CHAPTER 6

Concepts – evolution of a global conceptual framework

6.1 Introduction

The main purpose of this chapter is to discuss the rationale underlying financial reporting standards.

Objectives

By the end of the chapter, you should be able to:

- discuss how financial accounting theory has evolved;
- discuss the accounting principles set out in:
  - the International Framework;
  - the UK Statement of Principles;
  - FASB Statements of Financial Accounting Concepts;
- comment critically on rule-based and principles-based approaches.

6.1.1 Different countries meant different financial statements

In the previous chapter we discussed the evolution of national and international accounting standards. The need for standards arose initially as a means of the accounting profession protecting itself against litigation for negligence by relying on the fact that financial statements complied with the published professional standards. The standards were based on existing best practice and little thought was given to a theoretical basis.

Standards were developed by individual countries and it was a reactive process. For example, in the US the Securities and Exchange Commission (SEC) was set up in 1933 to restore investor confidence in financial reporting following the Great Depression. The SEC is an enforcement agency that enforces compliance with US GAAP, which comprises rule-based standards issued by the FASB.

There has been a similar reactive response in other countries often reacting to major financial crises and fraud, which has undermined investor confidence in financial statements. As a result, there has been a variety of national standards with national enforcement, e.g. in the UK principles-based standards are issued by the ASB and enforced by the Financial Reporting Review Panel.

With the growth of the global economy there has been a corresponding growth in the need for global standards so that investors around the world receive the same fair view of a company's results regardless of the legal jurisdiction in which the company is registered.

National standards varied in their quality and in the level of enforcement. This is illustrated by the following comment[1] by the International Forum on Accountancy Development (IFAD):

> **Lessons from the crisis**
> . . . the Asian crisis showed that under the forces of financial globalisation it is essential for countries to improve . . . the supervision, regulation and transparency of financial systems . . . Efficiency of markets requires reliable financial information from issuers. With hindsight, it was clear that local accounting standards used to prepare financial statements did not meet international standards. Investors, both domestic and foreign, did not fully understand the weak financial position of the companies in which they were investing.

We will see in this chapter that, in addition to the realisation that global accounting standards were required, there was also growing interest in basing the standards on a conceptual framework rather than fire-fighting with pragmatic standards often dealing with an immediate problem. However, just as there have been different national standards, so there have been different conceptual frameworks.

Rationale for accounting standards

It is interesting to take a historical overview of the evolution of the financial accounting theory underpinning standards and guiding standard setters to see how it has moved through three phases from the empirical inductive to the deductive and then to a formalised conceptual framework.

6.2 Historical overview of the evolution of financial accounting theory

Financial accounting practices have not evolved in a vacuum. They are dynamic responses to changing macro and micro conditions which may involve political, fiscal, economic and commercial changes, e.g.:

- How to take account of changing prices?
  - Ignore and apply historical cost accounting.
  - Ignore if inflation is low as is the present situation in many European countries.
  - Have a modified historical cost system where tangible non-current assets are revalued which has been the norm in the UK.
  - Have a coherent current cost system as implemented in the 1970s in the Netherlands.
- How to deal with changing commercial practices?
  - Ignore if not a material commercial practice, e.g. leasing in the early 1970s.
  - Apply objective, tightly defined, legalistic-based criteria, e.g. to define finance and operating leases.
  - Apply subjective criteria, e.g. assess the economic substance of a leasing transaction to see if a finance lease because the risks and rewards have substantially been passed to the lessee.
  - Accept that it is not possible to effectively regulate companies to achieve consistent treatment of similar economic transactions unless there is a common standard enforced.

It is clear from considering just these two questions that there could be a variety of accounting treatments for similar transactions and, if annual financial reports are to be useful in making economic decisions,[2] there is a need for uniformity and consistency in reporting.

Attempts to achieve consistency have varied over time.

- An **empirical inductive approach** was followed by the accounting profession prior to 1970.

  This resulted in standards or reporting practices that were based on rationalising what happened in practice, i.e. it established best current practice as the norm. Under this approach there was a general disclosure standard, e.g. IAS 1 *Disclosure of Accounting Policies*, and standards for major specific items, e.g. IAS 2 *Inventories*.
- A **deductive approach** followed in the 1970s.

  This resulted in standards or reporting practices that were based on rationalising what happened in practice, i.e. it established best current practice as the norm but there was also an acceptance of alternatives. Under this approach the accounting theoretical underpinning of the standards was that accounts should be prepared on an accrual basis, with the matching of revenue and related costs and assuming that the business was a going concern. Standards tended to deal with specific major items, for example, a measurement standard for inventories or disclosure of accounting policies, for example, how non-current assets were depreciated. Both types of standard were responding to the fact that there were a number of alternative accounting treatments for the same commercial transaction.
- A **conceptual framework approach** was promoted in the 1980s.

  It was recognised that standards needed to be decision-useful, that they should satisfy cost/benefit criteria and that their implementation could only be achieved by consensus. Consensus was generally only achievable where there was a clearly perceived rationale underprinning a standard and, even so, alternative treatments were required in order to gain support.
- A conceptual framework approach in the twenty-first century – the mandatory model. Under this approach standard setters do not permit alternative treatments.

6.2.1 Empirical inductive approach

The empirical inductive approach looked at the practices that existed and attempted to generalise from them.

This tended to be how the technical departments of accounting firms operated. By rationalising what they did, they ensured that the firm avoided accepting different financial reporting practices for similar transactions, e.g. accepting unrealised profit appearing in the statement of comprehensive income of one client and not in another. The technical department's role was to advise partners and staff, i.e. it was a **defensive role** to avoid any potential charge from a user of the accounts that they had been misled.

Initially a technical circular was regarded as a private good and distribution was restricted to the firm's own staff. However, it then became recognised that it could benefit the firm if its practices were accepted as the industry benchmark, so that in the event of litigation it could rely on this fact.

When the technical advice ceased to be a private good, there was a perceived additional benefit to the firm if the nature of the practice could be changed from being a positive statement, i.e. this is how we report profits on uncompleted contracts, to a **normative** statement, i.e. this is how we report *and* this is how all other financial reporters *ought* to report.

Consequently, there has been a growing trend since the 1980s for firms to publish rationalisations for their financial reporting practices. It has been commercially prudent for them to do so. It has also been extremely helpful to academic accountants and their students.

Typical illustrations of the result of such empirical induction are the wide acceptance of the historical cost model and various concepts such as matching and realisation that we discussed in Chapter 2. The early standards were produced under this regime, e.g. the standard on inventory valuation.

This approach has played an important role in the evolution of financial reporting practices and will continue to do so. After all, it is the preparers of the financial statements and their auditors who are first exposed to change, whether economic, political or commercial. They are the ones who have to think their way through each new problem that surfaces, for example, how to measure and report financial instruments. This means that a financial reporting practice already exists by the time the problem comes to the attention of theoreticians.

The major reasons that it has been felt necessary to try other approaches are both pragmatic and theoretical.

Pragmatic reason

The main pragmatic reason is that the past procedure, whereby deduction was dependent upon generalisation from existing practice within each individual accounting practice, has become untenable. The accelerating rate of economic, political and commercial change leaves too little time for effective and uniform practices to evolve.

Theoretical reasons

The theoretical reasons relate to the acceptability of the income determined under the traditional historical cost model. There are three principal reasons:

- **True income**. We have seen that economists had a view that financial reports should report a true income, which differed from the accountants' view.
- **User-defined income – public**. There is a view that there may be a number of relevant incomes depending upon differing user needs which may be regarded as public goods.
- **User-defined income – private**. There is a view that there may be a number of relevant incomes depending upon differing user needs which may be regarded as private rather than public goods.

