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Financial Reporting Theory

Overview

Chapter 2 is driven by the students’ need to understand the conceptual framework for accounting. In order to read and understand financial statements, a student must become familiar with the conceptual framework under which the financial statements were prepared. Therefore, this chapter highlights the ways in which authoritative literature and guidance are grounded in the conceptual framework and discusses how the objective of financial reporting and the elements of financial reporting are part of the conceptual framework.

Learning Objectives

1. Explain what a conceptual framework is and why it is important in accounting standard setting.
2. Define the objective of financial reporting.
3. Describe the qualitative characteristics of financial information, including the fundamental and enhancing characteristics of financial reporting.
4. Identify the elements of financial reporting.
5. Demonstrate an understanding of recognition and measurement in financial reporting including general recognition principles, revenue and expense recognition, and accrual accounting.
6. Explain the assumptions used in financial reporting.

Teaching Outline

Learning Objective 1: Overview of the Conceptual Framework

1. Overview of the Conceptual Framework
   1. Conceptual Framework Components
      * 1. *See Exhibit 2.1:* The framework’s role in standard setting
        2. *See Exhibit 2.2:* Revisions to the conceptual framework, which includes six topics
        3. *See Exhibit 2.3:* An overview of the current financial framework

IFRS Breakaway

* 1. Conceptual Framework: Although qualitative characteristics are identical between U.S. GAAP and IFRS, they differ in many other areas. IFRS is also in the process of revising its framework.

Learning Objective 2: The Objective of Financial Reporting

1. The objective of financial reporting is to provide relevant, useful information to stakeholders. Primary users of financial information are investors, lenders, and other creditors.

Learning Objective 3: The Qualitative Characteristics of Financial Information

1. The conceptual framework divides the qualitative characteristics into:

* Fundamental characteristics
* Enhancing characteristics
  1. Fundamental Characteristics: Distinguish useful information from that which is not useful*.*
     + 1. Relevance: Capable of making a difference in a decision.

1. Predictive value: Helps forecast future outcomes.
2. Confirmatory value: Provides feedback from prior evaluations.
3. Materiality: If reported inaccurately, would affect financial statement users’ decisions.
   * + 1. Faithful Representation: *See Exhibit 2.4.* Indicates whether financial information depicts the substance of an economic event in a manner that is:
4. Complete: Includes all information, both descriptions and explanations.
5. Neutral: Is free from bias.
6. Free from error: Contains no mistakes or omissions.
   1. Enhancing Characteristics: Comparability, verifiability, timeliness, and understandability help distinguish more useful information from less useful information.
      * 1. Comparability: Allows financial statement users to identify and understand similarities and differences among several entities.
        2. Verifiability: Allows a group of reasonably informed financial statement users to reach a consensus decision.
        3. Timeliness: Available early enough to make a difference in decision making.
        4. Un decision making. make a difference s:n.ich is not us of revising nderstandability: Classify, characterize, and clearly present all information. *See Exhibit 2.5.*
   2. Cost Constraint: Standard setters should compare the cost of requiring information to the benefits derived from presenting the information.

Learning Objective 4: Elements of Financial Reporting

1. There are two elements of financial reporting: Point-in-time elements and period-of-time elements.
   1. Elements: U.S. GAAP
      * 1. Point-in-Time Elements: Represent resources, claims to resources, or interests in resources for a specific point in time. *See* *Exhibit 2.6*. **Examples:** Accounts receivable and accounts payable
2. Assets: Probable future economic benefits resulting from some past event.
3. Liabilities: Probable future sacrifices of economic benefits arising from present obligations.
4. Equity: Net assets, the difference between assets and liabilities.
   * + 1. Period-of-Time Elements: Change point-in-time elements, as they represent events that occur between two balance sheet dates. Elements include, but are not limited to, investments by owners, distribution to owners, revenue, and gains. *See* *Exhibit 2.7*. **Examples:** Sales revenue, depreciation expense, and dividends declared

IFRS Breakaway

* 1. Elements
     + 1. Point-in-Time Elements: IFRS identifies the same three point-in-time elements as U.S. GAAP: assets, liabilities, and equity.
       2. Period-of-Time Elements: *See* *Exhibit 2.8*. Capital maintenance adjustments are handled differently between U.S. GAAP and IFRS. IFRS reports changes in equity and comprehensive income substantially differently from U.S. GAAP. These differences stem from IFRS’ restatements and revaluations of reported assets and liabilities.

