics** | South Korea | 148,944 |

*Source: http://money.cnn.com/magazines/fortune/global500/2012/full_list/index.html.*

**ILLUSTRATION 1-1**
Top 20 Global Companies in Terms of Sales

In addition, due to technological advances and less onerous regulatory requirements, investors are able to engage in financial transactions across national borders and to make investment, capital allocation, and financing decisions involving many foreign companies. Also, many investors, in attempts to diversify their portfolio risk, have invested more heavily in international markets. As a result, an increasing number of investors are holding securities of foreign companies. For example, over a recent seven-year period, estimated investments in foreign equity securities by U.S. investors increased over 20-fold, from $200 billion to $4,200 billion.

An indication of the significance of these international investment opportunities can be found when examining the number of foreign registrations on various securities exchanges. As shown in Illustration 1-2, a significant number of foreign companies are found on national exchanges.

**ILLUSTRATION 1-2**
International Exchange Statistics

| Exchange (Location) | Total Share Trading ($ billions) | Total Listings | Domestic Listings | Foreign Listings | Foreign % |
|---|---|---|---|---|---|
| NYSE Euronext (U.S.) | 18,027,080 | 2,308 | 1,788 | 520 | 22.5 |
| NASDAQ OMX | 12,723,520 | 2,680 | 2,383 | 297 | 11.1 |
| Tokyo SE Group | 3,986,204 | 2,291 | 2,280 | 11 | 0.5 |
| London SE Group | 2,825,662 | 2,886 | 2,288 | 598 | 20.7 |
| NYSE Euronext (Europe) | 2,125,422 | 1,112 | 969 | 143 | 12.9 |
| Korea Exchange | 2,022,640 | 1,816 | 1,799 | 17 | 0.9 |
| Deutsche Börse (Germany) | 1,750,853 | 746 | 670 | 76 | 10.2 |
| Hong Kong Exchanges | 1,444,712 | 1,496 | 1,472 | 24 | 1.6 |
| Australian Securities Exchange | 1,194,163 | 2,079 | 1,983 | 96 | 4.6 |
| Taiwan SE Corporation | 887,520 | 824 | 772 | 52 | 6.3 |
| Singapore Exchange | 284,289 | 773 | 462 | 311 | 40.2 |

*Source: Focus: The Monthly Newsletter of Regulated Exchanges* (September 2011).

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

## Financial Statements and Financial Reporting

**2 LEARNING OBJECTIVE**
Identify the major financial statements and other means of financial reporting.

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

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

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

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

## Accounting and Capital Allocation

**3 LEARNING OBJECTIVE**
Explain how accounting assists in the efficient use of scarce resources.

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

Accountants must measure performance accurately and fairly on a timely basis, so that the right managers and companies are able to attract investment capital. For example, relevant financial information that faithfully represents financial results allows investors and creditors to compare the income and assets employed by such companies as **Nokia** (FIN), **McDonald's** (USA), **Air China Ltd.** (CHN), and **Toyota Motor** (JPN). Because these users can assess the relative return and risks associated with investment opportunities, they channel resources more effectively. Illustration 1-3 (on page 6) shows how this process of capital allocation works.

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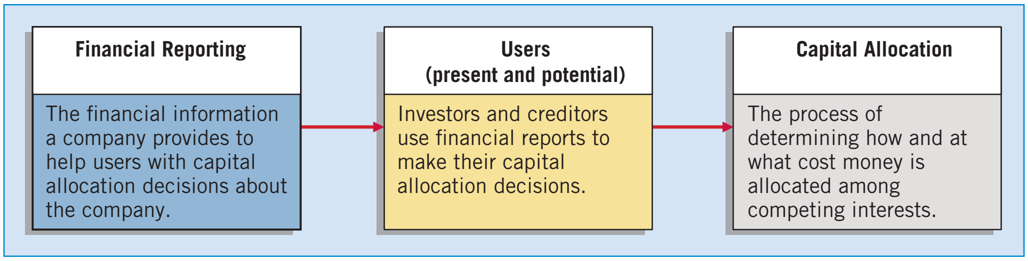
**ILLUSTRATION 1-3**
Capital Allocation Process




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

## High-Quality Standards

**LEARNING OBJECTIVE 4**
Explain the need for high-quality standards.

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

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

1. Single set of high-quality accounting standards established by a single standard-setting body.
2. Consistency in application and interpretation.
3. Common disclosures.
4. Common high-quality auditing standards and practices.
5. Common approach to regulatory review and enforcement.
6. Education and training of market participants.
7. Common delivery systems (e.g., eXtensible Business Reporting Language—XBRL).
8. Common approach to corporate governance and legal frameworks around the world.[1]

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

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

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# OBJECTIVE OF FINANCIAL REPORTING

**5 LEARNING OBJECTIVE**
Identify the objective of financial reporting.

What is the **objective (or purpose) of financial reporting**? The objective of general-purpose financial reporting is to **provide financial information about the reporting entity that is useful to present and potential equity investors, lenders, and other creditors in making decisions about providing resources to the entity**. Those decisions involve buying, selling, or holding equity and debt instruments, and providing or settling loans and other forms of credit. [1] Information that is decision-useful to capital providers (investors) may also be useful to other users of financial reporting who are not investors. Let's examine each of the elements of this objective.

IFRS

See the Authoritative Literature section (page 19).

## General-Purpose Financial Statements

**General-purpose financial statements** provide financial reporting information to a wide variety of users. For example, when **Nestlé** (CHE) issues its financial statements, these statements help shareholders, creditors, suppliers, employees, and regulators to better understand its financial position and related performance. Nestlé's users need this type of information to make effective decisions. To be cost-effective in providing this information, general-purpose financial statements are most appropriate. In other words, general-purpose financial statements provide at the **least cost the most useful information possible**.

## Equity Investors and Creditors

The objective of financial reporting identifies investors and creditors as the primary user group for general-purpose financial statements. Identifying investors and creditors as the primary user group provides an important focus of general-purpose financial reporting. For example, when Nestlé issues its financial statements, its primary focus is on investors and creditors because they have the most critical and immediate need for information in financial reports. Investors and creditors need this financial information to assess Nestlé's ability to generate net cash inflows and to understand management's ability to protect and enhance the assets of the company, which will be used to generate future net cash inflows. As a result, the primary user groups are not management, regulators, or some other non-investor group.

### *What do the numbers mean?* *DON'T FORGET STEWARDSHIP*

In addition to providing decision-useful information about future cash flows, management also is accountable to investors for the custody and safekeeping of the company's economic resources and for their efficient and profitable use. For example, the management of Nestlé has the responsibility for protecting its economic resources from unfavorable effects of economic factors, such as price changes, and technological and social changes. Because Nestlé's performance in discharging its responsibilities (referred to as its **stewardship** responsibilities) usually affects its ability to generate net cash inflows, financial reporting may also provide decision-useful information to assess management performance in this role. [2]

## Entity Perspective

As part of the objective of general-purpose financial reporting, an **entity perspective** is adopted. Companies are viewed as separate and distinct from their owners (present shareholders) using this perspective. The assets of Nestlé are viewed as assets of the company and not of a specific creditor or shareholder. Rather, these investors have claims on Nestlé's assets in the form of liability or equity claims. The entity perspective is consistent

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with the present business environment where most companies engaged in financial reporting have substance distinct from their investors (both shareholders and creditors). Thus, a perspective that financial reporting should be focused only on the needs of shareholders—often referred to as the **proprietary perspective**—is not considered appropriate.

## Decision-Usefulness

Investors are interested in financial reporting because it provides information that is useful for making decisions (referred to as the **decision-usefulness** approach). As indicated earlier, when making these decisions, investors are interested in assessing (1) the company's ability to generate net cash inflows and (2) management's ability to protect and enhance the capital providers' investments. Financial reporting should therefore help investors assess the amounts, timing, and uncertainty of prospective cash inflows from dividends or interest, and the proceeds from the sale, redemption, or maturity of securities or loans. In order for investors to make these assessments, the economic resources of an enterprise, the claims to those resources, and the changes in them must be understood. Financial statements and related explanations should be a primary source for determining this information.

