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Intermediate Accounting
IFRS 2nd Edition
Kieso, Weygandt, and Warfield
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.
Conceptual Framework establishes the concepts that underlie financial reporting.

Need for a Conceptual Framework

- Rule-making should build on and relate to an established body of concepts.
- Enables IASB to issue more useful and consistent pronouncements over time.
The need for a conceptual framework is highlighted by accounting scandals such as those at Royal Ahold (NLD), Enron (USA), and Satyan Computer Services (IND). 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 financial reporting objectives.
LEARNING OBJECTIVES

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Development of a Conceptual Framework

Presently, the Conceptual Framework is comprises of the following.

- Chapter 1: The Objective of General Purpose Financial Reporting
- Chapter 2: The Reporting Entity (not yet issued)
- Chapter 3: Qualitative Characteristics of Useful Financial Information
- Chapter 4: The Framework, comprised of the following:
  1. Underlying assumption—the going concern assumption;
  2. The elements of financial statements;
  3. Recognition of the elements of financial statements;
  4. Measurement of the elements of financial statements; and
  5. Concepts of capital and capital maintenance.

LO 2
CONCEPTUAL FRAMEWORK

Overview of the Conceptual Framework

Three levels:

- **First Level** = Objectives of Financial Reporting
- **Second Level** = Qualitative Characteristics and Elements of Financial Statements
- **Third Level** = Recognition, Measurement, and Disclosure Concepts.
ILLUSTRATION 2-7
Conceptual Framework for Financial Reporting

OBJECTIVE
Provide information about the reporting entity that is useful to present and potential equity investors, lenders, and other creditors in their capacity as capital providers.

ASSUMPTIONS
1. Economic entity
2. Going concern
3. Monetary unit
4. Periodicity
5. Accrual

PRINCIPLES
1. Measurement
2. Revenue recognition
3. Expense recognition
4. Full disclosure

CONSTRAINTS
1. Cost

QUALITATIVE CHARACTERISTICS
1. Fundamental qualities
2. Enhancing qualities

ELEMENTS
1. Assets
2. Liabilities
3. Equity
4. Income
5. Expenses

First level
The "why"—purpose of accounting

Second level
Bridge between levels 1 and 3

Third level
The "how"—implementation
LEARNING OBJECTIVES

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1. Describe the usefulness of a conceptual framework.
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3. **Understand the objective of financial reporting.**
4. Identify the qualitative characteristics of accounting information.
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8. Describe the impact that the cost constraint has on reporting accounting information.
FIRST LEVEL: BASIC OBJECTIVE

OBJECTIVE

“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.

- Provided by issuing general-purpose financial statements.
- Assumption is that users need reasonable knowledge of business and financial accounting matters to understand the information.
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4. **Identify the qualitative characteristics of accounting information.**
5. Define the basic elements of financial statements.
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SECOND LEVEL: FUNDAMENTAL CONCEPTS

Qualitative Characteristics of Accounting Information

IASB identified the Qualitative Characteristics of accounting information that distinguish better (more useful) information from inferior (less useful) information for decision-making purposes.
SECOND LEVEL: FUNDAMENTAL CONCEPTS

ILLUSTRATION 2-2
Hierarchy of Accounting Qualities
ILLUSTRATION 2-7
Conceptual Framework for Financial Reporting
Fundamental Quality—Relevance

To be relevant, accounting information must be capable of making a difference in a decision.
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.
Fundamental Quality—Relevance

Relevant information also helps users **confirm** or correct prior expectations.
Information is **material** if omitting it or misstating it could influence decisions that users make on the basis of the reported financial information.
ILLUSTRATION 2-7
Conceptual Framework for Financial Reporting

Faithful Representation

Objective
Provide information about the reporting entity that is useful to present and potential equity investors, lenders, and other creditors in their capacity as capital providers.

First level: The "why"—purpose of accounting

Second level: Bridge between levels 1 and 3

Qualitative Characteristics
1. Fundamental qualities
   A. Relevance
      1) Predictive value
      2) Confirmatory value
      3) Materiality
   B. Faithful representation
      1) Completeness
      2) Neutrality
      3) Free from error
   2. Enhancing qualities
      1) Comparability
      2) Verifiability
      3) Timeliness
      4) Understandability

Elements
1. Assets
2. Liabilities
3. Equity
4. Income
5. Expenses

Recognition, Measurement, and Disclosure Concepts

Assumptions
Principles
Constraint

Implementation
Fundamental Quality—Faithful Representation

Faithful representation means that the numbers and descriptions match what really existed or happened.
Completeness means that all the information that is necessary for faithful representation is provided.
Fundamental Quality—Faithful Representation