It was thought that the limitations implicit in the empirical inductive approach could be overcome by the deductive approach.

6.2.2 Deductive approach

The deductive approach is not dependent on existing practice, which is often perceived as having been tainted because it has been determined by finance directors and auditors. However, the problem remains: from whose viewpoint is the deduction to be made?

Possible alternatives to the preparers and auditors of the accounts are economists and users. However, economists are widely perceived as promoting unrealistic models and users as having needs so diverse that they cannot be realistically satisfied in a single set of accounts. Consider the attempts made to define income. Economists have supported the concept of a true income, while users have indicated the need for a range of relevant incomes.

True income

We have already seen in Chapter 3 that there is a significant difference between the accountant's income and the economist's income applying the ideas of Fisher and Hicks.

User needs and multiple incomes

Multiple measures of income, derived from the general price level adjusted accounting model, the replacement cost accounting model and the exit price accounting model, were considered in Chapter 4. Each model provides information that is relevant for different purposes, e.g. replacement cost accounting produces an income figure that indicates how much is available for distribution while still maintaining the operating capacity of the entity.

These income figures were regarded as a public good, i.e. cost-free to the user. Latterly, it has been recognised that there is a cost implication to the production of information, i.e. that it is not a public good; that standards should be capable of being empirically tested; and that consideration should be given to the economic consequences of standards. This has resulted in a concern that standards should deal with economic substance rather than form, e.g. the treatment of leases in IAS 17.[3]

It could be argued that the deductive approach to income, whether an economist's defined income or a theoretician's multiple income, has a basic weakness in that it gives priority to the information needs of only one user group – the investors. In the UK the ASB is quite explicit about this. The *Framework* is less clear about the primary focus, stating that financial statements are prepared to provide information that is useful in making economic decisions. The ASB has been supported by other academics[4] who have stated:

> As we have already noted that the needs of investors, creditors, employees and customers are not fundamentally different, it seems safe to look to the needs of present and potential investors as a guide . . .

There is little independent evidence put forward to support this view.

Where do we stand now?

We have seen that accounting theory was initially founded on generalisations from the accounting practices followed by practitioners. Then came the deductive approach of economists and theoreticians. The latter were not transaction based and were perceived to be too subjective relying on future cash flows.

The practitioners have now staked their claim to create accounting theory or a conceptual framework through the IASB. The advantage of this is that the conceptual framework will be based on consensus.

Conceptual framework

The framework does not seek to be seen as creating standards where none exist nor to override existing standards.

Its objectives are to assist:

- standard setters in the development of future standards so that there is a rational basis for reducing the number of alternatives in existing standards;
- preparers in applying standards and in having a principles basis for the treatment of matters not covered by a standard;
- auditors in satisfying themselves that financial statements being audited are in conformity with the Framework principles; and
- stakeholders when interpreting the financial statements.

We will now consider the evolution of conceptual frameworks from the earliest attempts in the 1970s by the FASB with the issue of Concepts Statements, which were picked up by the IASC with its *Framework for the Presentation and Preparation of Financial Statements* and developed by national standard setters. In this chapter we will review the Statement of Principles produced by the ASB, the UK national standard-setting body.

We will then discuss the collaboration taking place between the FASB, the IASB and a whole range of national standard-setting bodies.

6.3 FASB Concepts Statements

The FASB was the originator of attempts to create a conceptual framework with the issue of a series of Concepts Statements as a basis for financial accounting and reporting standards. It is easy to overlook this fact, particularly as the present preference for principles rather than rules in standard setting has tended to cast the FASB as rule bound. Instead it was in the lead when it came to formulating a conceptual framework. We will consider four of the statements below.

6.3.1 Concepts Statement No. 1: Objectives of Financial Reporting by Business Enterprises[5]

Financial reporting should provide information to present and potential investors and creditors that is understandable by a user who has a reasonable knowledge of business activities and useful in making rational investment and credit decisions. Such decisions are based on an assessment of the amounts, timing and uncertainty of prospective net cash inflows, i.e. ascertaining whether or not there is enough cash to pay creditors on time, cover capital expenditure and pay dividends.

The Concept Statement identified two reasons for providing information about past activities:

- investment and credit decisions are in part based on an evaluation of past performance; and
- owners require information as to the stewardship by the management of their use of resources.

Financial reporting should provide information about resources and claims, and reason for changes, i.e. a statement of financial position and a statement of cash flows, and information about past financial performance, i.e. a statement of financial performance. These statements allow users to check movements in operating capital and financing, see how cash has been spent and assess solvency, liquidity and profitability. Financial reporting is not restricted to financial statements but also includes non-financial and supplementary information.

6.3.2 Concepts Statement No. 2: Qualitative characteristics of Accounting Information[6]

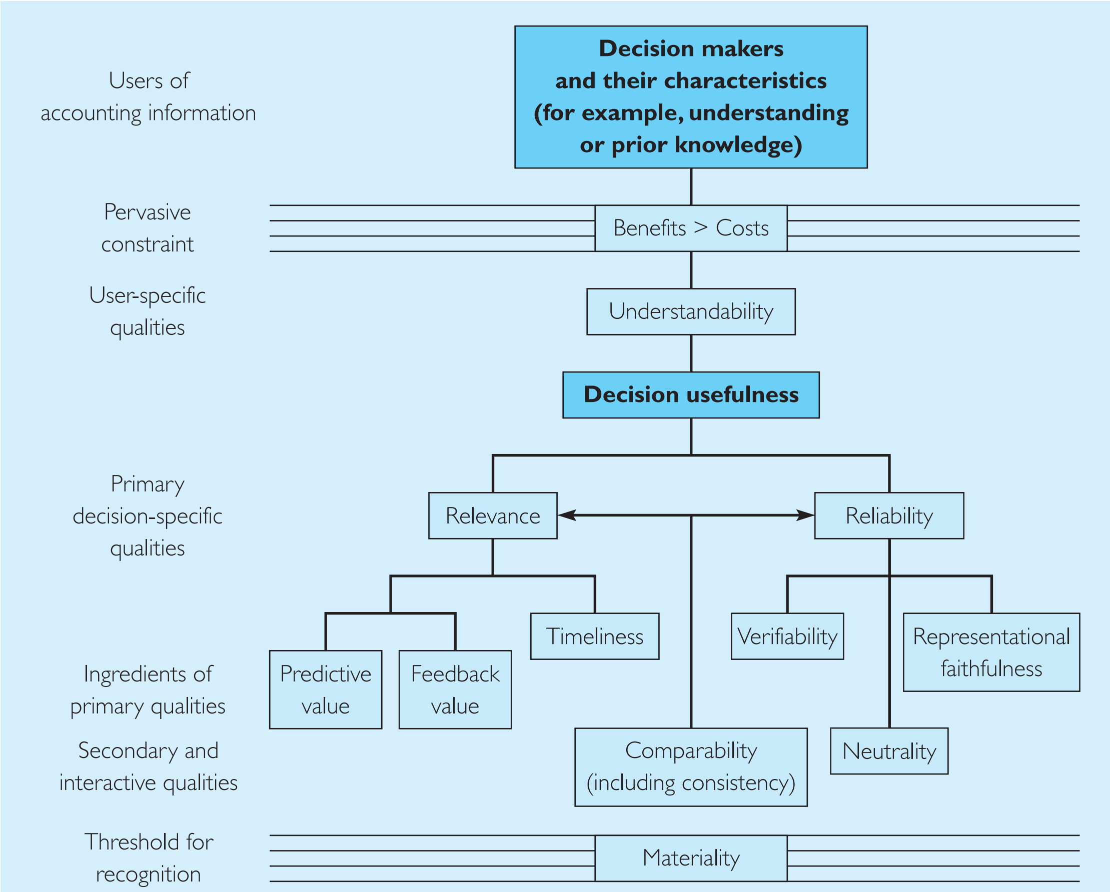
Figure 6.1 illustrates how close the *Statement of Principles* (see section 6.5.3) and Concepts Statement No. 2 are in their approach.

