

**Al-Mustaqbal university college**

# **Conceptual Framework for Financial Reporting**

**6**

**Third Level: Basic Assumptions**

**Prepared by**

**Ezzulddin Hasan Kadhim**

# Conceptual Framework for Financial Reporting

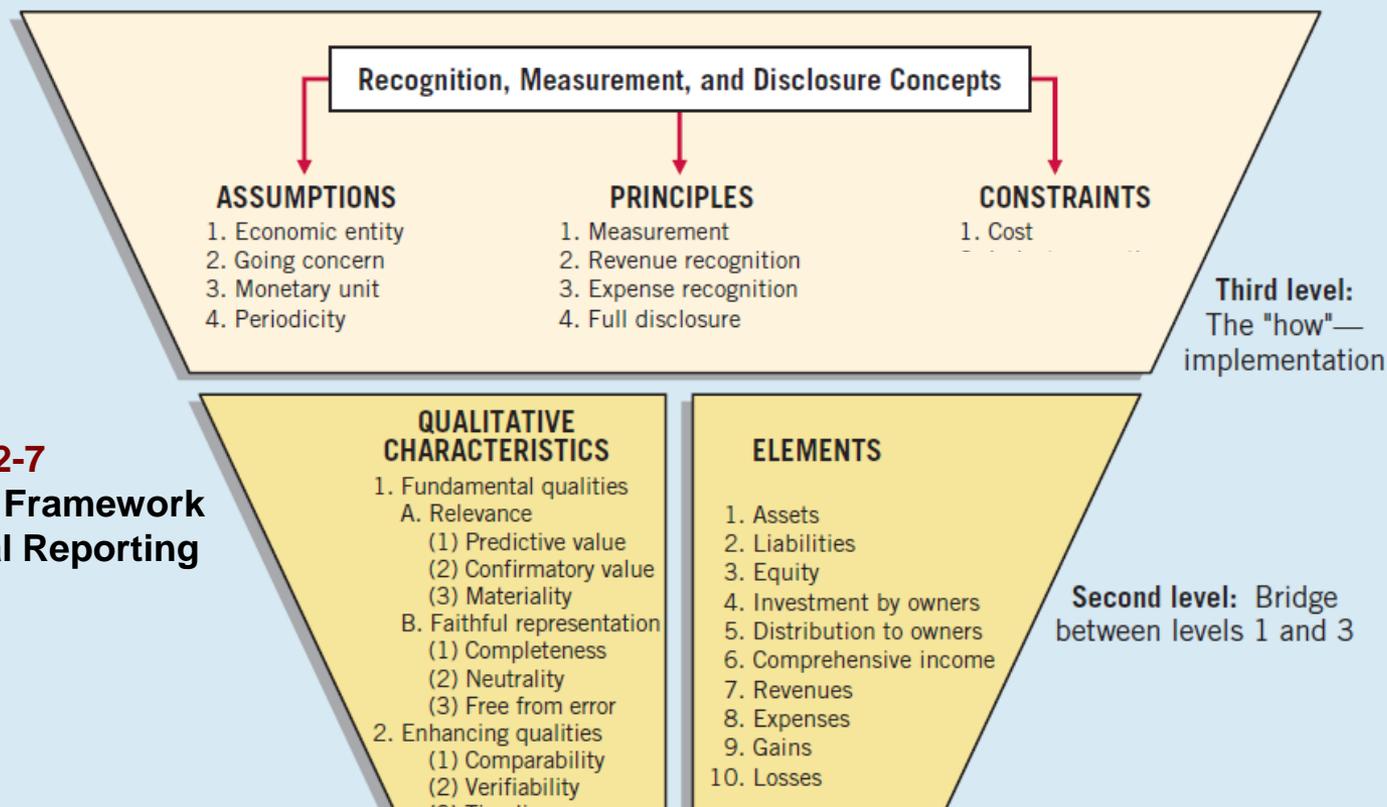
## LEARNING OBJECTIVES

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

1. Describe the usefulness of a conceptual framework.
2. Describe the FASB's 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.

# 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**

# 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*

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.

# Conceptual Framework for Financial Reporting

## LEARNING OBJECTIVES

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

1. Describe the usefulness of a conceptual framework.
2. Describe the FASB's 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.

