

Financial Reporting and Accounting Standards

1. The Environment of Accounting

2. The Conceptual Framework for Financial Reporting

- Basic Objectives of Financial Reporting
- Fundamental Concepts
- Recognition, Measurement, and Disclosure Concepts

1-3. Cash Flows and Income Measurement

ACCOUNTING

1.1 Definition, Objective, Importance

1.2 Accounting profession

1.3 Development of Accounting Standards

1.4 Financial Reporting

Challenges

DEFINITION, OBJECTIVE, IMPORTANCE

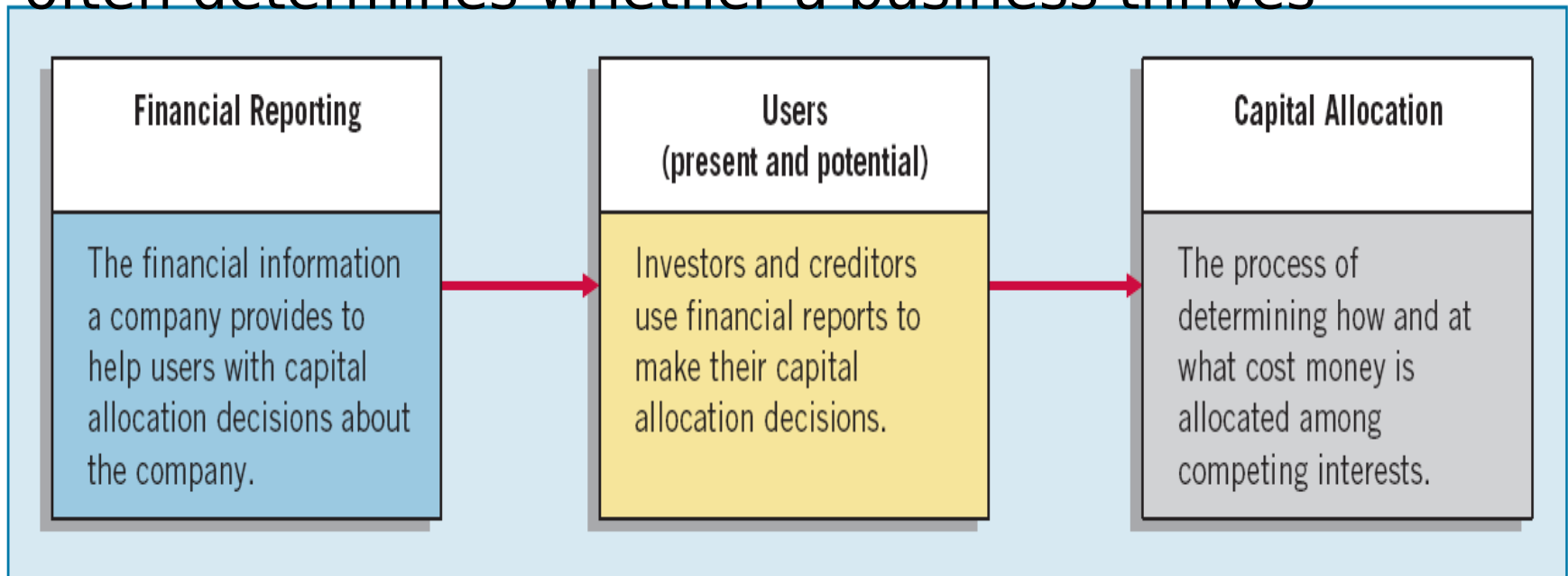
- Accounting is a/an:
 - Service activity
 - Descriptive/analytical discipline, and
 - Information system.
- As a service activity its function is to **provide interested parties with quantitative information, primarily financial in nature, about economic entities that is intended to be useful in making economic decisions** [decisions about the deployment and use of resources in¹⁻³ business and non-business entities and in the

DEFINITION, OBJECTIVE, IMPORTANCE

- As a descriptive/analytical discipline, it defines the great mass of events and transactions that characterize economic activity and through measurement, classification, and summarization, reduces those data to relatively small, highly significant, and interrelated items that, when properly assembled and reported, describe the financial condition, and results of operation of a specific economic activity.
- As an information system, it **collects and communicates economic information** about a business enterprise or other entity to a wide variety

DEFINITION, OBJECTIVE, IMPORTANCE

- Role of Accounting in Capital Allocation- accounting assists in the efficient use of scarce resources.
- Resources are **limited**. Efficient use of resources often determines whether a business thrives



DEFINITION, OBJECTIVE, IMPORTANCE

User group

Managers

Use

To help them to make decisions and plans for the business and to help them to exercise control to try to ensure that plans come to fruition

Employees (non-management)

To assess the ability of the business to continue to provide employment and to reward employees for their labor.

Owners [Investors]

To assess how effectively the managers are running the business and to make judgments about likely levels of risk and return in the future.

1-6 Creditors [Lenders]

To assess the ability of the business to meet its obligations and to pay interest

DEFINITION, OBJECTIVE, IMPORTANCE

Government	To assess how much tax the business should pay, whether it complies with agreed pricing policies [regulation], whether financial support is needed
Customers	To assess the ability of the business to continue in business and to supply the needs of the customers.
Suppliers	To assess the ability of the business to pay for the goods and services supplied.
Investment analysts	To assess the likely risks and returns associated with the business in order to determine its investment potential and to advise clients accordingly.
Community representatives	To assess the ability of the business to continue to provide employment for the community and use community resources, to help fund for environmental improvements, etc.

2 ACCOUNTING PROFESSION

Types of Accounting

Accountants may specialize in different accounting fields some of which include the following.

- Financial accounting - area of accounting aimed at serving information needs of external users.
- Managerial accounting - field of accounting concerned with serving information needs of internal users - managers.
- Cost accounting - a managerial accounting activity designed to help managers in identifying, measuring and controlling operating costs.
- Tax accounting - field of accounting that includes preparing tax returns and planning future transactions to manage the amount profit tax

2 ACCOUNTING PROFESSION

- Governmental Accounting, also known as public accounting or federal accounting, refers to the type of accounting information system used in the public sector.
- Forensic Accounting is the use of accounting, auditing and investigative techniques in cases of litigation or disputes.
- Social Accounting, also known as Corporate Social Responsibility Reporting and Sustainability Accounting, refers to the process of reporting implications of an organization's activities on its

1.3 DEVELOPMENT ACCOUNTING STANDARDS

- Accounting Standards, as a term, prevalent in recent years signifies all the rules, from whatever source, which govern accounting.
- Concepts, principles, and procedures were developed to meet the needs of external users.
 - The accounting standards: are IFRSs (both IFRS and IAS with their interpretations).

