

The objective of
financial reporting
and qualitative
characteristics and
constrai...



1 Introduction

The U. S. Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB), namely the Boards, jointly published a Discussion Paper and received 179 responses. The Exposure Draft was created from the Boards' redeliberations regarding issues being raised by respondents. The Boards published this common Exposure Draft for the public to comment and it is the Board's broader conceptual framework.

The Boards are considering their frameworks: to provide standards that are consistent, converge their standards, to develop a general and enhanced conceptual framework. The Boards decided that a reconsideration of concepts would not be efficient because many aspects of the frameworks are consistent and do not need fundamental revision. The Boards are focused on improving and converging their existing frameworks.

The conceptual framework for financial reporting established by the Board displays the concepts that underlie financial reporting. This conceptual framework consists of 2 chapters: the objective of financial reporting and qualitative characteristics and constraints of decision – useful financial reporting information – useful financial reporting information.

2 Chapter 1: The Objective of Financial Reporting

This conceptual framework establishes the objective of general purpose financial reporting by business entities in the private sector, which is the foundation of the framework. The objective of general purpose financial reporting is to provide financial information to current capital providers to

make decisions. This information might also be useful to users who are not capital providers.

The general purpose financial reporting develops superior reporting standards to help in the efficient functioning of economies and the efficient allocation of resources in capital markets. General purpose financial reporting focuses on an extensive range of users' needs that lack the ability to obtain financial information needed from the entity. It should be broad enough to comprehend information for the various users. Therefore, the financial report is where they depend on to acquire information. Diverse users may require different information which might go beyond the scope of general purpose financial reporting.

The financial reports are prepared from the entity's perspective (deemed to have substance on its own, separate from that of its owners), instead of the entity's capital providers. An entity attains economic resources (its assets) from capital providers in exchange for claims to those resources (its liabilities and equity). Capital providers include

Equity investors

Equity investors normally invest economic resources in an entity expecting to receive a return on, as well as a return of, the resources invested in. Hence, equity investors are concerned with the amount, timing, uncertainty of an entity's future cash flows and the entity's competence in generating those cash flows which affects the prices of their equity interests.

Furthermore, they are concerned with the performance of directors and

management of the entity in discharging their responsibility to make efficient and profitable use of the assets invested.

Lenders

Lenders usually expect to receive a return in the form of interest, repayments of borrowings, and increases in the prices of debt securities.

Lenders have similar interests as the equity investors.

Other creditors

Other creditors provide resources because of their relationship with the entity, instead of a capital provider; no primary relationship.

Employee – salary or compensation

Suppliers – extended credit

Customer – prepay for goods and services

Managers – responsible for preparing financial reports

Capital providers make decisions through useful information provided in financial reporting by particular entity. Financial reporting usefulness in assessing cash flow prospects depends on the entity's current cash resources and the ability to generate sufficient cash to reimburse its capital providers. Besides, financial reporting usefulness in assessing stewardship includes the management's responsibilities to protect the entity's economic resources (assets) from unfavourable effects. Management is also liable for safeguarding the assets of the entity which conforms to the laws, regulations

and contractual provisions; thus, the importance of management's performance in the decision usefulness.

The general purpose financial reporting is limited to information which does not reflect pertinent information from other sources that should be considered by the users. Financial reporting information is based on estimates, judgements, and models of the financial effects on an entity of transactions and other events in which, is only ideal for preparers and standard setters to strive. Achieving the framework's vision of ideal financial reporting to the fullest will be difficult in the short term because of technical infeasibility and cost constraints.

Financial reporting should include information about: the economic resources of an entity (assets), the claims of the entity are (liabilities and equity), the effects of transaction and any events or circumstances that can affect the entity's resources and claims and provide useful information about the ability of entity to generate its cash flow and how well the entity meets its management responsibilities.

The usefulness of financial reporting to the users:

Provide useful information about the amount, timing, and uncertainty of future cash flow

To identify the entity's financial strengths and weaknesses (especially for capital providers)

To indicate the potential of entity's cash flow for its economic resources and claims

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To identify the effectiveness of the entity's management responsibilities

To assess availabilities of the entity's nature and quantity of the resources for the use in its operation

To estimate the values of the entity.

The quantitative measures and other information regarding the changes in entity's economics resources and claims in the financial report can help the users to assess the amount, timing, and uncertainty of its cash flow; and indicate the effectiveness of management responsibilities.

Furthermore, the entity must provide a positive return on its economic resources in order to generate net cash inflows; and return the earning to its investors. Other information like variability of returns, past financial performance, and management's ability can be used to assess the entity's future financial performance.

The information regarding the accrual accounting in financial reporting can better provide the users to assess the entity's past financial performance and future prospects in generating net cash inflows without obtaining additional capital from its investors.

The entity's cash flow performance in financial reporting assist the investors to understand the entity's business model and operation through assessing how the entity obtains and spends cash. Information about its borrowing, repayment of borrowing, cash dividends and other distribution to investors, as well as the factors of entity's liquidity and solvency, can also assist the investors to determine the entity's cash flow accounting.