The emphasis on "assessing cash flow prospects" does not mean that the cash basis is preferred over the accrual basis of accounting. Information based on accrual accounting generally better indicates a company's present and continuing ability to generate favorable cash flows than does information limited to the financial effects of cash receipts and payments.

Recall from your first accounting course the objective of **accrual-basis accounting**: It ensures that a company records events that change its financial statements in the periods in which the events occur, rather than only in the periods in which it receives or pays cash. Using the accrual basis to determine net income means that a company recognizes revenues when it provides the goods or performs the services rather than when it receives cash. Similarly, it recognizes expenses when it incurs them rather than when it pays them. Under accrual accounting, a company generally recognizes revenues when it makes sales. The company can then relate the revenues to the economic environment of the period in which they occurred. Over the long run, trends in revenues and expenses are generally more meaningful than trends in cash receipts and disbursements.[2]

# STANDARD-SETTING ORGANIZATIONS

**LEARNING OBJECTIVE 6**

Identify the major policy-setting bodies and their role in the standard-setting process.

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

The main international standard-setting organization is based in London, United Kingdom, and is called the **International Accounting Standards Board (IASB)**. The IASB issues **International Financial Reporting Standards (IFRS)**, which are used on most foreign exchanges. As indicated earlier, IFRS is presently used or permitted in over 115 countries and is rapidly gaining acceptance in other countries as well.

[2]As used here, cash flow means "cash generated and used in operations." The term *cash flows* also frequently means cash obtained by borrowing and used to repay borrowing, cash used for investments in resources and obtained from the disposal of investments, and cash contributed by or distributed to owners.

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IFRS has the best potential to provide a common platform on which companies can report and investors can compare financial information. As a result, our discussion focuses on IFRS and the organization involved in developing these standards—the International Accounting Standards Board (IASB). (A detailed discussion of the U.S. system is provided at the book's companion website, *www.wiley.com/college/kieso*.) The two organizations that have a role in international standard-setting are the **International Organization of Securities Commissions** (IOSCO) and the IASB.

## International Organization of Securities Commissions (IOSCO)

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

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

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

### What do the numbers mean? HOW IS IT GOING?

How much progress has been made toward the goal of one single set of global accounting standards? To answer this question, the IASB conducted a major survey on IFRS adoption. The survey indicates that there is almost universal support (95 percent) for IFRS as the single set of global accounting standards. This includes those jurisdictions that have yet to make a decision on adopting IFRS, such as the United States.

More than 80 percent of the jurisdictions report IFRS adoption for all (or in five cases, almost all) public companies. Most of the remaining 11 non-adopters have made significant progress toward IFRS adoption. In addition, those jurisdictions that have adopted IFRS have made very few modifications to the standards. More than 40 percent of the IFRS adopters do so automatically, without an endorsement process. Moreover, where modifications have occurred, they are regarded as temporary arrangements to assist in the migration from national accounting standards to IFRS. It is expected that most of these transitional adjustments will ultimately disappear.

Admittedly, a few large and important economies have not yet (fully) adopted IFRS. But even in such countries, more progress is being made than many people are aware of. Japan already permits the use of full IFRS and has recently widened the scope of companies that are allowed to adopt it. In the United States, non-U.S. companies are allowed to use IFRS for listings on their exchanges. Today, more than 450 foreign private issuers are reporting using IFRS in U.S. regulatory filings, which represents trillions of dollars in market capitalization. In short, much progress has been made by countries in using IFRS.

*Source:* Adapted from Hans Hoogervorst, "Breaking the Boilerplate," IFRS Foundation Conference (June 13, 2013).

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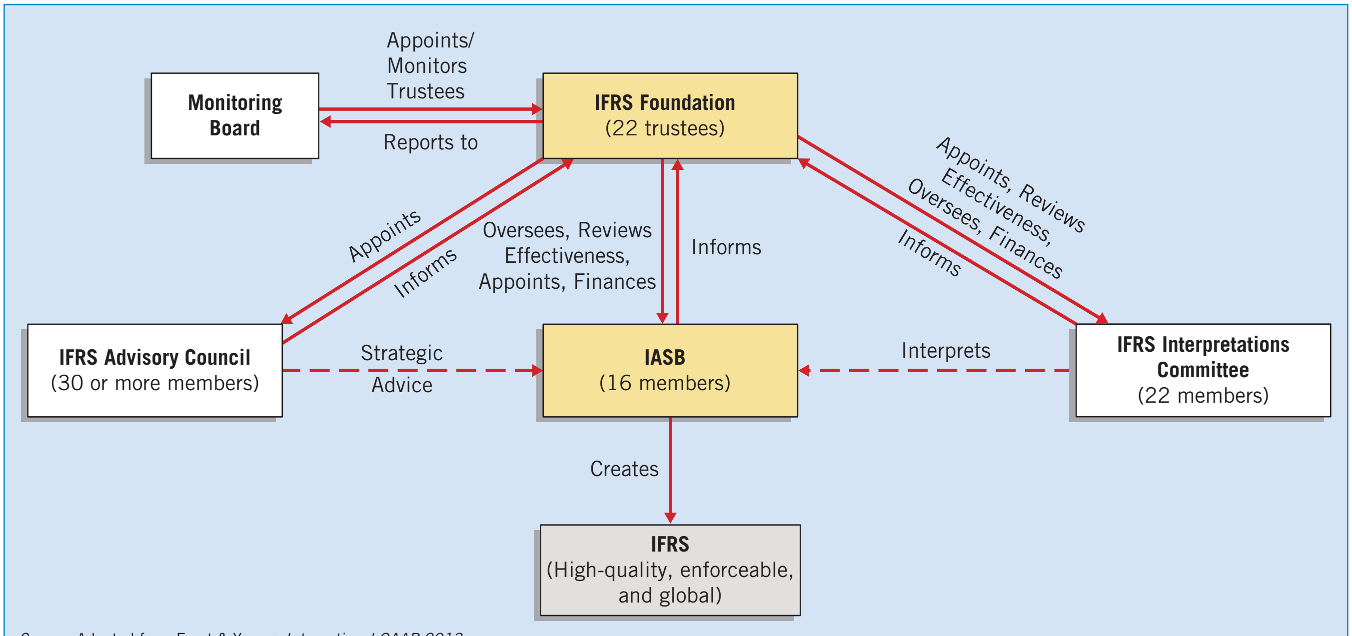
## International Accounting Standards Board (IASB)

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

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

In addition, as part of the governance structure, a **Monitoring Board** was created. The purpose of this board is to establish a link between accounting standard-setters and those public authorities (e.g., IOSCO) that generally oversee them. The Monitoring Board also provides political legitimacy to the overall organization. Illustration 1-4 shows the organizational structure for the setting of international accounting standards.