1.3 DEVELOPMENT ACCOUNTING

~~STANDARDS~~

➤ Historical Perspective and Standards

- ❖ International Standard Setting
 - Standards set by private-sector
 - Standards set by governmental body
- ❖ Organizations that have a role in international standard-setting are the IASB and International Organization of Securities Commissions (IOSCO).
- ❖ IASC/IASCF [International Accounting Standards Committee Foundation] formed in 1973
 - An independent body that oversees the IASB. It was formed as a not-for-profit corporation in the USA.
- ❖ IASC reorganized itself in 2001 and created a new standard-setting body called the International Accounting Standards Board [IASB]. Its base is in London

1.3 DEVELOPMENT ACCOUNTING STANDARDS

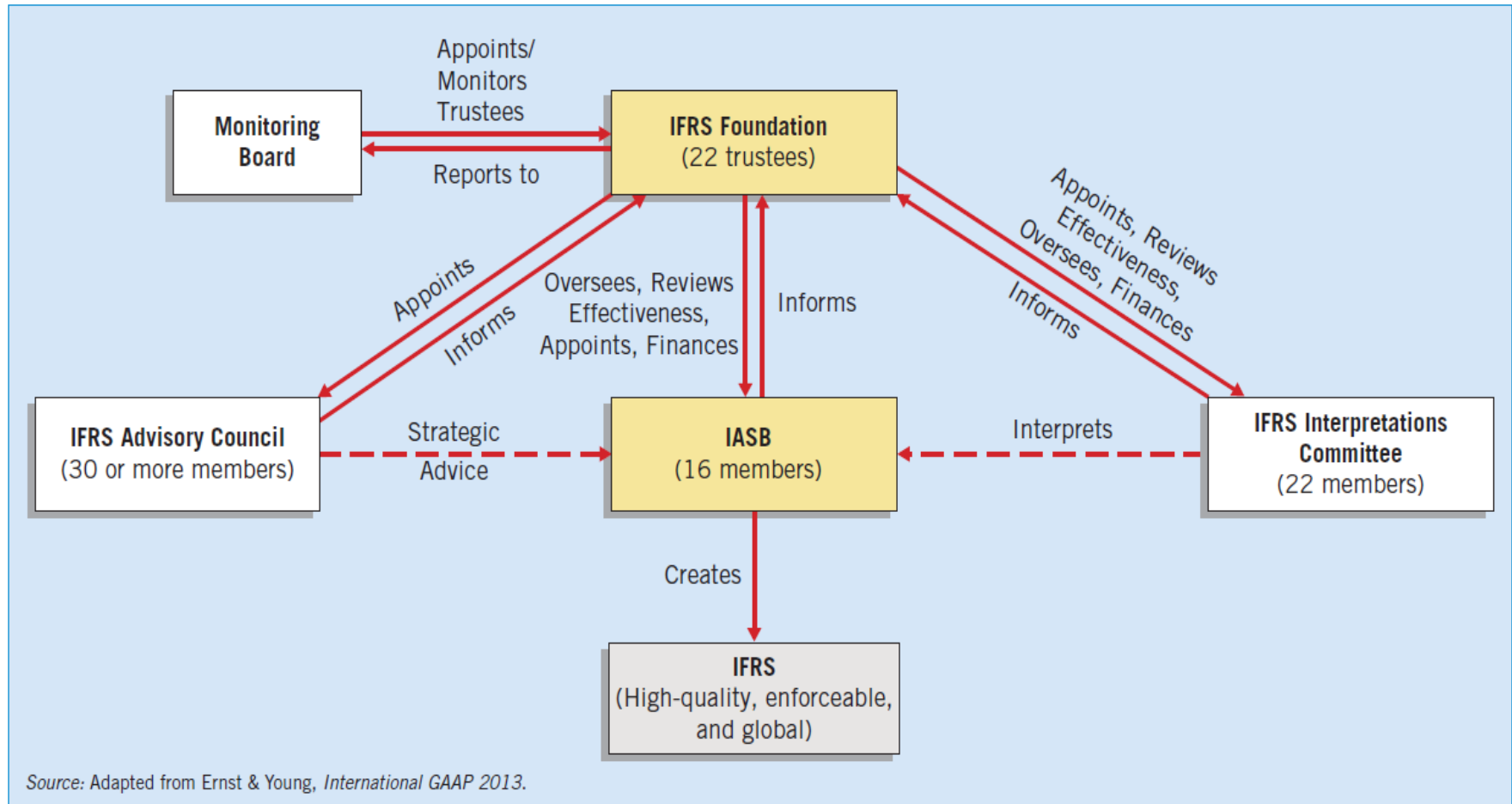
➤ International Accounting Standards Board (IASB)

Composed of four organizations—

- ▶ IFRS Foundation
- ▶ International Accounting Standards Board (**IASB**)
- ▶ IFRS Advisory Council
- ▶ IFRS Interpretations Committee

1.3 DEVELOPMENT ACCOUNTING STANDARDS

• International Standard-Setting Structure



1.3 DEVELOPMENT ACCOUNTING

~~STANDARDS~~

- IASB members include accounting profession, analysts, academics, regulators, and government.
- IFRS Foundation selects members, oversees, and ensures adequate funding.
- IFRS Advisory Council advises on agenda and work priorities.
- IFRS Interpretations Committee seeks to resolve accounting issues and interpret existing IFRS.
- International Organization of Securities Commissions (IOSCO) provides regulatory oversight of IASB.
- IASB is a private and non-governmental body with no authority to enforce the use of IFRS.

1.3 DEVELOPMENT ACCOUNTING

~~STANDARDS~~

► Role of International Accounting Standards Board (IASB)

- Issues **International Financial Reporting Standards (IFRS)**.
- Develop, promote and coordinate the use of a single set of high-quality, understandable, and enforceable global and harmonized accounting standards known as International Financial Reporting Standards.
- Prior to 2003 standards were issued as International Accounting Standards (IASs). In 2003 IFRS 1 was issued and all new standards are now designated as IFRSs.
- IFRS used in over 150 countries.

1.3 DEVELOPMENT ACCOUNTING ~~STANDARDS~~

- International Organization of Securities Commissions (IOSCO)
 - ▶ Does not set accounting standards.
 - ▶ Dedicated to ensuring that global markets can operate in an efficient and effective basis.
 - ▶ Supports the use of IFRS as the single set of international standards in cross-border offerings and listings.

1.3 DEVELOPMENT ACCOUNTING ~~STANDARDS~~

Due Process [Operating Procedures]

The **IASB due process** has the following elements:

1. Independent standard-setting board;
2. Thorough and systematic process for developing standards;
3. Engagement with investors, regulators, business leaders, and the global accountancy profession at every stage of the process; and
4. Collaborative efforts with the worldwide standard-setting community.

