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BREAK-OUT SESSION

**The Concepts/Ideas that Underlie the Preparation and
Presentation of Financial Reports for External Users: the
Conceptual Framework**

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1.0 Introduction

The Joint International Accounting Standards Board (IASB)/Financial Accounting Standards Board (FASB) Framework

The IASB (1989) framework, published in 1989, by the predecessor body to the IASB, the International Accounting Standards Committee (IASC), is to be replaced by the IASB/FASB joint project framework. In many cases, the 1989 framework required refinement, updating and completion. For example, it does not have a measurement concept—it has a list of measurements choices. The project also seeks to eliminate differences between IFRS and US GAAP. It is more difficult to develop improved and common requirements if each board bases its decisions on a different framework. Also, without such a framework, standard-setting would be based on the personal frameworks of individuals and standard setters might reach different conclusions about similar or even identical issues depending on the mix of board membership.

2.0 What is a conceptual framework?

Definition

A Conceptual Framework is a coherent system of interrelated objectives and fundamental concepts that prescribes the nature, function, and limits of financial accounting and reporting and that is expected to lead to consistent guidance. It is intended to serve the public interest by providing structure and direction to financial accounting and reporting to facilitate the provision of unbiased financial and related information. That information helps capital and other markets to function efficiently in allocating scarce resources in the economy and society.

Purpose

This *Framework* sets out the concepts that underlie the preparation and presentation of financial statements for external users. The purpose of the *Framework* is to:

- assist the IASB in the development of future International Financial Reporting Standards (IFRS) and in its review of existing IFRS to achieve consistency in reporting;
- assist the IASB in promoting harmonisation of regulations, accounting standards and procedures relating to the presentation of financial statements by providing a basis for reducing the number of alternative accounting treatments permitted by IFRS;
- assist preparers of financial statements in applying IFRS and in dealing with topics that have yet to form the subject of IFRS;
- assist auditors in forming an opinion as to whether financial statements conform with IFRS;
- assist users of financial statements in interpreting the information contained in financial statements prepared in conformity with IFRS; and

- provide those who are interested in the work of the IASB with information about its approach to the formulation of IFRS.

Scope

The *Framework* deals with:

- the objectives of financial reports;
- the qualitative characteristics that determine the usefulness of information in financial reports;
- the definition, recognition and measurement of the elements from which financial statements are constructed; and
- concepts of capital and capital maintenance.

The *Framework* is concerned with general purpose financial reports including consolidated financial statements.

Such financial reports are prepared and presented at least annually and are directed towards the common information needs of a wide range of users.

- Some of these users may require, and have the power to obtain, information in addition to that contained in the financial report. Many users, however, have to rely on the financial report as their major source of financial information and such financial reports should, therefore, be prepared and presented with their needs in view.
- Financial reports form part of the process of financial reporting. A complete financial report normally includes a [balance sheet, an income statement] statement of financial position, statement of comprehensive income , a statement of cash flows and a statement of changes in equity, and those notes and other statements and explanatory materials that are an integral part of the financial report.
- They may also include supplementary schedules and information based on or derived from, and expected to be read with, such statements. Such schedules and supplementary information may deal, for example, with financial information about industrial and geographical segments and disclosures about the effects of changing prices.
- Financial statements and notes do not, however, include such items as reports by directors, statements by the chairman, discussion and analysis by management and similar items that may be included in an annual or interim report.

Review Question 1

Authoritativeness of the Framework

Was the IASB wise to make the Framework the source of guidance on an accounting question in the absence of a special standard dealing with the subject? What are the advantages and disadvantages of doing that?

Review Question 2

Need for the Framework vs. Interpretations

Applying the Framework is subjective and requires judgment. Would the IASB be better off to abandon the Framework entirely and, instead, rely on a very active interpretations committee that develops detailed guidance in response to requests from constituents?