# 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.”

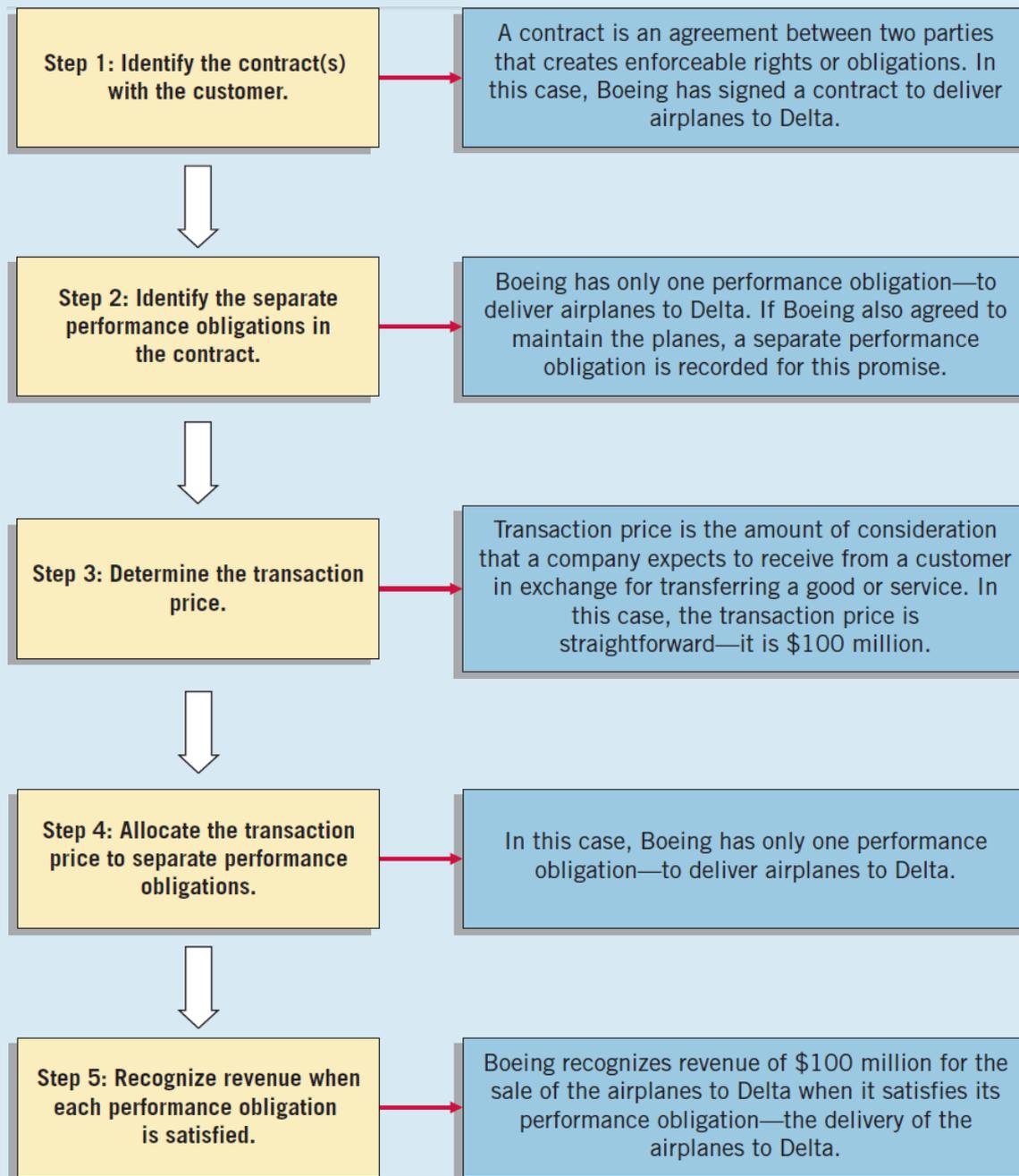
**Illustration 2-6**  
Expense Recognition

<u>Type of Cost</u>	<u>Relationship</u>	<u>Recognition</u>
<b>Product costs:</b> <ul style="list-style-type: none"><li>• Material</li><li>• Labor</li><li>• Overhead</li></ul>	Direct relationship between cost and revenue.	Recognize in period of revenue (matching).
<b>Period costs:</b> <ul style="list-style-type: none"><li>• Salaries</li><li>• Administrative costs</li></ul>	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.

**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.

*Revenue  
Recognition*

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

*Expense  
Recognition*

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

*Full  
Disclosure*

(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.

*Measurement*