Learning Objective 5: Principles of Recognition and Measurement

1. Three principles underlie accrual accounting:

* General recognition
* Revenue and expense recognition
* Bases of measurement
  1. General Recognition Principles
     + 1. Recognition is a multifaceted process that includes four criteria that consider the cost-benefit constraint and the materiality threshold:

1. The item meets the definition of one of the elements of the financial statements.
2. The item is measurable (i.e., reliably estimating an amount is important).
3. The item must be reliable, which is similar to faithful representation.
4. The item is relevant, which allows financial statement users to make rational economic decisions.
   1. Revenue and Expense Recognition
      * 1. Revenue recognition principle:
5. Realized or realizable: Exchanges goods or services for cash.
6. Earned: Seller has accomplished what it must do for revenue to be considered earned.
   * + 1. Expense recognition principles: *See Exhibit 2.9.* There are three approaches to determine when to report an expense:

* Match with revenues.
* Expense in period incurred.
* Systematically over periods of use.

1. Firms recognize expenses when economic benefits are consumed.
2. Firms recognize expenses when an asset has experienced a reduced (or eliminated) future benefit.
   1. Bases of Measurement
      * 1. Five aspects of measurement
3. Historical cost: Amount paid to acquire the asset.
4. Current cost: Amount for which the firm could acquire the asset currently.
5. Current market value: Amount for which the firm could sell the asset.
6. Net realizable value: The amount that could be received in exchange for an asset, less the cost of disposal.
7. Present value of future cash flows: Discounting net cash flows the firm expects to receive on the exchange of an asset.
   * + 1. Arms-length transactions: Involve a buyer and a seller who are independent and unrelated.
       2. Fair Value Measurement and the Fair Value Hierarchy: *See* *Exhibit 2.10.*

IFRS Breakaway

* 1. Recognition and Measurement: Differentiating between U.S. GAAP and IFRS.
     + 1. General Recognition Principles: *See Exhibit 2.11.*

1. The item meets the definition of one of the elements: Similar to U.S. GAAP.
2. The item is measurable: Similar to U.S. GAAP.
3. The measurement of the item must be reliable: Similar to U.S. GAAP.
4. It is probable that future economic benefits will flow to or from the company: Used instead of relevance used in U.S. GAAP.
   * + 1. Revenue and Expense Recognition
5. Revenue: 1) An increase in future economic benefits related to an increase in an asset or a decrease of a liability *and* 2) the revenue can be measured reliably.
6. Expense: 1) A decrease in future economic benefit related to a decrease of an asset or an increase of a liability *and* 2) the expense can be measured reliably.
   * + 1. Bases of Measurement
7. Historical cost
8. Current cost
9. Net realizable value
10. Present value of future cash flows
    1. Cash versus Accrual Accounting: U.S. GAAP is based on accrual accounting and does not allow for a cash-basis system.
       * 1. Cash-Basis Accounting: Firms recognize revenue when cash is received and an expense when cash is paid.
         2. Accrual Accounting: When firms pay or receive cash does not matter.

Learning Objective 6: Assumptions in Financial Reporting

1. Assumptions in Financial Reporting
   1. Going Concern Concept: Financial statements are prepared as if the entity will continue for an indefinite period of time.
   2. Business or Economic Entity Concept: Business transactions and personal affairs are kept separate.
   3. Monetary Unit Assumption: Economic activities are reported in dollars or other monetary units.
   4. Periodicity Assumption: An economic entity can divide its life into artificial time periods.

IFRS Breakaway

1. Assumptions in Financial Reporting: IFRS specifically addresses the going concern assumption, while all other assumptions are implied.

