Intermediate Accounting

CHAPTER ONE

CONCEPTUAL FRAMEWORK OF FINANCIAL ACCOUNTING

Finance & Banking Department

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❖ ACCOUNTING DEFINITION

Accounting is the recording of financial transactions of a business or organization. It also includes the process of summarizing, analyzing and reporting these transactions in financial statements. The following is main definition of accounting:

The process of identifying, measuring and communicating economic information to permit informed judgments and decisions by users of the information

❖ FUNCTIONS OF ACCOUNTING

Functions of Accounting involves the creation of financial records of business transactions, flows of finance, the process of creating wealth in an organization, and the financial position of a business at a particular moment in time. The progress & reputation of any business big or small it is built up on sound financial footing. There is a no of parties who are interested in accounting information relating to a business. Financial Accounting communicates financial information of the business concern to various parties. Financial accounting provides information regarding the status of a business & results of its operation. The functions of financial accounting are:

- **Recording Financial Information:** Accounting is an art of recording financial transactions of the business concern. This is the basic function of accounting.
- **Classification of Data:** The *Functions of Accounting* is Classification of concern with a systematic analysis of the recorded data with a view to group transactions of one nature is kept at one place. In other words, classification means that data of one nature is kept at one place. This is done in the book is termed as a ledger.
- **Making Summaries of Classified Data:** Another important function of financial accounting is to make summaries of recorded and classified data. Classified data is used to prepare final accounts that are P&L account and Balance Sheet.
- **Dealing with Financial Transactions:** Financial Accounting records only financial transactions and events capable of measuring in terms of money transactions which are not financial nature are not recorded in the book of accounts.
- **Interpretation of Financial Information:** The interpretation of financial information places a very important role in the decision-making process of a business organization. We recorded financial data is interpreted in a manner that the end users as bankers, investors, creditors and shareholders can make a meaning full judgment about the overall financial conditions profitable of a business.

- **Communicating Results:** Accounting is a language for communicative financial as part enterprises these who have an interest and using & interpreting them.

❖ USERS OF ACCOUNTING INFORMATION

Investors: Both present and potentials investor need the information to judge the prospect of present and potentials investment in the business. Present investor need the information in order to decide whether they should continue in the presents or not. Future investors may require the information to determine whether they should buy the shares of company or make investment somewhere else.

Creditors: creditors are the person who owes money to the business. Both short term and long term creditors need the information. Long term creditors are interested in both the solvency and liquidity of the business. On the other hand short term creditors are interested to determine whether the amount owing to them will be paid when due.

Employees: The interest of the employees in accounting information is related to that they want more salary and other monetary incentives like bonus, overtime payments, etc. They are interested in financial statements on account of various profit and bonus schemes negotiation with the management.

Managers: Managers or management are the main internal Users of accounting information. Managers need the information for making various decisions. Managers need the information to protect the Property of business from fraud, mismanagement, to make specific decision, to plan for future, to Measure the performance.

Customers: Customers are interested to judge the profitability and solvency of the business for knowing the ability of the company to survive so that they are supplied with to goods on regular basis. Strong financial background also implies quality products and more money on innovation of products.

Governments: Government needs information for various regulatory Purposes. They are interested in the accounting Information, account of taxation, labor and corporate laws. Different agencies like registrar of Company, company law board, and ministry of finance Use the information for framing policies for the Betterment of the economy.

General public: General public may be interested in the accounts of the business for social obligation of business. The Public is interested in pollution abatement, Community welfare program, ecological benefits or Hazards out of operation of the business. Public is Interested to know how the national resource are Being utilized by the organization and their Contribution in the economy.

❖ CONCEPTUAL FRAMEWORK OF ACCOUNTING

A conceptual framework is a theory of accounting prepared by a standard-setting body against which practical problems can be tested objectively. A conceptual framework deals with fundamental financial reporting issues such as the objectives and users of financial statements, the characteristics that make accounting information useful, the basic elements of financial statements (e.g., assets, liabilities, equity, income, and expenses), and the concepts for recognizing and measuring these elements in the financial statements.