1.3 DEVELOPMENT ACCOUNTING

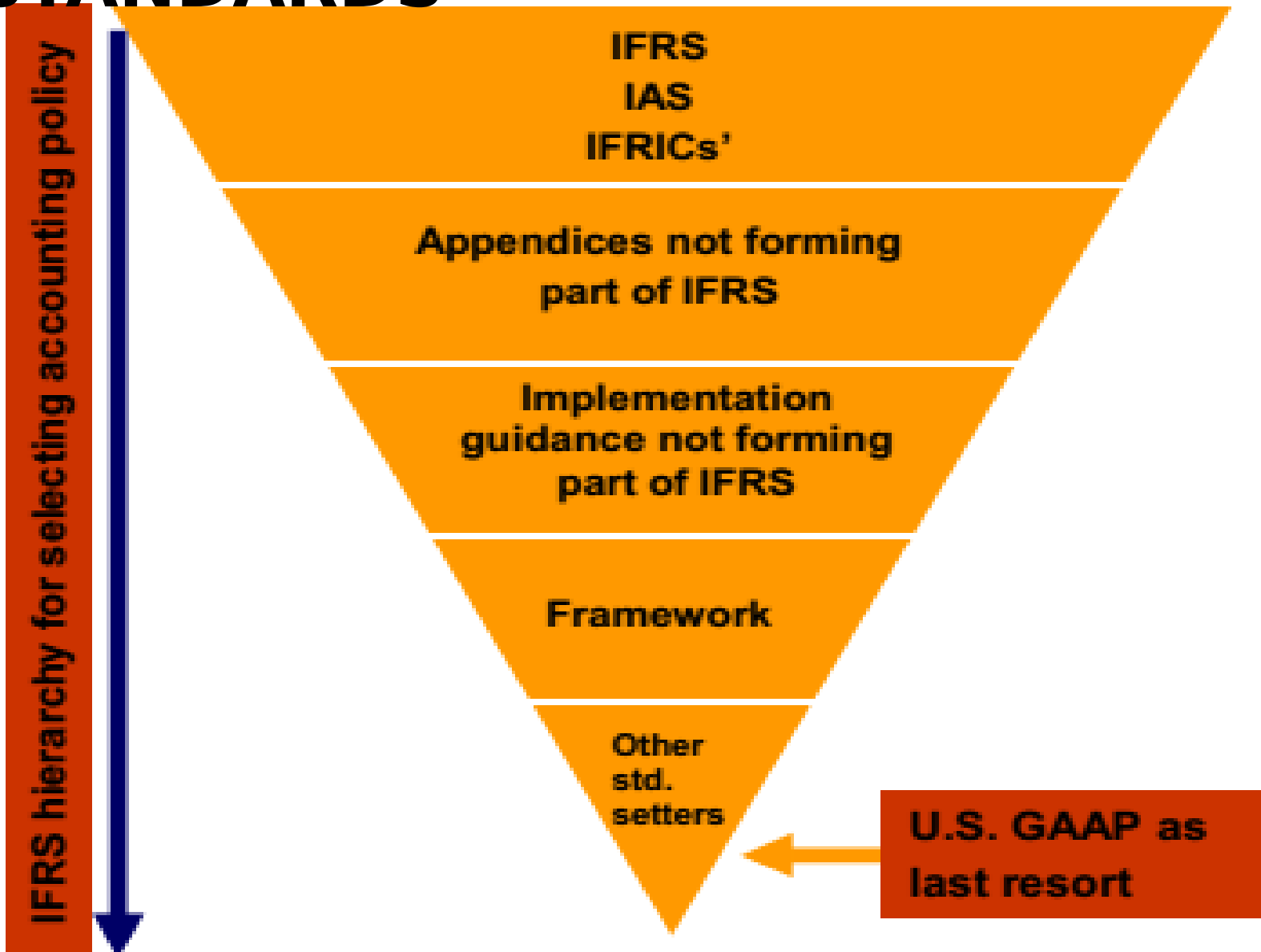
~~STANDARDS~~

➤ Hierarchy of IFRS

Companies first look to:

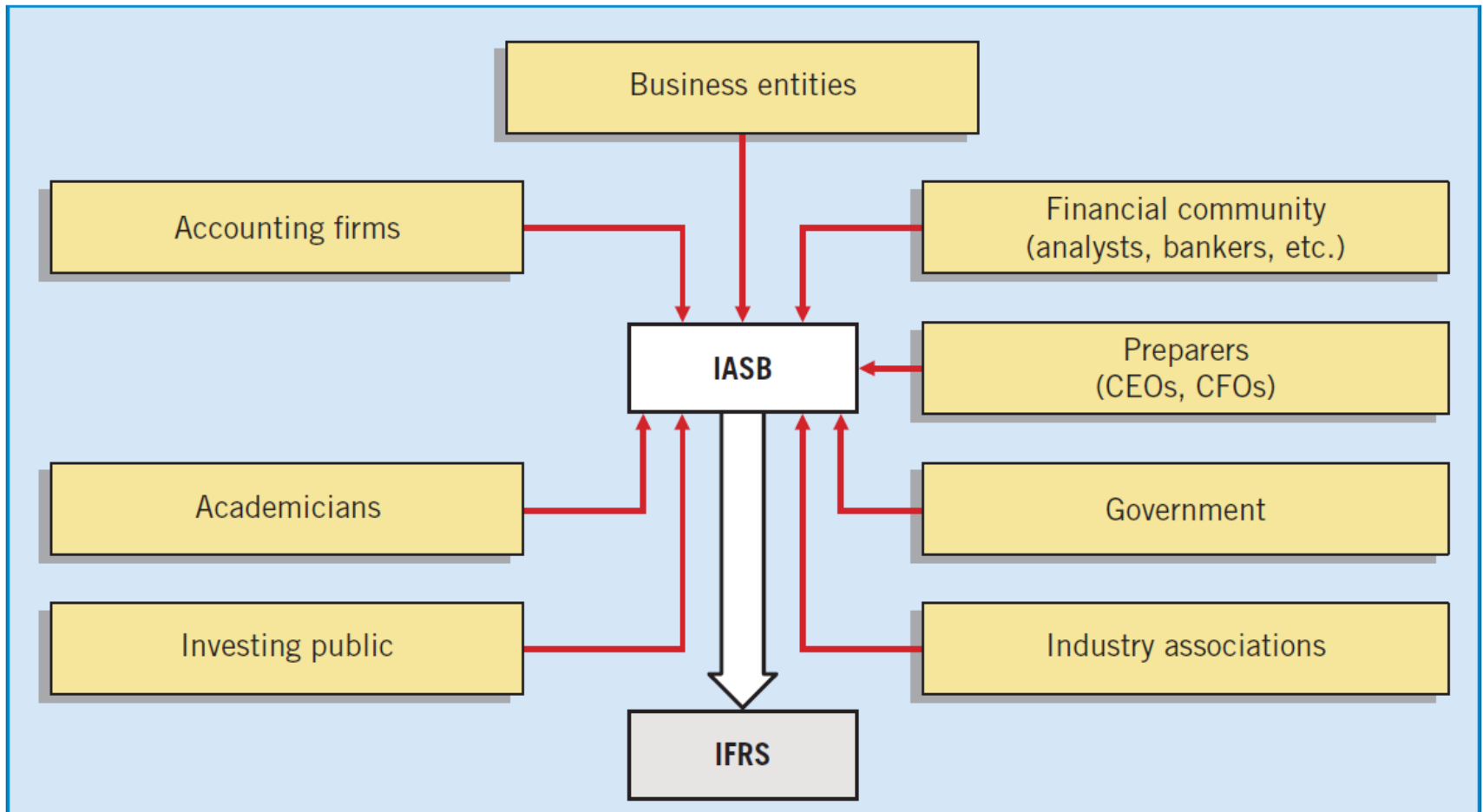
1. International Financial Reporting Standards; International Financial Reporting Standards, International Accounting Standards (issued by the predecessor to the IASB), and IFRS interpretations originated by the IFRS Interpretations Committee (and its predecessor, the IAS Interpretations Committee)-IFRICs (International Financial Reporting Interpretation Committee) & SICs (Standard Interpretation Committee);
2. The Conceptual Framework for Financial Reporting; and

1.3 DEVELOPMENT ACCOUNTING STANDARDS



1.3 DEVELOPMENT ACCOUNTING STANDARDS

- User groups that influence the formulation of accounting standards



2. The Conceptual Framework for Financial Reporting

2.1 Definition and Importance

2.2 Components

2.3 Basic Objectives of Financial Reporting

2.4 Fundamental Concepts

2.5 Recognition, Measurement, and
Disclosure Concepts

DEFINITION, IMPORTANCE,

~~COMPONENTS~~

➤ Definition of the Conceptual Framework

The Conceptual Framework is a coherent system of interrelated objectives and fundamentals that is expected to lead to consistent standards and that prescribes the nature, function and limits of financial accounting and reporting.