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Besides, information about the changes of entity's resources and claims not resulting from financial performance may assist the investors to differentiate the changes that are results of the entity's financial performance and those that are not.

The information of management explanation should be included in financial reporting to assist users for a better understanding about management decision in any events and circumstances that have affected or may affect the entity's financial performance. It is because the internal parties know about the entity's performance than the external users.

3 Chapter 2: “ Qualitative Characteristics and Constraints of Decision-Useful Financial Reporting Information”

Fundamental qualitative characteristics distinguish useful financial reporting information from information that is not useful or is misleading. For information to be useful, it must have two fundamental qualitative characteristics:

Relevance – capable of making a difference in the decisions made by users as capital providers. Information is relevant when it has predictive value, confirmatory value, or both.

Predictive value – information that assists the capitals providers to form their own expectations about the future.

Confirmatory value – information that confirms or changes past or present expectations based on previous evaluations.

IASB said that information is relevant “ when it influences the economic decisions of users by helping them evaluate past, present or future events or confirming, or correcting, their past evaluation.” FASB believes that to be relevant, “ accounting information must be capable of making a difference in a decision by helping users to form predictions about the outcome of past, present, and future events or to confirm or correct expectations.” Since some users may have been obtaining information elsewhere other than financial reporting, and emphasizes the relevance of information in their decisions, relevant information does not really make a difference in the past or in the future. Any information that might be able to make a difference is said to be relevant.

Faithful representation - depiction of an economic phenomenon is complete, neutral, and free from material error.

Complete - includes all information that is necessary for faithful representation of economic phenomena.

Neutrality - information which is bias free.

Freedom from error - estimation of the economic phenomena is based on the appropriate inputs and each input must reflect the best available information.

Relevance is concern with the connection between economic phenomena with the decisions of capital providers and not their depictions, therefore should be consider first. Then, the faithful representation is applied to

determine which depictions of economic phenomenon best corresponds to the relevant phenomenon.

Enhancing qualitative characteristics improves the decision usefulness of financial reporting information that is relevant and faithfully represented. They are used to distinguish more-useful information from less-useful information. The enhancing qualitative characteristics are comparability, verifiability, timeliness, and understandability.

Comparability

Comparability is the quality of information that enables users to identify similarities and the differences between two sets of economic phenomena. Since the essence of decision making is to select between alternatives, the information is more useful if it can be compared with similar information about the other entities and with similar information about the same entity for some other period. Comparability should not be confused with uniformity. Overemphasizing on uniformity may reduce comparability by making unlike things look alike.

The IASB Framework actually discusses comparability as a qualitative characteristic which is equally important as relevance and faithfully representation. However, FASB concludes that comparability is an enhancing qualitative characteristic because regardless of how comparable the information may be, it will not be useful if it is irrelevant to users' decisions and does not faithfully represent the economic phenomena.

Verifiability

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A quality of information that helps to assure users that information faithfully represents the economic phenomena that it purports to represent. If the information is verifiable, the knowledgeable and independent observers could come to the general consensus. The verifiability of the information focuses on whether the recognition or measurement method is correctly applied. Verification can either be direct or indirect. An amount or other representation itself verified such as by counting cash or observing marketable securities and their quoted prices are called direct verification. An example of verifying the carrying amount of inventory by checking the inputs (quantities and costs) and recalculating the ending inventory using the same cost flow assumption (accounting convention or methodology – average cost and first-in, first-out) is indirect verification.

IASB Framework does not include verifiability as an explicit aspect, yet FASB does. FASB observed that some of the information which is faithfully represented may not necessarily be verifiable. Therefore, if the information is verifiable, it is generally more useful. Thus, FASB concluded that verifiability is an enhancing qualitative characteristic.

Timeliness

Timeliness means having information available to decision makers before it loses its capacity to influence decisions. A lack of timeliness can rob information of its potential usefulness. The IASB Framework discusses timeliness separately, as a constraint that could rob information of relevance. However, FASB concluded that reporting information in a timely manner can enhance both the relevance and faithful representation of the

information since information can be reported in a timely manner but has no relevance, or information delayed in reporting remains its relevance.

Understandability

Understandability is the quality of information that enables users to comprehend its meaning. When the information is classified, characterized, and presented clearly and concisely, the understandability will be enhanced. Although the reporting information has to be understandable, the users of the financial report should also review and analyze the information with reasonable diligence as the users are assumed to have a reasonable knowledge of business and economic activities and to be able to read the financial report.

Enhancing qualitative characteristics should improve the usefulness of financial information and should be maximized to the extent possible. However, if the information is irrelevant or not faithfully represented, the enhancing qualitative characteristics cannot make that information useful for decision. Besides, the application of the enhancing qualitative characteristics is an iterative process which does not follow the prescribed order.