6.3.3 Concepts Statement No. 6: Elements of Financial Statements[7]

This Statement defines ten elements. These include seven elements that appear in the *Statement of Principles* (see section 6.5.4) with slight differences in their definition. These are:

- **Assets** – probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.
- **Liabilities** – probable future sacrifices of economic benefits arising from present obligations to transfer assets or provide services to other entities in the future as a result of past transactions or events.
- **Equity** – the residual interest in the assets of an entity that remains after deducting its liabilities. In a business enterprise, the equity is the ownership interest.

Figure 6.1 A hierarchy of accounting qualities



Source: Concept 2, Figure 1 from FASB, 1980, p. 13.

- **Investments by owners** – increases in equity. Assets are most commonly received as investments by owners but it might also include services or taking on liabilities of the enterprise.
- **Distributions to owners** – decreases in equity resulting from transferring assets, rendering services or incurring liabilities by the enterprise to owners. Distributions to owners decrease ownership interest (or equity).
- **Gains** – increases in equity (net assets) from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity except those that result from revenues or investments by owners.
- **Losses** – decreases in equity (net assets) from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity except those that result from expenses or distributions to owners.

The Statement also defines three additional elements:

- **Comprehensive income** – the change in equity during a period from transactions and other events and circumstances from non-owner sources. It includes all changes in equity during a period except those resulting from investments by owners and distributions to owners.

- **Revenues** – inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations.
- **Expenses** – outflows or other using up of assets or incurring liabilities (or a combination of both) from delivering or producing goods, rendering services or carrying out other activities that constitute the entity's ongoing major or central operations.

6.3.4 Concepts Statement No. 5: Recognition and Measurement in Financial Statements of Business Enterprises[8]

This statement defines financial statements, sets out recognition criteria for inclusion in the statements and comments on measurement.

Financial statements

Financial statements are a central feature of financial reporting being a principal means of communicating financial information to those outside an entity. Financial reporting also includes useful information that is better provided by other means, e.g. notes to the financial statements and supplementary information.

A full set of financial statements for a period should show:

- financial position at the end of the period;
- earnings for the period;
- comprehensive income for the period;
- cash flows during the period;
- investments by and distributions to owners during the period.

Recognition criteria

An item and information about it should meet four fundamental recognition criteria to be recognised and should be recognised when the criteria are met, subject to a cost–benefit constraint and a materiality threshold. Those criteria are:

- **Definitions**. The item meets the definition of an element of financial statements.
- **Measurability**. It has a relevant attribute measurable with sufficient reliability.
- **Relevance**. The information about it is capable of making a difference in user decisions.
- **Reliability**. The information is representationally faithful, verifiable and neutral.

Measurement

Attributes

Items currently reported in the financial statements are measured by different attributes as described in Chapters 3 and 4 above (e.g. historical cost, current (replacement) cost, current market value, net realisable value and present value of future cash flows), depending on the nature of the item and the relevance and reliability of the attribute measured.

Monetary unit

The monetary unit or measurement scale in current practice in financial statements is nominal units of money, that is, unadjusted for changes in purchasing power of money over time. The Board expects that nominal units of money will continue to be used to measure items recognised in financial statements.

6.4 IASC *Framework for the Presentation and Preparation of Financial Statements*[9]

The Framework differs from the International Financial Reporting Standard (IFRS) in that it does not define standards for the recognition, measurement and disclosure of financial information nor does it override any specific IFRS. However, if there is no IFRS for a particular situation, managers should consider the principles set out in the Framework when developing an accounting policy, which should aim at providing the most useful information to users of the entity's financial statements.

This exposure draft deals with the following:

- The objective of financial statements.
  The **objective** of financial statements is that they should provide information about the financial position, performance and changes in financial position of an enterprise that is useful to a wide range of potential users in making economic decisions.
- The qualitative characteristics that determine the usefulness of information in financial statements.
  The **qualitative characteristics** that determine the usefulness of information are **relevance** and **reliability**. Comparability is a qualitative characteristic that interacts with both relevance and reliability. Materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic. The balance between cost and benefit is a persuasive constraint rather than a qualitative characteristic.
- The definition, recognition and measurement of elements from which financial statements are constructed.
  The **definition** of an element is given in para. 46:

  > Financial statements portray the financial effects of transactions and other events by grouping the effects into broad classes according to their economic characteristics. These broad classes are termed the **elements** of financial statements. The elements directly related to the measurement of financial position in the statement of financial position are assets, liabilities and equity. The elements directly related to the measurement of performance in the profit and loss account are income and expense.

- The exposure draft defines each of the elements. For example, an asset is defined in para. 53: 'The future economic benefit embodied in an asset is the potential to contribute, directly or indirectly, to the flow of cash and cash equivalents to the enterprise.'
- It defines when an element is to be **recognised**. For example, in para. 87 it states: 'An asset is recognised in the statement of financial position when it is probable that the future economic benefits will flow to the enterprise and the asset has an attribute that can be measured reliably.'
  Regarding **measurement**, it comments in para. 99:

  > The measurement attribute most commonly adopted by enterprises in preparing their financial statements is historical cost. This is usually combined with other measurement attributes, such as realisable value. For example, inventories are usually carried at the lower of cost and net realisable value, and marketable securities may be carried at market value, that is, their realisable value. Furthermore, many enterprises combine historical costs and current costs as a response to the inability of the historical cost model to deal with the effects of changing prices of non-monetary assets.

- The document deals in a similar style with the other elements.
- The concepts of capital, capital maintenance and profit.
- Finally, regarding the concepts of **capital**, **capital maintenance** and **profit**, the IASC comments:

  > At the present time, it is not the intention of the Board of the IASC to prescribe a particular measurement model (i.e. historical cost, current cost, realisable value, present value) . . . This intention will, however, be reviewed in the light of world developments.

  An appropriate capital maintenance model is not specified but the Framework mentions historical cost accounting, current cost accounting, net realisable value (as discussed in Chapter 4) and present value models (as discussed in Chapter 3).

  The Framework has initiated the development of conceptual frameworks by other national standard setters for both private sector and public sector financial statements. Since then and up to the present day other jurisdictions have been influenced when drafting their own national conceptual frameworks, for example, Australia, Canada, New Zealand, South Africa and the UK have similar conceptual frameworks.

  One of the earliest conceptual frameworks developed subsequently was that developed by the ASB in the UK as the *Statement of Principles* – this expanded on the ideas underlying the Framework and the ASB deserves praise for this.

6.5 ASB *Statement of Principles 1999*[9]

The *Statement* fleshes out the ideas contained in the Framework.

As Sir David Tweedie, Chairman of the ASB, commented, 'The Board has developed its *Statement of Principles* in parallel with its development of accounting standards . . . It is in effect the Board's compass for when we navigate uncharted waters in the years ahead. This is essential reading for those who want to know where the Board is coming from, and where it is aiming to go.'

The statement contains eight chapters dealing with key issues. Each of the chapters is commented on below.

6.5.1 Chapter 1: 'The objective of financial statements'

The *Statement of Principles* follows the IASC *Framework* in the identification of user groups.