Benefits of a conceptual framework for financial reporting include:

1- Establishing precise definitions that facilitate discussion of accounting issues.
2- Providing guidance to accounting standard setters when developing and reviewing financial reporting rules.
3- Helping to ensure that accounting standards are internally consistent.
4- Helping preparers and auditors to resolve financial reporting problems in the absence of an accounting standard.
5- Helping to limit the volume of accounting standards by providing an overarching theory of accounting that can be applied to specific reporting problems.

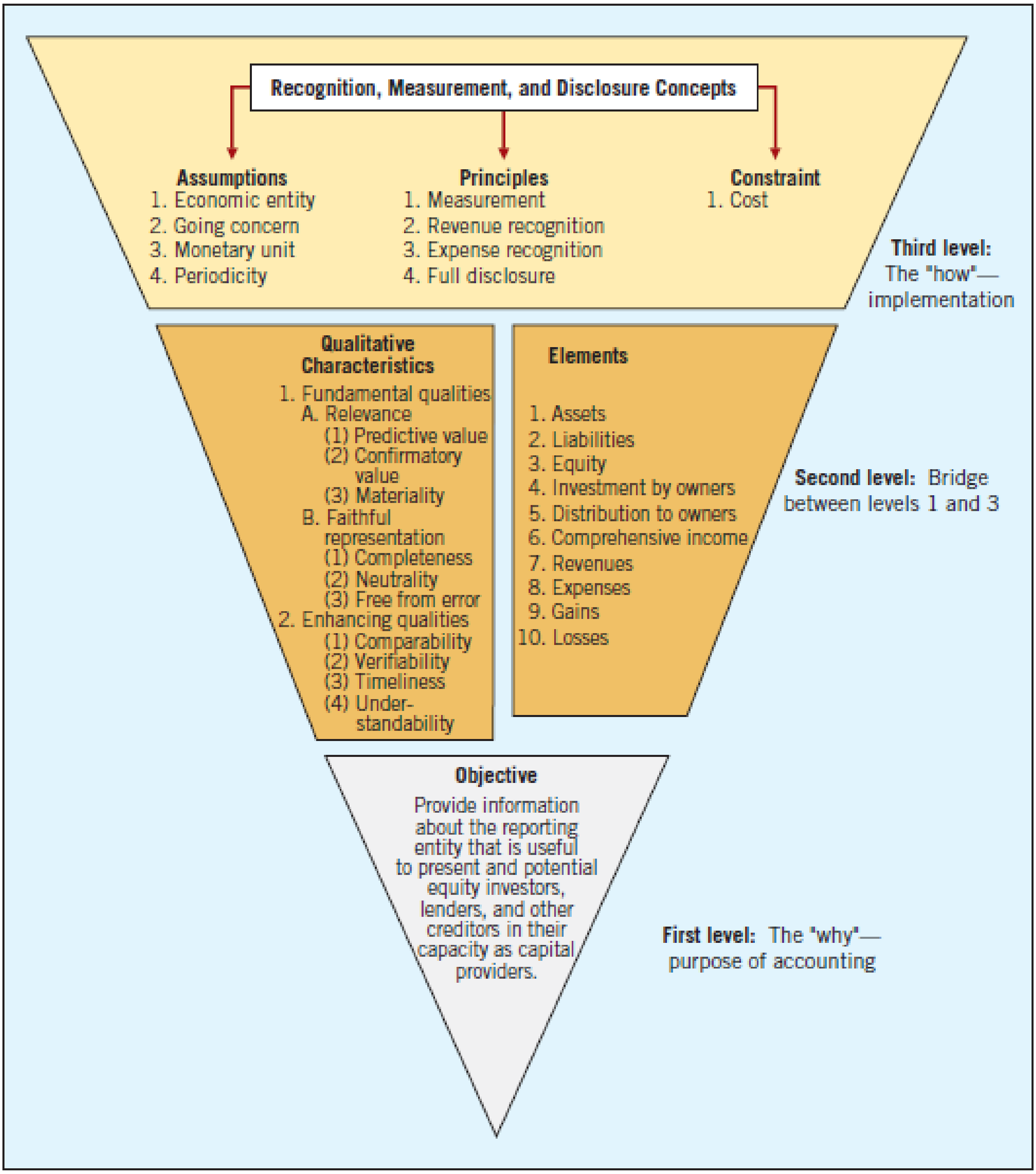
❖ CONTENTS OF CONCEPTUAL FRAMEWORK

