

What is a conceptual framework and why is it needed



What is a conceptual framework for financial accounting and why is it needed? The purpose of this essay is to address the definition of a conceptual framework (CF) for financial accounting and why it is needed. The CF can be described as a “ coherent system of inter-related objectives and fundamentals that should lead to consistent standards that prescribe the nature, function and limits of financial accounting and financial statements” (FASB, 1976). This suggests that the CF has a very important role in attempting to maintain domestic and international standards of practice.

The CF also provides structure to the process of creating financial reporting standards and ensures that standards are based on fundamental principles (Gore and Zimmerman, 2007). This indicates that the CF developed from theoretical underpinnings involved in financial reporting. It also suggests that the CF can be used as a structured outline for stakeholders when interpreting financial statements. The CF inhibits standards from becoming unplanned and transient. Therefore, the CF has significant and beneficial aspects to its development and existence.

However, the purpose of the CF is not to set standards where none exist, nor to over-ride existing standards. Instead, the relevance of the CF can be understood primarily as regulatory objectives in which: setters have set a benchmark for the development of future standards; preparers can apply standards and can rely on the CF to guide treatment of the information that may not be included in a specific standard; auditors can analyse the financial statements of companies in accordance with the principles of the CF (Elliot& Elliot, 2012).

As a result of differences in financial reporting, the CF was developed as a broad and informative consensus to guide and describe. The purpose of the CF was also to improve the processes involved in financial accounting and to limit the number of alternative standards of financial reporting.

Differences in financial reporting have developed from a complex array of factors that include: dissimilar legal systems; differences in the way industries are financed; differences in taxation treatment; the status of the accountancy profession in relation to the capital market; the extent to which accounting theory has developed; accidents in history; and language limitations that have produced difficulties in translating and understanding financial concepts and phrases (Elliot & Elliot, 2012).

Therefore, it was obvious that a structured and universal approach to financial reporting was necessary in order to standardise accounting practice on a global scale and reduce the number of problems and limitations faced by stakeholders. One of the most significant historical events that had a major impact on the development of the CF was the Asian Crisis. This crisis arose from disjointed local and international accounting standards that were separate and independent from each other.

This resulted in investors having a lack of insight in to the financial positions of the companies whom they were investing. Therefore, it became clear that a thorough revision of local and international accounting practice was necessary so that a fluent, structured and inter-related conceptual approach to financial accounting could be put in place (IFRS, 2010). This led to the introduction the Empirical Inductive Approach (pre 1970), which revised the

practices in existence and attempted to generalise standards from these practices.

In other words, the EIA established best current practice as the norm. However, due to the pragmatic and theoretical implications of the EIA, the Deductive Approach was developed. The DA was still based on rationalising what happened in practice and learning from the outcomes. However, unlike the EIA, the DA was open to accepting alternative standards of practice. However, one of the main weaknesses of the DA involved ambiguity concerning the stance of which the approach takes, i. e. preparers and auditors of the accounts or economists and users. The stance of the approach is important as each role can be accompanied by conflicting concepts and ideas. Therefore, the DA has been criticised for not being transaction based and being too subjective relying on future cash flows (Elliot & Elliot, 2012; p 242). The introduction of the CF developed from a demand by professionals suggesting that the lack of a CF inhibits both standard setters and those applying the standards (Dearing Report, 1988).

As a result, it is argued that one of the primary purposes of the CF is to offer clear and structured guidance that incorporates current and consistent approaches to accounting issues. Therefore, critics suggest that the introduction of the CF increases: the validity of fair and true judgements in relation to data representation; as well as the reliability associated with interpretation of standards and in resolving vague or complex accounting issues (ASB Principles, 1999; Dearing, 1988; IFRS, 2008).

Thus, the guidelines outlined in the CF are imperative for safe, ethical and effective accounting practices. Having said this, the details concerning the <https://assignbuster.com/what-is-a-conceptual-framework-and-why-is-it-needed/>

strength of the guidelines contained in the CF have been challenged by prior events suggesting that the CF may contain fundamental weaknesses concerned with its stability and power. In other words, this essay argues that the evolvement of the CF from the EIA to where the CF stands at present is remarkable.

However, in light of prior events, such as the Enron Scandal (2001), Ahold (2003) and Satyam (2010) events, it is also palpable that the CF is still far from being a robust framework for financial reporting. This issue is currently been addressed by the IASB and the US FASB who have developed a project that aims to eliminate discrepancies between the two sets of standards.

This suggests that an agreed and combined CF will result in an effective and systematic approach to accounting practice and will resolve discrepancies between the two sets of standards (IFRS, 2010). To conclude, the introduction and development of a CF has resulted in improved practice throughout accounting procedures. However, it is clear that a review of current approaches to financial accounting that incorporates clear, improved and joint guidance and structure based on prior knowledge is necessary in order to develop a contemporary and combined approach to a CF.