- Frame of reference/benchmark for financial reporting.

DEFINITION, IMPORTANCE,

COMPONENTS

➤ Importance of the Conceptual Framework

- a) Assist or guide the rule-making body in the standard setting process by providing a basis for developing new and revised accounting and reporting standards;
- b) Serve the public interest by providing structure and direction to financial accounting statements;
- c) Provides description of current practice;
- d) Serve as frame of reference for resolving new & emerging practical issues not covered by existing GAAP;

DEFINITION, IMPORTANCE, COMPONENTS

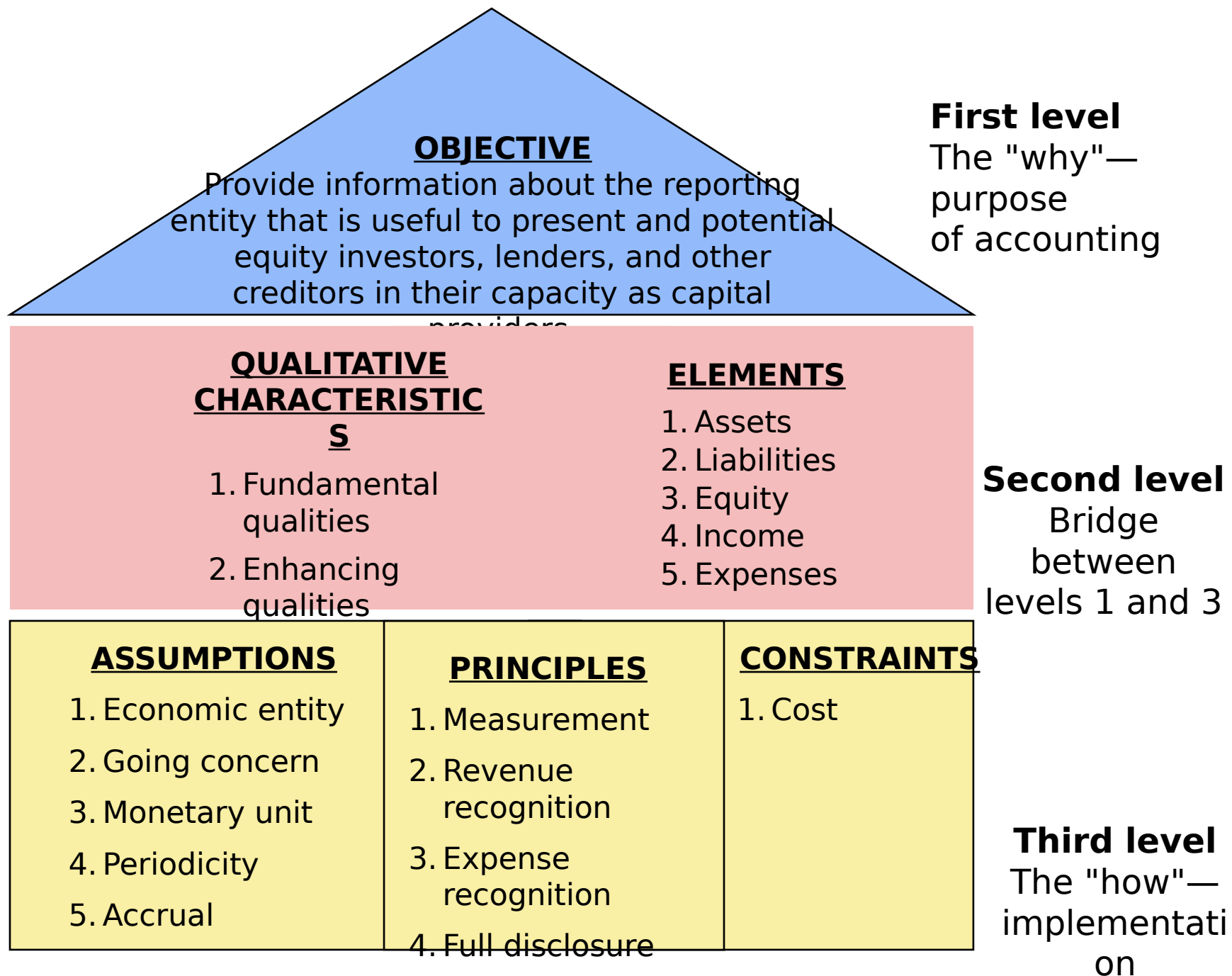
- f) Assist accountants and others in selecting from alternative accounting and reporting methods that best represents the economic reality of a given situation;
- g) Increase users' understanding of and confidence in financial statements;
- h) Enhance comparability through standardized accounting practice; and
- i) Forms the theoretical basis for determining which events should be accounted and how they should be measured and communicated to the users.

DEFINITION, IMPORTANCE, COMPONENTS

➤ Components of the Conceptual Framework

Three levels:

- ◆ **First Level** = Objectives of Financial Reporting
- ◆ **Second Level** = Qualitative Characteristics and Elements of Financial Statements [Fundamental Concepts]
- ◆ **Third Level** = Recognition, Measurement, and Disclosure Concepts [Operational Guidelines].



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.