*Source:* Adapted from Ernst & Young, *International GAAP 2013.*

**ILLUSTRATION 1-4**
International Standard-Setting Structure

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

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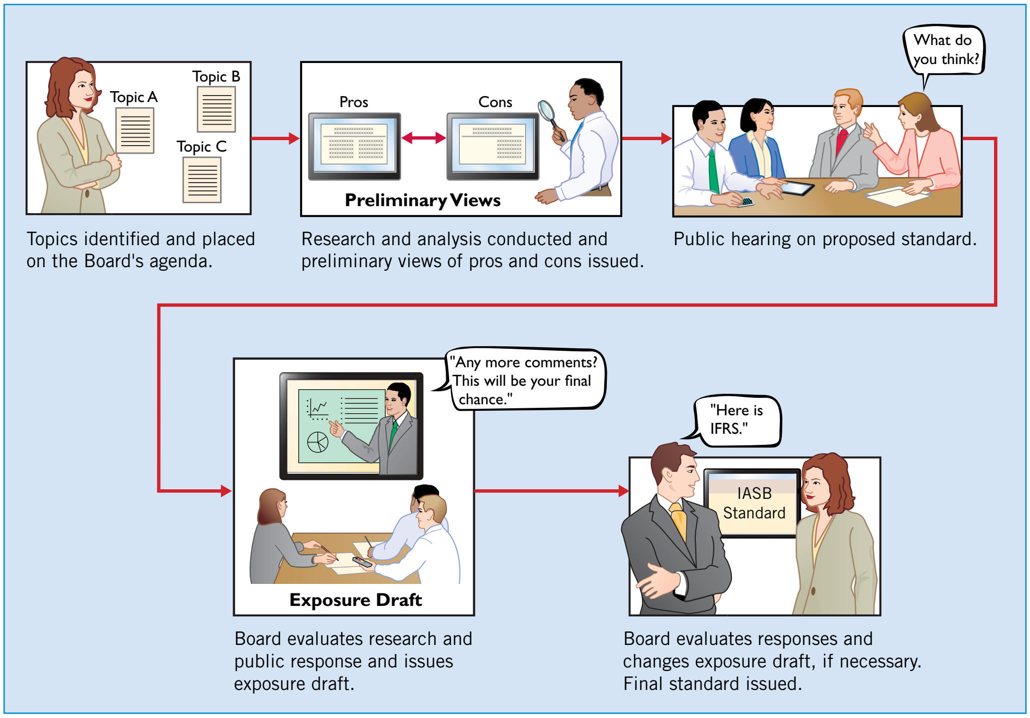
## Due Process

In establishing financial accounting standards, the IASB has a thorough, open, and transparent **due process**. The IASB due process has the following elements: (1) an independent standard-setting board overseen by a geographically and professionally diverse body of trustees; (2) a thorough and systematic process for developing standards; (3) engagement with investors, regulators, business leaders, and the global accountancy profession at every stage of the process; and (4) collaborative efforts with the worldwide standard-setting community.

To implement its due process, the IASB follows specific steps to develop a typical IFRS, as Illustration 1-5 shows.

**ILLUSTRATION 1-5**
IASB Due Process




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

- ***Membership.*** The Board consists of 16 members. Members are well-paid and appointed for five-year renewable terms. The 16 members come from different countries.[4]
- ***Autonomy.*** The IASB is not part of any other professional organization. It is appointed by and answerable only to the IFRS Foundation.
- ***Independence.*** Full-time IASB members must sever all ties from their past employer. The members are selected for their expertise in standard-setting rather than to represent a given country.
- ***Voting.*** Nine of 16 votes are needed to issue a new IFRS.

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

[4]IASB membership reflects geographical representation, generally with four members each from Asia/Oceania, Europe, and North America, and one member each from Africa and South America. Two members are appointed from any area to maintain geographical balance.

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### Types of Pronouncements

The IASB issues three major types of pronouncements:

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


***International Financial Reporting Standards.*** Financial accounting standards issued by the IASB are referred to as International Financial Reporting Standards (IFRS). The IASB has issued 13 of these standards to date, covering such subjects as business combinations and share-based payments.

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


***Conceptual Framework for Financial Reporting.*** As part of a long-range effort to move away from the problem-by-problem approach, the IASB uses an IFRS conceptual framework. This **Conceptual Framework for Financial Reporting** sets forth the fundamental objective and concepts that the Board uses in developing future standards of financial reporting. The intent of the document is to form a cohesive set of interrelated concepts—a conceptual framework—that will serve as tools for solving existing and emerging problems in a consistent manner. For example, the objective of general-purpose financial reporting discussed earlier is part of this Conceptual Framework. The Conceptual Framework and any changes to it pass through the same due process (preliminary views, public hearing, exposure draft, etc.) as an IFRS. However, this Conceptual Framework is not an IFRS and hence does not define standards for any particular measurement or disclosure issue. Nothing in this Conceptual Framework overrides any specific international accounting standard. The Conceptual Framework is discussed more fully in Chapter 2.


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

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

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

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## Hierarchy of IFRS

**7 LEARNING OBJECTIVE**
Explain the meaning of IFRS.

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

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

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

In the absence of a standard or an interpretation in item 1 above, companies look to the Conceptual Framework for Financial Reporting and then to most recent pronouncements of other standard-setting bodies that use a similar conceptual framework to develop accounting standards (or other accounting literature and accepted industry practices to the extent they do not conflict with the above). The overriding requirement of IFRS is that the financial statements provide a fair presentation (often referred to as a "true and fair view"). Fair representation is assumed to occur if a company follows the guidelines established in IFRS.[5] **[3]**

# FINANCIAL REPORTING CHALLENGES

**8 LEARNING OBJECTIVE**
Describe the challenges facing financial reporting.

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

## IFRS in a Political Environment

User groups are possibly the most powerful force influencing the development of IFRS. User groups consist of those most interested in or affected by accounting rules. Various participants in the financial reporting environment may want particular economic events accounted for or reported in a particular way, and they fight hard to get what they want. They know that the most effective way to influence IFRS is to participate in the formulation of these rules or to try to influence or persuade the formulators of them.[6]

These user groups often target the IASB, to pressure it to change the existing rules and develop new ones. In fact, these pressures have been multiplying. Some influential groups

[5]However, as IASB chairman Hans Hoogervorst noted, "It is not always obvious what is lobbying by vested interests and what is public interest feedback whose purpose is to help us deliver a high quality standard. More often than not the vested interest is packaged in public interest arguments. Sometimes even users do not want change. Analysts are so much in love with their own models that they do not want our standards to shed light on complex issues." See "Strengthening Institutional Relationships," *www.IASB.org* (September 23, 2013).

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

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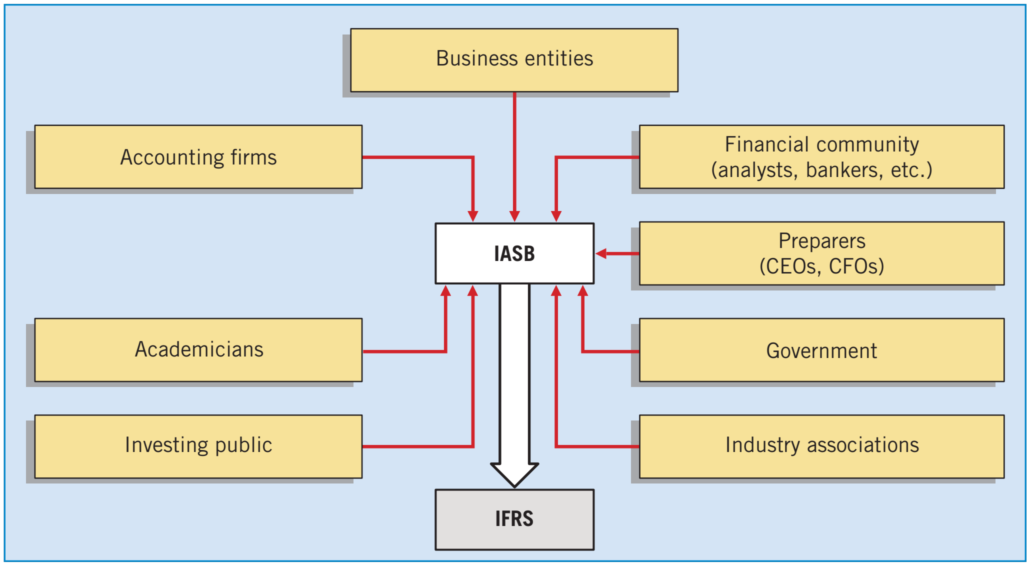
demand that the accounting profession act more quickly and decisively to solve its problems. Other groups resist such action, preferring to implement change more slowly, if at all. Illustration 1-6 shows the various user groups that apply pressure.