Student Supplement to Teaching Outline

Learning Objective 1: Overview of the Conceptual Framework

1. Overview of the Conceptual Framework
   1. Conceptual Framework Components

IFRS Breakaway

* 1. Conceptual Framework

Learning Objective 2: The Objective of Financial Reporting

1. The Objective of Financial Reporting

Learning Objective 3: The Qualitative Characteristics of Financial Information

1. The Qualitative Characteristics of Financial Information
   1. Fundamental Characteristics
      * 1. Relevance
        2. Faithful Representation
   2. Enhancing Characteristics
      * 1. Comparability
        2. Verifiability
        3. Timeliness
        4. Understandability
   3. Cost Constraint

Learning Objective 4: Elements of Financial Reporting

1. Elements of Financial Reporting
   1. Elements
      * 1. Point-in-Time Elements
        2. Period-of-Time Elements

IFRS Breakaway

* 1. Elements
     + 1. Point-in-Time Elements
       2. Period-of-Time Elements

Learning Objective 5: Principles of Recognition and Measurement

1. Principles of Recognition and Measurement
   1. General Recognition Principles
   2. Revenue and Expense Recognition
   3. Bases of Measurement
      * 1. Fair Value Measurement and the Fair Value Hierarchy

IFRS Breakaway

* 1. Recognition and Measurement
     + 1. General Recognition Principles
       2. Revenue and Expense Recognition
       3. Bases of Measurement
  2. Cash versus Accrual Accounting
     + 1. Cash-Basis Accounting
       2. Accrual Accounting

Learning Objective 6: Assumptions in Financial Reporting

1. Assumptions in Financial Reporting
   1. Going Concern Concept
   2. Business or Economic Entity Concept
   3. Monetary Unit Assumption
   4. Periodicity Assumption