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

Primary users of accounting information

CAPITAL PROVIDERS (Investors and Creditors)
AND THEIR CHARACTERISTICS

Constraint

COST

Pervasive criterion

DECISION-USEFULNESS

Fundamental qualities

RELEVANCE

FAITHFUL REPRESENTATION

Ingredients of fundamental qualities

Predictive value

Confirmatory value

Materiality

Completeness

Neutrality

Free from error

Enhancing qualities

Comparability

Verifiability

Timeliness

Understandability

Recognition, Measurement, and Disclosure Concepts

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

CONSTRAINT

1. Cost

Th
Th
impl

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

Second level:
between levels

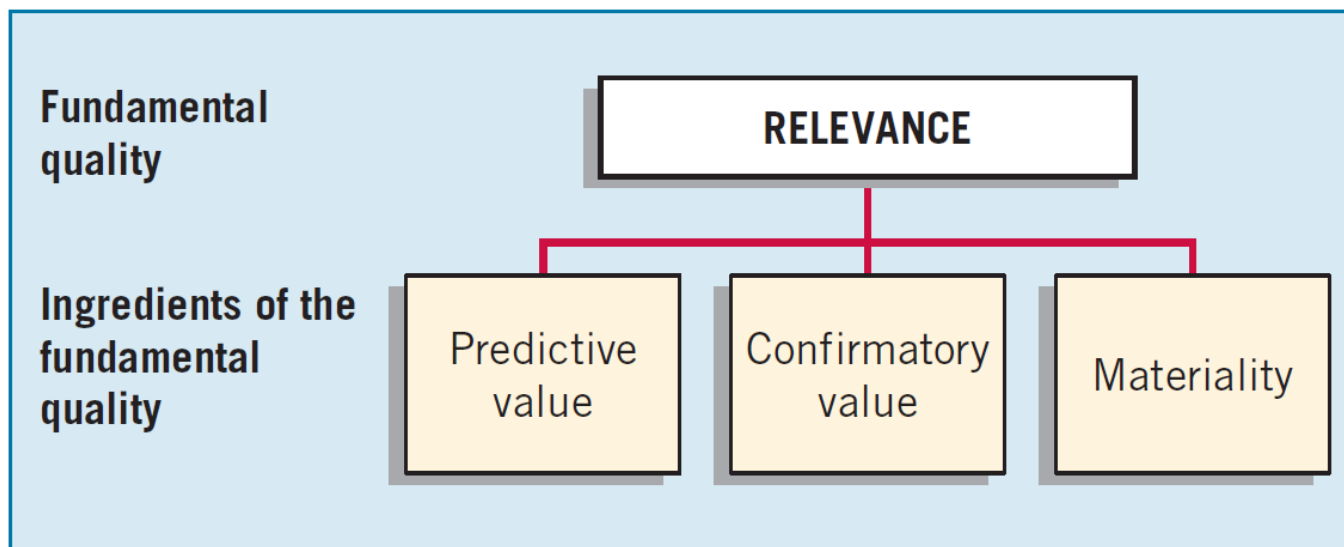
OBJECTIVE

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: FUNDAMENTAL ~~CONCEPTS~~

Fundamental Quality—Relevance



To be **relevant**, accounting information must be capable of **making a difference in a decision**.

SECOND LEVEL: FUNDAMENTAL ~~CONCEPTS~~

Ingredients of Relevance

1. 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.
2. Confirmatory value: Relevant information also helps users **confirm** or correct prior expectations.
3. Materiality: Information is **material** if omitting it or misstating it could influence decisions that users make on the basis of the reported financial

SECOND LEVEL: FUNDAMENTAL

CONCEPTS

- Materiality: Refers to the magnitude of an omission or misstatement of accounting information, considering the circumstances, makes it likely that the judgment of a reasonable person relying on the information would have been influenced by the omission or misstatement.
- A quantitative threshold for recognition.
- All material items should be disclosed in the financial statements.
- A decision to disclose or not certain information may be made because users have need or no need for that information (it is relevant or irrelevant) and because the amount is large enough or too small to make a difference in a decision (i.e. it is material or immaterial)

- Amounts which are immaterial can be aggregated

SECOND LEVEL: FUNDAMENTAL

~~CONCEPTS~~

- Permit treatment of immaterial items in an expedient (convenient and cost effective) manner.
- Involves exercise of subjective judgment to assess whether or not an item is material:
 - a) Nature of the item, i.e. arises from abnormal instead of normal circumstances, &
 - b) Value of the item i.e. relative instead of absolute.
- There is no absolute measure of materiality. It is common to apply a convenient rule of thumb (for example material items are those with a value greater than 5% of net profits). However some items disclosed in the accounts are regarded as particularly sensitive and even a very small misstatement of such an item is taken as a material error.

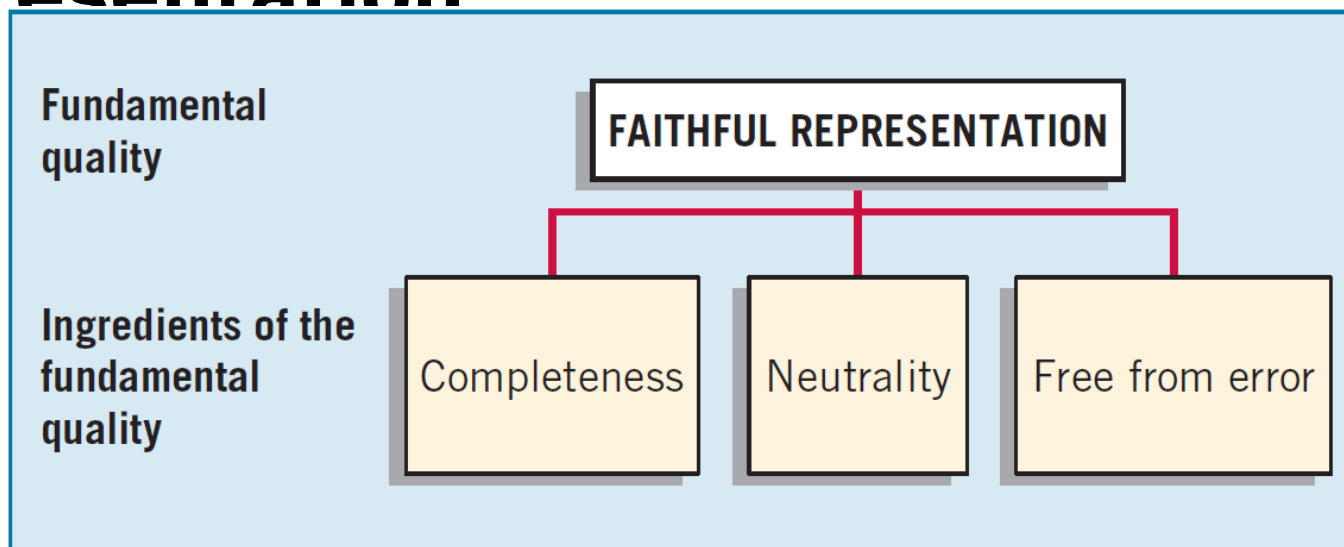
Example **SECOND LEVEL: FUNDAMENTAL**

CONCEPTS

- a) If a statement of financial position shows non-current assets of Br.2 million and inventories of Br.30,000, an error of Br.20,000 in the depreciation calculations might not be regarded as material. However, an error of Br.20,000 in the inventory valuation would be material. In other words, the total of which the error forms part must be considered.
- b) If a business has a bank loan of Br.50,000 and a Br.55,000 balance on bank deposit account, it will be a material misstatement if these two amounts are displayed on the statement of financial position as 'cash at bank Br.5,000'. In other words, incorrect presentation may amount to material misstatement even if there

SECOND LEVEL: FUNDAMENTAL CONCEPTS

Fundamental Quality—Faithful Representation



Faithful representation means that the numbers and descriptions match what really existed or happened.

SECOND LEVEL: FUNDAMENTAL

~~CONCEPTS~~

- Validity
- Correspondence or agreement between a measure or description and the underlying economic event or resource.
- Reduce measurement bias
- Having RF in one decision making context does not mean that accounting information will be relevant for other decisions. For instance, current cost would be useful for an economic resource that is expected to be replaced in the near future, but it might not be useful if there were no intention of replacement.

~~SECOND LEVEL FUNDAMENTAL Legal~~ ~~CONCEPTS~~

The principle that transactions and other events are accounted for and presented in accordance with their substance and economic reality and not merely their legal form.

Faithful representation of a transaction is only possible if it is accounted for according to its **substance and economic reality**, not with its legal form. Substance over form usually applies to transactions which are fairly complicated. It is very important because it acts as a 'catch-all' to stop entities distorting their results by following the letter of the law, instead of showing what the entity has really been doing.

SECOND LEVEL: FUNDAMENTAL

~~CONCEPTS~~

For instance, one party may sell an asset to another party and the sales documentation may record that legal ownership has been transferred. However, if agreements exist whereby the party selling the asset continues to enjoy the future economic benefits arising from the asset, then in substance no sale has taken place.

