Segment: Financial Reporting

Topic: Conceptual Framework

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Introduction

For a while, accounting standards had evolved in a piece-meal approach. That is, standards were developed without having a coherent framework that guides standard-setters in establishing standards and in providing a frame of reference for resolving accounting issues. As a result, a number of standard-setters around the world developed a conceptual framework for financial reporting.

In 1985, the US' Financial Accounting Standards Board developed the first conceptual framework. The IASB conceptual framework was completed in 1989.

The development of a conceptual framework can be important for standard-setters, preparers, auditors and users of financial reports. It consists of statements that address the objective of financial reporting, the qualitative characteristics of accounting information, the elements of financial statements and the recognition and measurement of financial statements.

The IASB identified the way in which a conceptual framework assists those who prepare financial statements in applying accounting standards and in dealing with topics that have yet to form the subject of an accounting standard auditors in forming an opinion as to whether financial statements conform with accounting standards users of financial statements in interpreting the information contained in financial statements

those who are interested in the work of standard setters, providing them with information about how accounting standards are formulated

Learning Objectives

At the end of this topic, you will be able to:

- describe the purpose of the conceptual framework in financial reporting
- identify the seven qualitative characteristics accounting information should possess.

1. Objective of Financial Reporting

The outcome of financial reporting is the financial statements and the relevant footnote disclosures. Statements about the objective of financial reporting address the following issues:

1. Should financial statements be geared toward specific needs of a particular user group, or must they have a general purpose?
2. Should companies assume that financial statements' users are knowledgeable about the financial information and reporting, or must they assume that users have limited ability?

2. Qualitative Characteristics of Accounting Information

Accounting information contained in the financial statements should possess certain characteristics. Statements about the characteristics of accounting information tend to argue that information must possess certain qualities.

Qualitative Characteristics of Accounting Information

The qualitative characteristics of accounting information is further explained below:

Understand ability

Even if users are assumed to be knowledgeable, accounting information has different levels of comprehension. The information contained in the financial report must therefore allow a knowledgeable user to understand it.

Relevance

Published accounting information should be relevant. Accounting information is considered relevant if it makes a difference in decisions made by user groups.

Relevance has three main aspects:

1. **Predictive value** - Accounting information is considered relevant if it affects predictions about a company's future cash generation or earnings abilities.
2. **Feedback value** - Accounting information is considered relevant if it provides feedback to users that help them confirm or revise earlier expectations.
3. **Timeliness -** To be relevant, accounting information must be timely in that it must be Reliability Published accounting information should also be reliable.

Reliability

Published accounting information should also be reliable. Reliability has three main aspects:

- **Verifiability -** To be reliable, accounting information must be verifiable. That is, individuals other than those who produce the accounting information initially, but having equal skills and training, should be able to reconstruct the information.
- **Representational faithfulness -** The measurement of accounting information should correspond with the phenomenon it is attempting to measure. For example, if the replacement cost of an asset is the property to be measured, then the actual market value of the asset would achieve representational faithfulness. However, the amount the company could sell that asset for would not achieve representational faithfulness.
- **Neutrality -** Accounting information should also be presented in a neutral manner. In other words, management must present the information free from bias that aims to purposely achieve a pre-determined outcome.

Comparability

Published accounting information should be comparable across companies. Accounting information from different companies can best be compared when the companies follow the same accounting principles and procedures.

Consistency

Over time, published accounting information should be based on consistent accounting methods and procedures. Although accounting information should possess the above characteristics to be useful and valid, the provision of accounting information is constrained by two factors – net benefits and materiality.

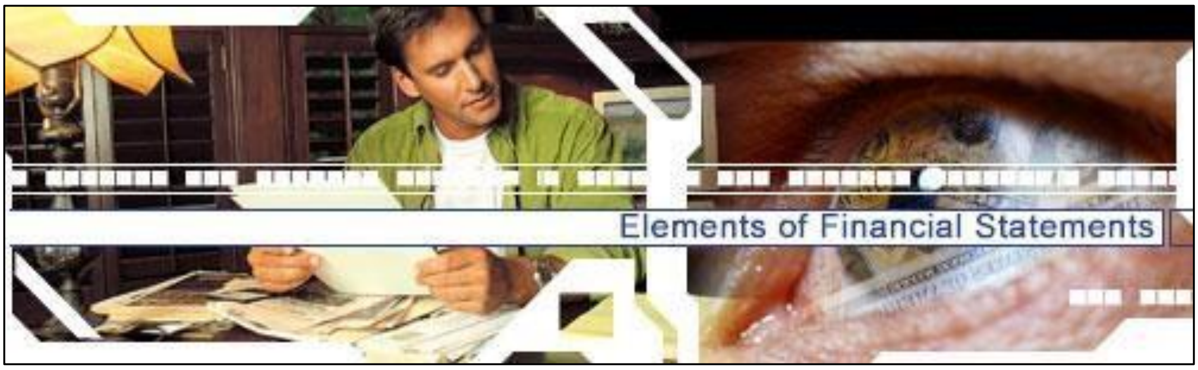
Net Benefits

Accounting information has economic consequences in that decisions are made on the basis of the information contained in the financial statements. The benefits of accounting information should exceed the costs. The benefits are represented primarily by the user's utility of the information. The costs of accounting information comprise direct and indirect costs. Some of the direct costs include the cost of gathering, preparing and disseminating accounting information. A key indirect cost relates to competitive disadvantages. For example, many companies argue that while published information about the geographic and line-of-business segments of their operations are useful to investors, creditors and other users, they are also extremely useful to competitors.

Materiality

Accounting information is considered material if its amount has the potential to influence a decision. Immaterial amounts are not disclosed separately in the financial report and their accounting treatment does not affect the audit report.

3. Elements of Financial Statements



The key elements of the financial statements are assets, liabilities, equity, revenues, expenses, gains, losses and net income. Statements about the elements of financial statements tend to provide specific definition for these elements. While different countries advocate slightly different definitions for each of these elements, the definitions provided in the subject glossary are generally consistent with most of these definitions.

Recognition and Measurement in Financial Statements

Defining the elements of the financial statements does not mean that all items that meet these definitions will be recognised in the financial statements. A conceptual framework sets certain criteria that must be met before an asset, e.g., is recognised in the financial statements. It also specifies how to measure certain assets, e.g., should a particular asset be reported on the balance sheet using its acquisition historical cost, replacement cost, selling price or value-in-use.

It is beyond the scope of this segment to address the details of the recognition criteria and measurement rules of the elements of the financial statements. However, in later segments, you will be introduced to these criteria and rules as they apply to key elements of the financial statements. You should be aware, however, that the development of this component of the conceptual framework has been quite contentious in many countries and is considered by many academics and accounting practitioners and professionals as an outright failure.

4. Summary

Here is a quick recap of what we have learnt so far:

- The conceptual framework of financial reporting was developed in response to inconsistencies and gaps in financial reporting standards
- This conceptual framework:
- specifies the objectives of financial reporting
- defines the elements of the financial statements
- outlines the qualitative characteristics of accounting information
- spells out the recognition criteria and measurement basis for the elements of the financial statements
- The framework has been implemented in a few countries.