The Framework consists of three levels:

- **First Level:** Basic Objectives.
- **Second Level:** Qualitative Characteristics and Basic Element
- **Third Level:** Recognition and Measurement Concepts.

❖ OVERVIEW OF THE CONCEPTUAL FRAMEWORK

The illustration provides an overview of the IASB’s Conceptual Framework for Financial Reporting, also referred to simply as the Conceptual Framework.



First Level: Basic Objectives.

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.

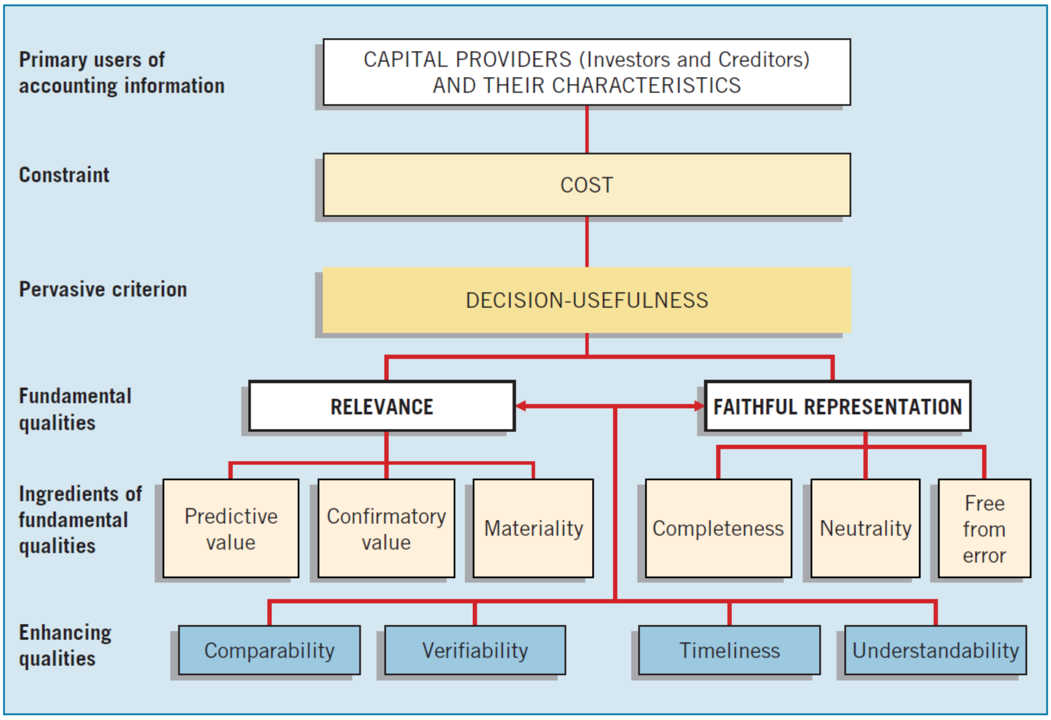
Information that is **decision-useful** to capital providers may also be helpful to other users of financial reporting who are not capital providers.