In addition, FASB considered whether some other qualitative characteristics should be added, such as transparency, true and fair view, credibility, internal consistency, and high quality. FASB concluded that it would be redundant if transparency is added as one of the qualitative characteristics. True and fair view is not a qualitative characteristic itself, but it should result from applying the qualitative characteristics. FASB concluded that it should be the goal to achieve high quality to which financial reporting and standard <https://assignbuster.com/the-objective-of-financial-reporting-and-qualitative-characteristics-and-constraints-accounting-essay/>

setters aspire. By adherence to the objective and qualitative characteristics of financial reporting information, the goal can be achieved. Therefore, the characteristics mentioned in not added as the qualitative characteristics of the financial reporting information.

In a nutshell, the qualitative characteristics of financial reporting information in this draft can be categorized into fundamental qualitative characteristics and enhancing qualitative characteristics as shown in the following:

Figure 1

Compared to the conceptual framework issued by the Malaysian Accounting Standard Board (MASB) in 2007, most of the qualitative characteristics are identical to the characteristic discussed in this draft. However, the most distinctive aspect which can be found is MASB did not categorize the qualitative characteristics into fundamental and enhancing qualitative characteristics. The qualitative characteristics concluded by MASB are shown in the figure below.

Figure 2

MASB concluded that the relevance of information is affected by its nature and materiality while FASB discusses materiality under the constraints of financial reporting. MASB provides that the economic decisions of users taken on the basis of the financial statements could be influenced when the omission or misstatement of the information is material. Thus, materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which information must have for it to be useful.

Besides, MASB also discussed about substance over form and prudence under the characteristic of reliability. MASB provides that if information is to represent faithfully the transactions and other events that it purports to represent, it is necessary that they are accounted for and presented in accordance with their substance and economic reality and not merely their legal form. However, FASB did not identify substance over form as a component of faithful representation as it would be redundant to do so. In addition, FASB did not conclude prudence as a qualitative characteristic because it might conflict with the quality of neutrality.

MASB discussed the characteristic of timeliness as a constraint on relevant and reliable information. If there is undue delay in the reporting of information it may lose its relevance. Management may need to balance the relative merits of timely reporting and the provision of reliable information. However, FASB concluded timeliness as an enhancing qualitative characteristic of the financial reporting information.

There should be a balance between the qualitative characteristic as the IASB Framework says: “ In practice a balancing, or trade-off, between qualitative characteristics is often necessary. Generally the aim is to achieve an appropriate balance among the characteristics in order to meet the objective of financial statements. The relative importance of the characteristics in different cases is a matter of professional judgments.”

The information provided by financial reporting is limited by materiality and the cost of providing.

Materiality

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Materiality depends on the nature and amount of the item judged in the particular circumstance of its omission or misstatement. It is important to consider the materiality of information because material omissions or misstatements will cause information to contain error, making it biased and incomplete. However, it is hard to specify a uniform quantitative threshold at which the information is material.

Concepts Statement 2 and IASB Framework define materiality similarly but discuss materiality differently. IASB describes materiality as an aspect of relevance and does not indicate that it has a relationship to other qualitative characteristics. On the other hand, Concepts Statement 2 provides that materiality should be considered together with qualitative characteristics (not only relevance). Thus, the Boards conclude that materiality is pertinent to all of the other qualitative characteristics.

Cost

The Boards emphasized the balance between the benefits of financial reporting information and the cost of providing and using it.

Costs of providing information:

Cost of collecting and processing

Cost of verifying

Cost of disseminating

Cost of analysis and interpretation

Cost resulted from omission of decision-useful information

Benefits of financial reporting information:

More efficient functioning of capital market

Lower cost of capital

Improved access to capital market

Favourable effect on public relations

Better management decisions

However, the major problem for the standard setters in conducting rigorous cost-benefit analyses is the difficulty in qualifying the benefits of a certain reporting requirement. Besides, it is also difficult to obtain complete, quantitative information about the initial and ongoing cost of a requirement and impose them. Nevertheless, standard seekers should take into account both benefits and costs of proposed financial reporting requirements.

There are 3 constraints of financial reporting information mentioned by the MASB:

Balance between benefit and cost

As mentioned in FASB, cost is one of the constraints of financial reporting information and the Boards emphasizes on the balance between the benefits of financial reporting information and the cost of providing and using it.

Balance between qualitative characteristic

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MASB provides that, “ In practice a balancing or trade-off, between qualitative characteristics is often necessary. The relative importance of the characteristics in different cases is a matter of professional judgments”. The FASB also mentions, “ In assessing whether the benefits of reporting information are likely to justify the costs, it is necessary to consider whether one or more qualitative characteristics might be sacrificed to some degree to reduce cost”.

Timeliness

MASB mentioned that a constraint which is not mentioned in the conceptual framework of FASB; timeliness. MASB provides that if there is undue delay in the reporting of information it may lose its relevance. To provide information on a timely basis it may often be necessary to report before all aspects of a transaction or other event are known. On the other hand, if reporting is delayed until all aspects are known, the information may be highly reliable but of little use to users who have had to make decisions in the interim. Management may need to balance the timely reporting and the provision of reliable information.