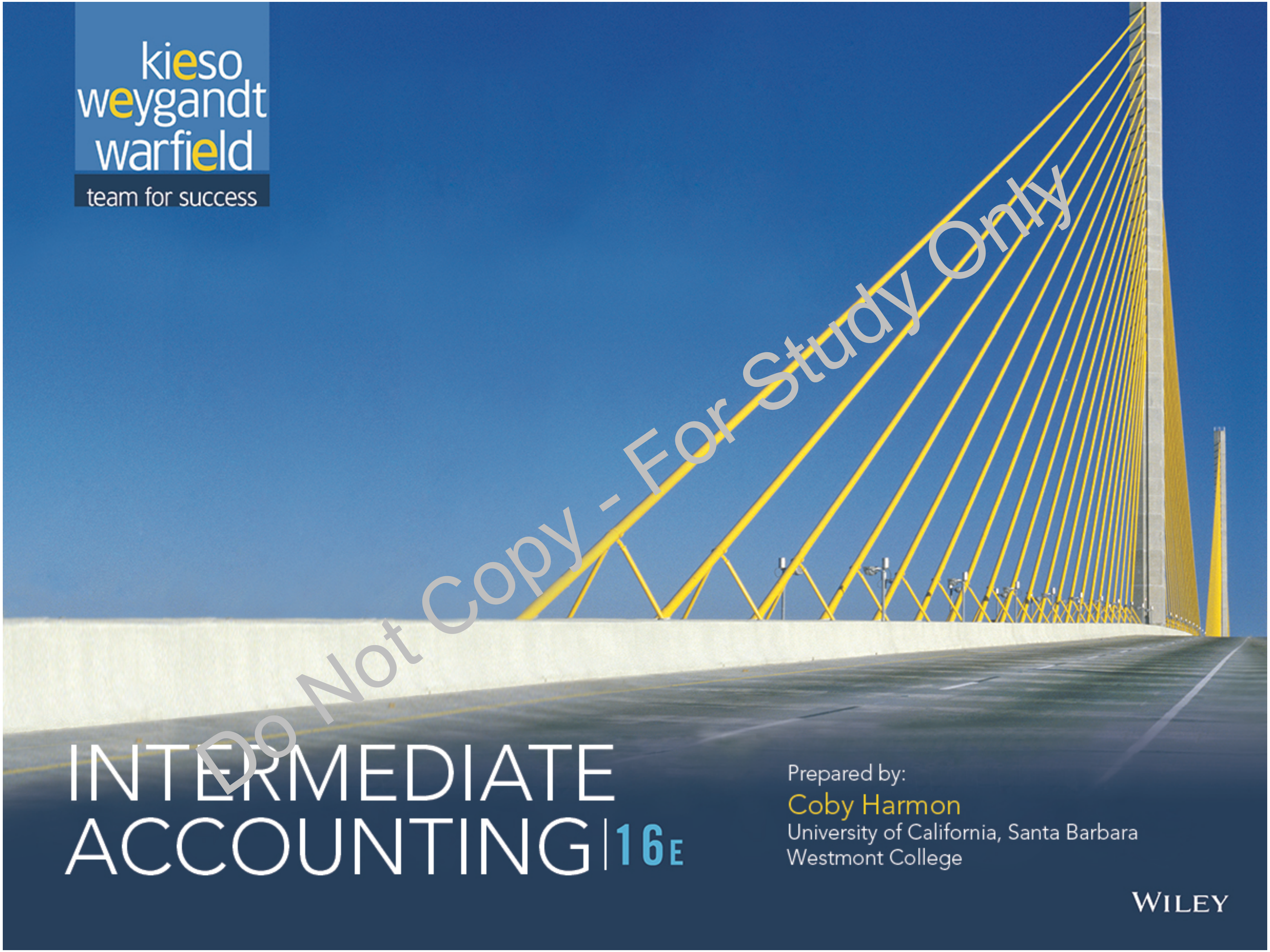

kieso
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warfield
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INTERMEDIATE ACCOUNTING | 16E

Prepared by:
Coby Harmon
University of California, Santa Barbara
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WILEY

PREVIEW OF CHAPTER 2

CONCEPTUAL FRAMEWORK FOR FINANCIAL REPORTING

CONCEPTUAL FRAMEWORK
- Need
- Development
- Overview

FIRST LEVEL: BASIC OBJECTIVE

SECOND LEVEL: FUNDAMENTAL CONCEPTS
- Qualitative characteristics
- Basic elements

THIRD LEVEL: RECOGNITION AND MEASUREMENT CONCEPTS
- Basic assumptions
- Basic principles
- Cost constraint
- Summary of the structure

Intermediate Accounting
16th Edition
Kieso ● Weygandt ● Warfield

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. Understand the objective of financial reporting.
3. Identify the qualitative characteristics of accounting information.
4. Define the basic elements of financial statements.
5. Describe the basic assumptions of accounting.
6. Explain the application of the basic principles of accounting.
7. Describe the impact that the cost constraint has on reporting accounting information.

CONCEPTUAL FRAMEWORK

-

The Need for a Conceptual Framework

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

CONCEPTUAL FRAMEWORK

-

Question (true or false):

A conceptual framework underlying financial accounting is important because it can lead to consistent standards and it prescribes the nature, function, and limits of financial accounting and financial statements.

True

CONCEPTUAL FRAMEWORK

-

Question (true or false):

A conceptual framework underlying financial accounting is necessary because future accounting practice problems can be solved by reference to the conceptual framework and a formal standard-setting body will not be necessary.

False

LO 1

WHAT DO THE NUMBERS MEAN?

WHAT'S YOUR PRINCIPLE?

The need for a conceptual framework is highlighted by accounting scandals such as those at **Enron** and **Lehman Brothers**. To restore public confidence in the financial reporting process, many have argued that regulators should move toward principles-based rules. They believe that companies exploited the detailed provisions in rules-based pronouncements to manage accounting reports, rather than report the economic substance of transactions. For example, many of the off–balance-sheet arrangements of Enron avoided transparent reporting by barely achieving 3 percent outside equity ownership, a requirement in an obscure accounting rule interpretation. Enron's financial engineers were able to structure transactions to achieve a desired accounting treatment, even if that accounting treatment did not reflect the transaction's true nature. Under principles-based rules, hopefully top management's financial reporting focus will shift from demonstrating compliance with rules to demonstrating that a company has attained the objective of financial reporting.

Development of Conceptual Framework

-

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

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

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

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

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

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

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

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

CONCEPTUAL FRAMEWORK

-

Overview of the Conceptual Framework

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

INTERNATIONAL PERSPECTIVE

The IASB has also issued a conceptual framework. Although the FASB and the IASB have worked together to converge elements of their conceptual frameworks (related to objectives and qualitative characteristics issued in 2010), the IASB has recently proposed additional changes to its own framework. This may result in differences with the FASB conceptual framework.

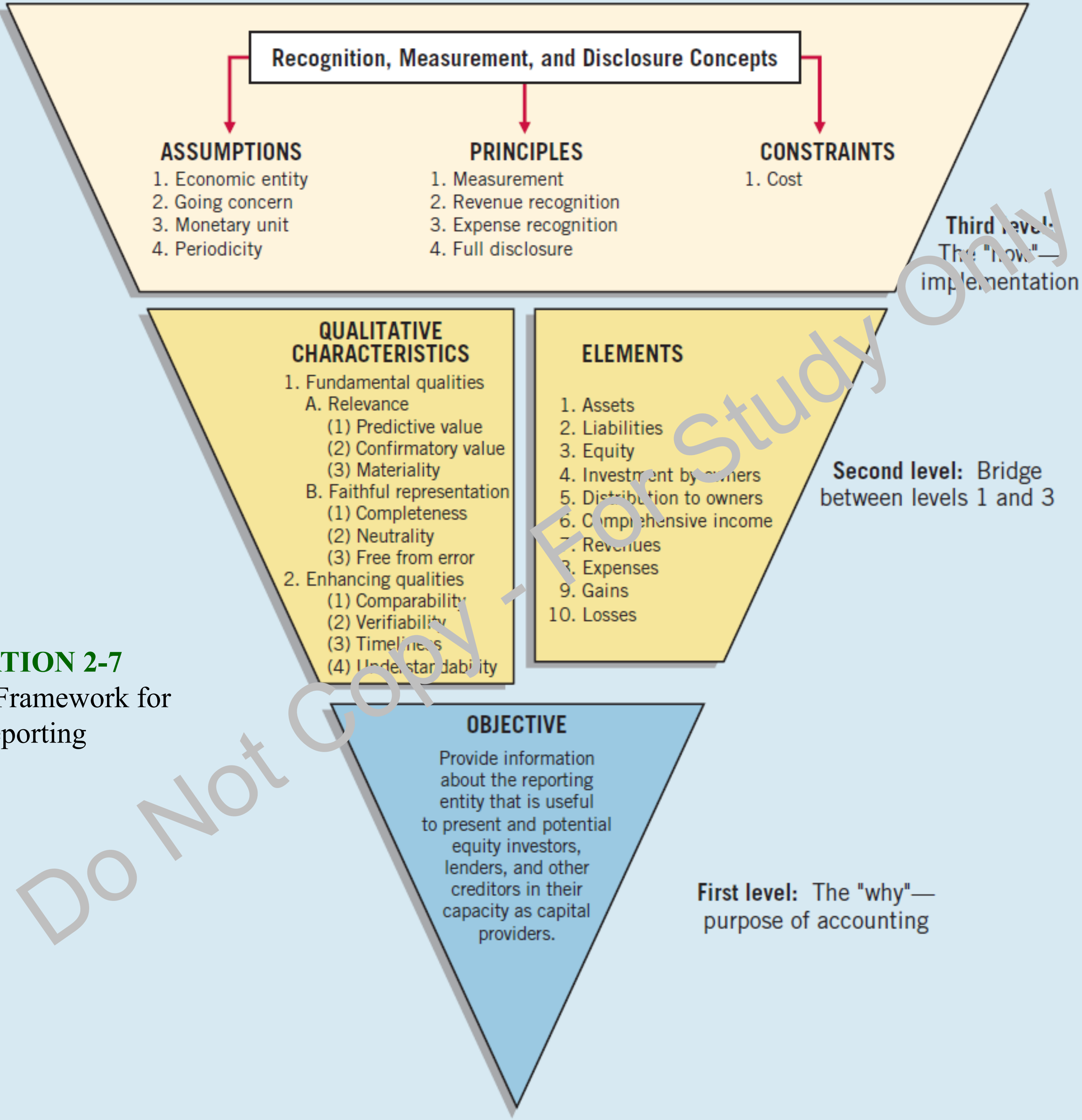

ILLUSTRATION 2-7
Conceptual Framework for Financial Reporting

LO 1

CONCEPTUAL FRAMEWORK

Question

What are the Statements of Financial Accounting Concepts intended to establish?

a. Generally accepted accounting principles in financial reporting by business enterprises.

b. The meaning of "Present fairly in accordance with generally accepted accounting principles."

c. The objectives and concepts for use in developing standards of financial accounting and reporting.

d. The hierarchy of sources of generally accepted accounting principles.