**ILLUSTRATION 1-6**
User Groups that Influence the Formulation of Accounting Standards




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

That is not to say that politics in establishing IFRS is a negative force. Considering the **economic consequences** of many accounting rules, special interest groups are expected to vocalize their reactions to proposed rules.[7] What the Board should *not* do is issue standards that are primarily politically motivated. While paying attention to its constituencies, the Board should base IFRS on sound research and a conceptual framework that has its foundation in economic reality.

## What do the numbers mean? FAIR CONSEQUENCES?

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

Most notable was the lobbying of then French President Nicolas Sarkozy in urging his European Union counterparts to back changes to accounting rules and give banks and insurers some breathing space amid the market turmoil. Mr. Sarkozy sought agreement to new regulations, including changes to the mark-to-market accounting rules that have been blamed for aggravating the crisis. International regulators also have conducted studies of fair value accounting and its role in the credit crisis. It is unclear whether these political pressures will have an effect on fair value accounting, but there is no question that the issue has stirred significant worldwide political debate. In short, the numbers have consequences.

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

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

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## The Expectations Gap

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

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

## Significant Financial Reporting Issues

While our reporting model has worked well in capturing and organizing financial information in a useful and reliable fashion, much still needs to be done. For example, if we would move ahead to the year 2025 and look back at financial reporting today, we might read the following.

- ***Non-financial 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.
- ***Forward-looking information.*** Financial reports failed to provide forward-looking information needed by present and potential investors and creditors. One individual noted that financial statements in 2015 should have started with the phrase, "Once upon a time," to signify their use of historical cost and accumulation of past events.
- ***Soft assets.*** Financial reports focused on hard assets (inventory, plant assets) but failed to provide much information about a company's soft assets (intangibles). The most valuable assets are often intangible. Consider **Sony**'s (JPN) expertise in electronics and **Ikea**'s (NLD) brand image.
- ***Timeliness.*** Companies only prepared financial statements quarterly and provided audited financials annually. Little to no real-time financial statement information was available.

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

- Already, some companies voluntarily disclose information deemed relevant to investors. Often such information is non-financial. For example, banking companies now disclose data on loan growth, credit quality, fee income, operating efficiency, capital management, and management strategy.
- Initially, companies used the Internet to provide limited financial data. Now, most companies publish their annual reports in several formats on the Web. The most innovative companies offer sections of their annual reports in a format that the user can readily manipulate, such as in an electronic spreadsheet format. Companies also format their financial reports using eXtensible Business Reporting Language (XBRL), which permits quicker and lower-cost access to companies' financial information.
- More accounting standards now require the recording or disclosing of fair value information. For example, companies either record investments in shares and bonds, debt obligations, and derivatives at fair value, or companies show information related to fair values in the notes to the financial statements.

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

## Ethics in the Environment of Financial Accounting

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

In accounting, as in other areas of business, we frequently encounter ethical dilemmas. Some of these dilemmas are simple and easy to resolve. However, many are not, requiring difficult choices among allowable alternatives. Companies that concentrate on "maximizing the bottom line," "facing the challenges of competition," and "stressing short-term results" place accountants in an environment of conflict and pressure. Basic questions such as, "Is this way of communicating financial information good or bad?" "Is it right or wrong?" and "What should I do in the circumstance?" cannot always be answered by simply adhering to IFRS or following the rules of the profession. Technical competence is not enough when encountering ethical decisions.

Doing the right thing is not always easy or obvious. The pressures "to bend the rules," "to play the game," or "to just ignore it" can be considerable. For example, "Will my decision affect my job performance negatively?" "Will my superiors be upset?" or "Will my colleagues be unhappy with me?" are often questions businesspeople face in making a tough ethical decision. The decision is more difficult because there is no comprehensive ethical system to provide guidelines. Time, job, client, personal, and peer pressures can complicate the process of ethical sensitivity and selection among alternatives. Throughout this textbook, **we present ethical considerations to help sensitize you** to the type of situations you may encounter in the performance of your professional responsibility.

## International Convergence

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

1. China is reforming its financial reporting system through an approach called a continuous convergence process. The goal is to eliminate differences between its standards and IFRS.
2. Japan now permits the use of IFRS for domestic companies. The number of companies electing to use IFRS is expected to increase substantially in the near future.
3. The IASB and the FASB (of the United States) have spent the last 12 years working to converge their standards. The two Boards just issued a new standard on revenue recognition and will soon follow with other substantial standards on financial instruments and lease accounting.
4. Recently, Malaysia was instrumental in helping to amend the accounting for agricultural assets.
5. Italy's standard-setting group has provided advice and counsel on the accounting for business combinations under common control.

In addition, U.S. and European regulators have agreed to recognize each other's standards for listing on the various world securities exchanges. As a result, costly reconciliation requirements have been eliminated and hopefully will lead to greater comparability and transparency. Because international accounting issues are so important, we provide in each chapter of this textbook **Global Accounting Insights**, which highlight

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non-IFRS standards, mostly those from the United States. This feature will help you to understand the changes that are taking place in the financial reporting area as we move to one set of global accounting standards.

## CONCLUSION

International convergence is underway. Many projects already are completed and differences eliminated. Others are on the drawing board. It appears to be only a matter of time until we have one set of global standards that will be established by the IASB. However, as one international regulator indicates, "the ultimate question remains whether IFRS will in fact function as the single set of high-quality, global accounting standards that the world has been seeking for so long. At least, when it comes to satisfying investors' concerns, there is no question of the attractiveness of the promise of a truly global accounting standard. The only real question is not whether this is good for investors, but how quickly both the accounting standards and the process by which they are established and developed can be globally recognized as world-class."

# GLOBAL ACCOUNTING INSIGHTS

## INTERNATIONAL FINANCIAL REPORTING

Most agree that there is a need for one set of international accounting standards. Here is why:

- ***Multinational corporations.*** Today's companies view the entire world as their market. For example, many companies find their largest market is not in their home country.
- ***Mergers and acquisitions.*** The mergers that led to international giants **Kraft/Cadbury** (USA and GBR) and **Vodafone/Mannesmann** (GBR and DEU) suggest that we will see even more such mergers in the future.
- ***Information technology.*** As communication barriers continue to topple through advances in technology, companies and individuals in different countries and markets are becoming comfortable buying and selling goods and services from one another.
- ***Financial markets.*** Financial markets are some of the most significant international markets today. Whether it is currency, equity securities (shares), bonds, or derivatives, there are active markets throughout the world trading these types of instruments.

### Relevant Facts

Following are the key similarities and differences between U.S. GAAP (the standards issued by the Financial Accounting Standards Board) and IFRS related to the financial reporting environment.

#### Similarities

- Generally accepted accounting principles (GAAP) for U.S. companies are developed by the Financial Accounting Standards Board (FASB). The FASB is a private organization. The U.S. Securities and Exchange Commission (SEC) exercises oversight over the actions of the FASB. The IASB is also a private organization. Oversight over the actions of the IASB is regulated by IOSCO.
- Both the IASB and the FASB have essentially the same governance structure, that is, a Foundation that provides oversight, a Board, an Advisory Council, and an Interpretations Committee. In addition, a general body that involves the public interest is part of the governance structure.
- The FASB relies on the U.S. SEC for regulation and enforcement of its standards. The IASB relies primarily on IOSCO for regulation and enforcement of its standards.
- Both the IASB and the FASB are working together to find common grounds for convergence. A good example is the recent issuance of a new standard on revenue recognition that both organizations support. Also, the Boards are working together on other substantial projects such as the measurement and classification of financial instruments.