Second level: fundamental concepts

The objective (first level) focuses on the purpose of financial reporting. Later, we will discuss the ways in which this purpose is implemented (third level). What, then, is the purpose of the second level? The second level provides conceptual building blocks that explain the qualitative characteristics of accounting information and define the elements of financial statements. That is, the second level forms a bridge between the why of accounting (the objective) and the how of accounting (recognition, measurement, and financial statement presentation).

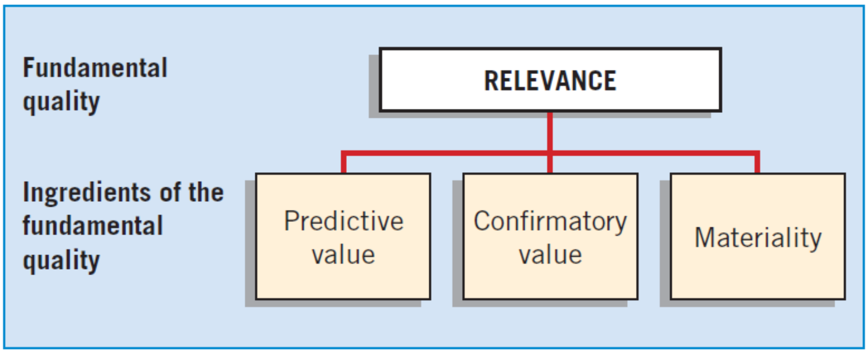
Qualitative Characteristics of Accounting Information

Qualitative characteristics are either fundamental or enhancing characteristics, depending on how they affect the decision-usefulness of information. Regardless of classification, each qualitative characteristic contributes to the decision-usefulness of financial reporting information. However, providing useful financial information is limited by a pervasive constraint on financial reporting—cost should not exceed the benefits of a reporting practice.



Fundamental Quality—Relevance

Relevance is one of the two fundamental qualities that make accounting information useful for decision-making. Relevance and related ingredients of this fundamental quality are shown below.



To be relevant, accounting information must be capable of making a difference in a decision. Information with no bearing on a decision is irrelevant. Financial information is capable of making a difference when it has predictive value, confirmatory value, or both.

- **Predictive value**

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. For example, if potential investors are interested in purchasing ordinary shares in **Nippon (JPN),** they may analyze its current resources and claims to those resources, its dividend payments, and its past income performance to predict the amount, timing, and uncertainty of **Nippon's** future cash flows.

- **Confirmatory value**

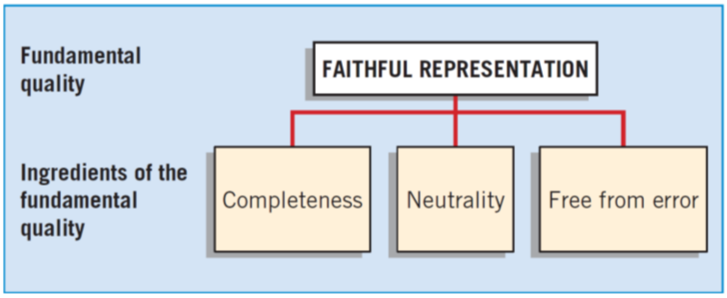
Relevant information also helps users confirm or correct prior expectations; it has confirmatory value. For example, when Nippon issues its year-end financial statements, it confirms or changes past (or present) expectations based on previous evaluations. It follows that predictive value and confirmatory value are interrelated. For example, information about the current level and structure of Nippon's assets and liabilities helps users predict its ability to take advantage of opportunities and to react to adverse situations. The same information helps to confirm or correct users' past predictions about that ability.

- **Materiality**

Materiality is a company-specific aspect of relevance. Information is material if omitting it or misstating it could influence decisions that users make on the basis of the reported financial information. An individual company determines whether information is material because both the nature and/or magnitude of the item(s) to which the information relates must be considered in the context of an individual company's financial report. Information is immaterial, and therefore irrelevant, if it would have no impact on a decision-maker. In short, it must make a difference or a company need not disclose it.