3.0 A Comparison of the Objectives and Qualitative Characteristics of IASB (1989) Framework and Proposed IASB/FASB Framework

3.1 The Objectives of Financial Reports

The objectives of financial reporting are the foundation of the conceptual framework.

IASB 1989 Framework

The objective of financial statements is to provide information about the financial position, financial performance and cash flows of an entity that is useful to a wide range of users in making economic decisions.

IASB/FASB Framework

The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity. Those decisions involve buying, selling, or holding equity and debt instruments and providing or settling loans and other forms of credit.

Comment on the Change in Objective

Consistent with the Board's responsibilities, the Conceptual Framework establishes an objective of financial reporting and not just of financial statements.

The Boards propose to adopt the "entity perspective", i.e. it is the entity, not its owners and others having an interest in it, which is the object of general-purpose financial reporting. In other words, the focus is placed on reporting the entity's resources (assets), the claims to the entity's resources (liabilities and equity) and the changes in them. Shareholders are seen not so much as owners of the entity but merely as providers of resources to the entity, in much

the same way as liabilities. Both present and potential equity investors, lenders and other creditors are seen as constituting a single primary user group. This group makes decisions about the allocation of resources as well as decisions relating to protecting or enhancing their claim on the entity's resources. Other potential user groups e.g. governments and other regulatory bodies, customers, employees and their representatives are not the focus of the objective.

The following objectives of IASB/FASB Framework differ from IASB 1989 Framework

- Decisions by existing and potential investors about buying, selling, or holding equity and debt instruments depend on the returns that they expect from an investment in those instruments; for example, dividends, principal and interest payments, or market price increases. Similarly, decisions by existing and potential lenders and other creditors about providing or settling loans and other forms of credit depend on the principal and interest payments or other returns that they expect. Investors', lenders', and other creditors' expectations about returns depend on their assessment of the amount, timing, and uncertainty of (the prospects for) future net cash inflows to the entity. Consequently, existing and potential investors, lenders, and other creditors need information to help them assess the prospects for future net cash inflows to an entity.

- Other parties, such as regulators and members of the public other than investors, lenders, and other creditors, also may find general purpose financial reports useful. However, those reports are not primarily directed to these other groups.

Comment on the Differences in the Objectives

- Other potential users, such as regulators, were not identified as primary users because they often have the power to demand the information needed.

- The Boards acknowledged that the interests of investors, lenders, and other creditors often overlap with those of regulators. However, expanding the objective of financial reporting to include maintaining financial stability could at times create conflicts between the objectives that the Boards are not well equipped to resolve. For example, some may take the view that the best way to maintain financial stability is to require entities not to report or to delay reporting some changes in asset or liability values. That requirement almost certainly would result in depriving investors, lenders, and other creditors of information that they need. The only way to avoid conflicts would be to eliminate or deemphasize the existing objective of providing information to investors, lenders, and other creditors. The Boards concluded that eliminating that objective would be inconsistent with its basic mission, which is to serve the information needs of participants in capital markets. The Board also noted that providing relevant and faithfully represented financial information can improve users' confidence in the information and, thus, contribute to promoting financial stability.

IASB 1989 Framework - Who are the Users?

The wide range of users include:

- (a) Investors - The providers of risk capital and their advisers are concerned with the risk inherent in, and return provided by, their investments. They need information to help them determine whether they should buy, hold or sell. Shareholders are also interested in information which enables them to assess the ability of the entity to pay dividends.
- (b) Employees - Employees and their representative groups are interested in information about the stability and profitability of their employers. They are also interested in information which enables them to assess the ability of the entity to provide remuneration, retirement benefits and employment opportunities.
- (c) Lenders - Lenders are interested in information that enables them to determine whether their loans, and the interest attaching to them, will be paid when due.
- (d) Suppliers and other trade creditors - Suppliers and other creditors are interested in information that enables them to determine whether amounts owing to them will be paid when due. Trade creditors are likely to be interested in an entity over a shorter period than lenders unless they are dependent upon the continuation of the entity as a major customer.
- (e) Customers - Customers have an interest in information about the continuance of an entity, especially when they have a long-term involvement with, or are dependent on, the entity.
- (f) Governments and their agencies - Governments and their agencies are interested in the allocation of resources and, therefore, the activities of entities. They also require information in order to regulate the activities of entities, determine taxation policies and as the basis for national income and similar statistics.
- (g) Public - Entities affect members of the public in a variety of ways. For example, entities may make a substantial contribution to the local economy in many ways including the number of people they employ and their patronage of local suppliers. Financial statements may assist the public by providing information about the trends and recent developments in the prosperity of the entity and the range of its activities.