2 Conceptual Framework for Financial Reporting

LEARNING OBJECTIVES

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6. Explain the application of the basic principles of accounting.
7. Describe the impact that the cost constraint has on reporting accounting information.

FIRST LEVEL: BASIC OBJECTIVES

-

Objective of financial reporting:

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

FIRST Level: Basic Objectives

Question

According to the FASB conceptual framework, the objectives of financial reporting for business enterprises are based on?

a. Generally accepted accounting principles

b. Reporting on management's stewardship.

c. The need for conservatism.

d. The needs of the users of the information.

2 Conceptual Framework for Financial Reporting

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

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LO 3

SECOND LEVEL: FUNDAMENTAL CONCEPTS

-

Qualitative Characteristics of Accounting Information

"The **FASB** identified the **qualitative characteristics** of accounting information that distinguish better (more useful) information from inferior (less useful) information for decision-making purposes."

 LO 3

Second Level: Fundamental Concepts

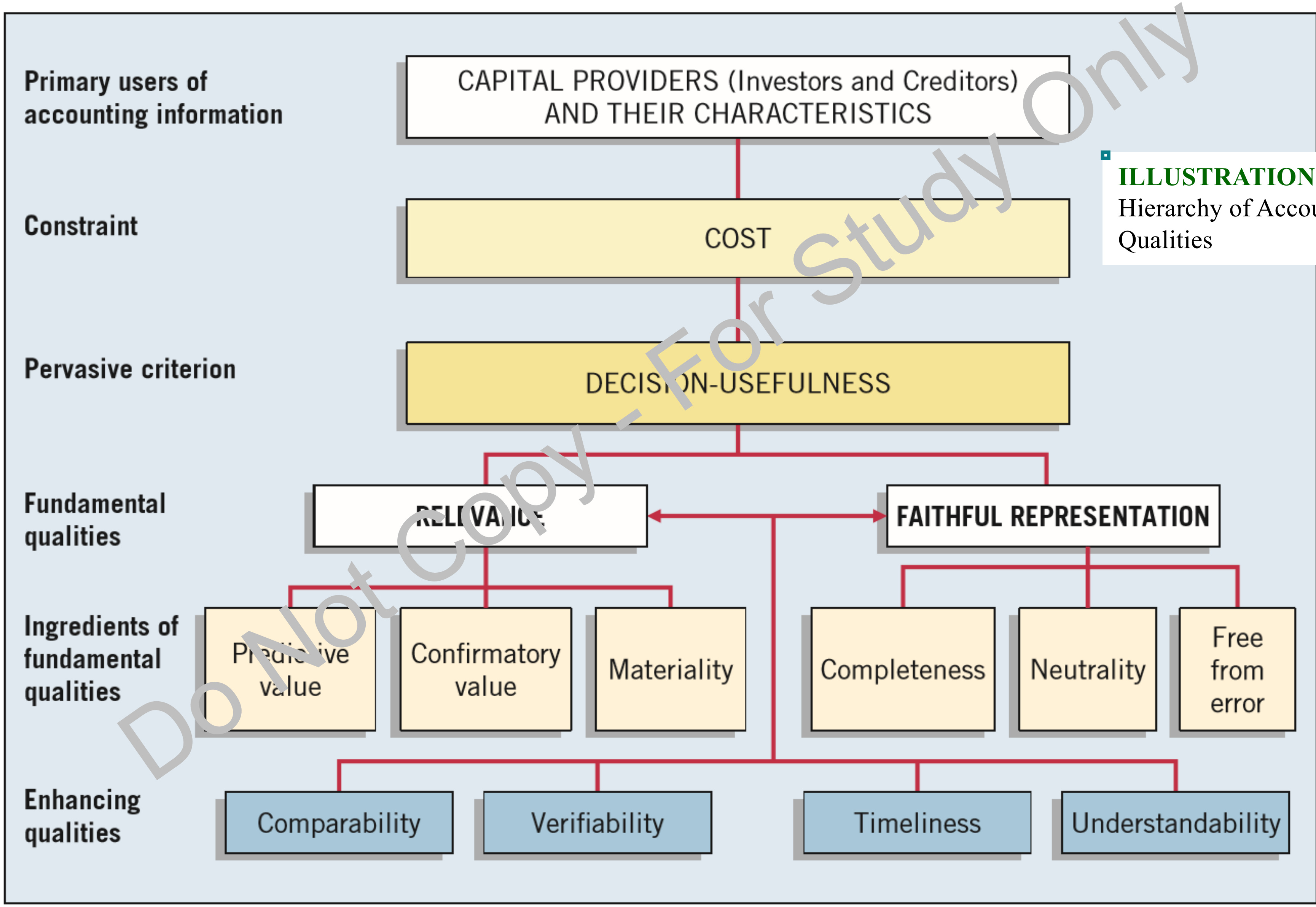

ILLUSTRATION 2-2
Hierarchy of Accounting Qualities

LO 3

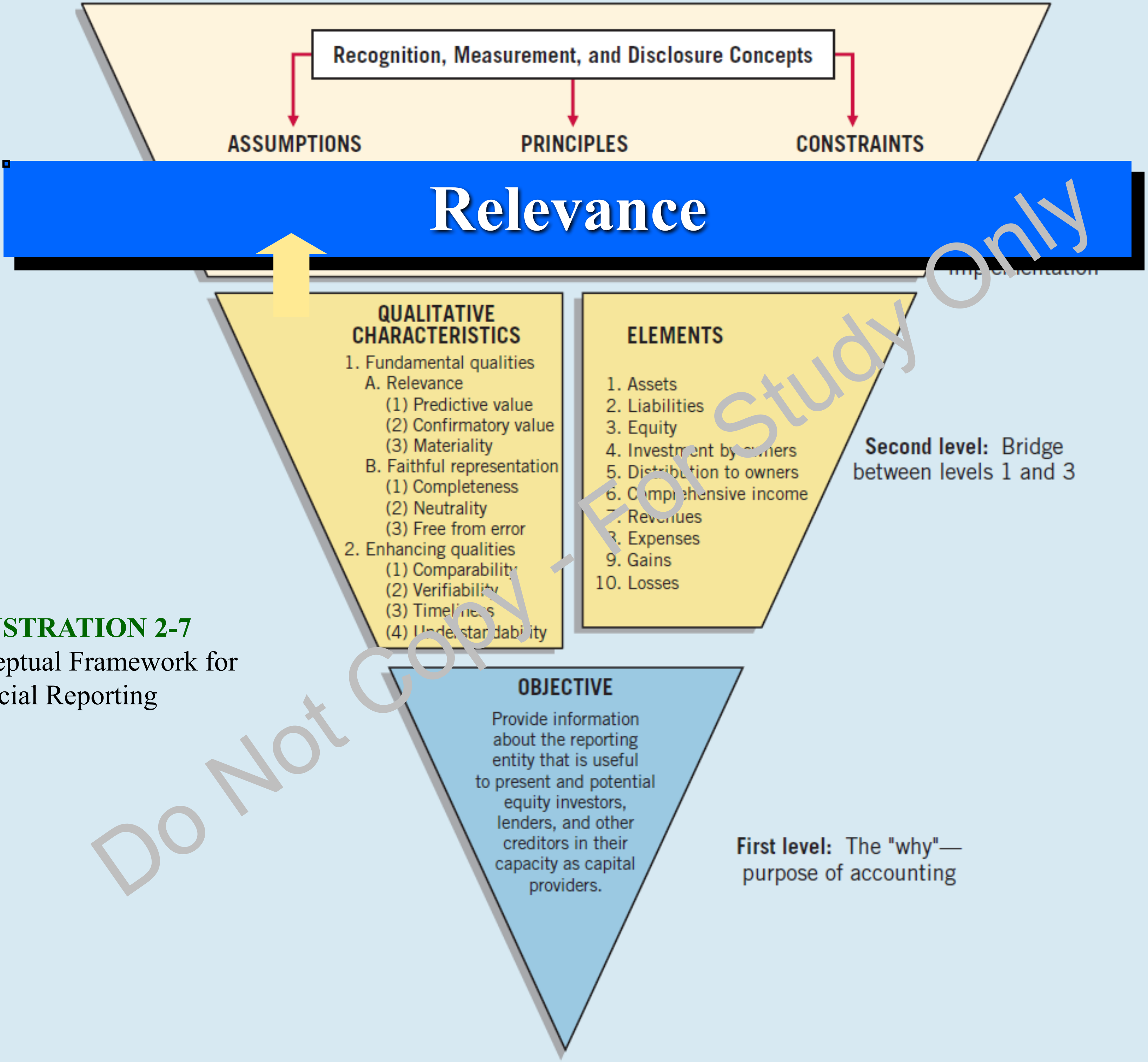

ILLUSTRATION 2-7
Conceptual Framework for Financial Reporting

LO 3

Second Level: Fundamental Concepts

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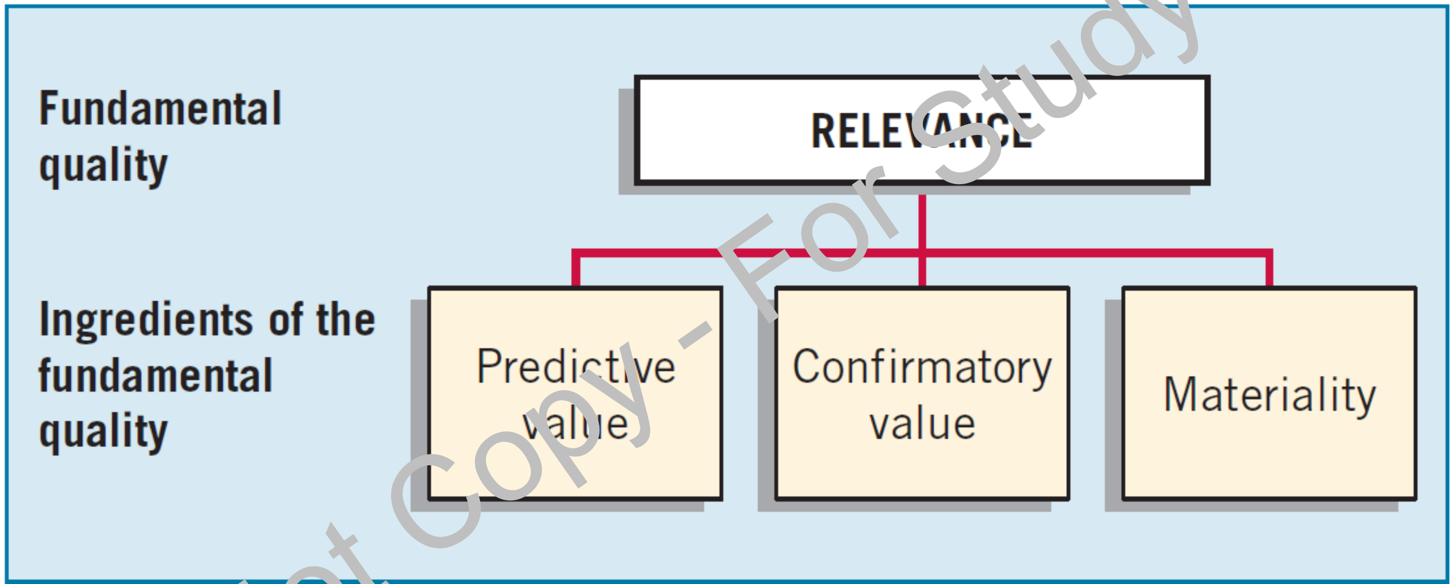
Fundamental Quality—Relevance