Fundamental Quality—Faithful Representation

Faithful representation is the second fundamental quality that makes accounting information useful for decision-making. Faithful representation and related ingredients of this fundamental quality are shown below.



Faithful representation means that the numbers and descriptions match what really existed or happened. Faithful representation is a necessity because most users have neither the time nor the expertise to evaluate the factual content of the information. For example, if **Siemens AG's (DEU)** income statement reports sales of €60,510 million when it had sales of €40,510 million, then the statement fails to faithfully represent the proper sales amount. To be a faithful representation, information must be complete, neutral, and free of material error.

- **Completeness**

Completeness means that all the information that is necessary for faithful representation is provided. An omission can cause information to be false or misleading and thus not be helpful to the users of financial reports. For example, when **Société Générale (FRA)** fails to provide information needed to assess the value of its subprime loan receivables (toxic assets), the information is not complete and therefore not a faithful representation of their values.

- **Neutrality**

Neutrality means that a company cannot select information to favor one set of interested parties over another. Providing neutral or unbiased information must be the overriding consideration. For example, in the notes to financial statements, tobacco companies such as **British American Tobacco (GBR)** should not suppress information about the numerous lawsuits that have been filed because of tobacco-related health concerns—even though such disclosure is damaging to the company. Neutrality in rule-making has come under increasing attack. Some argue that the IASB should not issue pronouncements that cause undesirable economic effects on an industry or company. We disagree. Accounting rules (and the standard-setting process) must be free from bias, or we will no longer have credible financial statements. Without credible financial statements, individuals will no longer use this information. An analogy demonstrates the point: Many individuals bet on boxing matches because such contests are assumed not to be fixed. But nobody bets on wrestling matches. Why? Because the public assumes that wrestling matches are rigged. If financial information is biased (rigged), the public will lose confidence and no longer use it.

- **Free from Error.**

An information item that is free from error will be a more accurate (faithful) representation of a financial item. For example, if **UBS (CHE)** misstates its loan losses, its financial statements are misleading and not a faithful representation of its financial results. However, faithful representation does not imply total freedom from error. This is because most financial reporting measures involve estimates of various types that incorporate management's judgment. For example, management must estimate the amount of uncollectible accounts to determine bad debt expense. And determination of depreciation expense requires estimation of useful lives of plant and equipment, as well as the residual value of the assets.

Enhancing Qualities

Enhancing qualitative characteristics are complementary to the fundamental qualitative characteristics. These characteristics distinguish more-useful information from less-useful information. Enhancing characteristics, shown below, are comparability, verifiability, timeliness, and understandability.

- **Comparability:**

Information that is measured and reported in a similar manner for different companies is considered comparable. Comparability enables users to identify the real similarities and differences in economic events between companies. For example, historically the accounting for pensions in Japan differed from that in the United States. In Japan, companies generally recorded little or no charge to income for these costs. U.S. companies recorded pension cost as incurred. As a result, it is difficult to compare and evaluate the financial results of **Toyota (JPN)** or **Honda (JPN) to General Motors (USA)** or **Ford (USA)**. Investors can only make valid evaluations if comparable information is available.

- **Consistency**

Is present when a company applies the same accounting treatment to similar events, from period to period. Through such application, the company shows consistent use of accounting standards. The idea of consistency does not mean, however, that companies cannot switch from one accounting method to another. A company can change methods, but it must first demonstrate that the newly adopted method is preferable to the old. If approved, the company must then disclose the nature and effect of the accounting change, as well as the justification for it, in the financial statements for the period in which it made the change. When a change in accounting principles occurs, the auditor generally refers to it in an explanatory paragraph of the audit report. This paragraph identifies the nature of the change and refers the reader to the note in the financial statements that discusses the change in detail.