IASB/FASB Framework – There should be Primary User Group of Accounting Information

Who are these Primary Users?

To assess an entity's prospects for future net cash inflows, existing and potential investors, lenders, and other creditors need information about the resources of the entity, claims against the entity, and how efficiently and effectively the entity's management and governing boards have discharged their responsibilities to use the entity's resources. Examples of such responsibilities include protecting the entity's resources from unfavorable effects of

economic factors such as price and technological changes and ensuring that the entity complies with applicable laws, regulations, and contractual provisions. Information about management's discharge of its responsibilities also is useful for decisions by existing investors, lenders, and other creditors who have the right to vote on or otherwise influence management's actions.

Comment on the Differences in the Primary Users of Information

- Paragraph 9 of the Framework (1989) stated that users included “present and potential investors, employees, lenders, suppliers and other trade creditors,” (and later added advisers in the discussion of investors' needs). Paragraph 9 of the Framework (1989) also included a list of other potential users such as customers, governments and their agencies, and the public, who may be interested in financial reports but are not the primary users.
- Paragraph 10 of the Framework (1989) stated that “as investors are providers of risk capital to the entity, the provision of financial statements that meet their needs will also meet most of the needs of other users that financial statements can satisfy,” which might have been read to narrow the focus to investors only. However, paragraph 12 explicitly stated that the objective of financial statements is to provide information “that is useful to a wide range of users in making economic decisions.” Thus, the Framework (1989) focused on investors' needs as representative of the needs of a wide range of users but did not explicitly identify a group of primary users.
- The Boards sympathized with their information needs but concluded that without a defined group of primary users, the Conceptual Framework would risk becoming unduly abstract or vague.
- The reasons why the Boards concluded that the primary user group should be the existing and potential investors, lenders, and other creditors of a reporting entity are:
 - a. Existing and potential investors, lenders, and other creditors have the most critical and immediate need for the information in financial reports and many cannot require the entity to provide the information to them directly.
 - b. The Boards responsibilities require them to focus on the needs of participants in capital markets, which include not only existing investors, but also potential investors and existing and potential lenders and other creditors.
 - c. Information that meets the needs of the specified primary users is likely to meet the needs of users both in jurisdictions with a corporate governance model defined in the context of shareholders and those with a corporate governance model defined in the context of all types of stakeholders.
- Many existing and potential investors, lenders, and other creditors cannot compel reporting entities to provide information directly to them and must rely on general purpose financial statement

Management's Information Needs

The Board stated that some of the information directed to the primary users is likely to meet some of management's needs but not all of them. However, management has the ability to access additional financial information, and consequently, general purpose financial reporting need not be directed explicitly to management.

Stewardship

IASB 1989 Framework – Stewardship

- Paragraph 14 - Financial statements also show the results of the *stewardship of management*, or the accountability of management for the resources entrusted to it. Those users who wish to assess the stewardship or accountability of management do so in order that they may make economic decisions; these decisions may include, for example, whether to hold or sell their investment in the entity or whether to reappoint or replace the management.