#### Differences

- U.S. GAAP is more detailed or rules-based. IFRS tends to simpler and more flexible in the accounting and disclosure requirements. The difference in approach has resulted in a

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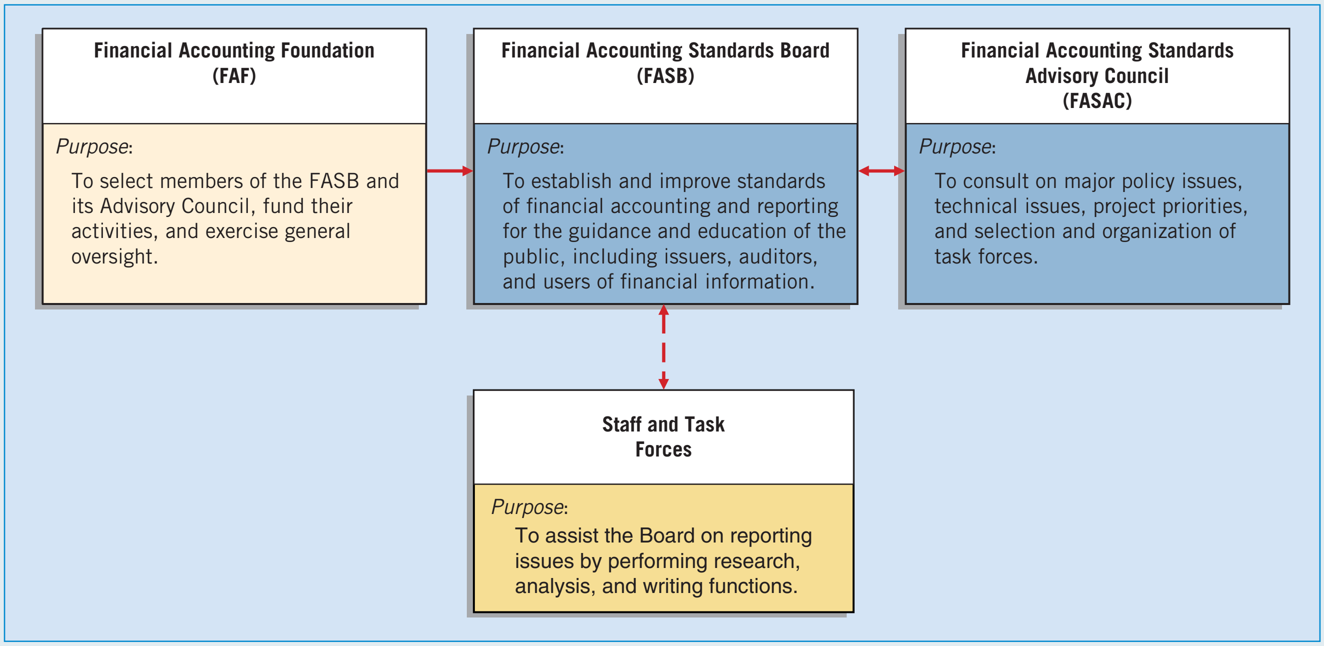
debate about the merits of principles-based versus rules-based standards.

- Differences between U.S. GAAP and IFRS should not be surprising because standard-setters have developed standards in response to different user needs. In some countries, the primary users of financial statements are private investors. In others, the primary users are tax authorities or central government planners. In the United States, investors and creditors have driven accounting-standard formulation.

## About the Numbers

The FASB and its predecessor organizations have been developing standards for nearly 70 years. The IASB is a relatively new organization (formed in 2001). As a result, it has looked to the United States to determine the structure it should follow in establishing IFRS. Thus, the international standard-setting structure (presented on page 10) is very similar to the U.S. standard-setting structure. Presented below is a chart of the FASB's standard-setting structure.




## On the Horizon

Both the IASB and the FASB are hard at work developing standards that will lead to the elimination of major differences in the way certain transactions are accounted for and reported. In fact, beginning in 2010, the IASB (and the FASB on its joint projects with the IASB) started its policy of phasing in adoption of new major standards over several years. The major reason for this policy is to provide companies time to translate and implement international standards into practice.

Much has happened in a very short period of time in the international accounting environment. It now appears likely that in a fairly short period of time, companies around the world will be close to using a single set of high-quality accounting standards.

### KEY TERMS

accrual-basis accounting, *8*
Conceptual Framework for Financial Reporting, *12*
decision-usefulness, *8*
due process, *11*
economic consequences, *14*
entity perspective, *7*
expectations gap, *15*
financial accounting, *5*

## SUMMARY OF LEARNING OBJECTIVES

**1 Describe the growing importance of global financial markets and its relation to financial reporting.** World markets are becoming increasingly intertwined. With the integration of capital markets, the automatic linkage between the location of the company and the location of the capital market is loosening. As a result, companies have expanded choices of where to raise capital, either equity or debt. The move toward adoption of global accounting standards has and will continue to facilitate this trend.

**2 Identify the major financial statements and other means of financial reporting.** Companies most frequently provide (1) the statement of financial position, (2) the income statement or statement of comprehensive income, (3) the statement of cash flows, and (4) the statement of changes in equity. Financial reporting other than

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financial statements may take various forms. Examples include the president's letter and supplementary schedules in the corporate annual report, prospectuses, reports filed with government agencies, news releases, management's forecasts, and descriptions of a company's social or environmental impact.

**3 Explain how accounting assists in the efficient use of scarce resources.** Accounting provides reliable, relevant, and timely information to managers, investors, and creditors to allow resource allocation to the most efficient enterprises. Accounting also provides measurements of efficiency (profitability) and financial soundness.

**4 Explain the need for high-quality standards.** A single, widely accepted set of high-quality accounting standards is a necessity to ensure adequate comparability. Investors are increasingly making investing decisions across international jurisdictions. As a result, investors need financial information that is comparable across national boundaries. But what are high-quality accounting standards, how should they be developed, and how should they be enforced is still a much debated issue.

**5 Identify the objective of financial reporting.** The objective of general-purpose financial reporting is to provide financial information about the reporting entity that is useful to present and potential equity investors, lenders, and other creditors in making decisions about providing resources to the entity. Information that is decision-useful to investors may also be useful to other users of financial reporting who are not investors.

**6 Identify the major policy-setting bodies and their role in the standard-setting process.** The International Organization of Securities Commissions (IOSCO) does not set accounting standards but is dedicated to ensuring that the global markets can operate in an efficient and effective manner. The International Accounting Standards Board (IASB) is the leading international accounting standard-setting organization. Its mission is to develop, in the public interest, a single set of high-quality and understandable International Financial Reporting Standards (IFRS) for general-purpose financial statements. Standards issued by the IASB have been adopted by over 115 countries worldwide, and all publicly traded European companies must use IFRS.

**7 Explain the meaning of IFRS.** IFRS is comprised of (a) International Financial Reporting Standards, (b) International Accounting Standards, and (c) interpretations issued by the IFRS Interpretations Committee or the former Standing Interpretations Committee (SIC). In the absence of a standard or an interpretation, other accounting literature, including that contained in the Conceptual Framework for Financial Reporting and recent pronouncements of other standard-setting bodies that use a similar conceptual framework, can be applied.

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



## IFRS AUTHORITATIVE LITERATURE


[1] The Conceptual Framework for Financial Reporting, "Chapter 1, The Objective of General Purpose Financial Reporting" (London, U.K.: IASB, September 2010), par. OB2.

[2] The Conceptual Framework for Financial Reporting, "Chapter 1, The Objective of General Purpose Financial Reporting" (London, U.K.: IASB, September 2010), par. OB4.

[3] International Accounting Standard 8, *Accounting Policies, Changes in Accounting Estimates and Errors* (London, U.K.: IASB, 1993), par. 12.