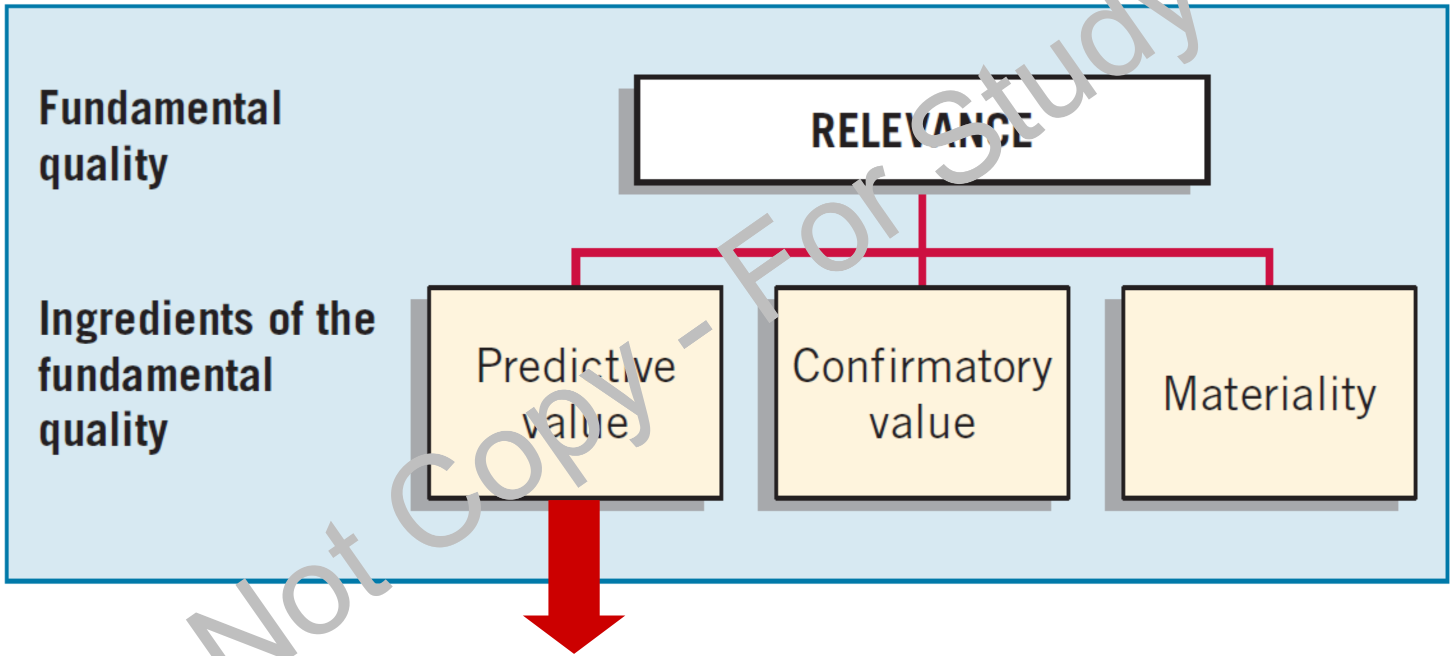


To be **relevant**, accounting information must be capable of **making a difference in a decision**.

Second Level: Fundamental Concepts

-

Fundamental Quality—Relevance

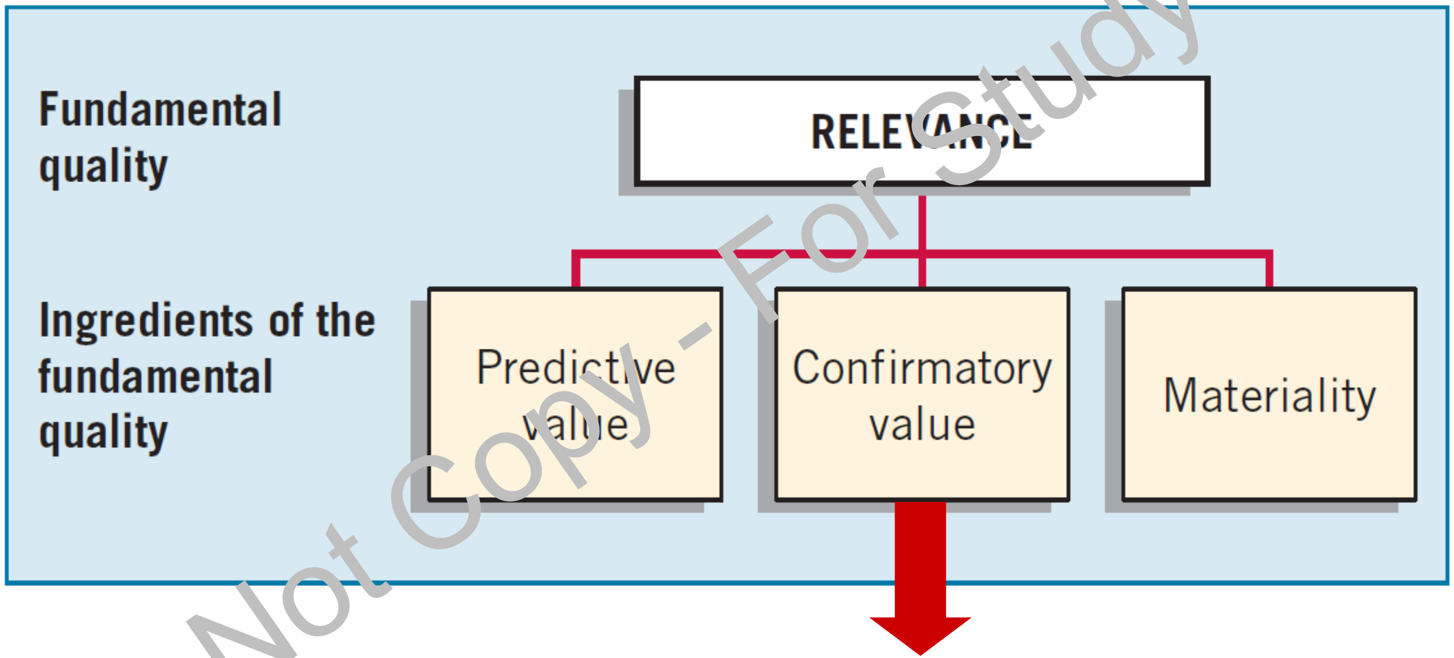


Financial information has **predictive value** if it has value as an input to predictive processes used by investors to form their own expectations about the future.

Second Level: Fundamental Concepts

-

Fundamental Quality—Relevance



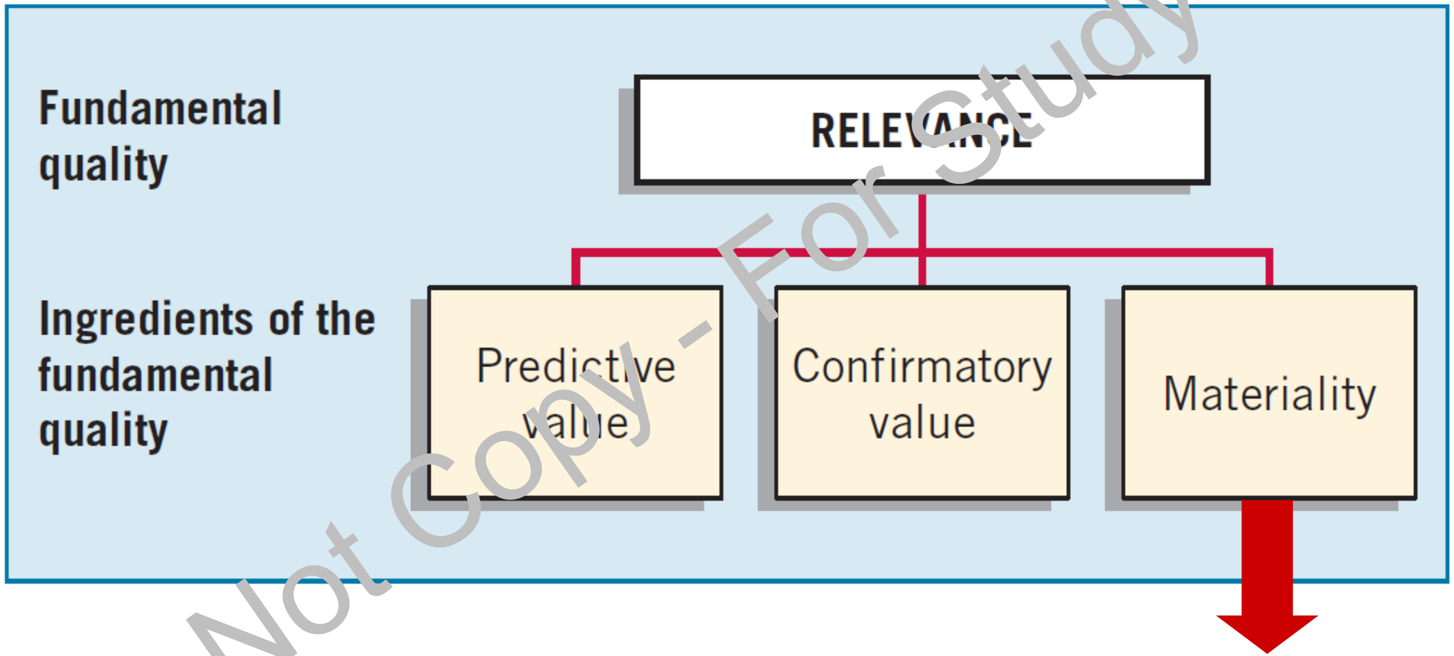
Relevant information also helps users **confirm** or correct prior expectations.

LO 3

Second Level: Fundamental Concepts

-

Fundamental Quality—Relevance



Information is **material** if omitting it or misstating it could influence decisions that users make on the basis of the reported financial information.