Neutrality means that a company cannot select information to favor one set of interested parties over another.
An information item that is free from error will be a more accurate (faithful) representation of a financial item.
Information that is measured and reported in a similar manner for different companies is considered comparable.
Enhancing Qualities

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

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

**Understandability** is the quality of information that lets reasonably informed users see its significance.
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ILLUSTRATION 2-7
Conceptual Framework for Financial Reporting

Basic Elements

QUALITATIVE CHARACTERISTICS
1. Fundamental qualities
   A. Relevance
      (1) Predictive value
      (2) Confirmatory value
      (3) Materiality
   B. Faithful representation
      (1) Completeness
      (2) Neutrality
      (3) Free from error
2. Enhancing qualities
   (1) Comparability
   (2) Verifiability
   (3) Timeliness
   (4) Understandability

ELEMENTS
1. Assets
2. Liabilities
3. Equity
4. Income
5. Expenses

OBJECTIVE
Provide information about the reporting entity that is useful to present and potential equity investors, lenders, and other creditors in their capacity as capital providers.

First level: The "why"—purpose of accounting
Second level: Bridge between levels 1 and 3

Recognition, Measurement, and Disclosure Concepts

ASSUMPTIONS
PRINCIPLES
CONSTRAINT

LO 5
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.
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.
SECOND LEVEL: BASIC ELEMENTS

Elements of Financial Statements

- Asset
- Liability
- Equity
- Income
- Expenses

The residual interest in the assets of the entity after deducting all its liabilities.
Increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.
Decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants.
**SECOND LEVEL: BASIC ELEMENTS**

### Exercise 2-4: Identify the qualitative characteristic(s) to be used given the information provided.

(a) Qualitative characteristic being displayed when companies in the same industry are using the same accounting principles.

(b) Quality of information that confirms users’ earlier expectations.

(c) Imperative for providing comparisons of a company from period to period.

(d) Ignores the economic consequences of a standard or rule.

<table>
<thead>
<tr>
<th>Characteristics</th>
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<tbody>
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</table>

**LO 5**
Exercise 2-4: Identify the qualitative characteristic(s) to be used given the information provided.

(e) Requires a high degree of consensus among individuals on a given measurement.

(f) Predictive value is an ingredient of this fundamental quality of information.

(g) Four qualitative characteristics that enhance both relevance and faithful representation.

(h) An item is not reported because its effect on income would not change a decision.

<table>
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<tr>
<td>Comparability</td>
</tr>
</tbody>
</table>
Exercise 2-4: Identify the qualitative characteristic(s) to be used given the information provided.

(i) Neutrality is a key ingredient of this fundamental quality of accounting information.

(j) Two fundamental qualities that make accounting information useful for decision-making purposes.

(k) Issuance of interim reports is an example of what enhancing ingredient?

Characteristics
- Relevance
- Faithful representation
- Predictive value
- Confirmatory value
- Neutrality
- Materiality
- Timeliness
- Verifiability
- Understandability
- Comparability
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THIRD LEVEL: RECOGNITION, MEASUREMENT, AND DISCLOSURE CONCEPTS

These concepts explain how companies should recognize, measure, and report financial elements and events.

**Assumptions**
1. Economic entity
2. Going concern
3. Monetary unit
4. Periodicity
5. Accrual

**Principles**
1. Measurement
2. Revenue recognition
3. Expense recognition
4. Full disclosure

**Constraints**
1. Cost

ILLUSTRATION 2-7
Conceptual Framework for Financial Reporting
THIRD LEVEL: ASSUMPTIONS

Basic Assumptions

**Economic Entity** – company keeps its activity separate from its owners and other business unit.

**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.

**Accrual Basis of Accounting** – transactions are recorded in the periods in which the events occur.
THIRD LEVEL: ASSUMPTIONS

BE2-8: Identify which basic assumption of accounting is best described in each item below.

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

(b) Total S.A. (FRA) does not adjust amounts in its financial statements for the effects of inflation.

(c) Barclays (GBR) reports current and non-current classifications in its statement of financial position.

(d) The economic activities of Tokai Rubber Industries (JPN) and its subsidiaries are merged for accounting and reporting purposes.

- Periodicity
- Monetary Unit
- Going Concern
- Economic Entity
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Measurement Principles

- **Historical Cost** is generally thought to be a faithful representation of the amount paid for a given item.

- **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.”

- IASB has given companies the option to use fair value as the basis for measurement of financial assets and financial liabilities.
Measurement Principles

IASB established a **fair value hierarchy** that provides insight into the priority of valuation techniques to use to determine fair value.