IFRS Breakaway

1. Assumptions in Financial Reporting

Assignment Grid

| Assignment | Topic(s) | Learning Objective(s) | Estimated Time in Minutes | Level of Difficulty |
| --- | --- | --- | --- | --- |
| Questions | | | | |
| Q2-1 | Conceptual Framework | 1 | 10 | Easy |
| Q2-2 | FASB and IASB Conceptual Frameworks | 1 | 10 | Easy |
| Q2-3 | Conceptual Framework | 1 | 10 | Easy |
| Q2-4 | Users of Financial Statements | 2 | 10 | Easy |
| Q2-5 | Relevance | 3 | 10 | Easy |
| Q2-6 | Relevance | 3 | 10 | Easy |
| Q2-7 | Materiality | 3 | 10 | Easy |
| Q2-8 | Predictive Value | 3 | 10 | Easy |
| Q2-9 | Predictive Value versus Confirmatory Value | 3 | 10 | Easy |
| Q2-10 | Understandability | 3 | 10 | Easy |
| Q2-11 | Point-in-Time versus Period-of-Time Elements | 4 | 10 | Easy |
| Q2-12 | Elements of Financial Reporting | 4 | 10 | Easy |
| Q2-13 | Definition of an Asset | 4 | 10 | Easy |
| Q2-14 | Recognition Principle | 5 | 10 | Easy |
| Q2-15 | Revenue Recognition Principle | 5 | 10 | Easy |
| Q2-16 | Expense Recognition under U.S. GAAP | 5 | 10 | Easy |
| Q2-17 | Expense Recognition under IFRS | 5 | 10 | Easy |
| Q2-18 | Accrual Accounting Transactions | 5 | 10 | Easy |
| Q2-19 | Historical Cost | 5 | 10 | Easy |
| Q2-20 | Going Concern | 6 | 10 | Easy |
| Brief Exercises | | | | |
| BE2-1 | Components of the Conceptual Framework | 1 | 5–10 | Easy |
| BE2-2 | Users of Financial Information | 2 | 5–10 | Easy |
| BE2-3 | Objective of Financial Reporting | 2 | 5–10 | Easy |
| BE2-4 | Relevant and Faithful Representation | 3 | 10–15 | Easy |
| BE2-5 | Fundamental and Enhancing Characteristics | 3 | 10–15 | Easy |
| BE2-6 | Faithful Representation | 3 | 15–20 | Medium |
| BE2-7 | Costs and Benefits of Financial Reporting | 3 | 10–15 | Easy |
| BE2-8 | Historical Cost | 3, 5 | 15–20 | Medium |
| BE2-9 | Fundamental and Enhancing Characteristics | 3 | 10–15 | Easy |
| BE2-10 | Faithful Representation | 3 | 10–15 | Easy |
| BE2-11 | Enhancing Characteristics | 3 | 10–15 | Easy |
| BE2-12 | Revenues and Gains | 4 | 10–15 | Easy |
| BE2-13 | Capital Maintenance Adjustments, IFRS | 4 | 15–20 | Medium |
| BE2-14 | Expense Recognition | 5 | 10–15 | Easy |
| BE2-15 | Element Definitions | 4 | 10–15 | Easy |
| BE2-16 | Element Definitions | 4 | 10–15 | Medium |
| BE2-17 | Element Definitions, U.S. GAAP, IFRS | 4 | 15–20 | Medium |
| BE2-18 | Recognition, U.S. GAAP, IFRS | 5 | 10–15 | Easy |
| BE2-19 | Measurement Bases | 5 | 10–15 | Easy |
| BE2-20 | Cash versus Accrual Bases of Accounting | 5 | 15–20 | Medium |
| BE2-21 | Assumptions in Financial Reporting | 6 | 15–20 | Medium |
| Brief Exercises | | | | |
| E2-1 | Conceptual Framework | 3, 5, 6 | 15–20 | Medium |
| E2-2 | Qualitative Characteristics | 3 | 15–20 | Medium |
| E2-3 | Enhancing Characteristics | 3 | 15–20 | Medium |
| E2-4 | Concepts | 3, 5, 6 | 15–20 | Medium |
| E2-5 | Terms and Concepts | 1, 3, 4, 5, 6 | 15–20 | Medium |
| E2-6 | Concepts | 3, 5, 6 | 25–30 | Difficult |
| E2-7 | Cash versus Accrual Bases of Accounting | 5 | 15–20 | Medium |
| E2-8 | Cash versus Accrual | 5 | 25–30 | Difficult |

Suggestions for Class Activities

Students should be encouraged to question the differences between U.S. GAAP and IFRS rather than accept these differences on a superficial level. In that way, students can see that some of the IFRS concepts are different from U.S. GAAP for valid reasons. Some IFRS principles and accounts are virtually identical to U.S. GAAP, but nomenclature plays a role. For example, in U.S. GAAP, the concept of equity is very close to the IFRS concept of reserves.

Learning Objective 1

* Start by reviewing Exhibit 2.1, which shows the conceptual framework’s role in standard setting. Ask students how and why these aspects are interrelated. Is there one area in the framework that takes precedence over another? If so, why? Have students substantiate their answers.

Learning Objective 2

* Judgment in accounting is a constant characteristic, and students should be reminded that when IFRS is adopted in the United States, there will be more reliance upon use of judgment. Although U.S. GAAP is not completely rules based and IFRS is not completely principles based, there is a tendency to describe these frameworks with these underlying concepts. Even at this stage in the course, we suggest a class discussion of principles versus rules and ask students if they believe U.S. GAAP is more rules based or more principles based and why.
* Use Paul Pacter’s interview to begin a discussion of the pros and cons of having a conceptual framework agreed upon before the U.S. convergence with IFRS. Ask students how completely they think agreement should be on a conceptual framework in future accounting standard setting. Another aspect of discussion from this same excerpt could be the critical importance of transparency. Did the Sarbanes-Oxley Act of 2002 sufficiently address the aspect of financial transparency?

Learning Objective 3

* Materiality is a critical aspect in many areas in accounting, taxes, and auditing. Ask students why materiality is important in general, how they understand the concept, and how it relates to this chapter in particular.