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## QUESTIONS

1. What is happening to world markets, and what are the implications for financial reporting?
2. Differentiate broadly between financial accounting and managerial accounting.
3. What are the major financial statements, and what is the difference between financial statements and financial reporting?
4. How does accounting help in the capital allocation process?
5. What is the benefit of a single set of high-quality accounting standards?
6. What is the objective of financial reporting?
7. What is meant by general-purpose financial statements?
8. Who is the primary user group for general-purpose financial statements?
9. Comment on the following statement: A perspective that financial reporting should be focused only on the needs of the shareholders—often referred to as the *proprietary perspective*—is considered appropriate.
10. Comment on the following statement: The objective of financial reporting is primarily to provide decision-useful information for assessing the performance of management.
11. Who are the two key organizations in the development of international accounting standards? Explain their role.
12. What is IOSCO?
13. What is the mission of the IASB?
14. What is the purpose of the Monitoring Board?
15. How are IASB preliminary views and IASB exposure drafts related to IASB standards?
16. Distinguish between IASB standards and the Conceptual Framework for Financial Reporting.
17. Rank from most authoritative to least authoritative the following three items: Conceptual Framework for Financial Reporting, International Financial Reporting Standards, and International Financial Reporting Standards Interpretations.
18. Explain the role of the IFRS Interpretations Committee.
19. What are some of the major challenges facing the accounting profession?
20. What are the sources of pressure that change and influence the development of IFRS?
21. Some individuals have indicated that the IASB must be cognizant of the economic consequences of its pronouncements. What is meant by "economic consequences"? What dangers exist if politics play too much of a role in the development of IFRS?
22. If you were given complete authority in the matter, how would you propose that IFRS should be developed and enforced?
23. One writer recently noted that a high percentage of all companies prepare statements that are in accordance with IFRS. Why then is there such concern about fraudulent financial reporting?
24. What is the "expectations gap"? What is the profession doing to try to close this gap?
25. How are financial accountants challenged in their work to make ethical decisions? Is technical mastery of IFRS not sufficient to the practice of financial accounting?

## CONCEPTS FOR ANALYSIS

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

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

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

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

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**4.** The objective of financial reporting uses an entity rather than a proprietary approach in determining what information to report.

**CA1-3 (Financial Reporting and Accounting Standards)** Answer the following multiple-choice questions.

**1.** IFRS stands for:
**(a)** International Federation of Reporting Services.
**(b)** Independent Financial Reporting Standards.
**(c)** International Financial Reporting Standards.
**(d)** Integrated Financial Reporting Services.

**2.** The major key organizations on the international side are the:
**(a)** IASB and IFRS Advisory Council.
**(b)** IOSCO and the U.S. SEC.
**(c)** London Stock Exchange and International Securities Exchange.
**(d)** IASB and IOSCO.

**3.** Which governmental body is most influential in enforcing IFRS?
**(a)** Monitoring Board. **(c)** IOSCO.
**(b)** IFRS Advisory Council. **(d)** IFRS Foundation.

**4.** Accounting standard-setters use the following process in establishing international standards:
**(a)** Research, exposure draft, discussion paper, standard.
**(b)** Discussion paper, research, exposure draft, standard.
**(c)** Research, preliminary views, discussion paper, standard.
**(d)** Research, preliminary views, exposure draft, standard.

**5.** IFRS is comprised of:
**(a)** International Financial Reporting Standards and FASB financial reporting standards.
**(b)** International Financial Reporting Standards, International Accounting Standards, and International Accounting Standards Interpretations.
**(c)** International Accounting Standards and International Accounting Standards Interpretations.
**(d)** FASB financial reporting standards and International Accounting Standards.

**6.** The authoritative status of the Conceptual Framework for Financial Reporting is as follows:
**(a)** It is used when there is no standard or interpretation related to the reporting issues under consideration.
**(b)** It is not as authoritative as a standard but takes precedence over any interpretation related to the reporting issue.
**(c)** It takes precedence over all other authoritative literature.
**(d)** It has no authoritative status.

**7.** The objective of financial reporting places most emphasis on:
**(a)** reporting to capital providers.
**(b)** reporting on stewardship.
**(c)** providing specific guidance related to specific needs.
**(d)** providing information to individuals who are experts in the field.

**8.** General-purpose financial statements are prepared primarily for:
**(a)** internal users. **(c)** auditors.
**(b)** external users. **(d)** government regulators.

**9.** Economic consequences of accounting standard-setting means:
**(a)** standard-setters must give first priority to ensuring that companies do not suffer any adverse effect as a result of a new standard.
**(b)** standard-setters must ensure that no new costs are incurred when a new standard is issued.
**(c)** the objective of financial reporting should be politically motivated to ensure acceptance by the general public.
**(d)** accounting standards can have detrimental impacts on the wealth levels of the providers of financial information.

**10.** The expectations gap is the difference between:
**(a)** what financial information management provides and what users want.
**(b)** what the public thinks accountants should do and what accountants think they can do.
**(c)** what the governmental agencies want from standard-setting and what the standard-setters provide.
**(d)** what the users of financial statements want from the government and what is provided.

**CA1-4 (Financial Accounting)** Omar Morena has recently completed his first year of studying accounting. His instructor for next semester has indicated that the primary focus will be the area of financial accounting.

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**Instructions**

**(a)** Differentiate between financial accounting and managerial accounting.

**(b)** One part of financial accounting involves the preparation of financial statements. What are the financial statements most frequently provided?

**(c)** What is the difference between financial statements and financial reporting?

**CA1-5 (Need for IASB)** Some argue that having various organizations establish accounting principles is wasteful and inefficient. Rather than mandating accounting rules, each company could voluntarily disclose the type of information it considered important. In addition, if an investor wants additional information, the investor could contact the company and pay to receive the additional information desired.

**Instructions**

Comment on the appropriateness of this viewpoint.

**CA1-6 (IASB Role in Standard-Setting)** A press release announcing the appointment of the trustees of the new IFRS Foundation stated that the International Accounting Standards Board (to be appointed by the trustees) ". . . will become the established authority for setting accounting Standards."

**Instructions**

**(a)** Identify the sponsoring organization of the IASB and the process by which the IASB arrives at a decision and issues an accounting standard.

**(b)** Indicate the major types of pronouncements issued by the IASB and the purposes of each of these pronouncements.

**CA1-7 (Accounting Numbers and the Environment)** Hardly a day goes by without an article appearing on the crises affecting many of our financial institutions. It is estimated that the financial institution debacle of 2008, for example, caused a deep recession. Some argue that if financial institutions had been required to report their investments at fair value instead of cost, large losses would have been reported earlier, which would have signaled regulators to close these financial institutions and, therefore, minimize the losses to many investors.

**Instructions**

Explain how reported accounting numbers might affect an individual's perceptions and actions. Cite two examples.

**CA1-8 (Politicization of IFRS)** Some accountants have said that politicization in the development and acceptance of International Financial Reporting Standards (IFRS) is taking place. Some use the term "politicization" in a narrow sense to mean the influence by governmental agencies, such as the European Union and the U.S. Securities and Exchange Commission, on the development of IFRS. Others use it more broadly to mean the compromise that results when the bodies responsible for developing IFRS are pressured by interest groups, businesses through their various organizations, financial analysts, bankers, lawyers, academics, auditors, and so on.

**Instructions**

**(a)** What arguments can be raised to support the "politicization" of accounting rule-making?

**(b)** What arguments can be raised against the "politicization" of accounting rule-making?

**CA1-9 (Models for Setting IFRS)** Presented below are three models for setting IFRS.

1. The purely political approach, where national legislative action decrees IFRS.
2. The private, professional approach, where IFRS is set and enforced by private professional actions only.
3. The public/private mixed approach, where IFRS is basically set by private-sector bodies that behave as though they were public agencies and whose standards to a great extent are enforced through governmental agencies.

**Instructions**

**(a)** Which of these three models best describes international standard-setting? Comment on your answer.

**(b)** Why do companies, financial analysts, labor unions, industry trade associations, and others take such an active interest in standard-setting?