The statement identifies the investor group as the primary group for whom the financial statements are being prepared. It then states the information needs of each group as follows:

- **Investors**. These need information to:
  - assess the stewardship of management, e.g. in safeguarding the entity's resources and using them properly, efficiently and profitably;
  - take decisions about management, e.g. assessing need for new management;
  - take decisions about their investment or potential investment, e.g. deciding whether to hold, buy or sell shares and assessing the ability to pay dividends.
- **Lenders**. These need information to:
  - determine whether their loans and interest will be paid on time;
  - decide whether to lend and on what terms.

- **Suppliers**. These need information to:
  - decide whether to sell to the entity;
  - determine whether they will be paid on time;
  - determine longer-term stability if the company is a major customer.
- **Employees**. These need information to:
  - assess the stability and profitability of the company;
  - assess the ability to provide remuneration, retirement benefits and employment opportunities.
- **Customers**. These need information to:
  - assess the probability of the continued existence of the company taking account of their own degree of dependence on the company, e.g. for future provision of specialised replacement parts and servicing product warranties.
- **Government and other agencies**. These need information to:
  - be aware of the commercial activities of the company;
  - regulate these activities;
  - raise revenue;
  - produce national statistics.
- **Public**. Members of the public need information to:
  - determine the effect on the local economy of the company's activities, e.g. employment opportunities, use of local suppliers;
  - assess recent developments in the company's prosperity and changes in its activities.

The information needs of which group are to be dominant?

Seven groups are identified, but there is only one set of financial statements. Although they are described as general-purpose statements, a decision has to be made about which group's needs take precedence.

The *Statement of Principles* identifies the **investor** group as the defining class of user, i.e. the primary group for whom the financial statements are being prepared.

It takes the view that financial statements 'are able to focus on the common interest of users'. The common interest is described thus: 'all potential users are interested, to a varying degree, in the financial performance and financial position of the entity as a whole'.

This means that it is a prerequisite that the information must be relevant to the investor group. This suggests that any need of the other groups that is not also a need of the investors will not be met by the financial statements.

The 1995 Exposure Draft stated: 'Awarding primacy to investors does not imply that other users are to be ignored. The information prepared for investors is useful as a frame of reference for other users, against which they can evaluate more specific information that they may obtain in their dealings with the enterprise.'

It is important, therefore, for all of the other users to be aware that this is one of the principles. If they require specific disclosures that might be relevant to them, they will need to take their own steps to obtain them, particularly where there is a conflict of interest. For example, if a closure is being planned by the directors, it may be in the investors' interest for the news to be delayed as long as possible to minimise the cost to the company; employees, suppliers, customers and the public must not expect any assistance from the financial statements – their information needs are not the primary concern.

What information should be provided to satisfy the information needs?

The *Statement* proposes that information is required in four areas: financial performance, financial position, generation and use of cash, and financial adaptability.

Financial performance

Financial performance is defined as the return an entity obtains from the resources it controls. This return is available from the profit and loss account and provides a means to assess past management performance, how effectively resources have been utilised and the capacity to generate cash flows.

Financial position

Financial position is available from an examination of the statement of financial position and includes:

- the economic resources controlled by an entity, i.e. assets and liabilities;
- financial structure, i.e. capital gearing indicating how profits will be divided between the different sources of finance and the capacity for raising additional finance in the future;
- liquidity and solvency, i.e. current and liquid ratios;
- capacity to adapt to changes – see below under **Financial adaptability**.

Generation and use of cash

Information is available from the cash flow statement which shows cash flows from operating, investment and financing activities providing a perspective that is largely free from allocation and valuation issues. This information is useful in assessing and reviewing previous assessments of cash flows.

Financial adaptability

This is an entity's ability to alter the amount and timing of its cash flows. It is desirable in order to be able to cope with difficult periods, e.g. when losses are incurred and to take advantage of unexpected investment opportunities. It is dependent on factors such as the ability, at short notice, to:

- raise new capital;
- repay capital or debt;
- obtain cash from disposal of assets without disrupting continuing business, i.e. realise readily marketable securities that might have been built up as a liquid reserve;
- achieve a rapid improvement in net cash flows from operations.

6.5.2 Chapter 2: 'The reporting entity'

This chapter focuses on identifying when an entity should report and which activities to include in the report.

When an entity should report

The principle is that an entity should prepare and publish financial statements if:

- there is a legitimate demand for the information, i.e. it is the case both that it is decision-useful and that benefits exceed the cost of producing the information; and
- it is a cohesive economic unit, i.e. a unit under a central control that can be held accountable for its activities.

Which activities to include

The principle is that those activities should be included that are within the direct control of the entity, e.g. assets and liabilities which are reported in its own statement of financial position, or indirect control, e.g. assets and liabilities of a subsidiary of the entity which are reported in the consolidated statement of financial position.

Control is defined as (a) the ability to deploy the resources and (b) the ability to benefit (or to suffer) from their deployment. Indirect control by an investor can be difficult to determine. The test is not to apply a theoretical level of influence such as holding x% of shares but to review the relationship that exists between the investor and investee in practice, such as the investor having the power to veto the investee's financial and operating policies and benefit from its net assets.

6.5.3 Chapter 3: 'The qualitative characteristics of financial information'

The *Statement of Principles* is based on the IASC *Framework* and contains the same four principal qualitative characteristics relating to the content of information and how the information is presented. The two primary characteristics relating to content are the need to be relevant and reliable; the two relating to presentation are the need to be understandable and comparable. The characteristics appear diagrammatically in Figure 6.2.

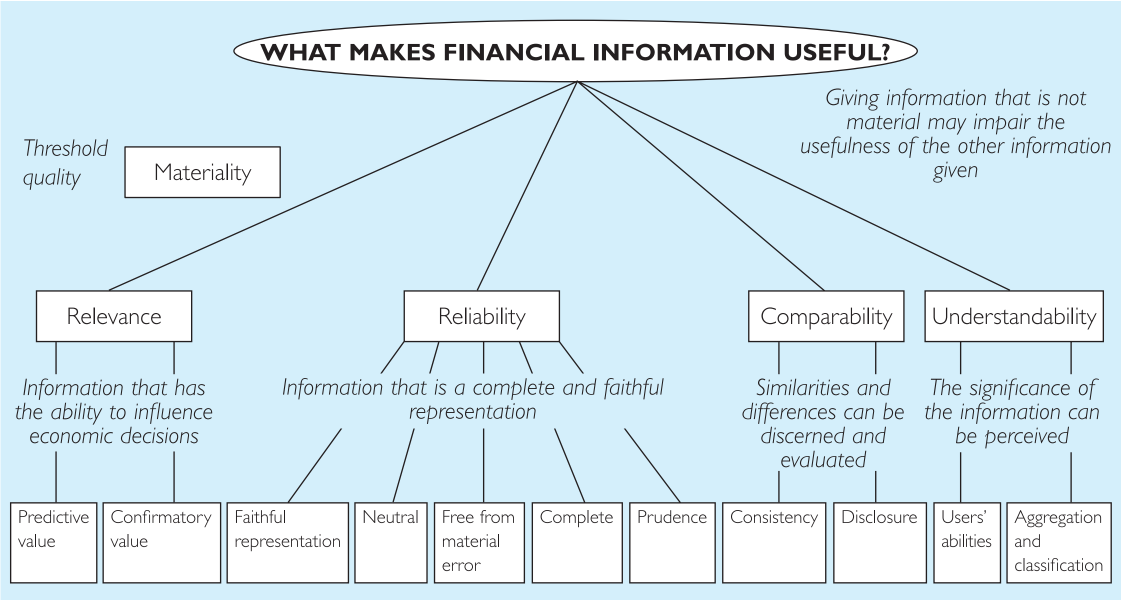
From the diagram we can see that for information content to be **relevant** it must have:

- the ability to influence the economic decisions of users;
- predictive value, i.e. help users to evaluate or assess past, present or future events; or
- confirmatory value, i.e. help users to confirm their past evaluations.