Faithful Representation

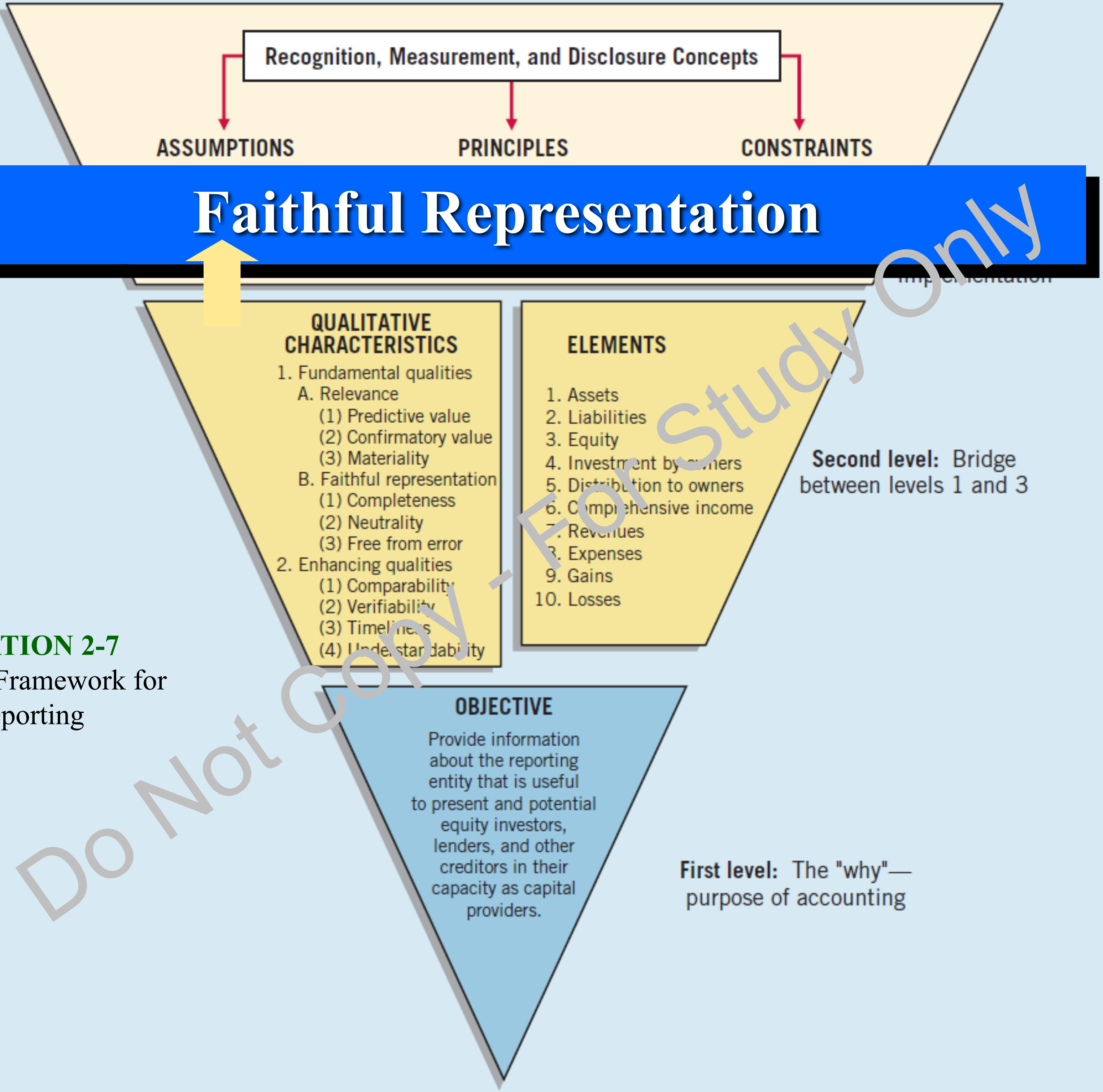


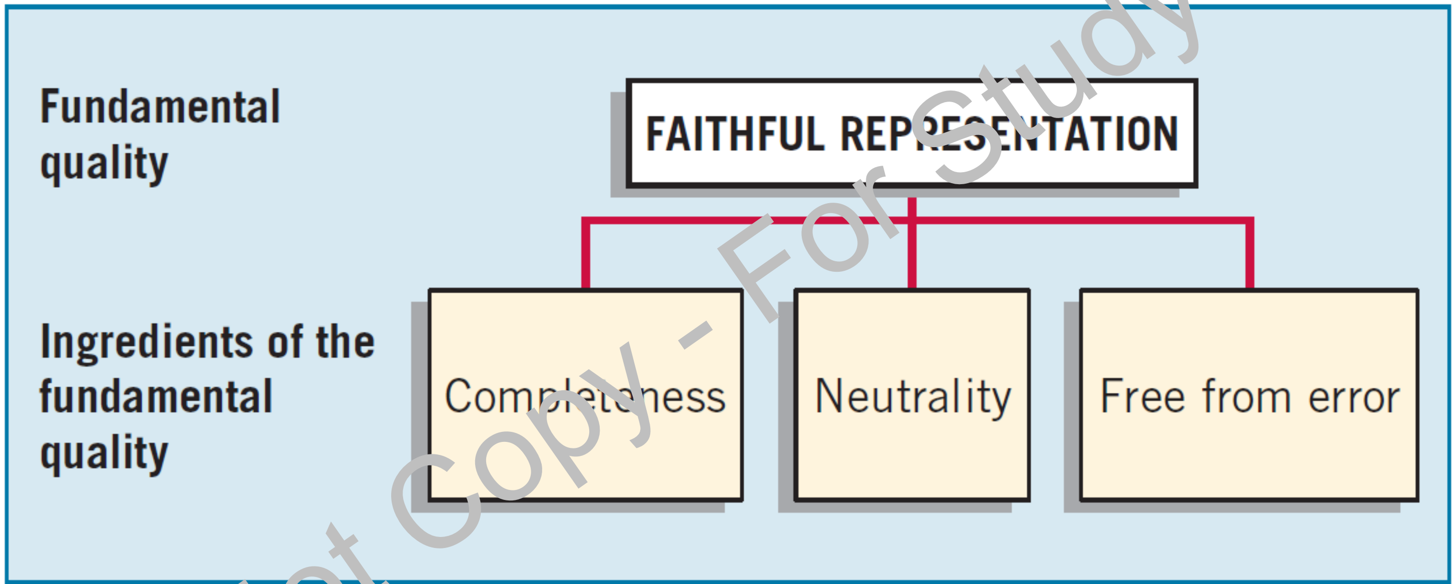
ILLUSTRATION 2-7
Conceptual Framework for Financial Reporting

LO 3

Second Level: Fundamental Concepts

-

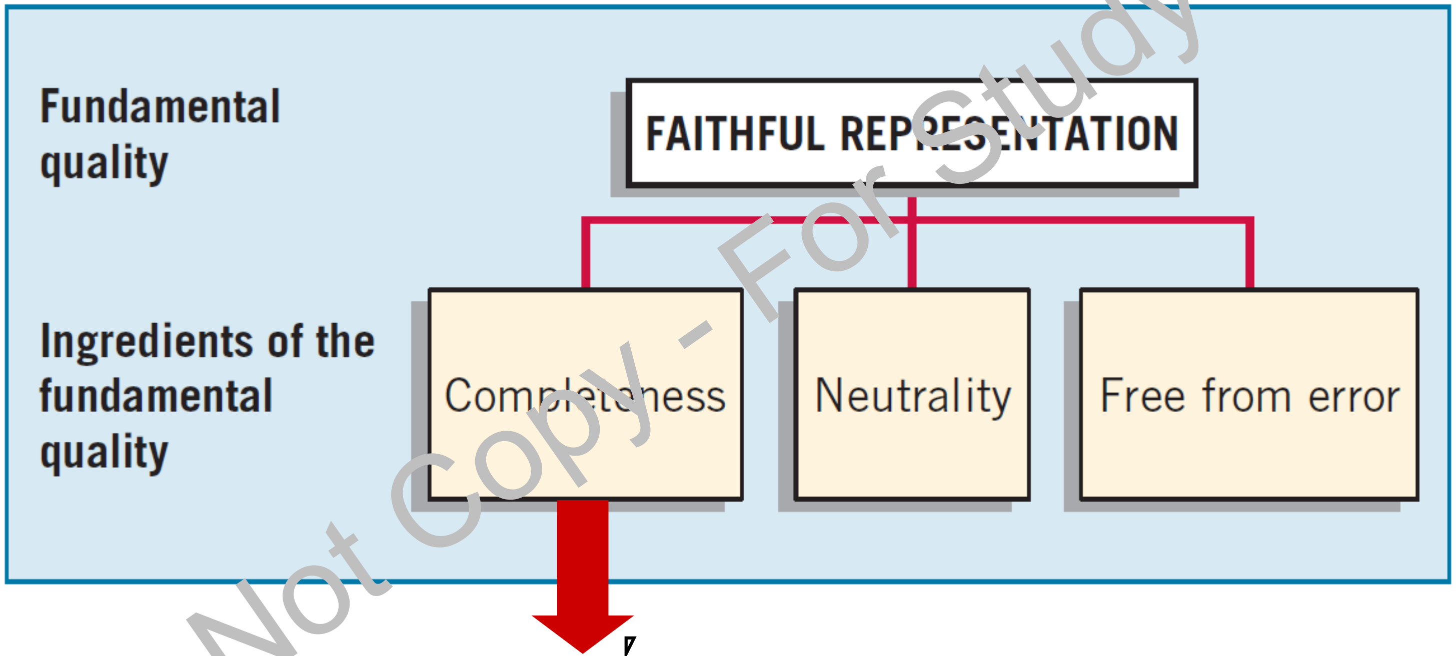
Fundamental Quality—Faithful Representation



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

Second Level: Fundamental Concepts

Fundamental Quality—Faithful Representation



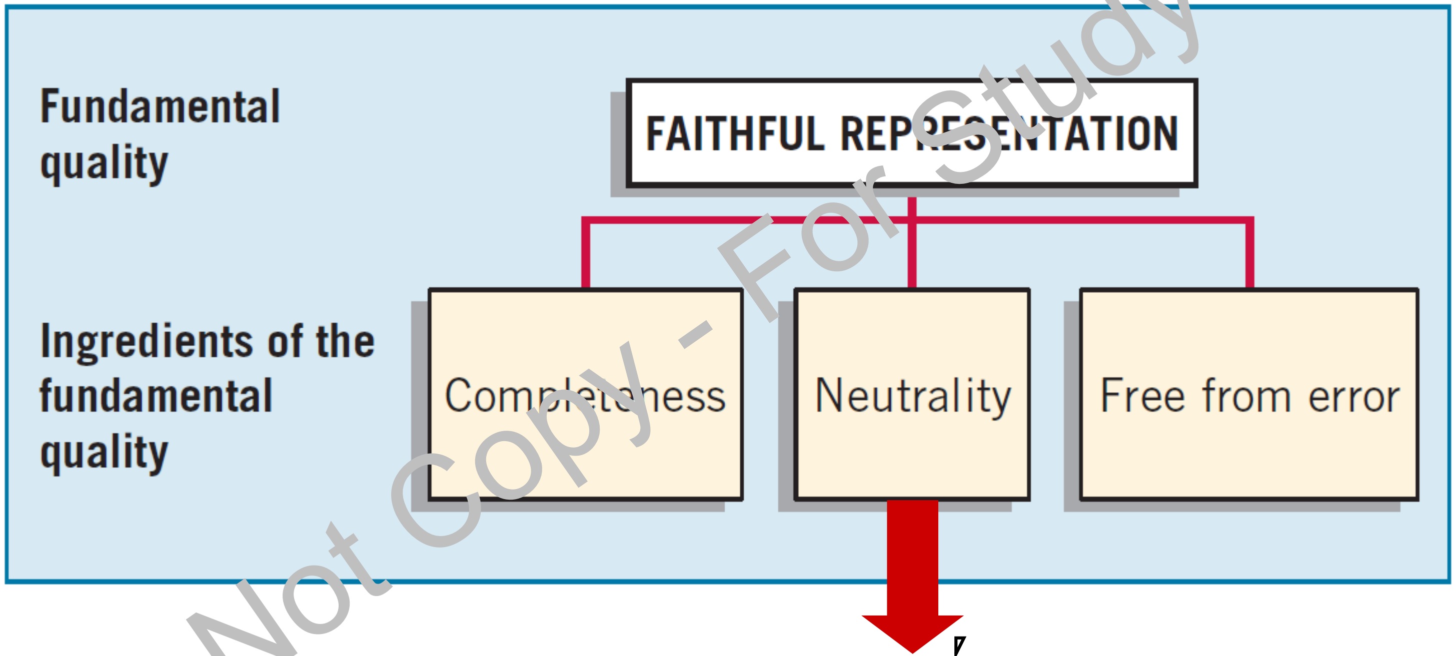
Completeness means that all the information that is necessary for faithful representation is provided.