Learning Objective 5

* Students in a class of this level understand the basic differences between cash basis and accrual basis; however, they most likely have not yet been exposed to how different the financial results would be between one set of rules and the other. Use Example 2.1 to walk students through the theory and calculations of net income when using the cash basis and when using the accrual basis. The end result is the same, but the results vary drastically in the short run each month.

Learning Objective 6

* Explain the many examples of arms-length transactions. This concept is important in auditing because auditors need to find out if there are related-party transactions. Students benefit greatly when they can see the many interconnections between their courses and different subfields in the accounting discipline. Consider having students role-play being part of the audit team or being part of a small family-run business. Students can decide how they want to communicate to the auditor that all their transactions are or are not related-party transactions. A follow-up could be a discussion of why shareholders would be interested in knowing about possible related-party transactions if the company is publicly held.
* The going concern assumption is often not discussed at length in courses other than those on auditing. To make this topic come alive to students, divide the class into small groups and have them brainstorm all the possible areas of concern from a sample company’s financials. Given them approximately 20 minutes to create a list of potential red flags that could lead to a company’s demise (e.g., liquidity issues, solvency, inventory buildup or turnover, excess long-term debt, high COGS). Once they have created their lists, have the small groups report to the class about how these areas could be of consequence to the going concern assumption.

Guidance on Incorporating IFRS Material

Students should begin using commonly used IFRS websites, such as IFRS.org, to read about recent developments in the possible convergence with U.S. GAAP. They could be given an assignment to write a summary about some aspects of that website. Another assignment could be to ask them to research some different topics in recent accounting debate from the AICPA website (aicpa.org). Students should be encouraged to join the AICPA at the reduced student rate. This is a great opportunity for students to add credibility to their resumes and to understand that the accounting profession is a highly developed part of the business community.

Numerous topics are introduced in this chapter that will be examined further in subsequent chapters. However, at the end of this chapter students can be assigned a short research project to investigate the IFRS.org website on topics discussed in Chapter 2, primarily revenue recognition.

Some analysts depict IFRS as being more aggressive in their revenue recognition criteria, but some members of the IASB dispute this assessment. The basic difference in revenue recognition is the timing of the revenue recognition: IFRS recognizes revenue earlier than does U.S. GAAP in the reporting cycle. Some analysts have described IFRS as being less conservative in revenue recognition as well as in other areas of financial reporting.

Interview Discussion Questions

1. Discuss several components of the current conceptual framework that provide guidance and direction to accountants when exercising judgment.