For information to be **reliable** it must be:

- free from material error, i.e. transactions have been accurately recorded and reported;
- a faithful representation, i.e. reflecting the commercial substance of transactions;

Figure 6.2 What makes financial information useful?



- neutral, i.e. not presented in a way to achieve a predetermined result;
- prudent, i.e. not creating hidden reserves or excessive provisions, deliberately understating assets or gains, or deliberately overstating liabilities or losses;
- complete, i.e. the information is complete subject to a materiality test.

To be useful, the financial information also needs to be **comparable** over time and between companies and **understandable**.

It satisfies the criteria for understandability if it is capable of being understood by a user with a reasonable knowledge of business activities and accounting, and a willingness to study the information with reasonable diligence. However, the trade-off between relevance and reliability comes into play with the requirement that complex information that is relevant to economic decision making should not be omitted because some users find it too difficult to understand. There is no absolute answer where there is the possibility of a trade-off and it is recognised by the ASB that the relative importance of the characteristics in different cases is a matter of judgement.

The chapter also introduces the idea of **materiality** as a threshold quality and any item that is not material does not require to be considered further. The statement recognises that no information can be useful if it is not also material by introducing the idea of a threshold quality which it describes as follows: 'An item of information is material to the financial statements if its misstatement or omission might reasonably be expected to influence the economic decisions of users of those financial statements, including their assessment of management's stewardship.'[10]

First, this means that it is justified not to report immaterial items which would impose unnecessary costs on preparers and impede decision makers by obscuring material information with excessive detail.

Secondly, it means that the important consideration is not user expectation (e.g. users might expect turnover to be accurate to within 1%) but the effect on decision making (e.g. there might only be an effect if turnover were to be more that 10% over- or understated in which case, only errors exceeding 10% are material).

It also states that 'Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement.' The need to exercise judgement means that the preparer needs to have a benchmark.

A discussion paper issued in January 1995 by the Financial Reporting & Auditing Group of the ICAEW entitled *Materiality in Financial Reporting FRAG 1/95* identified that there are few instances where an actual figure is given by statute or by standard setters, e.g. FRS 6,[11] para. 76 refers to a material minority and indicates that this is defined as 10%.

The paper also referred to a rule of thumb used in the USA:

> The staff of the US Securities and Exchange Commission have an informal rule of thumb that errors of more than 10% are material, those between 5% and 10% may be material and those under 5% are usually not material. These percentages are applied to gross profit, net income, equity and any specific line in the financial statements that is potentially misstated.

The ASB has moved away from setting percentage benchmarks and there is now a need for more explicit guidance on the application of the materiality threshold.

Unresolved trade-offs

There are a number of characteristics where there is no guidance given as to the trade-off. For example, is relevance more important than reliability? Does being neutral conflict with prudence? Does relevance require a faithful representation and does a faithful representation require the information to be verifiable?

Unresolved relative importance

The approach taken has to be to regard decision usefulness as paramount. It is not clear where this leaves accountability and stewardship. There are unresolved questions such as, for example, whether comparability is as important as relevance or reliability.

6.5.4 Chapter 4: 'The elements of financial statements'

This chapter gives guidance on the items that *could* appear in financial statements. These are described as **elements** and have the following essential features:

- **Assets**. These are rights to future economic benefits controlled by an entity as a result of past transactions or events.
- **Liabilities**. These are obligations of an entity to transfer future economic benefits as a result of past transactions or events, i.e. ownership is not essential.
- **Ownership interest**. This is the residual amount found by deducting all liabilities from assets which belong to the owners of the entity.
- **Gains**. These are increases in ownership interest not resulting from contributions by the owners.
- **Losses**. These are decreases in ownership interest not resulting from distributions to the owners.
- **Contributions by the owners**. These are increases in ownership interest resulting from transfers from owners in their capacity as owners.
- **Distributions to owners**. These are decreases in ownership interest resulting from transfers to owners in their capacity as owners.

These definitions have been used as the basis for developing standards, e.g. assessing the substance of a transaction means identifying whether the transaction has given rise to new assets or liabilities, defined as above.

6.5.5 Chapter 5: 'Recognition in financial statements'

The objective of financial statements is to disclose in the statement of financial position and the profit and loss account the effect on the assets and liabilities of **transactions**, e.g. purchase of stock on credit and the effect of **events**, e.g. accidental destruction of a vehicle by fire. This implies that transactions are recorded under the double entry principle with an appropriate debit and credit made to the element that has been affected, e.g. the asset element (stock) and the liability element (creditors) are debited and credited to recognise stock bought on credit. Events are also recorded under the double entry principle, e.g. the asset element (vehicle) is derecognised and credited because it is no longer able to provide future economic benefits and the loss element resulting from the fire damage is debited to the profit and loss account. The emphasis is on determining the effect on the assets and liabilities, e.g. the increase in the asset element (stock), the increase in the liability element (creditors) and the reduction in the asset element (vehicle).

This emphasis has a particular significance for application of the matching concept in preparing the profit and loss account. The traditional approach to allocating expenditure across accounting periods has been to identify the costs that should be matched against the revenue in the profit and loss account and carry the balance into the statement of financial position, i.e. the allocation is driven by the need to match costs to revenue. The *Statement of Principles* approach is different in that it identifies the amount of the expenditure to be recognised as an asset and the balance is transferred to the profit and loss account, i.e. the question is 'Should this expenditure be recognised as an asset (capitalised) and, if so, should any part of it be derecognised (written off as a loss element)?'

This means that the allocation process now requires an assessment as to whether an asset exists at the statement of financial position date by applying the following test:

1 If the future economic benefits are eliminated at a single point in time, it is at that point that the loss is recognised and the expenditure derecognised, i.e. the debit balance is transferred to the profit and loss account.
2 If the future economic benefits are eliminated over several accounting periods – typically because they are being consumed over a period of time – the cost of the asset that comprises the future economic benefits will be recognised as a loss in the performance statement over those accounting periods, i.e. written off as a loss element as their future economic benefit reduces.

The result of this approach should not lead to changes in the accounts as currently prepared but it does emphasise that matching cost and revenue is not the main driver of recognition, i.e. the question is not 'How much expenditure should we match with the revenue reported in the profit and loss account?' but rather 'Are there future economic benefits arising from the expenditure to justify inclusion in the statement of financial position?' and, if not, derecognise it, i.e. write it off.

Dealing with uncertainty

There is almost always some uncertainty as to when to recognise an event or transaction, e.g. when is the asset element of raw material inventory to be disclosed as the asset element work-in-progress? Is it when an inventory requisition is issued, when the storekeeper isolates it in the inventory to be issued bay, when it is issued onto the workshop floor, when it begins to be worked on?

The *Statement of Principles* states that the principle to be applied if a transaction has created or added to an existing asset or liability is to recognise it if:

1 sufficient evidence exists that the new asset or liability has been created or that there has been an addition to an existing asset or liability; and
2 the new asset or liability or the addition to the existing asset or liability can be measured at a monetary amount with sufficient reliability.

The use of the word sufficient reflects the uncertainty that surrounds the decision when to recognise and the *Statement* states: 'In the business environment, uncertainty usually exists in a continuum, so the recognition process involves selecting the point on the continuum at which uncertainty becomes acceptable.'[12]

Before that point it may, for example, be appropriate to disclose by way of note to the accounts a contingent liability that is possible (less than 50% chance of crystallising into a liability) but not probable (more than 50% chance of crystallising).