- **Verifiability**

Verifiability occurs when independent measurers, using the same methods, obtain similar results. Verifiability occurs in the following situations. Two independent auditors count **Tata Motors' (IND)** inventory and arrive at the same physical quantity amount for inventory. Verification of an amount for an asset therefore can occur by simply counting the inventory (referred to as direct verification). 2. Two independent auditors compute Tata Motors' inventory value at the end of the year using the FIFO method of inventory valuation. Verification may occur by checking the inputs (quantity and costs) and recalculating the outputs (ending inventory value) using the same accounting convention or methodology (referred to as indirect verification).

- **Timeliness**

Timeliness means having information available to decision-makers before it loses its capacity to influence decisions. Having relevant information available sooner can enhance its capacity to influence decisions, and a lack of timeliness can rob information of its usefulness. For example, if **Lenovo Group (CHN)** waited to report its interim results until nine months after the period, the information would be much less useful for decision-making purposes.

- **Understandability**

Decision-makers vary widely in the types of decisions they make, how they make decisions, the information they already possess or can obtain from other sources, and their ability to process the information. For information to be useful there must be a connection (linkage) between these users and the decisions they make. This link, understandability, is the quality of information that lets reasonably informed users sees its significance. Understandability is enhanced when information is classified, characterized, and presented clearly and concisely.

Basic Elements

Assets. Probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.

Liabilities. Probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.

Equity. Residual interest in the assets of an entity that remains after deducting its liabilities. In a business enterprise, the equity is the ownership interest.

Investments by Owners. Increases in net assets of a particular enterprise resulting from transfers to it from other entities of something of value to obtain or increase ownership interests (or equity) in it. Assets are most commonly received as investments by owners, but that which is received may also include services or satisfaction or conversion of liabilities of the enterprise.

Distributions to Owners. Decreases in net assets of a particular enterprise resulting from transferring assets, rendering services, or incurring liabilities by the enterprise to owners. Distributions to owners decrease ownership interests (or equity) in an enterprise.

Comprehensive Income. Change in equity (net assets) of an entity during a period from transactions and other events and circumstances from nonowner sources. It includes all changes in equity during a period except those resulting from investments by owners and distributions to owners.

Revenues. Inflows or other enhancements of assets of an entity or settlement of its liabilities (or a combination of both) during a period from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations.
Expenses. Outflows or other using up of assets or incurrences of liabilities (or a combination of both) during a period from delivering or producing goods, rendering services, or carrying out other activities that constitute the entity's ongoing major or central operations.
Gains. Increases in equity (net assets) from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity during a period except those that result from revenues or investments by owners.
Losses. Decreases in equity (net assets) from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity during a period except those that result from expenses or distributions to owners

THIRD LEVEL: RECOGNITION,MEASUREMENT, AND DISCLOSURE CONCEPTS

Basic Assumptions

1. **Economic Entity Assumption**

The **economic entity assumption** **means that economic activity can be identified with a particular unit of accountability**. In other words, a company keeps its activity separate and distinct from its owners and any other business unit.

2. Going Concern Assumption

Most accounting methods rely on the **going concern assumption**—**that the company will have a long life**. Despite numerous business failures, most companies have a fairly high continuance rate. As a rule, we expect companies to last long enough to fulfill their objectives and commitments.

3.Periodicity Assumption

To measure the results of a company's activity accurately, we would need to wait until it liquidates. Decision-makers, however, cannot wait that long for such information. Users need to know a company's performance and economic status on a timely basis so that they can evaluate and compare companies, and take appropriate actions. Therefore, companies must report information periodically.

4. Monetary Unite Assumption

The **monetary unit assumption** means that money is the common denominator of economic activity and provides an appropriate basis for accounting measurement and analysis. That is, the monetary unit is the most effective means of expressing to interested parties changes in capital and exchanges of goods and services. Application of this assumption depends on the even more basic assumption that quantitative data are useful in communicating economic information and in making rational economic decisions.
The **periodicity** (or **time period**) **assumption** implies that a company can divide its economic activities into artificial time periods. These time periods vary, but the most common are monthly, quarterly, and yearly.