SECOND LEVEL: FUNDAMENTAL

CONCEPTS

Ingredients of Faithful Representation

- 1. Completeness:** means that all the information that is necessary for faithful representation is provided.
- 2. Free from Error:** An information item that is free from error will be a more accurate (faithful) representation of a financial item.

SECOND LEVEL: FUNDAMENTAL

CONCEPTS

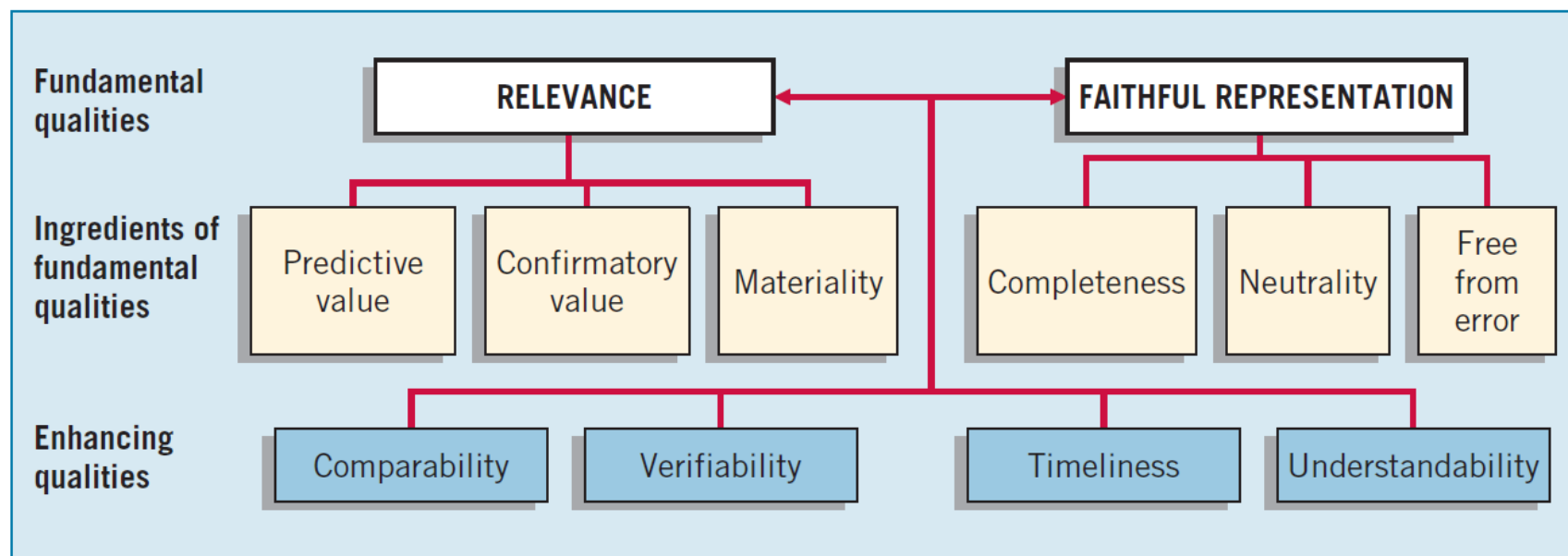
Ingredients of Faithful Representation

3. **Neutrality:** means that a company cannot select information to favor one set of interested parties over another. Information must be free from bias to be reliable. Neutrality is lost if the financial statements are prepared so as to influence the user to make a judgment or decision in order to achieve a predetermined outcome, i.e. influence behavior in particular direction. It does not mean that information has no purpose or does not influence human

SECOND LEVEL: FUNDAMENTAL

CONCEPTS

Enhancing Qualities



Comparability: Information that is measured and reported in a similar manner for different companies is considered comparable. IAS 1 requires comparative information to be disclosed for the previous period for all numerical information, unless another IFRS permits/requires otherwise.

SECOND LEVEL: FUNDAMENTAL

~~CONCEPTS~~

▪ Comparability

- Intercompany (i.e. across companies or cross sectional analysis) or Intracompany (i.e. across period within company or time series analysis).
- Ability to identify (discern) and explain similarities and differences between two or more sets of economic facts or data.
- Enable or useful for SWOT analysis

~~SECOND LEVEL: FUNDAMENTAL~~

~~CONCEPTS~~

- Ingredient of comparability
- To maintain consistency, the measurement, presentation and classification of items in the financial statements should stay the same from one period to the next, except as follows.
 - a) There is a significant change in the nature of the operations or a review of the financial statements indicates a more appropriate presentation.
 - ¹⁻⁴⁴ b) A change in presentation is required by an

SECOND LEVEL: FUNDAMENTAL

CONCEPTS

- **Verifiability:** occurs when independent measurers, using the same methods, obtain similar results.
- Objectivity and consensus among measurers
- Pertains to the correct application, (i.e. without errors or bias) of a measurement basis.
- Ability to replicate or duplicate measurement results

SECOND LEVEL: FUNDAMENTAL

Timeliness: means having information available to decision-makers before it loses its capacity to influence decisions. Example: Interim reports.

▪ **Understandability** is the quality of information that lets reasonably informed users see its significance.

a) User specific (inherent in user)

▪ Provides a link/connection between user characteristics and decision specific characteristics inherent in the information itself.

1-46 ▪ It is the quality of information that enables users to perceive its significance

SECOND LEVEL: FUNDAMENTAL

CONCEPTS

- Assume that users' have prior reasonable knowledge of business or economic activities and willingness to comprehend/study the information with reasonable diligence.

b) Decision specific

- Understandability is enhanced when information is classified, characterized, and presented clearly and concisely.

SECOND LEVEL: BASIC ELEMENTS

Elements of Financial Statements

Asset: 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.

Liability: 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.

Equity: The residual interest in the assets of the entity after deducting all its liabilities.

SECOND LEVEL: BASIC ELEMENTS

Elements of Financial Statements

Income: 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. Note connection with assets and liabilities.

Expenses: 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. Note connection with assets and

THIRD LEVEL: RECOGNITION, MEASUREMENT, AND DISCLOSURE CONCEPTS

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

Recognition, Measurement, and Disclosure		
<u>ASSUMPTIONS</u>	<u>Concepts</u> <u>PRINCIPLES</u>	<u>CONSTRAINTS</u>
<ol style="list-style-type: none">1. Economic entity2. Going concern3. Monetary unit4. Periodicity5. Accrual	<ol style="list-style-type: none">1. Measurement2. Revenue recognition3. Expense recognition4. Full disclosure	<ol style="list-style-type: none">1. Cost

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.

ASSUMPTION UNDERLYING FINANCIAL STATEMENTS

Going Concern

- The entity is normally viewed as a going concern, that is, as continuing in operation for the foreseeable future. It is assumed that the entity has neither the intention nor the necessity of liquidation or of curtailing materially the scale of its operations.
- Financial statements are prepared under the going concern assumption
- Implications of going concern:
 - Allocation of depreciation over useful life
 - Supports inclusion of good will in statement of financial position
 - Set aside if management intends to liquidate the entity's operations

ASSUMPTION UNDERLYING FINANCIAL STATEMENTS

- ~~Going concern~~ concept assumes that, when preparing a normal set of accounts, the business will continue to operate in approximately the same manner for the foreseeable future (at least the next 12 months). In particular, the entity will not go into liquidation or scale down its operations in a material way.
- The main significance of a going concern is that the assets should not be valued at their 'break-up' value; the amount they would sell for if they were sold off piecemeal and the business were broken up.