Sufficient reliability

Prudence requires more persuasive evidence of the measurement for the recognition of items that result in an increase in ownership interest than for the recognition of items that do not. However, the exercise of prudence does not allow for the omission of assets or gains where there is sufficient evidence of occurrence and reliability of measurement, or for the inclusion of liabilities or losses where there is not. This would amount to the deliberate understatement of assets or gains, or the deliberate overstatement of liabilities or losses.

Reporting gains and losses

Chapter 5 does not address the disclosure treatment of gains and losses. A change in assets or liabilities might arise from three classes of past event: transactions, contracts for future performance and other events such as a change in market price.

If the change in an asset is offset by a change in liability, there will be no gain or loss. If the change in asset is not offset by a change in liability, there will be a gain or loss. If there is a gain or loss, a decision is required as to whether it should be recognised in the profit and loss account or in the statement of total recognised gains and losses.

Recognition in profit and loss account

For a gain to be recognised in the profit and loss account, it must have been earned and realised. **Earned** means that no material transaction, contract or other event must occur before the change in the assets or liabilities will have occurred; **realised** means that the conversion into cash or cash equivalents must either have occurred or be reasonably assured.

Profit, as stated in the profit and loss account, is used as a prime measure of performance. Consequently, prudence requires particularly good evidence for the recognition of gains.

It is important to note that in this chapter the ASB is following a **statement of financial position orientated** approach to measuring gains and losses. The conventional profit and loss account approach would identify the **transactions** that had been undertaken and allocate these to financial accounting periods.

6.5.6 Chapter 6: 'Measurement in financial statements'

The majority of listed companies in the UK use the mixed measurement system whereby some assets and liabilities are measured using historical cost and some are measured using a current value basis. The *Statement of Principles* envisages that this will continue to be the practice and states that the aim is to select the basis that:

- provides information about financial performance and financial position that is useful in evaluating the reporting entity's cash-generation abilities and in assessing its financial adaptability;
- carries values which are sufficiently reliable: if the historical cost and current value are equally reliable, the better measure is the one that is the most relevant; current values may frequently be no less reliable than historical cost figures given the level of estimation that is required in historical cost figures, e.g. determining provisions for bad debts, stock provisions, product warranties;
- reflects what the asset and liability represents: e.g. the relevance of short-term investments to an entity will be the specific future cash flows and these are best represented by current values.

ASB view on need for a current value basis of measurement

The *Statement* makes the distinction[13] between return *on* capital – i.e. requiring the calculation of accounting profit – and return *of* capital – i.e. requiring the measurement of capital and testing for capital maintenance. The *Statement* makes the point that the financial capital maintenance concept is not satisfactory when *significant* general or specific price changes have occurred.

ASB gradualist approach

The underlying support of the ASB for a gradualist move towards the use of current values is reflected in 'Although the objective of financial statements and the qualitative characteristics of financial information, in particular relevance and reliability may not change . . . as markets develop, measurement bases that were once thought unreliable may become reliable. Similarly, as access to markets develops, so a measurement basis that was once thought insufficiently relevant may become the most relevant measure available.'[14]

Determining current value

Current value systems could be defined as replacement cost (entry value), net realisable value (exit value) or value in use (discounted present value of future cash flows). The approach of the *Statement* is to identify the value to the business by selecting from these three alternatives the measure that is most relevant in the circumstances. This measure is referred to as deprival value and represents the loss that the entity would suffer if it were deprived of the asset.

The value to the business is determined by considering whether the company would replace the asset. If the answer is *yes*, then use replacement cost; if the answer is *no* but the asset is worth keeping, then use value in use; and if *no* and the asset is not worth keeping, then use net realisable value.

This can be shown diagrammatically as in Figure 6.3.

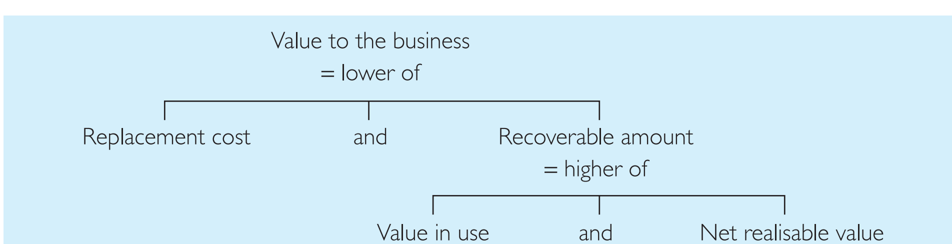
How will value to the business be implemented?

The ASB is being pragmatic by following an incremental approach to the question of measurement stating that 'practice should develop by evolving in the direction of greater use of current values consistent with the constraints of reliability and cost'. This seems a sensible position for the ASB to take. Its underlying views were clear when it stated that 'a real terms capital maintenance system improves the relevance of information because it shows current operating margins as well as the extent to which holding gains and losses reflect the effect of general inflation, so that users of real terms financial statements are able to select the particular information they require'.[15]

Policing the mixed measurement system

Many companies have adopted the modified historical cost basis and revalued their fixed assets on a selective basis. However, this piecemeal approach allowed companies to cherry-pick the assets they wish to revalue on a selective basis at times when market values have risen. The ASB have adopted the same approach as IAS 16.[16]

Figure 6.3 Value to the business



The fair value measurement system

A value to the business approach (often referred to as deprival value) was presented as a logical approach to selecting a value to be recognised in financial statements. Standard setters, e.g. the FASB are currently considering requiring fair values to be the most relevant values for stakeholders.[17]

Does the fair value measurement system make current cost and deprival value redundant?

It is interesting to consider the analysis set out in the Discussion Paper *Measurement Bases for Financial Reporting – Measurement on Initial Recognition*.[18] This is a discussion paper prepared by the staff at the Canadian Accounting Standards Board which was issued (but not adopted) by the IASB in March 2006 for comment. The discussion paper proposes a four-level measurement hierarchy for assets and liabilities when they are initially recognised. The four levels start with two levels where there is a market (fair) value available, i.e. Level 1 – where there are observable market prices and Level 2 – where there are accepted valuation models or techniques. The third and fourth levels deal with transactions where a substitute has to be found for market value – this takes us back to the bases discussed in Chapter 4. For example, when an asset cannot be reliably measured under Level 1 or 2 then the deprival value approach is proposed.

6.5.7 Chapter 7: 'Presentation of financial information'

Chapter 7 states that the objective of the presentation adopted is to communicate clearly and effectively and in as simple and straightforward manner as is possible without loss of relevance or reliability and without significantly increasing the length of the financial statements.

The point about length is well made given the length of current annual reports and accounts. Recent examples include Jenoptik AG extending to eighty-one pages, Sea Containers Ltd seventy-six pages and Hugo Boss over one hundred pages.

The *Statement* analyses the way in which information should be presented in financial statements to meet the objectives set out in Chapter 1. It covers the requirement for items to be aggregated and classified and outlines good presentation practices in the statement of financial performance, statement of financial position, cash flow statement and accompanying information, e.g.:

Statement of financial performance

Good presentation involves:

- Recognising only gains and losses.
- Classifying items by function, e.g. production, selling, administrative and nature, e.g. interest payable.
- Showing separately amounts that are affected in different ways by economic or commercial conditions, e.g. continuing, acquired and discontinued operations, segmental geographical information.
- Showing separately:
  - items unusual in amount or incidence;
  - expenses that are not operating expenses, e.g. financing costs and taxation;
  - expenses that relate primarily to future periods, e.g. research expenditure.