**CA1-10 (Economic Consequences)** Several years ago, then French President Nicolas Sarkozy urged his European Union counterparts to put pressure on the IASB to change accounting rules to give banks and insurers some relief from fair value accounting rules amid market turmoil. Mr. Sarkozy sought changes to the mark-to-market accounting rules that have been blamed for aggravating the crisis.

**Instructions**

Explain how government intervention could possibly affect capital markets adversely.

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**CA1-11 (Rule-Making Issues)** When the IASB issues new pronouncements, the implementation date is usually delayed for several months from date of issuance, with early implementation encouraged. Karen Weller, controller, discusses with her financial vice president the need for early implementation of a rule that would result in a fairer presentation of the company's financial condition and earnings. When the financial vice president determines that early implementation of the rule will adversely affect the reported net income for the year, he discourages Weller from implementing the rule until it is required.

#### Instructions

Answer the following questions.

**(a)** What, if any, is the ethical issue involved in this case?
**(b)** Is the financial vice president acting improperly or immorally?
**(c)** What does Weller have to gain by advocacy of early implementation?
**(d)** Which stakeholders might be affected by the early implementation decision?

**CA1-12 (Financial Reporting Pressures)** Presented below is abbreviated testimony from Troy Normand in the WorldCom (USA) case. He was a manager in the corporate reporting department and is one of five individuals who pleaded guilty. He is testifying in hopes of receiving no prison time when he is ultimately sentenced.

**Q.** Mr. Normand, if you could just describe for the jury how the meeting started and what was said during the meeting?
**A.** I can't recall exactly who initiated the discussion, but right away Scott Sullivan acknowledged that he was aware we had problems with the entries, David Myers had informed him, and we were considering resigning.

He said that he respected our concerns but that we weren't being asked to do anything that he believed was wrong. He mentioned that he acknowledged that the company had lost focus quite a bit due to the preparations for the Sprint merger, and that he was putting plans in place and projects in place to try to determine where the problems were, why the costs were so high.

He did say he believed that the initial statements that we produced, that the line costs in those statements could not have been as high as they were, that he believes something was wrong and there was no way that the costs were that high.

I informed him that I didn't believe the entry we were being asked to do was right, that I was scared, and I didn't want to put myself in a position of going to jail for him or the company. He responded that he didn't believe anything was wrong, nobody was going to be going to jail, but that if it later was found to be wrong, that he would be the person going to jail, not me.

He asked that I stay, don't jump off the plane, let him land it softly, that's basically how he put it. And he mentioned that he had a discussion with Bernie Ebbers asking Bernie to reduce projections going forward and that Bernie had refused.
**Q.** Mr. Normand, you said that Mr. Sullivan said something about don't jump out of the plane. What did you understand him to mean when he said that?
**A.** Not to quit.
**Q.** During this meeting, did Mr. Sullivan say anything about whether you would be asked to make entries like this in the future?
**A.** Yes, he made a comment that from that point going forward we wouldn't be asked to record any entries, high-level late adjustments, that the numbers would be the numbers.
**Q.** What did you understand that to be mean, the numbers would be the numbers?
**A.** That after the preliminary statements were issued, with the exception of any normal transaction, valid transaction, we wouldn't be asked to be recording any more late entries.
**Q.** I believe you testified that Mr. Sullivan said something about the line cost numbers not being accurate. Did he ask you to conduct any analysis to determine whether the line cost numbers were accurate?
**A.** No, he did not.
**Q.** Did anyone ever ask you to do that?
**A.** No.
**Q.** Did you ever conduct any such analysis?
**A.** No, I didn't.
**Q.** During this meeting, did Mr. Sullivan ever provide any accounting justification for the entry you were asked to make?
**A.** No, he did not.
**Q.** Did anything else happen during the meeting?
**A.** I don't recall anything else.
**Q.** How did you feel after this meeting?
**A.** Not much better actually. I left his office not convinced in any way that what we were asked to do was right. However, I did question myself to some degree after talking with him wondering whether I was making something more out of what was really there.

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**Instructions**

Answer the following questions.

**(a)** What appears to be the ethical issue involved in this case?
**(b)** Is Troy Normand acting improperly or immorally?
**(c)** What would you do if you were Troy Normand?
**(d)** Who are the major stakeholders in this case?

# USING YOUR JUDGMENT

## FINANCIAL REPORTING

### Financial Reporting Problem

Lola Otero, a new staff accountant, is confused because of the complexities involving accounting standard-setting. Specifically, she is confused by the number of bodies issuing financial reporting standards of one kind or another and the level of authoritative support that can be attached to these reporting standards. Lola decides that she must review the environment in which accounting standards are set, if she is to increase her understanding of the accounting profession.

Lola recalls that during her accounting education there was a chapter or two regarding the environment of financial accounting and the development of IFRS. However, she remembers that her instructor placed little emphasis on these chapters.

#### Instructions

**(a)** Help Lola by identifying key organizations involved in accounting rule-making at the international level.
**(b)** Lola asks for guidance regarding authoritative support. Please assist her by explaining what is meant by authoritative support.

### International Reporting Case

The following comments were made at an Annual Conference of the Financial Executives Institute (FEI).

There is an irreversible movement toward a single set of rules for financial reporting throughout the world. The international capital markets require an end to:

1. The confusion caused by international companies announcing different results depending on the set of accounting standards applied.
2. Companies in some countries obtaining unfair commercial advantages from the use of particular national accounting standards.
3. The complications in negotiating commercial arrangements for international joint ventures caused by different accounting requirements.
4. The inefficiency of international companies having to understand and use a myriad of different accounting standards depending on the countries in which they operate and the countries in which they raise capital and debt. Executive talent is wasted on keeping up to date with numerous sets of accounting standards and the never-ending changes to them.
5. The inefficiency of investment managers, bankers, and financial analysts as they seek to compare financial reporting drawn up in accordance with different sets of accounting standards.

#### Instructions

**(a)** What is the International Accounting Standards Board?
**(b)** What stakeholders might benefit from the use of international accounting standards?
**(c)** What do you believe are some of the major obstacles to convergence?

### Accounting, Analysis, and Principles

The founders of Oslo Company, Finn Elo and Vender Hakala, are about to realize their dream of taking their company public. They are trying to better understand the various legal and accounting issues they will face as a public company.

#### Accounting

**(a)** What are some of the reporting requirements that their company will have to comply with when they offer securities to investors and creditors?

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**(b)** Identify the two entities that are primarily responsible for establishing IFRS, which will be applied when preparing their financial statements. Explain the relationship of these two organizations to one another.

### Analysis

**(a)** What is decision-usefulness?
**(b)** Briefly describe how the financial statements that Oslo prepares for its investors and creditors will contribute to decision-usefulness.

### Principles

Oslo will prepare its statements in conformity with IFRS. Finn and Vender have heard about an IFRS hierarchy. Briefly explain this hierarchy and advise them on how the hierarchy affects the application of IFRS.