**Level 1:** Observable inputs that reflect quoted prices for identical assets or liabilities in active markets.

**Level 2:** Inputs other than quoted prices included in Level 1 that are observable for the asset or liability either directly or through corroboration with observable data.

**Level 3:** Unobservable inputs (for example, a company’s own data or assumptions).
Revenue Recognition

When a company agrees to perform a service or sell a product to a customer, it has a performance obligation.

Requires that companies recognize revenue in the accounting period in which the performance obligation is satisfied.
**Illustration:** Assume the **Airbus** (DEU) signs a contract to sell airplanes to **British Airways** (GRB) for €100 million. To determine when to recognize revenue, Airbus uses the five steps for revenue recognition shown at right.

**Step 1:** Identify the contract with the customers.

A contract is an agreement between two parties that creates enforceable rights or obligations. In this case, Airbus has signed a contract to deliver airplanes to British Airways.

**Step 2:** Identify the separate performance obligations in the contract.

Airbus has only one performance obligation—to deliver airplanes to British Airways. If Airbus 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, Airbus has only one performance obligation—to deliver airplanes to British Airways.

**Step 5:** Recognize revenue when each performance obligation is satisfied.

Airbus recognizes revenue of €100 million for the sale of the airplanes to British Airways when it satisfies its performance obligation—the delivery of the airplanes to British Airways.
Expense Recognition - Outflows or “using up” of assets or incurring of liabilities during a period as a result of delivering or producing goods and/or rendering services.

<table>
<thead>
<tr>
<th>Type of Cost</th>
<th>Relationship</th>
<th>Recognition</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Product costs:</strong></td>
<td>Direct relationship between cost and revenue.</td>
<td>Recognize in period of revenue (matching).</td>
</tr>
<tr>
<td>• Material</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Labor</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Overhead</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Period costs:</strong></td>
<td>No direct relationship between cost and revenue.</td>
<td>Expense as incurred.</td>
</tr>
<tr>
<td>• Salaries</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Administrative costs</td>
<td></td>
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</tr>
</tbody>
</table>

“Let the expense follow the revenues.”
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

BE2-9: Identify which basic principle of accounting is best described in each item below.

(a) Parmalat (ITA) reports revenue in its income statement when it delivered goods instead of when the cash is collected.

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

(c) KC Corp. (USA) reports information about pending lawsuits in the notes to its financial statements.

(d) Fuji Film (JPN) reports land on its statement of financial position at the amount paid to acquire it, even though the estimated fair market value is greater.
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THIRD LEVEL: COST CONSTRAINT

Cost Constraint

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.
**BE2-11:** Determine whether you would classify these transactions as material.

(a) In the current year, Blair Co. reduces its bad debt expense to ensure another positive earnings year. The impact of this adjustment is equal to 3% of net income. **Material**

(b) Damon Co. expenses all capital equipment under €2,500 on the basis that it is immaterial. The company has followed this practice for a number of years. **Likely not material**
ILLUSTRATION 2-7
Conceptual Framework for Financial Reporting
THE CONCEPTUAL FRAMEWORK

The IASB and the FASB have been working together to develop a common conceptual framework. This framework is based on the existing conceptual frameworks underlying U.S. GAAP and IFRS. The objective of this joint project is to develop a conceptual framework consisting of standards that are principles-based and internally consistent, thereby leading to the most useful financial reporting.
Relevant Facts

Following are the key similarities and differences between U.S. GAAP and IFRS related to the Conceptual Framework for Financial Reporting.

Similarities

• In 2010, the IASB and FASB completed the first phase of a jointly created conceptual framework. In this first phase, they 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 converged phase, the Conceptual Framework gave more emphasis to the objective of providing information on management’s performance (stewardship).
Relevant Facts

Similarities

• The existing conceptual frameworks underlying U.S. 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.

• The converged framework should be a single document, unlike the two conceptual frameworks that presently exist. It is unlikely that the basic structure related to the concepts will change.
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 on fair value measurement so that the definition of fair value, measurement techniques, and disclosures are the same between U.S. GAAP and IFRS when fair value is used in financial statements.

Differences

• Although both U.S. 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.
Relevant Facts

Differences

• U.S. 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 U.S. GAAP.

• 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).
Relevant Facts

Differences

• 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.
About The Numbers

While the conceptual framework that underlies U.S. GAAP is very similar to that used to develop IFRS, the elements identified and their definitions under U.S. GAAP are different.
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 challenging issues to overcome. 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? We are optimistic that the new converged conceptual framework will be a significant improvement over its predecessors and will lead to standards that will help financial statement users to make better decisions.
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