Statement of financial position

Good presentation involves:

- Recognising only assets, liabilities and ownership interest.
- Classifying assets so that users can assess the nature, amounts and liquidity of available resources.
- Classifying assets and liabilities so that users can assess the nature, amounts and timing of obligations that require or may require liquid resources for settlement.
- Classifying assets by function, e.g. show fixed assets and current assets separately.

Accompanying information

Typical information includes chairman's statement, directors' report, operating and financial review, highlights and summary indicators.

The *Statement* states that the more complex an entity and its transactions become, the more users need an objective and comprehensive analysis and explanation of the main features underlying the entity's financial performance and financial position.

Good presentation involves discussion of:

- The main factors underlying financial performance, including the principal risks, uncertainties and trends in main business areas and how the entity is responding.
- The strategies adopted for capital structure and treasury policy.
- The activities and expenditure (other than capital expenditure) that are investment in the future.

It is interesting to note the *Statement* view that highlights and summary indicators, such as amounts and ratios that attempt to distil key information, cannot on their own adequately describe or provide a basis for meaningful analysis or prudent decision making. It does, however, state: 'That having been said, well-presented highlights and summary indicators are useful to users who require only very basic information, such as the amount of sales or dividends.' The ASB will be giving further consideration to this view that there is a need for a really brief report.

6.5.8 Chapter 8: 'Accounting for interests in other entities'

Interests in other entities can have a material effect on the company's own financial performance and financial position and need to be fully reflected in the financial statements. As an example, an extract from the 2006 Annual Report and Accounts of Stagecoach plc shows:

	Company statement of financial position	*Consolidated statement of financial position*
Tangible assets	£0.1m	£893.4m
Investments	£964.9m	—

In deciding whether to include the assets in the consolidated statement of financial position, a key factor is the degree of influence exerted over the activities and resources of the investee:

- If the degree of influence allows control of the operating and financial policies, the financial statements are aggregated.
- If the investor has joint control or significant influence, the investor's share of the gains and losses are recognised in the consolidated statement of comprehensive income and reflected in the carrying value of the investment.

However, there is no clear agreement on the treatment of interests in other entities, and further developments can be expected.

6.6 Conceptual framework developments

The FASB in America and the IASB have been collaborating on revising the IASB Framework and the FASB Concepts Statements (e.g. Statement 1: Objectives of financial reporting by business enterprise). The intention is to adopt a principles-based approach. This is also supported also by a report[19] from the Institute of Chartered Accountants of Scotland which concludes that the global convergence of accounting standards cannot be achieved by a 'tick-box' rules-driven approach but should rely on judgement-based principles.

A principles-based approach allows companies the flexibility to deal with new situations.

A rules-based approach provides the auditor with protection against litigious claims because it can be shown that other auditors would have adopted the same accounting treatment. However, following the Enron disaster, the rules-based approach was heavily criticised in America and it was felt that a principles-based approach would have been more effective in preventing it.

A rules-based approach means that financial statements are more comparable. Recognising that a principles-based approach could lead to different professional judgements for the same commercial activity, it is important that there should be full disclosure and transparency.

6.6.1 Piecemeal development

The IASB and FASB started a convergence project in 2004 to prepare an agreed Framework over eight phases. These are:

- Phase A: Objective and qualitative characteristics (Final chapter published).
- Phase B: Elements and recognition (DP expected Q4 of 2010).
- Phase C: Measurement (DP Q4 2010).
- Phase D: Reporting entity (ED Q1 2010).
- Phase E: Presentation and disclosure.
- Phase F: Purpose and status of framework.
- Phase G: Applicability to not-for-profit entities.
- Phase H: Other issues, if necessary.

The main points of Phase A Chapter 1 (Objective of Financial Reporting) and Chapter 2 (Qualitative Characteristics and Constraints of Decision-useful Financial Reporting Information) are described below.

The objective of financial reporting

The fundamental objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to present and potential equity investors when making investment decisions and assessing stewardship. The fundamental objective does not specifically mention stewardship although there is an acceptance that reviewing past performance has an implication for assessing future cash flows. There is also a presumption that such general-purpose financial statements will satisfy the information needs of lenders and others such as customers, suppliers and employees.

Qualitative characteristics and constraints of decision-useful financial reporting information

There are two fundamental qualitative characteristics if information is to be decision-useful and not misleading. These are relevance and faithful representation.

There are other characteristics that may make the information more useful. These are comparability, consistency, verifiability, timeliness and understandability.

Some characteristics were considered but not included on the grounds that they were covered by the above characteristics. For instance, true and fair was not included because it was considered to be equivalent to faithful representation.

As with other frameworks, there are constraints on the information to be disclosed. These are materiality, defined in the usual way as being information whose omission or misstatement could influence decisions, and cost, if this exceeds the benefit of providing the information.

We can see that the project by the IASB to develop an agreed Conceptual Framework is progressing in a piecemeal fashion with only Chapters 1 and 2 finalised and the date for the finalisation of some of the other chapters still to be announced. This might be seen as a strength in that time and thought are being given to the project. However, there is also a downside as seen in the ASB response to the IASB (see www.frc.org.uk/documents/pagemanager/asb/Conceptual_framework/Conceptual%20Framework%20IASB%20ED_ASB%20Response_Final.pdf) which expressed concern that:

- The current Framework applies to financial *statements* rather than financial **reporting**. If it is to be extended to financial reporting, this could include other areas such as prospectuses, news releases, management's forecasts but this has not been defined.
- There is a risk that the piecemeal approach could lead to internal inconsistencies and decisions being made in the earlier chapters could have as yet unforeseen adverse consequences.
- The consequences of adopting the entity approach on the remainder of the Framework may be extensive. For example, there is a link between the stewardship objective and the proprietary view and that by dismissing that view from the Framework entirely may lead to difficulties for entities in providing information in the financial reports that fulfils that objective.

The last point concerning the implication for stewardship reporting reflects the US influence on the Framework with less emphasis being given to it.

The piecemeal approach perhaps reflects the differences that need to be resolved between the IASB and FASB from differences in terminology, for example, substituting *faithful representation* for *reliability* to more fundamental differences relating to the scope of the Framework, for example, its very objective and its boundaries as to whether it relates to financial *statements* or financial *reports*.

Summary

Directors and accountants are constrained by a mass of rules and regulations which govern the measurement, presentation and disclosure of financial information. Regulations are derived from three major sources: the legislature in the form of statutes, the accountancy profession in the form of standards, and the Financial Services Authority in the form of Listing Rules.

There have been a number of reports relating to financial reporting. The preparation and presentation of financial statements continue to evolve. Steps are being taken to provide a conceptual framework and there is growing international agreement on the setting of global standards.

User needs have been accepted as paramount; qualitative characteristics of information have been specified; the elements of financial statements have been defined precisely; the presentation of financial information has been prescribed; and comparability between companies is seen as desirable.

However, the intention remains to produce financial statements that present a fair view. This is not achieved by detailed rules and regulations, and the exercise of judgement will continue to be needed. This opens the way for creative accounting practices that bring financial reporting and the accounting profession into disrepute. Strenuous efforts will continue to be needed from the auditors, the ASB, the Review Panel and the Financial Reporting Council to contain the use of unacceptable practices. The regulatory bodies show that they have every intention of accepting the challenge.

The question of the measurement base that should be used has yet to be settled. The measurement question still remains a major area of financial reporting that needs to be addressed.