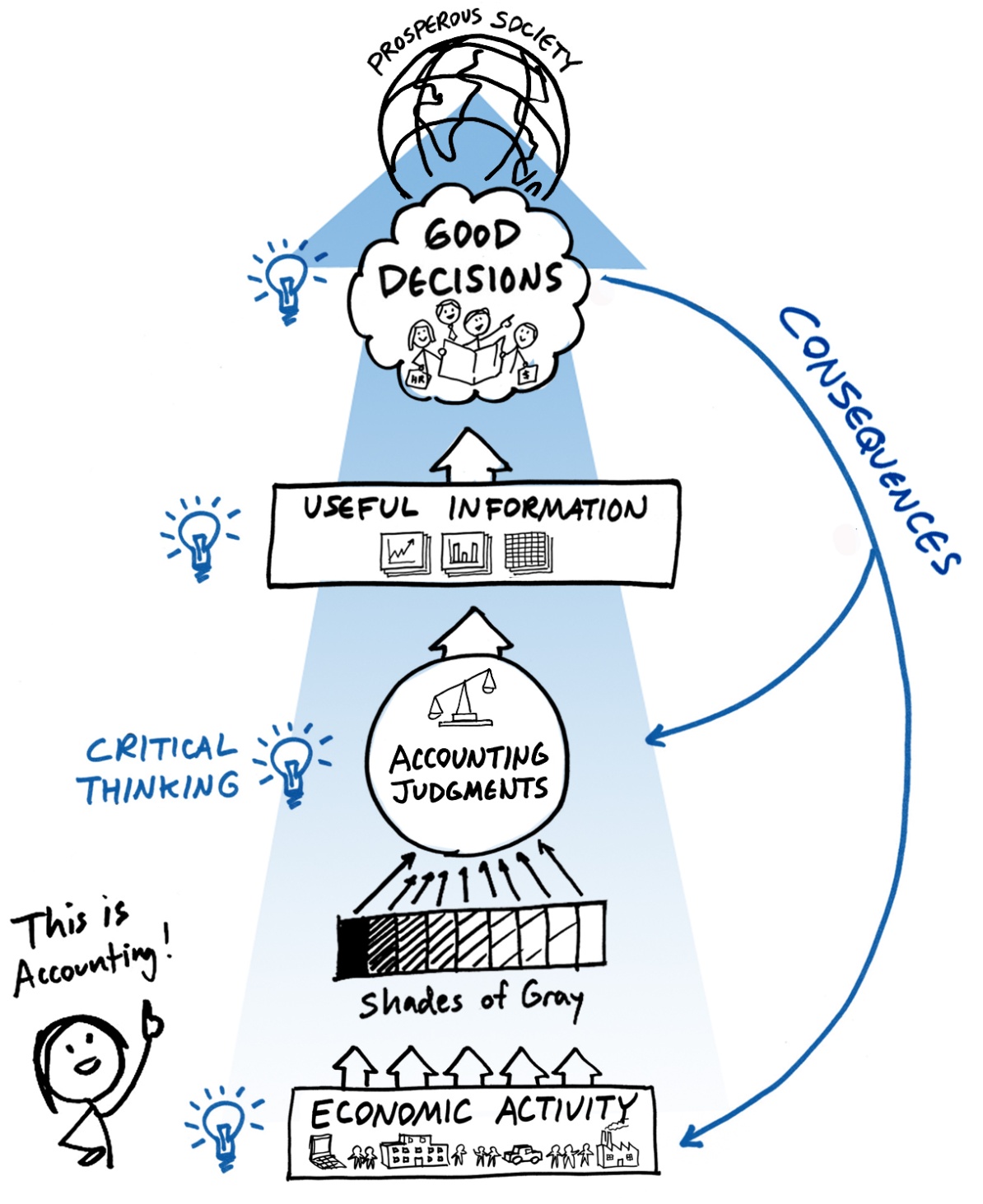
***Suggested Discussion Points:*** Accountants use judgment on a day-to-day basis when applying accounting concepts, assumptions, and principles. For example, the cost constraint involves determining the expected cost of implementation of a new accounting standard. Materiality is subjective and can be difficult to apply. The measurement of financial statement elements at fair value requires a significant amount of judgment and estimation. How does an accountant know that the information provided is “complete” or “neutral?” Can an accountant be sure that the statements meet the threshold of full disclosure? Judgment plays a major role in implementing the concepts, assumptions, and principles included in the conceptual framework.

1. Discuss the meaning of Paul Pacter’s statement, “We accountants must never lose sight of the important public interest in our work.”

***Suggested Discussion Points:*** The accounting profession has an obligation to meet the public interest and plays a critical role in our society. The role of accounting in serving the interest of the constituents within the environment in which it operates includes setting standards, ensuring compliance with regulatory requirements, enhancing corporate social responsibility, and monitoring and minimizing the potential for accounting fraud. Taking these steps creates confidence and public trust in the financial system and ensures proper functioning of our capital markets.

The picture below illustrates the accountant’s role in society. Starting with economic activity, accountants use their judgment to provide useful information that leads to good decision making and, ultimately, a prosperous society. Thus, the accountant’s role in society and serving the public interest is critical.

The Pathways Commission on Accounting Higher Education generated the picture (“Pathways Vision Model”) to represent their vision of accounting in society. The Pathways Commission on Accounting Higher Education was created in 2010 by the American Accounting Association (AAA) and the American Institute of Certified Public Accountants (AICPA) to study the future structure of higher education for the accounting profession and develop recommendations for educational pathways to engage and retain the strongest possible community of students, academics, practitioners, and other knowledgeable leaders in the practice and study of accounting.

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