IASB/FASB Framework – Stewardship

- The 2 Boards decided not to use the term *stewardship* because there would be difficulties in translating it into other languages. Instead, the Board described what stewardship encapsulates. Accordingly, the objective of financial reporting acknowledges that users make resource allocation decisions as well as decisions as to whether management has made efficient and effective use of the resources provided.

Financial Reporting of the Reporting Entity

IASB 1989 Framework

- Financial reporting entity has been defined as an entity in which it is reasonable to expect the existence of users who depend on general purpose financial reports for information for decision making purpose. IASB 1989 Framework suggested a no. of indicators to assess the existence of a reporting entity such as:
 - Separation of management from economic interest – the greater the spread of ownership and the greater the extent of the separation between management and owners, the more need for general purpose financial reports
 - Economic or political importance/influence – the greater the economic or political importance or influence of an entity, the more likely it is that dependent users will exist
 - The larger the size of an entity, the more likely the need for general purpose financial reports

IASB/FASB Framework

- Over time, the separation between businesses and their owners has grown. The vast majority of today's businesses have legal substance separate from their owners by virtue of their legal form of organization, numerous investors with limited legal liability, and professional managers separate from the owners.

Consequently, the Boards concluded that financial reports should reflect that separation by accounting for the entity (and its economic resources and claims) rather than its primary users and their interests in the reporting entity.

3.2 The Qualitative Characteristics of Financial Reports

The qualitative characteristics are the qualities that financial information must have to meet the objective of financial reporting.

IASB 1989 Framework - Qualitative Characteristics of Financial Statements

Paragraph 24 - Qualitative characteristics are the attributes that make the information provided in financial statements useful to users. The four principal qualitative characteristics are understandability, relevance, reliability and comparability.

- Understandability
- Relevance
 - Materiality
- Reliability
 - Faithful Representation
 - Substance over Form
 - Neutrality
 - Prudence
 - Completeness
- Comparability

IASB/FASB Framework Objective based Qualitative Characteristics

The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity. The decision makers on which this Conceptual Framework focuses are existing and potential investors, lenders, and other creditors.

That objective by itself leaves a great deal to judgment and provides little guidance on how to exercise that judgment. It identifies and describes the qualitative characteristics that financial information should have if it is to meet the objective of financial reporting. It also discusses cost, which is a pervasive constraint on financial reporting.

Fundamental Qualitative Characteristics

Relevance

➤ Materiality

It is self-evident that financial information is only useful for making a decision if it is capable of making a difference in that decision. *Relevance* is the term used in the Conceptual Framework to describe that capability. It is a fundamental qualitative characteristic of useful financial information.

The definition of relevance in the Conceptual Framework is consistent with the definition in FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*. The definition of relevance in the *Framework* (1989) was that information is relevant only if it actually makes a difference in users' decisions. However, users consider a variety of information from many sources, and the extent to which a decision is affected by a particular economic phenomenon is difficult, if not impossible, to determine, even after the fact.

Review Question 3

Relevant information for an investment company

A year ago you bought shares of stock in an investment company. The investment company, in turn, buys, holds, and sells shares of business enterprises. You want to use the financial statements of the investment company to assess its performance over the past year.

What financial information about the investment company's holdings would be most relevant to you?

Materiality meaning did not change from the previous IASB (1989) Framework – still seen as an aspect of relevance

Faithful Representation

The discussion of faithful representation differs from that in the previous frameworks in two significant ways. First, it uses the term *faithful representation* instead of the term *reliability*. Second, substance over form, prudence (conservatism), and verifiability, which were aspects of reliability in the *Framework* (1989), is not considered aspects of faithful representation.

Substance over form and prudence were removed because of;

- Substance over form is not considered a separate component of faithful representation because it would be redundant. Faithful representation means that financial information represents the substance of an economic phenomenon rather than merely representing its legal form. Representing a legal form that differs

from the economic substance of the underlying economic phenomenon could not result in a faithful representation.