The Framework sees the objective of financial statements as providing information about the financial position, performance and financial adaptability of an enterprise that is useful to a wide range of users in making economic decisions. It recognises that they are limited because they largely show the financial effects of past events and do not necessarily show non-financial information. On the question of measurement the view has been expressed that:

> historical cost has the merit of familiarity and (to some extent) objectivity; current values have the advantage of greater relevance to users of the accounts who wish to assess the current state or recent performance of the business, but they may sometimes be unreliable or too expensive to provide. It concludes that practice should develop by evolving in the direction of greater use of current values to the extent that this is consistent with the constraints of reliability, cost and acceptability to the financial community.[20]

There are critics[21] who argue that the concern with recording current asset values rather than historical costs means that:

> the essential division between the IASC and its critics is one between those who are more concerned about where they want to be and those who want to be very clear about where they are now. It is a division between those who see the purpose of financial statements as taking economic decisions about the future, and those who see it as a basis for making management accountable and for distributing the rewards among the stakeholders.

Finally, it is interesting to give some thought to extracts from two publications which indicate that there is still a long way to go in the evolution of financial reporting, and that there is little room for complacency.

The first is from *The Future Shape of Financial Reports*:

> As Solomons[22] and *Making Corporate Reports Valuable* discussed in detail, the then system of financial reporting in the UK fails to satisfy the purpose of providing information to shareholders, lenders and others to appraise past performance in order to form expectations about an organisation's future performance in five main respects:

1 . . . measures of performance . . . are based on original or historical costs . . .
2 Much emphasis is placed on a single measure of earnings per share . . .
3 . . . insufficient attention is paid to changes in an enterprise's cash or liquidity position . . .
4 The present system is essentially backward looking . . .
5 Emphasis is often placed on the legal form rather than on the economic substance of transactions . . .[23]

We have seen that some of these five limitations are being addressed, but not all, e.g. the provision of projected figures.

The second extract is from *Making Corporate Reports Valuable*:

> The present statement of financial position almost defies comprehension. Assets are shown at depreciated historical cost, at amounts representing current valuations and at the results of revaluations of earlier periods (probably also depreciated); that is there is no consistency whatsoever in valuation practice. The sum total of the assets, therefore, is meaningless and combining it with the liabilities to show the entity's financial position does not in practice achieve anything worthwhile.[24]

The IASC has taken steps to deal with the frequency of revaluations but the criticism still holds in that there will continue to be financial statements produced incorporating mixed measurement bases.

The point made by some critics remains unresolved:

> Accountability and the IASC's decision usefulness are not compatible. Forward-looking decisions require forecasts of future cash flows, which in the economic model are what determines the values of assets. These values are too subjective to form the basis of accountability. The definition of assets and the recognition rules restrict assets to economic benefits the enterprise controls as a result of past events and that are measurable with sufficient reliability. But economic decision making requires examination of all sources of future cash flows, not just a restricted sub-set of them.[25]

In the USA, Australia, Canada, the UK and the IASB, the approach has been the same, i.e. commencing with a consideration of the objectives of financial statements, qualitative characteristics of financial information, definition of the elements, and when these are to be recognised in the financial statements. There is a general agreement on these areas. Agreement on measurement has yet to be reached. A global framework is being developed between the IASB and the FASB and it is interesting to see that the same tensions exist, for example, between accountability and decision-usefulness.

REVIEW QUESTIONS

1 (a) Name the user groups and information needs of the user groups identified by the IASC *Framework for the Presentation and Preparation of Financial Statements.*

(b) Discuss the effect of the Framework on current financial reporting practice.

2 The workload on the IASB in seeking to converge standards with the FASB has diverted resources from dealing with more fundamental problems such as off-balance sheet issues. Discuss.

3 R. MacVe in *A Conceptual Framework for Financial Accounting and Reporting: The Possibilities for an Agreed Structure* suggested that the search for a conceptual framework was a political process. Discuss the effect that this thinking has had and will have on standard setting.

4 (a) In 1999 in the UK, the ASB published the *Statement of Principles*. Explain what you consider to be the purpose and status of the *Statement*.

(b) Chapter 4 of the *Statement* identifies and defines what the ASB believes to be the elements that make up financial statements. Define any four of the elements and explain how, in your opinion, the identification and definition of the elements of financial statements would enhance financial reporting.

5 'The replacement of accrual accounting with cash flow accounting would avoid the need for a conceptual framework.'[26] Discuss.

6 Financial accounting theory has accumulated a vast literature. A cynic might be inclined to say that the vastness of the literature is in sharp contrast to its impact on practice.

(a) Describe the different approaches that have evolved in the development of accounting theory.

(b) Assess its impact on standard setting.

(c) Discuss the contribution of accounting theory to the understanding of accounting practice, and suggest contributions that it might make in the future.

7 The President of the ICAEW has proposed that regulators from developed and developing countries start talking to agree a set of principles for universal application that could underpin the regulation of accounting and auditing. Discuss the extent to which the IASC Framework provides such a set of principles in dealing with the complexities of global business.

8 Explain the different ways in which future economic benefits may arise in a pharmaceutical company.

9 As fair values may be unreliable and mislead users into thinking that the statement of financial position shows the net worth of an entity, historical costs are preferable for reporting assets and liabilities in the statement of financial position. Discuss.

10 Rules-based accounting adds unnecessary complexity, encourages financial engineering and does not necessarily lead to a 'true and fair view' or a 'fair presentation'. Discuss.

11 The key qualitative characteristics in the Framework are relevance and reliability. Preparers of financial statements may face a dilemma in satisfying both criteria at once. Discuss.

12 An asset is defined in the Framework as a resource which an entity controls as a result of past events and from which future economic benefits are expected to flow to the entity. Discuss whether property, plant and equipment automatically qualify as assets.

EXERCISES

Question 1

The following extract is from *Conceptual Framework for Financial Accounting and Reporting: Elements of Financial Statements and Their Measurement*, FASB 3, December 1976.

> The benefits of achieving agreement on a conceptual framework for financial accounting and reporting manifest themselves in several ways. Among other things, a conceptual framework can (1) guide the body responsible for establishing accounting standards, (2) provide a frame of reference for resolving accounting questions in the absence of a specific promulgated standard, (3) determine bounds for judgement in preparing financial statements, (4) increase financial statement users' understanding of and confidence in financial statements, and (5) enhance comparability.

Required:

(a) Define a conceptual framework.

(b) Critically examine why the benefits provided in the above statements are likely to flow from the development of a conceptual framework for accounting.

Question 2

The following extract is from 'Comments of Leonard Spacek', in R.T. Sprouse and M. Moonitz, *A Tentative Set of Broad Accounting Principles for Business Enterprises*, Accounting Research Study No. 3, AICPA, New York, 1962, reproduced in A. Belkaoui, *Accounting Theory*, Harcourt Brace Jovanovich.

> A discussion of assets, liabilities, revenue and costs is premature and meaningless until the basic principles that will result in a fair presentation of the facts in the form of financial accounting and financial reporting are determined. This fairness of accounting and reporting must be for and to people, and these people represent the various segments of our society.

Required:

(a) Explain the term 'fair'.

(b) Discuss the extent to which the IASB conceptual framework satisfies the above definition.

Question 3

The following is an extract from *Accountancy Age*, 25 January 2001.

> A powerful and 'shadowy' group of senior partners from the seven largest firms has emerged to move closer to edging control of accounting standards from the world's accountancy regulators . . . they form the Global Steering Committee . . . The GSC has worked on plans to improve standards for the last two years after scathing criticism from investors that firms produced varying standards of audit in different countries.

Discuss the effect on standard setting if control were to be edged from the world's accountancy regulators.

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