 LO 3

Second Level: Fundamental Concepts

-

Fundamental Quality—Faithful Representation

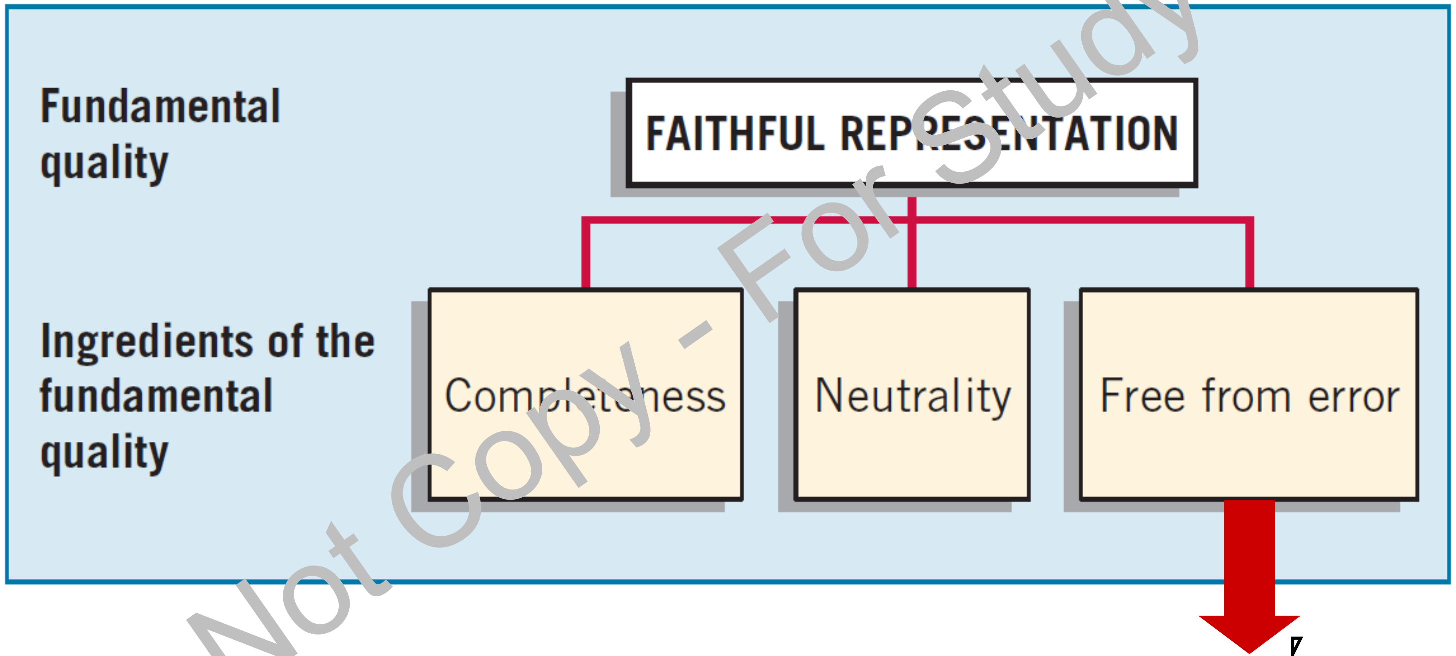


Neutrality means that a company cannot select information to favor one set of interested parties over another.

Second Level: Fundamental Concepts

-

Fundamental Quality—Faithful Representation

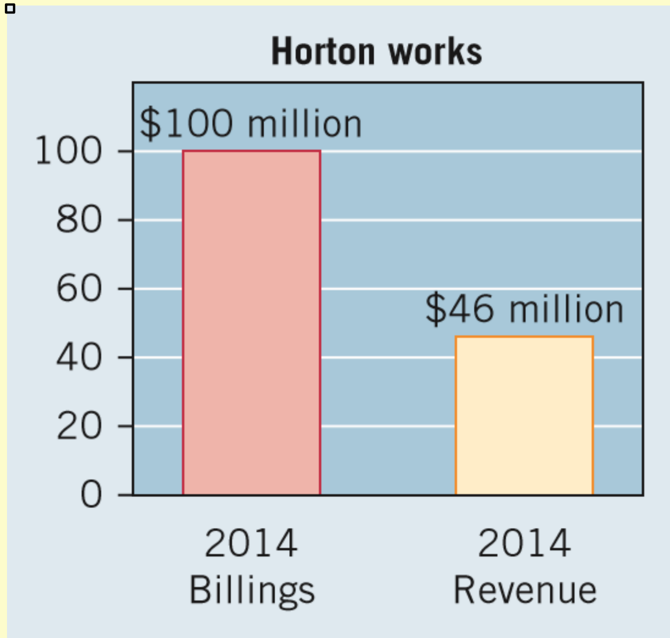


An information item that is **free from error** will be a more accurate (faithful) representation of a financial item.

LO 3

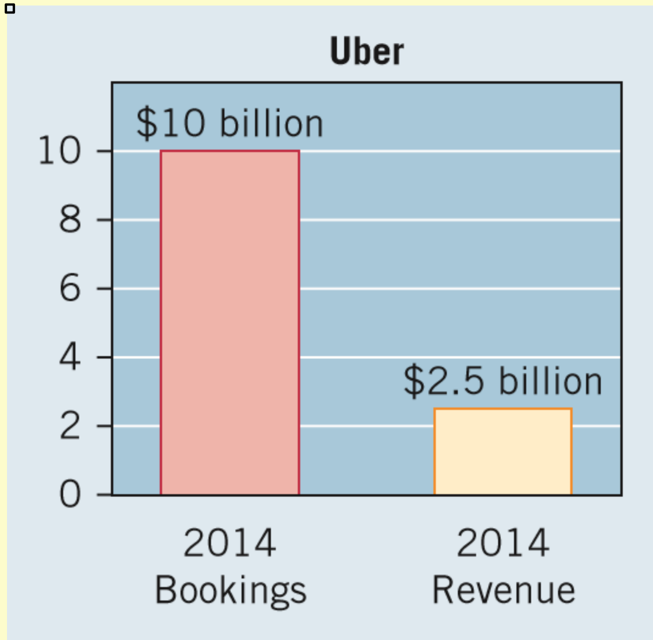
WHAT DO THE NUMBERS MEAN? SHOW ME THE EARNINGS!

Some young technology companies, in an effort to attract investors who will help them strike it rich, are using unconventional financial terms in their financial reports. As an example, instead of revenue, these privately held companies use terms such as “bookings,” annual recurring revenues, or other numbers that often exceed actual revenue. **Hortonworks Inc.** (a software company) is a classic illustration. It forecast in March 2014 that it would have a strong $100 million in billing by year-end. It turns out the company was not talking about revenues but rather a non-GAAP number that it uses to gauge future business. This number looked a lot smaller after Hortonworks went public and reported financial results—just $46 million in revenues, as shown in the chart.



WHAT DO THE NUMBERS MEAN? SHOW ME THE EARNINGS!

Another example is **Uber Technologies** (the sometimes controversial ride service). Uber recently noted that it is on target to reach $10 billion in bookings for 2015. Uber defines bookings as total fares paid by customers. But Uber keeps little of the money from these bookings. As shown in the chart below, Uber gets only 25 cents on each $1 of bookings. If Uber was a public company, it would report the 25 cents as revenues, not the one dollar. The lesson for investors: Keep an eye on reliable financial measures of performance and be sure to count expenses and net income according to GAAP. Using gross measures such as billings, recurring revenues, or some nonfinancial and non-GAAP measures to determine success may be hazardous to your financial health.

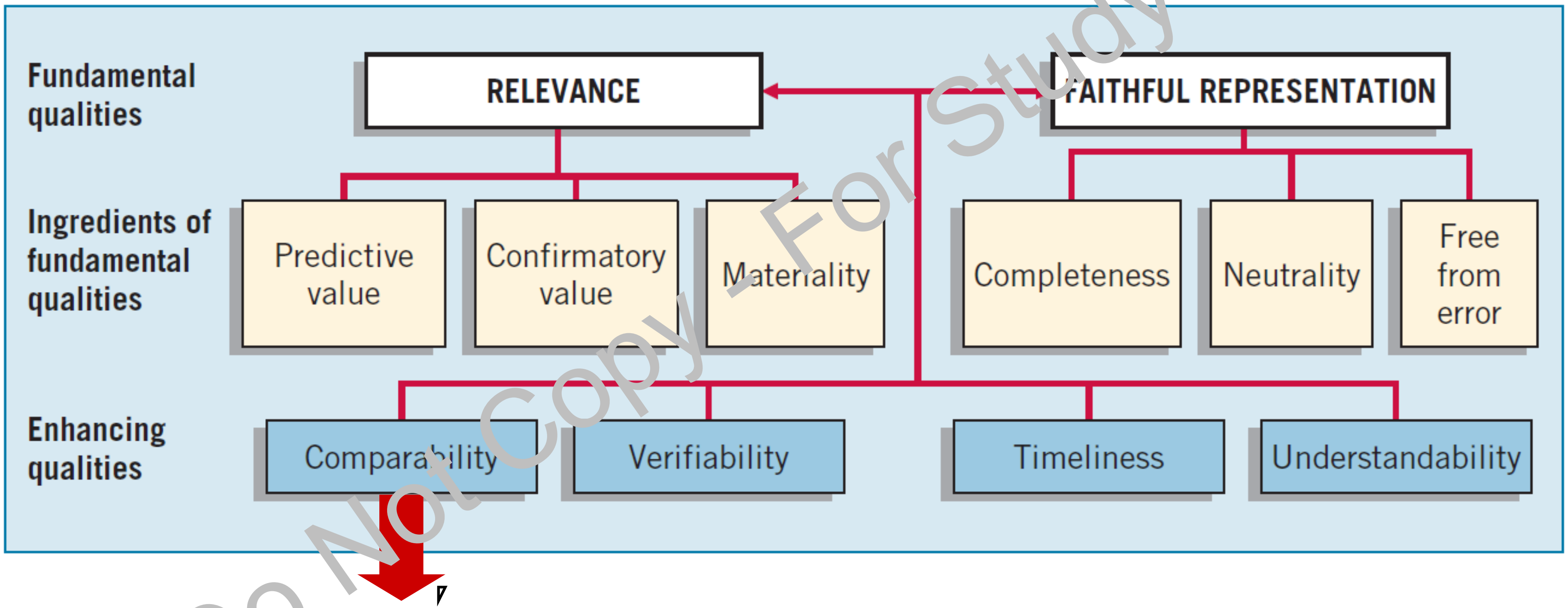


Source: Telis Demos, Shira Ovide, and Susan Pulliam, "Tech Startups Play Numbers Game," Wall Street Journal (June 10, 2015), pp. A1 and A12.