Accrual basis accounting

Companies prepare financial statements using the accrual basis of accounting. **Accrual basis accounting** means that transactions that change a company's financial statements are recorded in the periods in which the events occur. **[8]** For example, using the accrual basis means that companies recognize revenues when it is probable that future economic benefits will flow to the company and reliable measurement is possible (the revenue recognition principle). This is in contrast to recognition based on receipt of cash. Likewise, under the accrual basis, companies recognize expenses when incurred (the expense recognition principle) rather than when paid

Basic Principles of Accounting

We generally use four basic **principles of accounting** to record and report transactions: (1) measurement, (2) revenue recognition, (3) expense recognition, and (4) full disclosure. We look at each in turn.

1. Measurement Principles

Historical Cost. IFRS requires that companies account for and report many assets and liabilities on the basis of acquisition price. This is often referred to as the **historical cost principle**. Cost has an important advantage over other valuations: **It is generally thought to be a faithful representation of the amount paid for a given item.**

To illustrate this advantage, consider the problems if companies select current selling price instead. Companies might have difficulty establishing a value for unsold items. Every member of the accounting department might value the assets differently. Further, how often would it be necessary to establish sales value? All companies close their accounts at least annually. But some compute their net income every month. Those companies would have to place a sales value on every asset each time they wished to determine income. Critics raise similar objections against current cost (replacement cost, present value of future cash flows) and any other basis of valuation **except historical cost**.

Fair Value. **Fair value** is defined as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date." Fair value is therefore a market-based measure. **[9]** Recently, IFRS has increasingly called for use of fair value measurements in the financial statements. This is often referred to as the **fair value principle**. Fair value information may be more useful than historical cost for certain types of assets and liabilities and in certain industries. For example, companies report many financial instruments, including derivatives, at fair value. Certain industries, such as brokerage houses and mutual funds, prepare their basic financial statements on a fair value basis. At initial acquisition, historical cost equals fair value. In subsequent periods, as market and economic conditions change, historical cost and fair value often diverge. Thus, fair value measures or estimates often provide more relevant information about the expected future cash flows related to the asset or liability. For example, when long-lived assets decline in value, a fair value measure determines any impairment loss.

2. Revenue Recognition Principle

When a company agrees to perform a service or sell a product to a customer, it has a **performance obligation**. When the company satisfies this performance obligation, it recognizes revenue. The **revenue recognition principle** therefore requires that companies recognize revenue in the accounting period in which the performance obligation is satisfied.

3. Expense Recognition Principle

Expenses are defined as outflows or other "using up" of assets or incurring of liabilities (or a combination of both) during a period as a result of delivering or producing goods and/or rendering services. It follows then that recognition of expenses is related to net changes in assets and earning revenues. In practice, the approach for recognizing expenses is, "Let the expense follow the revenues." This approach is the **expense recognition principle**.

Matching Costs and Revenue principle:

The accounting rule that all expenses incurred in earning revenue is deducted from the revenue in determining net income.

4. Full Disclosure Principle

In deciding what information to report, companies follow the general practice of providing information that is of sufficient importance to influence the judgment and decisions of an informed user. Often referred to as the **full disclosure principle**, it recognizes that the nature and amount of information included in financial reports reflects a series of judgmental trade-offs. These trade-offs strive for (1) sufficient detail to disclose matters that **make a difference** to users, yet (2) sufficient condensation to make the **information understandable**, keeping in mind costs of preparing and using it..

Cost Constraint

In providing information with the qualitative characteristics that make it useful, companies must consider an overriding factor that limits (constrains) the reporting. This is referred to as the cost constraint. That is, companies must weigh the costs of providing the information against the benefits that can be derived from using it. Rule-making bodies and governmental agencies use cost-benefit analysis before making final their informational requirements. In order to justify requiring a particular measurement or disclosure, the benefits perceived to be derived from it must exceed the costs perceived to be associated with it.