- Deliberately reflecting conservative estimates of assets, liabilities, income, or equity sometimes has been considered desirable to counteract the effects of some management estimates that have been perceived as excessively optimistic. However, even with the prohibitions against deliberate misstatement that appear in the existing frameworks, to be prudent is likely to lead to a bias. Understating assets or overstating liabilities in one period frequently leads to overstating financial performance in later periods—a result that cannot be described as prudent or neutral.

Verifiability is now described as an enhancing qualitative characteristic rather than as part of this fundamental qualitative characteristic because:

- Verifiable information can be used with confidence. Lack of verifiability does not necessarily render information useless, but users are likely to be more cautious because there is a greater risk that the information does not faithfully represent what it purports to represent.
- That reported financial information should be verifiable to assure users that it is free from material error and bias and can be depended on to represent what it purports to represent. Therefore, verifiability was considered an aspect of faithful representation. Some respondents pointed out that including verifiability as an aspect of faithful representation could result in excluding information that is not readily verifiable. Those respondents recognized that many forward-looking estimates that are very important in providing relevant financial information (for example, expected cash flows, useful lives, and salvage values) cannot be verified directly. However, excluding information about those estimates would make the financial reports much less useful. The Board agreed and repositioned verifiability as an enhancing qualitative characteristic, very desirable but not necessarily required.

Replacement of the term Reliability

Framework (1989) used the term *reliability* to describe what is now called faithful representation.

- The *Framework* (1989) said:
“Information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully that which it either purports to represent or could reasonably be expected to represent”.
- Unfortunately, the framework did not convey the meaning of reliability clearly. The comments of respondents to numerous proposed standards indicated a lack of a common understanding of the term *reliability*. Some

focused on *verifiability* or *free from material error* to the virtual exclusion of faithful representation. Others focused more on faithful representation, perhaps combined with neutrality. Some apparently think that reliability refers primarily to precision.

- Because attempts to explain what reliability was intended to mean in this context have proven unsuccessful, the Board sought a different term that would more clearly convey the intended meaning. The term *faithful representation*, the faithful depiction in financial reports of economic phenomena, was the result of that search. That term encompasses the main characteristics that the previous frameworks included as aspects of reliability.

Enhancing Qualitative Characteristics

Comparability

- The *Framework* (1989) stated that comparability is as important as relevance and faithful representation
- Relevant and faithfully represented information is most useful if it can be readily compared with similar information reported by other entities and by the same entity in other periods. One of the most important reasons that financial reporting standards are needed is to increase the comparability of reported financial information. However, even if it is not readily comparable, relevant and faithfully represented information is still useful. Comparable information, however, is not useful if it is not relevant and may mislead if it is not faithfully represented. Therefore, *comparability* is considered an enhancing qualitative characteristic instead of a fundamental qualitative characteristic.

Verifiability

- Verifiable information can be used with confidence. Lack of verifiability does not necessarily render information useless, but users are likely to be more cautious because there is a greater risk that the information does not faithfully represent what it purports to represent.
- Repositioning verifiability as an enhancing qualitative characteristic, very desirable but not necessarily required.

Timeliness

- The *Framework* (1989) discussed timeliness as a constraint that could rob information of relevance.
- Timeliness is very desirable, but it is not as critical as relevance and faithful representation. Timely information is useful only if it is relevant and faithfully represented. In contrast, relevant and faithfully represented

information may still be useful (especially for confirmatory purposes) even if it is not reported in as timely a manner as would be desirable.

Understandability

- The *Framework* (1989) included understandability, a qualitative characteristic that enables users to comprehend the information and therefore make it useful for making decisions. Both frameworks also similarly described that for financial information to be understandable, users should have a reasonable degree of financial knowledge and a willingness to study the information with reasonable diligence.
- If understandability considerations were fundamental, it might be appropriate to avoid reporting information about very complicated things even if the information is relevant and faithfully represented. Classifying understandability as an enhancing qualitative characteristic is intended to indicate that information that is difficult to understand should be presented and explained as clearly as possible.
- To clarify another frequently misunderstood point, the Conceptual Framework explains that users are responsible for *actually* studying reported financial information with reasonable diligence rather than only being *willing* to do so (which was the statement in the previous frameworks). In addition, the Conceptual Framework states that users may need to seek the aid of advisers to understand economic phenomena that particularly are complex.