Second Level: Fundamental Concepts

-

Enhancing Qualities



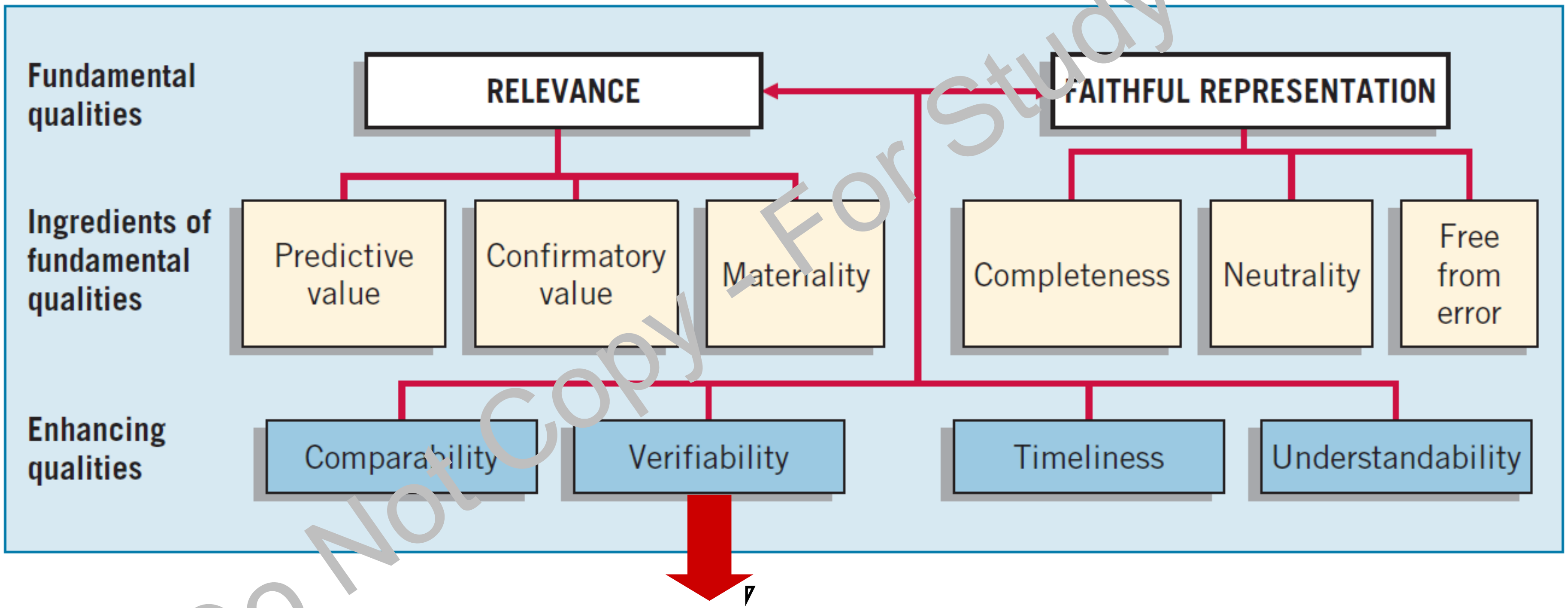
Information that is measured and reported in a similar manner for different companies is considered **comparable**.

LO 3

Second Level: Fundamental Concepts

-

Enhancing Qualities



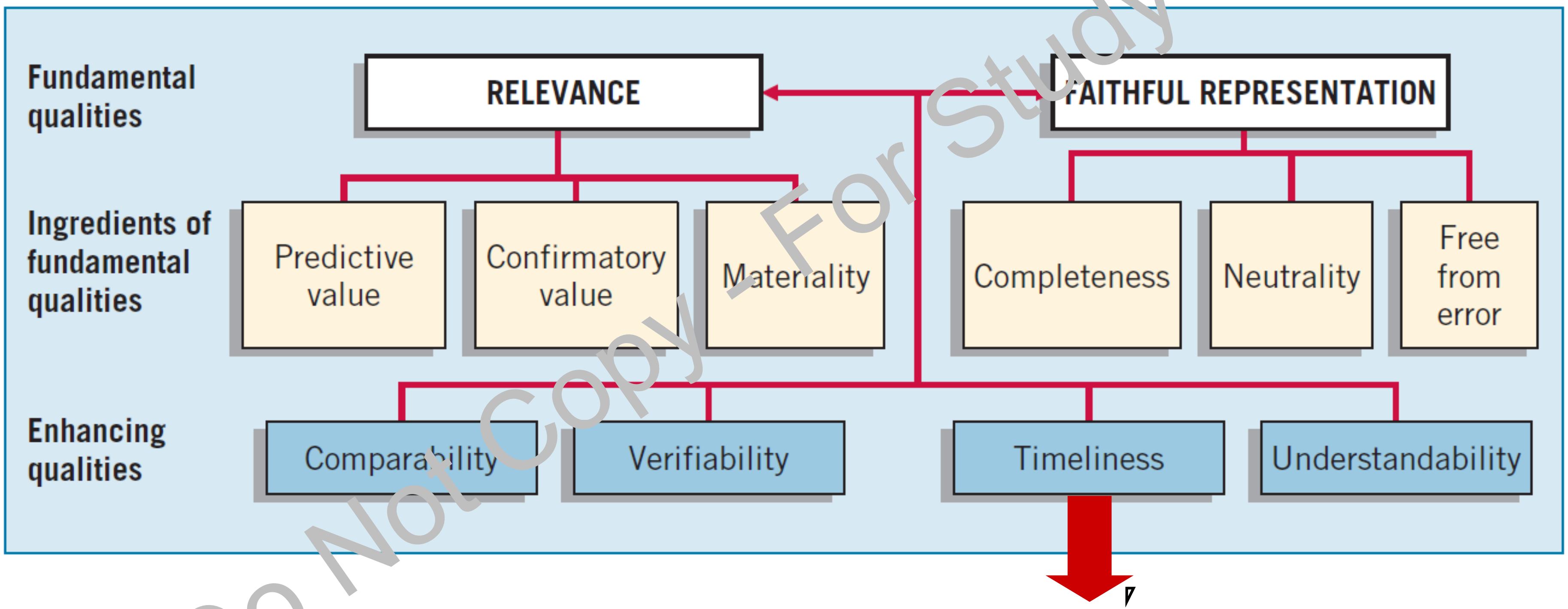
Verifiability occurs when independent measurers, using the same methods, obtain similar results.

LO 3

Second Level: Fundamental Concepts

-

Enhancing Qualities

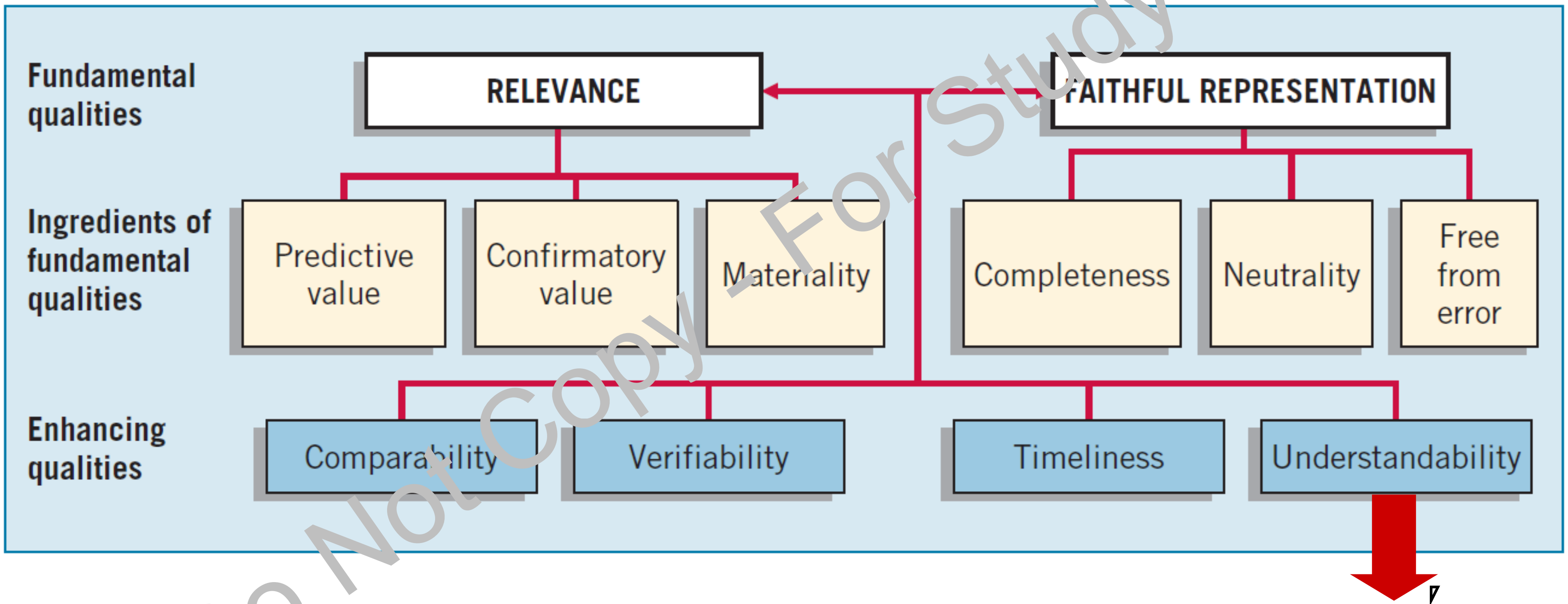


Timeliness means having information available to decision-makers before it loses its capacity to influence decisions.