## IFRS BRIDGE TO THE PROFESSION

## Professional Research

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

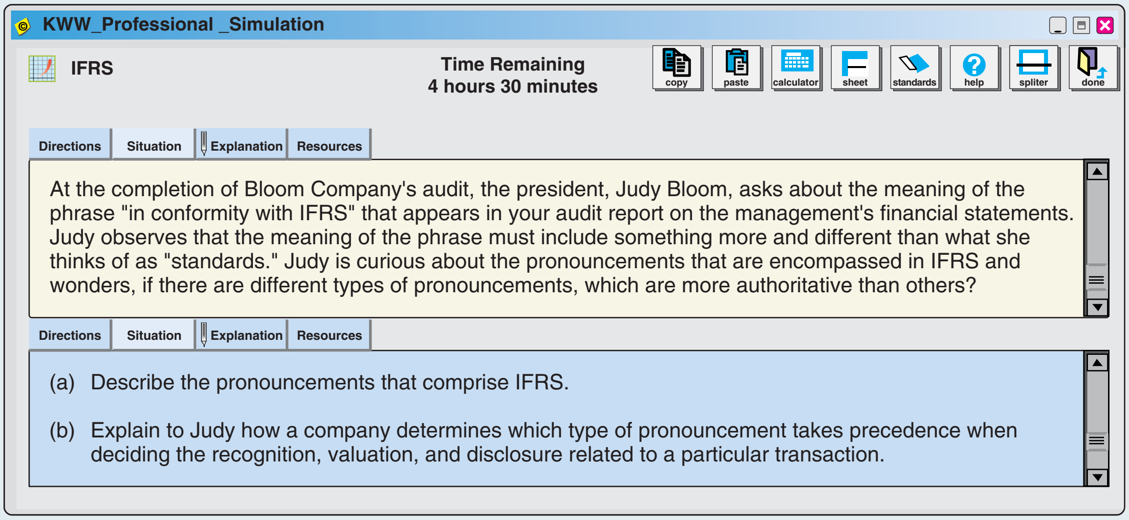
### Instructions

Access the Conceptual Framework at the IASB website (*http://eifrs.iasb.org/*) (you may register for free eIFRS access at this site). When you have accessed the document, you can use the search tool in your Internet browser to respond to the following items. (Provide paragraph citations.)

**(a)** What is the objective of financial reporting?
**(b)** What other means are there of communicating information, besides financial statements?
**(c)** Indicate some of the users and the information they are most directly concerned with in economic decision-making.

## Professional Simulation

In this simulation, you are asked questions regarding accounting standards. Prepare responses to all parts.




**Remember to check the book's companion website, at www.wiley.com/college/kieso, to find additional resources for this chapter.**

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CHAPTER 2

# Conceptual Framework for Financial Reporting

## LEARNING OBJECTIVES

*After studying this chapter, you should be able to:*

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

## What Is It?

Everyone agrees that accounting needs a framework—a conceptual framework, so to speak—that will help guide the development of standards. To understand the importance of developing this framework, let's see how you would respond in the following two situations.

### Situation 1: "Taking a Long Shot . . . "

To supplement donations collected from its general community solicitation, Tri-Cities United Charities holds an Annual Lottery Sweepstakes. In this year's sweepstakes, United Charities is offering a grand prize of $1,000,000 to a single winning ticket holder. A total of 10,000 tickets have been printed, and United Charities plans to sell all the tickets at a price of $150 each.

Since its inception, the Sweepstakes has attracted area-wide interest, and United Charities has always been able to meet its sales target. However, in the unlikely event that it might fail to sell a sufficient number of tickets to cover the grand prize, United Charities has reserved the right to cancel the Sweepstakes and to refund the price of the tickets to holders.

In recent years, a fairly active secondary market for tickets has developed. This year, buying–selling prices have varied between $75 and $95 before stabilizing at about $90.

When the tickets first went on sale this year, multimillionaire Phil N. Tropic, well-known in Tri-Cities civic circles as a generous but sometimes eccentric donor, bought one of the tickets from United Charities, paying $150 cash.

How would you answer the following questions?

1. Should Phil N. Tropic recognize his lottery ticket as an asset in his financial statements?
2. Assuming that Phil N. Tropic recognizes the lottery ticket as an asset, at what amount should it be reported? Some possible answers are $150, $100, and $90.

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## CONCEPTUAL FOCUS

> This chapter summarizes conceptual elements that will be referred to throughout subsequent chapters.

## INTERNATIONAL FOCUS

> Read the **Global Accounting Insights** on pages 47–49 for a discussion of convergence efforts in developing a common conceptual framework.

## Situation 2: The $20 Million Question

The Hard Rock Mining Company has just completed the first year of operations at its new strip mine, the Lonesome Doe. Hard Rock spent $10 million for the land and $20 million in preparing the site for mining operations. The mine is expected to operate for 20 years. Hard Rock is subject to environmental statutes requiring it to restore the Lonesome Doe mine site on completion of mining operations.

Based on its experience and industry data, as well as current technology, Hard Rock forecasts that restoration will cost about $10 million when it is undertaken. Of those costs, about $4 million is for restoring the topsoil that was removed in preparing the site for mining operations (prior to opening the mine); the rest is directly proportional to the depth of the mine, which in turn is directly proportional to the amount of ore extracted.

How would you answer the following questions?

1. Should Hard Rock recognize a liability for site restoration in conjunction with the opening of the Lonesome Doe Mine? If so, what is the amount of that liability?
2. After Hard Rock has operated the Lonesome Doe Mine for 5 years, new technology is introduced that reduces Hard Rock's estimated future restoration costs to $7 million, $3 million of which relates to restoring the topsoil. How should Hard Rock account for this change in its estimated future liability?

The answer to the questions on the two situations depends on how assets and liabilities are defined and how they should be valued. Hopefully, this chapter will provide you with a framework to resolve questions like these.

*Source:* Adapted from Todd Johnson and Kim Petrone, *The FASB Cases on Recognition and Measurement,* Second Edition (New York: John Wiley and Sons, Inc., 1996).

## PREVIEW OF CHAPTER 2

As our opening story indicates, users of financial statements can face difficult questions about the recognition and measurement of financial items. To help develop the type of financial information that can be used to answer these questions, financial accounting and reporting relies on a conceptual framework. In this chapter, we discuss the basic concepts underlying the conceptual framework, as follows.

**Conceptual Framework for Financial Reporting**

| Conceptual Framework | First Level: Basic Objective | Second Level: Fundamental Concepts | Third Level: Recognition, Measurement, and Disclosure Concepts |
|---|---|---|---|
| • Need<br>• Development<br>• Overview | | • Qualitative characteristics<br>• Basic elements | • Basic assumptions<br>• Basic principles<br>• Cost constraint<br>• Summary of the structure |

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# CONCEPTUAL FRAMEWORK

**LEARNING OBJECTIVE 1**

Describe the usefulness of a 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; and (4) how they should be summarized and reported.[1]

## 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."[2]

In other words, standard-setting that is based on personal conceptual frameworks will lead to different conclusions about identical or similar issues than it did previously. As a result, standards will not be consistent with one another, and past decisions may not be indicative of future ones. Furthermore, the framework should increase financial statement users' understanding of and confidence in financial reporting. It should enhance comparability among companies' financial statements.

Second, as a result of a soundly developed conceptual framework, the profession should be able to more quickly solve new and emerging **practical problems by referring to an existing framework of basic theory**. For example, assume that **Aphrodite Gold Ltd.** (AUS) sold two issues of bonds. It can redeem them either with $2,000 in cash or with 5 ounces of gold, whichever is worth more at maturity. Both bond issues have a stated interest rate of 8.5 percent. At what amounts should Aphrodite or the buyers of the bonds record them? What is the amount of the premium or discount on the bonds? And how should Aphrodite amortize this amount, if the bond redemption payments are to be made in gold (the future value of which is unknown at the date of issuance)? Consider that Aphrodite cannot know, at the date of issuance, the value of future gold bond redemption payments.

It is difficult, if not impossible, for the IASB to prescribe the proper accounting treatment quickly for situations like this or like those represented in our opening story.

IFRS

See the Authoritative Literature section (page 50).

[1]Recall from our discussion in Chapter 1 that while the Conceptual Framework and any changes to it pass through the same due process (discussion paper, preliminary views, public hearing, exposure draft, etc.) as do the IFRSs, the Conceptual Framework is not an IFRS. That is, the Conceptual Framework does not define standards for any particular measurement or disclosure issue, and nothing in the Conceptual Framework overrides any specific IFRS. [1]

[2]C. Horngren, "Uses and Limitations of a Conceptual Framework," *Journal of Accountancy* (April 1981), p. 90.