Example: A retailer commences business on 1 January and buys inventory of 20 washing machines, each

costing Br.150. During the year he sells 17 machines at Br.150 each. How should the remaining machines be valued at 31 December in the following circumstances?

Case 1: He is forced to close down his business at the end of the year and the remaining machines will realise only Br.60 each in a forced sale.

➤ If the business is to be closed down, the remaining three machines must be valued at the amount they will realise in a forced sale, ie $3 \times \text{Br.60} = \text{Br.180}$.

Case 2: He intends to continue his business into the next year.

➤ If the business is regarded as a going concern, the inventory unsold at 31 December will be carried forward into the following year, when the cost of the three machines will be matched against the eventual sale proceeds in computing that year's profits. The three machines will therefore be valued at cost, $3 \times$

ASSUMPTION UNDERLYING FINANCIAL STATEMENTS

- In the accruals basis of accounting, items are recognised as assets, liabilities, equity, income and expenses (the elements of financial statements) when they satisfy the definitions and recognition criteria for those elements in the Framework.
- Entities should prepare their financial statements on the basis that transactions are recorded in them, **not as the cash is paid or received, but as the revenues or expenses are earned or incurred in the accounting period to which they relate.** According to the accrual assumption, in computing profit revenue earned must be matched against the expenditure incurred in earning it.

THIRD LEVEL: BASIC PRINCIPLES

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

THIRD LEVEL: BASIC PRINCIPLES

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.

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

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

Fair Presentation & Compliance with IASs/IFRSs

Most importantly, financial statements should present fairly the financial position, financial performance and cash flows of an entity. Compliance with IASs/IFRS will almost always achieve this. The following points made by IAS 1 expand on this principle.

- Compliance with IASs/IFRSs should be disclosed.
- All relevant IASs/IFRSs must be followed if compliance with IASs/IFRSs is disclosed.
- Use of an inappropriate accounting treatment cannot be rectified either by disclosure of accounting policies or notes/explanatory material.

THIRD LEVEL: BASIC PRINCIPLES

The Fair Presentation Override

There may be (very rare) circumstances when management decides that compliance with a requirement of an IAS/IFRS would be misleading.

Departure from the IAS/IFRS is therefore required to achieve a fair presentation. The following should be disclosed in such an event.

- Management confirmation that the financial statements fairly present the entity's financial position, performance and cash flows.
- Statement that all IASs/IFRSs have been complied with except departure from one IAS/IFRS to achieve a

THIRD LEVEL: BASIC PRINCIPLES

- ~~Details of the nature of the departure, why the~~
IAS/IFRS treatment would be misleading, and the treatment adopted.
- Financial impact of the departure.

IAS 1 states what is required for a fair presentation.

- Selection and application of accounting policies.
- Presentation of information in a manner which provides relevant, reliable, comparable and understandable information.
- Additional disclosures where required.

THIRD LEVEL: BASIC PRINCIPLES

Prudence

IAS 1 also considers three other concepts extremely important. Prudence, substance over form and materiality should govern the selection and application of accounting policies.

Prudence is the inclusion of a degree of caution in the exercise of the judgements needed in making the estimates required under conditions of uncertainty, such that assets or income are not overstated and liabilities or expenses are not understated.

Prudence must be exercised when preparing financial statements because of the **uncertainty** surrounding many transactions. It is not permitted, however, to create secret or hidden reserves using prudence as a justification.

THIRD LEVEL: BASIC PRINCIPLES

~~There are three important issues to bear in mind.~~

- Where **alternative procedures or valuations** are possible, the one selected should be the one which gives the most cautious result.
- Where a **loss is foreseen**, it should be anticipated and taken into account immediately. Even when the exact amount of the loss is not known, an estimate of the loss should be made, based on the best information available.

THIRD LEVEL: BASIC PRINCIPLES

- If a business purchases inventory for Br.1,200 but, because of a sudden slump in the market, only Br.900 is likely to be realised when the inventory is sold, the prudence concept dictates that the inventory is valued at Br.900. It is not enough to wait until the inventory is sold, and then recognise the Br.300 loss; it must be recognised as soon as it is foreseen.
- Profits should only be recognised when **realised** in the form of cash or another asset with a reasonably certain cash value.

~~Example Application of principles~~ THIRD LEVEL BASIC PRINCIPLES

A company begins trading on 1 January 20X5 and sells goods worth Br.100,000 during the year to 31 December. At 31 December there are accounts receivable outstanding of Br.15,000. Of these, the company is now doubtful whether Br.6,000 will ever be paid. The company should make an *allowance for receivables* of Br.6,000. Sales for 20X5 are shown in the income statement at their full value of Br.100,000, but the allowance for receivables is a charge of Br.6,000. Since there is some uncertainty that the sales will be realised in the form of cash, prudence dictates that the Br.6,000 should not be included in the profit for the year.

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. It is a pervasive constraint.

- ◆ 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.

THIRD LEVEL: COST CONSTRAINT

Concepts of Capital

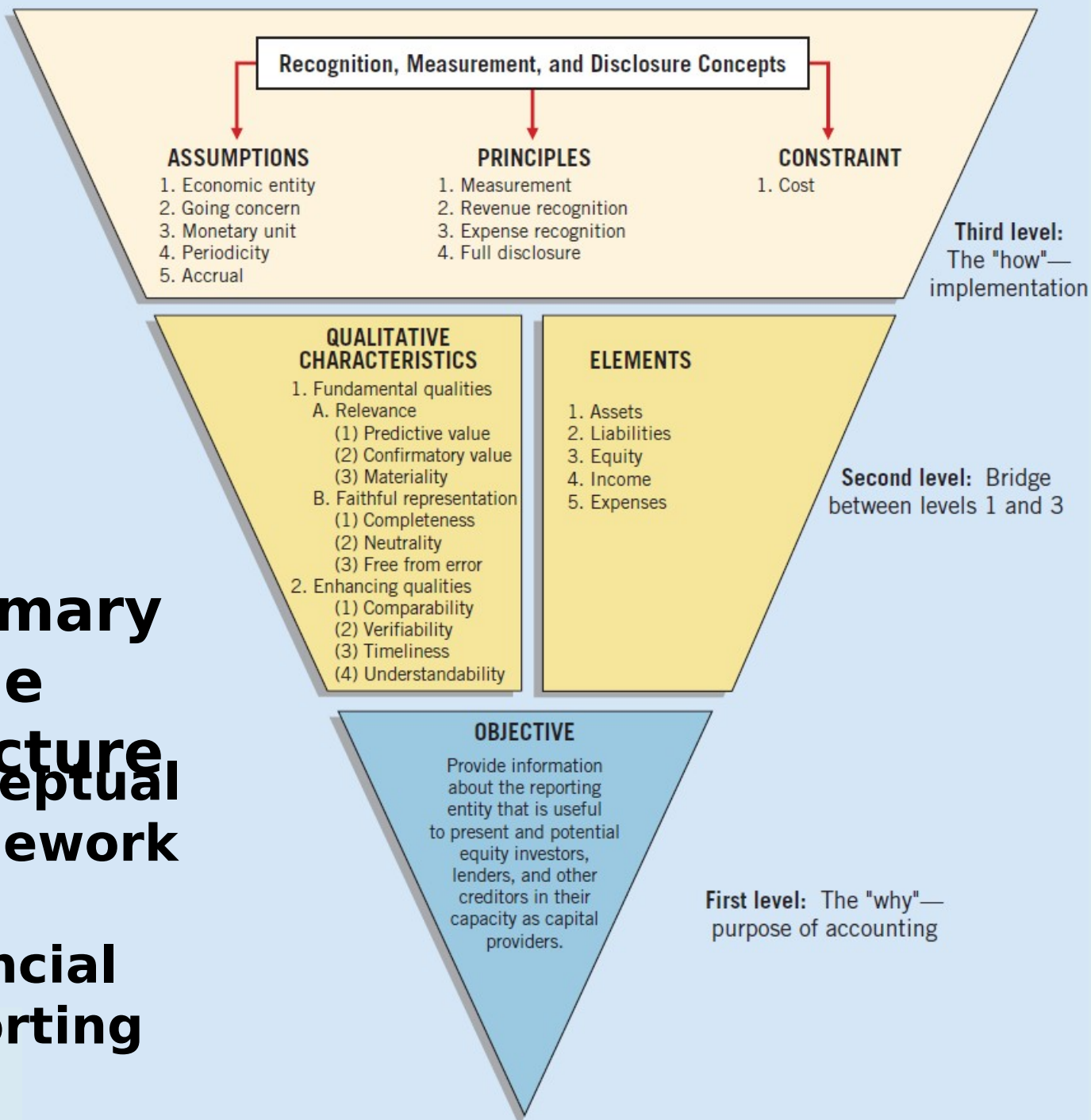
➤ Financial capital concept:

- Capital is synonymous with the net assets or equity of the entity
- Profit exists only after the entity has maintained its capital

➤ Physical capital concept:

- Viewed as the operating capability of the entity's assets
- Profit exists only after the entity has set aside enough capital to maintain the operating capability of its assets

Summary of the Structure Conceptual Framework for Financial Reporting



Exercise 1-1: Identify the qualitative characteristic(s) to be used given the information provided.

Characteristics

(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

Relevance

Faithful

representation

Predictive value

Confirmatory value

Neutrality

Materiality

Timeliness

Verifiability

Understandability

Comparability

Exercise 1-2: Identify the qualitative characteristic(s) to be used given the information provided.

Characteristics

(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.

Relevance

Faithful

representation

Predictive value

Confirmatory value

Neutrality

Materiality

Timeliness

Verifiability

Understandability

Comparability

Exercise 1-3: Identify the qualitative characteristic(s) to be used given the information provided.

Characteristics

(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?

Relevance

Faithful

representation

Predictive value

Confirmatory value

Neutrality

Materiality

Timeliness

Verifiability

Understandability

Comparability

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**

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.

**Revenue
Recognition**

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

**Expense
Recognition**

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

**Full
Disclosure**

(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.

Measurement

THIRD LEVEL: COST CONSTRAINT

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

EXERCISES

Exercise 4: Identify which **basic assumption** of accounting is best described in each item below.

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

Periodicity

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

**Monetary
Unit**

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

Going Concern

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

**Economic
Entity**

EXERCISES

Exercise 5: 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.

**Revenue
Recognition**

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

**Expense
Recognition**

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

**Full
Disclosure**

(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.

Measurement

EXERCISES

Exercise 6: 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

3. Cash Flows & Income Measurement (Cash & Accrual Basis Accounting)

1. Cash Basis of Accounting

- ✓ Under cash basis of accounting, revenue is recognized when ***cash is received***,
- ✓ Expenses are recognized when ***cash is paid***.
- ✓ Not acceptable under IFRS

2. Accrual Basis of Accounting

- ✓ Under accrual basis of accounting, revenue is recognized when it is ***realized (earned)***,
- ✓ Expenses are recognized when ***incurred (expired)***
- ✓ Acceptable under IFRS

Cash Flows & Income Measurement (Cash & Accrual Basis Accounting) ...

- **Con't** Most companies use accrual-basis accounting:
- They recognize revenue when the performance obligation is satisfied and expenses in the period incurred, without regard to the time of receipt or payment of cash.
- Some small companies and the average individual taxpayer,
- However, use a strict or modified cash-basis approach. Under the strict cash basis, companies record revenue only when they receive cash, and they record expenses only when they disperse cash.
- IFRS do not accept cash basis of Accounting. Therefore, it is important to convert from cash basis to accrual basis of Accounting.

- To illustrate this conversion, assume that Dr. Abebe, like many small business owners, keeps accounting records on a cash basis. In the year 2015, Dr. Abebe received 300,000 from his patients and paid 170,000 for operating expenses, resulting in an excess of cash receipts over disbursements of 130,000 (300,000 - 170,000).
- At January 1 and December 31, 2015, he has accounts receivable, unearned service revenue, accrued liabilities, and prepaid expenses as shown in Illustration

	January 1, 2015	December 31, 2015
Accounts receivable	12,000	9,000
Unearned service revenue	–0–	4,000
Accrued liabilities	2,000	5,500
Prepaid expenses	1,800	2,700

- **Service Revenue Computation**

- Cash receipt from customer –Beginning A/R + ending A/R = Accrual base revenue
- Cash from customer + Beg unearned Rev –End unearned Rev =Accrual revenue

Therefore revenue for Dr Abebe will be

Cash receipts from customers		300,000
-Beginning accounts receivable	(12,000)	
+ Ending accounts receivable	9,000	
+ Beginning unearned service revenue	-0-	
- Ending unearned service revenue	(4,000)	(7,000)
Service revenue (accrual)		293,000

- **Operating Expense Computation**
- Cash paid for operating exp + Beginning Prepaid exp - ending Pre paid exp = Exp Acc B
- Cash paid for operating exp - Beginning Acc lia + ending Acc lia = Exp Acc B

Therefore Dr Abebe's Accrual base expenses will amount

Cash paid for operating expenses		170,000
+ Beginning prepaid expense	1,800	
- Ending prepaid expense	(2,700)	
- Beginning accrued liabilities	(2,000)	
+ Ending accrued liabilities	5,500	2,600
Operating expenses (accrual)		172,600

- **Detail conversion is depicted below**

Dr Abebe Clinic				
Conversion of Income Statement Data from Cash Basis to Accrual Basis				
For the year ending 2015				
		Adjustment		
Account Title	Cash Base	Add	Deduct	Accrual Base
Collections from customers	300,000			
– Accounts receivable, Jan. 1			12,000	
+ Accounts receivable, Dec. 31		9,000		
+ Unearned service revenue, Jan. 1				
– Unearned service revenue, Dec. 31			4,000	
Service revenue				293,000
Disbursement for expenses	170,000			
+ Prepaid expenses, Jan. 1		1,800		
– Prepaid expenses, Dec. 31			2,700	
– Accrued liabilities, Jan. 1			2,000	
+ Accrued liabilities, Dec. 31		5,500		
Operating expenses				172,600
Excess of cash collections over disbursements—cash basis	130,000			
Net income—accrual basis				120,400

End of Chapter 1