Second Level: Fundamental Concepts

-

Enhancing Qualities



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

Basic Elements

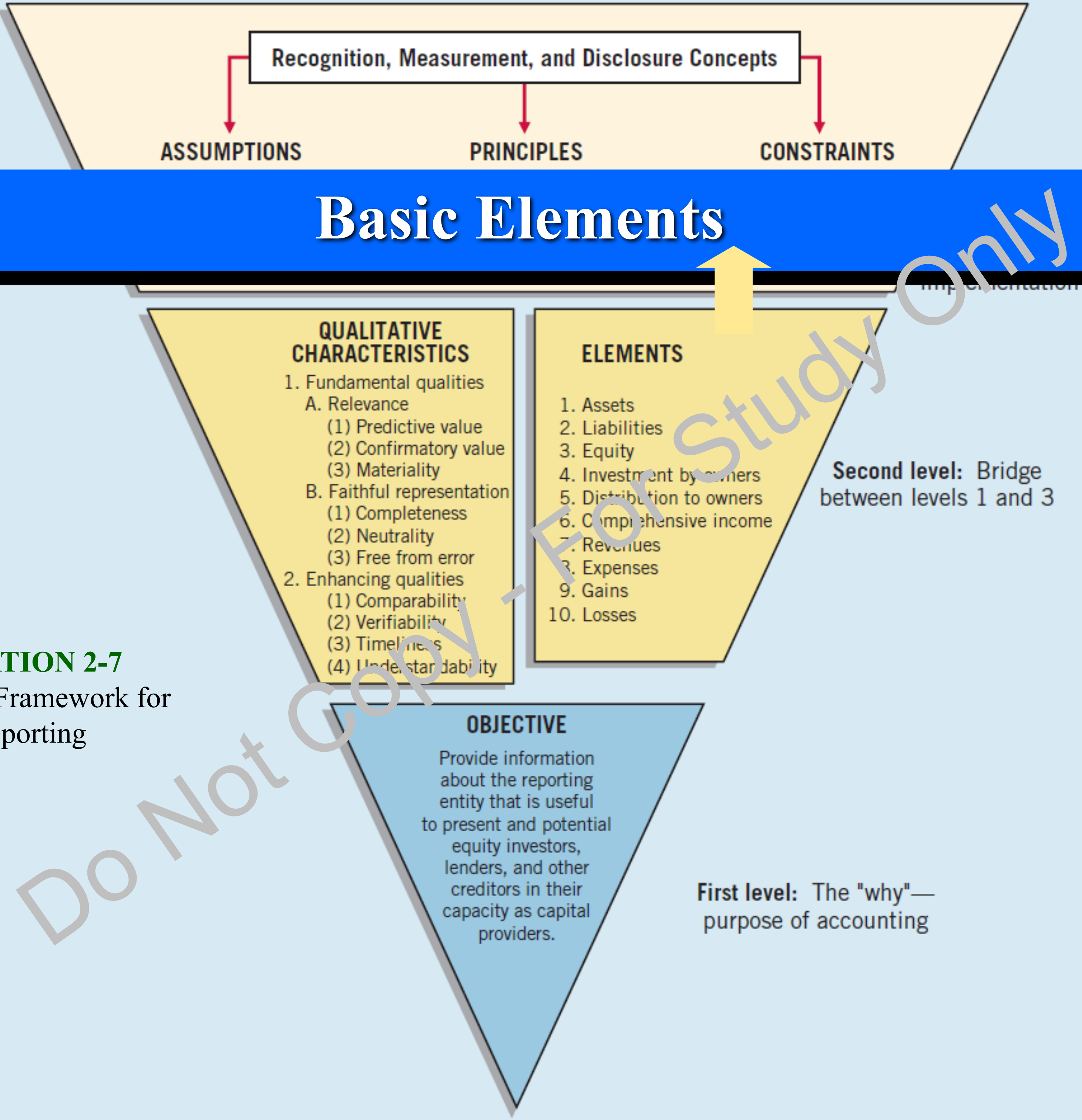


ILLUSTRATION 2-7
Conceptual Framework for Financial Reporting

LO 3

2 Conceptual Framework for Financial Reporting

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

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7. Describe the impact that the cost constraint has on reporting accounting information.

Second Level: Basic Elements

-

Concepts Statement No. 6 defines ten interrelated elements that relate to measuring the performance and financial status of a business enterprise.

"Moment in Time"

- Assets
- Liabilities
- Equity

"Period of Time"

- Investment by owners
- Distribution to owners
- Comprehensive income
- Revenue
- Expenses
- Gains
- Losses

Second Level: Basic Elements

Question

According to the FASB conceptual framework, an entity's revenue may result from

a. A decrease in an asset from primary operations.

b. An increase in an asset from incidental transactions.

c. An increase in a liability from incidental transactions.

d. A decrease in a liability from primary operations.

2 Conceptual Framework for Financial Reporting

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Third Level: Recognition and Measurement

-

The FASB sets forth most of these concepts in its **Statement of Financial Accounting Concepts No. 5**, "Recognition and Measurement in Financial Statements of Business Enterprises."

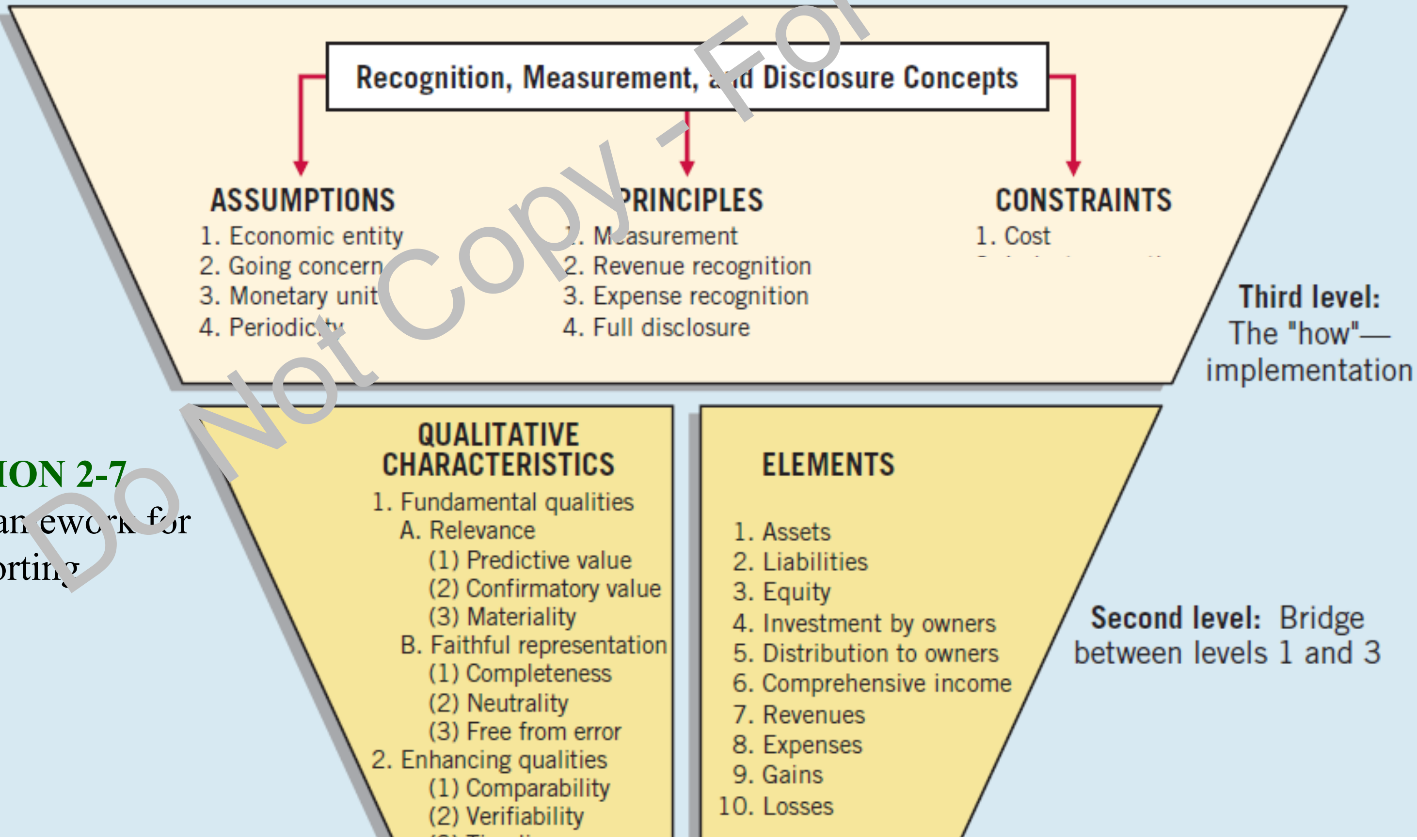

ILLUSTRATION 2-7
Conceptual Framework for Financial Reporting

LO 5

Third Level: Basic Assumptions

-

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

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

Monetary Unit - money is the common denominator.

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

Third Level: Basic Assumptions

Illustration: Identify which basic assumption of accounting is best described in each item below.

(a) The economic activities of KC Corporation are divided into 12-month periods for the purpose of issuing annual reports.

Periodicity

(b) Solectron Corporation, Inc. does not adjust amounts in its financial statements for the effects of inflation.

Monetary Unit

(c) Walgreen Co. reports current and noncurrent classifications in its balance sheet.

Going Concern

(d) The economic activities of General Electric and its subsidiaries are merged for accounting and reporting purposes.

Economic Entity

WHAT DO THE NUMBERS MEAN?

WHOSE COMPANY IS IT?

The importance of the entity assumption is illustrated by scandals involving **W. R. Grace** and, more recently, **Adelphia**. In both cases, senior company employees entered into transactions that blurred the line between the employee's financial interests and those of the company. At Adelphia, among many other self-dealings, the company guaranteed over $2 billion of loans to the founding family. W. R. Grace used company funds to pay for an apartment and chef for the company chairman. As a result of these transactions, these insiders benefitted at the expense of shareholders. Additionally, the financial statements failed to disclose the transactions. Such disclosure would have allowed shareholders to sort out the impact of the employee transactions on company results.

2 Conceptual Framework for Financial Reporting

LEARNING OBJECTIVES

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Third Level: Basic Principles

-

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

Issues:

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

Third Level: Basic Principles

-

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

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

ILLUSTRATION 2-6
Expense Recognition

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

Third Level: Basic Principles

-

Illustration: Assume the **Boeing Corporation** signs a contract to sell airplanes to **Delta Air Lines** for $100 million. To determine when to **recognize revenue**, use the five steps for revenue recognition shown at right.

Step 1: Identify the contract(s) with the customer.	A contract is an agreement between two parties that creates enforceable rights or obligations. In this case, Boeing has signed a contract to deliver airplanes to Delta.
Step 2: Identify the separate performance obligations in the contract.	Boeing has only one performance obligation—to deliver airplanes to Delta. If Boeing also agreed to maintain the planes, a separate performance obligation is recorded for this promise.
Step 3: Determine the transaction price.	Transaction price is the amount of consideration that a company expects to receive from a customer in exchange for transferring a good or service. In this case, the transaction price is straightforward—it is $100 million.
Step 4: Allocate the transaction price to the separate performance obligations.	In this case, Boeing has only one performance obligation—to deliver airplanes to Delta.
Step 5: Recognize revenue when each performance obligation is satisfied.	Boeing recognizes revenue of $100 million for the sale of the airplanes to Delta when it satisfies its performance obligation—the delivery of the airplanes to Delta.

