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Conceptual Framework for Financial Reporting

7

Third Level: Constraints

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CHAPTER 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. **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: 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.

LO 8 Describe the impact that the cost constraint has on reporting accounting information.

What do the numbers mean? YOU MAY NEED A MAP

Beyond touting nonfinancial measures to investors many companies increasingly promote the performance of their companies through the reporting of various “pro-forma” earnings measures. A recent survey of newswire reports found 36 instances of the reporting of pro-forma measures in just a three-day period. Pro-forma measures are standard measures (such as earnings) that companies adjust, usually for one-time or nonrecurring items. For example, companies usually adjust earnings for the effects of an extraordinary item. Such adjustments make the numbers more comparable to numbers reported in periods without the unusual item. However, rather than increasing comparability, it appears that some companies use pro-forma reporting to accentuate the positive in their results. Examples include Yahoo Inc. 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. 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). REG G requires companies to reconcile non-GAAP financial measures to GAAP, thereby giving investors a roadmap to analyze adjustments companies make to their GAAP numbers to arrive at pro-forma results.

Summary of the Structure

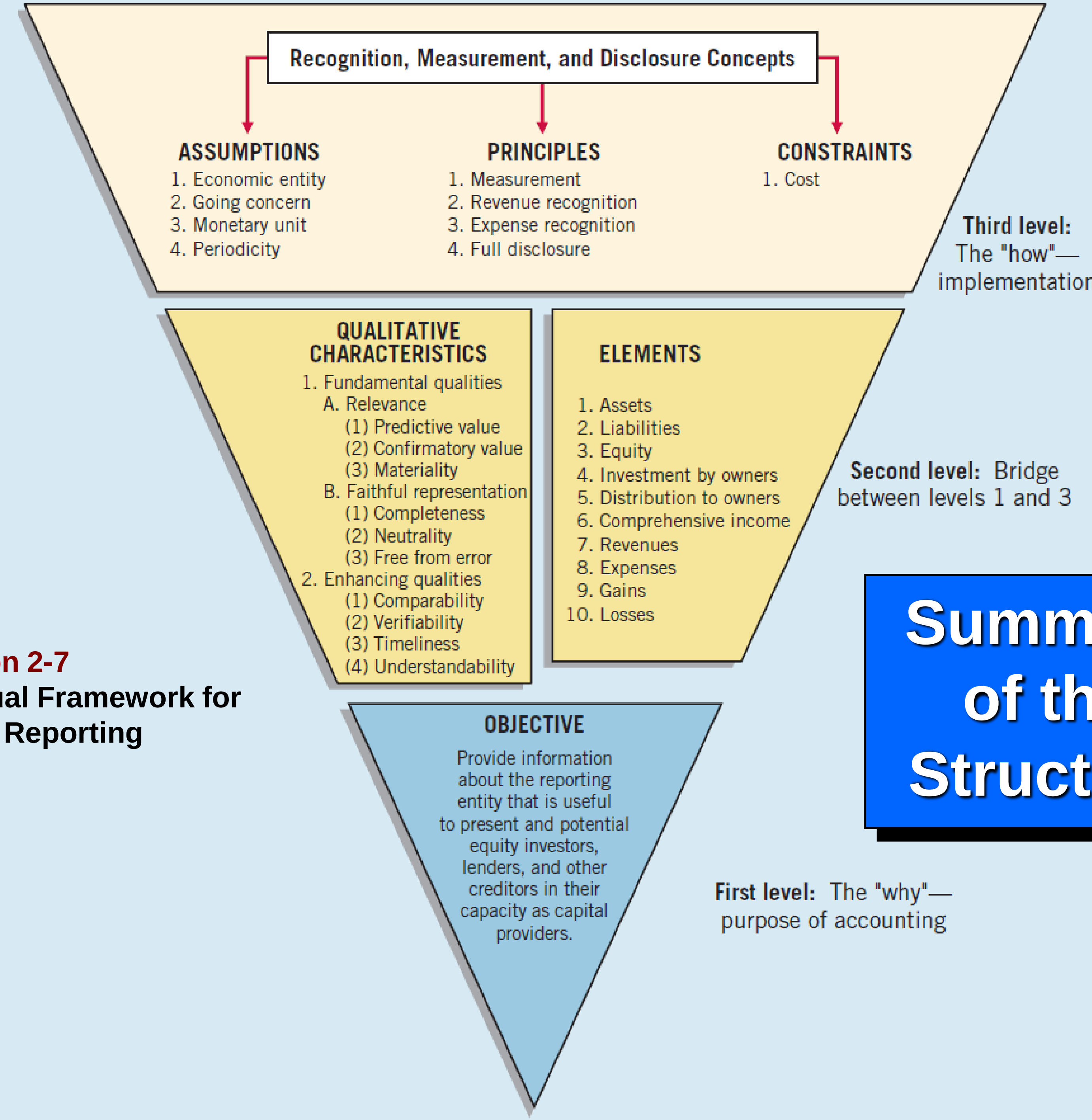

Illustration 2-7
Conceptual Framework for Financial Reporting

RELEVANT FACTS

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.
- The existing conceptual frameworks underlying GAAP and IFRS are very similar.
- 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

- 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.

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.

RELEVANT FACTS

- 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 is considering a proposal to provide expanded guidance on estimating fair values.
- 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.
- 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

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 9 Compare the conceptual frameworks underlying GAAP and IFRS.

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.

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? We are optimistic that the new document will be a significant improvement over its predecessors and will lead to principles-based standards that help users of the financial statements make better decisions.

LO 9 Compare the conceptual frameworks underlying GAAP and IFRS.

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 stewardship as well as providing information to assist users in decision-making?

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