ILLUSTRATION 2-5

Third Level: Basic Principles

-

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

Provided through:

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

Third Level: Basic Principles

-

Illustration: Identify which basic principle of accounting is best described in each item below.

(a) KC Corporation reports revenue in its income statement when it is earned instead of when the cash is collected.

(b) Yahoo, Inc. recognizes depreciation expense for a machine over the 2-year period during which that machine helps the company earn revenue.

(c) Oracle Corporation reports information about pending lawsuits in the notes to its financial statements.

(d) Eastman Kodak Company reports land on its balance sheet at the amount paid to acquire it, even though the estimated fair market value is greater.

Revenue Recognition

Expense Recognition

Full Disclosure

Measurement

WHAT DO THE NUMBERS MEAN? DON'T COUNT THESE PLEASE

Beyond touting nonfinancial measures to investors, many companies increasingly promote the performance of their companies through the reporting of various "pro forma" earnings measures. Pro forma measures are standard measures (such as earnings) that companies adjust, usually for unusual or non-recurring items. Such adjustments make the numbers more comparable to numbers reported in periods without these unusual or non-recurring items. However, rather than increasing comparability, it appears that some companies use pro forma reporting to accentuate the positive in their results. Examples include Yahoo! and Cisco, which define pro forma income after adding back payroll tax expense. Level 8 Systems transformed an operating loss into a pro forma profit by adding back expenses for depreciation and amortization of intangible assets. And taking a more macro look, the following table shows the difference between pro forma (non-GAAP) and GAAP earnings per share for the three main Standard & Poor's stock indexes for recent year.

continued

WHAT DO THE NUMBERS MEAN? DON'T COUNT THESE PLEASE

Index	Non-GAAP Earnings	GAAP Earnings	% Variance (GAAP less Non-GAAP)
S&P 400	$54.53	$45.68	−19.4%
S&P 500	96.82	86.51	−11.9%
S&P 600	21.62	16.33	−32.4%

What this table shows is that the S&P 600 is especially biased with a variance of 32.4% (non-GAAP higher than GAAP). Lynn Turner, former chief accountant at the SEC, calls such earnings measures EBS—"Everything but Bad Stuff." To provide investors a more complete picture of company profitability, not the story preferred by management, the SEC issued Regulation G (REG G). For example, REG G (and related item 10E) requires companies to reconcile non-GAAP financial measures to GAAP, thereby giving investors a roadmap to analyze the adjustments that companies make to their GAAP numbers to arrive at pro forma results.

Sources: Adapted from Gretchen Morgenson, "How Did They Value Stocks? Count the Absurd Ways," The New York Times (March 18, 2001), section 3, p. 1; Regulation G, "Conditions for Use of Non-GAAP Financial Measures," Release No. 33-8176 (March 28, 2003, updated January, 2010); and J. Adamo, "Even GAAP Is Better Than These Adjustments," Barron's (November 4, 2013).

2 Conceptual Framework for Financial Reporting

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6. Explain the application of the basic principles of accounting.
7. **Describe the impact that the cost constraint has on reporting accounting information.**

Third Level: Constraints

-

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

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

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

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

Summary of the Structure

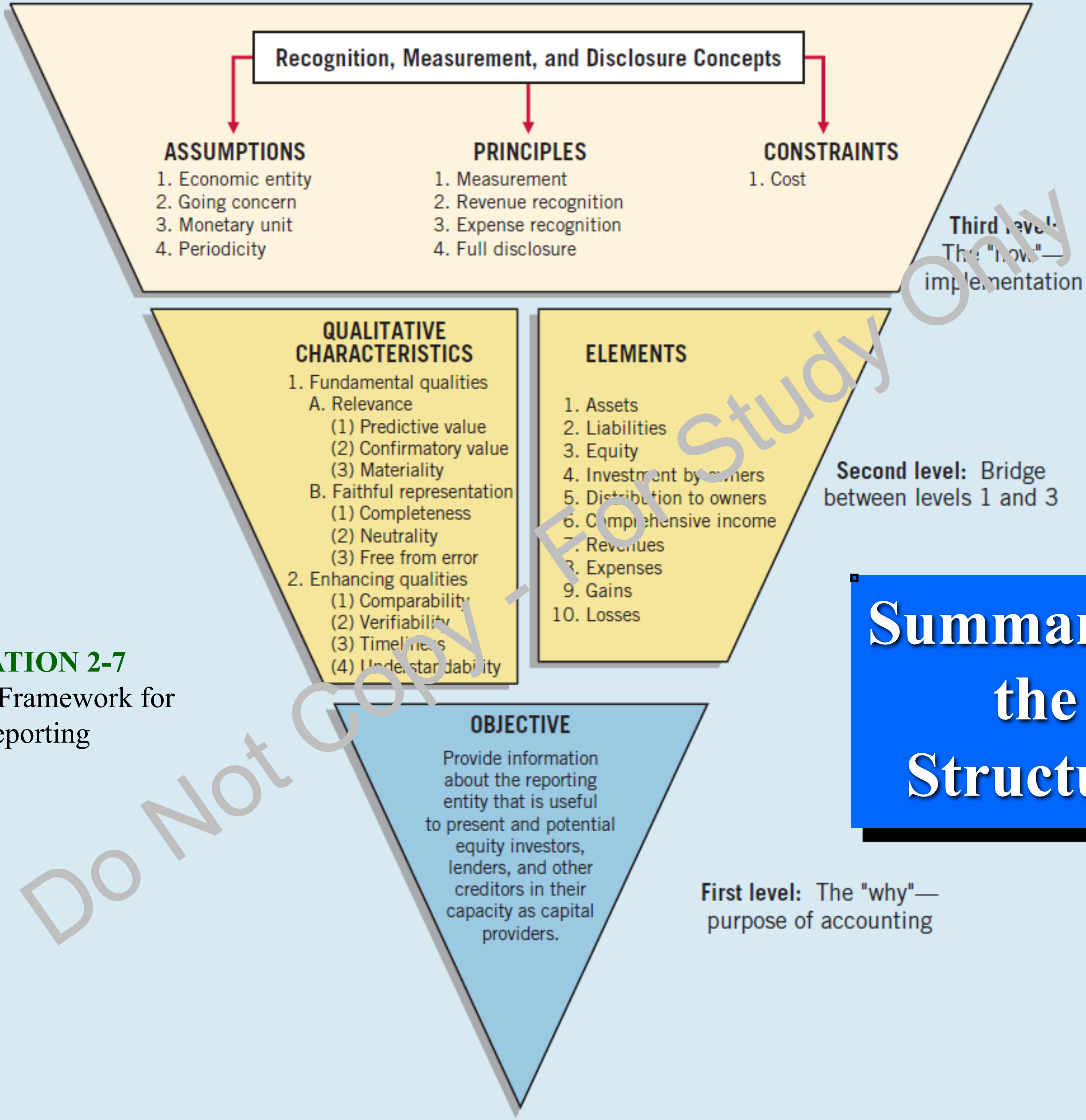

ILLUSTRATION 2-7
Conceptual Framework for Financial Reporting

LO 7

IFRS Insights

RELEVANT FACTS

Similarities

- In 2010, the IASB and FASB agreed on the objective of financial reporting and a common set of desired qualitative characteristics. These were presented in the Chapter 2 discussion. Note that prior to this agreement, the IASB conceptual framework gave more emphasis to the objective of providing information on management's performance (stewardship).
- The existing conceptual frameworks underlying GAAP and IFRS are very similar. That is, they are organized in a similar manner (objective, elements, qualitative characteristics, etc.). There is no real need to change many aspects of the existing frameworks other than to converge different ways of discussing essentially the same concepts.

IFRS Insights

RELEVANT FACTS

Similarities

- Both the IASB and FASB have similar measurement principles, based on historical cost and fair value. In 2011, the Boards issued a converged standard fair value measurement so that the definition of fair value, measurement techniques, and disclosures are the same between GAAP and IFRS when fair value is used in financial statements.

IFRS Insights

RELEVANT FACTS

Differences

- Although both GAAP and IFRS are increasing the use of fair value to report assets, at this point IFRS has adopted it more broadly. As examples, under IFRS, companies can apply fair value to property, plant, and equipment; natural resources; and in some cases, intangible assets.

- GAAP has a concept statement to guide estimation of fair values when market-related data is not available (Statement of Financial Accounting Concepts No. 7, "Using Cash Flow Information and Present Value in Accounting"). The IASB has not issued a similar concept statement; it has issued a fair value standard (IFRS 13) that is converged with GAAP.

LO 8

RELEVANT FACTS

Differences

- The monetary unit assumption is part of each framework. However, the unit of measure will vary depending on the currency used in the country in which the company is incorporated (e.g., Chinese yuan, Japanese yen, and British pound). IFRS makes an explicit assumption that financial statements are prepared on an accrual basis.

- The economic entity assumption is also part of each framework, although some cultural differences result in differences in its application. For example, in Japan many companies have formed alliances that are so strong that they act similar to related corporate divisions although they are not actually part of the same company.

IFRS Insights

ABOUT THE NUMBERS

Financial Statement Elements

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

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

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

LO 8

IFRS Insights

ABOUT THE NUMBERS

Financial Statement Elements

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

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

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

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

Conceptual Framework Work Plan

Moving ahead in its stand-alone conceptual framework project, the IASB has decided that:

1. The conceptual framework project should focus on elements of financial statements, reporting entity, presentation, and disclosure.
2. The aim should be to work toward a single discussion paper covering all of the identified areas, rather than separate discussion papers for each area.

IFRS Insights

ON THE HORIZON

The IASB and the FASB face a difficult task in attempting to update, modify, and complete a converged conceptual framework. There are many difficult issues. For example: How do we trade off characteristics such as highly relevant information that is difficult to verify? How do we define control when we are developing a definition of an asset? Is a liability the future sacrifice itself or the obligation to make the sacrifice? Should a single measurement method, such as historical cost or fair value, be used, or does it depend on whether it is an asset or liability that is being measured?

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IFRS SELF-TEST QUESTION

Which of the following statements about the IASB and FASB conceptual frameworks is not correct?

a. The IASB conceptual framework does not identify the element comprehensive income.

b. The existing IASB and FASB conceptual frameworks are organized in similar ways.

c. The FASB and IASB agree that the objective of financial reporting is to provide useful information to investors and creditors.

d. IFRS does not allow use of fair value as a measurement basis.

IFRS SELF-TEST QUESTION

Which of the following statements is false?

a. The monetary unit assumption is used under IFRS.

b. Under IFRS, companies may use fair value for property, plant, and equipment.

c. The FASB and IASB are working on a joint conceptual framework project.

d. Under IFRS, there are the same number of financial statement elements as in GAAP.

IFRS SELF-TEST QUESTION

The issues that the FASB and IASB must address in developing a common conceptual framework include all of the following except:

a. Should the characteristic of relevance be traded-off in favor of information that is verifiable?

b. Should a single measurement method be used?

c. Should the common framework lead to standards that are principles-based or rules-based?

d. Should the role of financial reporting focus on internal decision-making as well as providing information to assist users in decision-making?

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