Review Question 4

Substance Over Form

X Ltd sold some property to Y Ltd for \$1 000 000 cash in June 2011, recording a profit of \$200 000. A further element of the sale was that X Ltd gave Y Ltd an options to sell the property back to X Ltd at any time after 30 June 2011, the end of X Ltd's reporting period, for \$1 000 000. If Y Ltd exercised the option, there would be no cash flow to Y Ltd from X Ltd until 2 years have passed. The land has a current fair value of \$800 000 with no changes expected in this amount in the next 3 years.

Required: Discuss the appropriate accounting treatment in the books of X Ltd.

4.0 The Elements of Financial Statements

Financial statements portray the financial effects of transactions and other events by grouping them 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 balance sheet are assets, liabilities and equity.
- The elements directly related to the measurement of performance in the income statement are income and expenses.
- The cash flow statement usually reflects income statement elements and changes in balance sheet elements; accordingly, this *Framework* identifies no elements that are unique to this statement.

Asset

IASB (1989) Framework

An asset is defined as “a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity”.

This definition defines three essential characteristics;

- The resource must contain future economic benefits – such as it can be exchanged for another asset, it can be used to settle a liability or it can be used in conjunction with other assets to earn income
- The entity must have a control in a way to deny or regulate the access of others
- The event giving rise to the control and future benefit must have occurred

IASB/FASB Framework

Several shortcomings of the definition in the IASB (1989) Framework definition were identified. They are;

- In the existing definition, the focus is on future economic benefit, it is believed that focus should be on the existence of a present economic resource.
- The existing definition of ‘control’ has been misinterpreted and used in the same sense as control over subsidiaries. Hence, it is proposed that the new definition should focus on the rights or privileged access to the economic resources.
- The focus of the past transaction has taken away the emphasis on whether the economic resource and rights to it exist at the end of the financial year or not.
- It is not clear if the definition applied to contractual promises or not.

- Any assessment of likelihood should be removed.

Therefore, the new definition proposed is:

“An asset on an entity is a present economic resource to which, through an enforceable right or other means, the entity has access or can limit the access of others”.

This definition places emphasis on the existence of a present economic resource and the need for an enforceable right that limits the access of others to those resources.

Review Question 5

Changes in the definitions of the accounting elements

Explain why the changes in the definition of the accounting elements in the IASB/FASB Framework will subsequently have implications for the profits of reporting entities.

Review Question 6

After the OPEC oil embargo of 1973, the US government passed a law aimed at encouraging domestic exploration for oil and gas, to make the US less dependent on foreign suppliers. At about the same time, the FASB proposed an accounting standard that would have required oil and gas exploration companies to charge to expense, immediately, all unsuccessful exploration costs (no oil or gas discovered). Some exploration companies had been capitalising and amortising such unsuccessful costs. They said the FASB's proposed new standard would cause them to report losses, their sources of venture capital would disappear, and they would stop their exploration activities, which is contrary to government economic policy. How does the *Framework* relate to the accounting question? Consider, particularly, the issue of faithful representation.

(Note: There has been no decision made in the IASB/FASB Framework with regards to the definitions and recognition criteria of Liabilities, Expenses, Income and Equity)

IASB (1989) Framework

Liabilities

A liability has been defined as “a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity or resources embodying economic benefits”.

Equity

Equity is the residual interest in the assets of the enterprise after deducting all the liabilities under the Historical Cost Accounting model. Equity is also known as owner's equity. Under the units of constant purchasing power model equity is the constant real value of shareholders' equity.

The financial performance of an enterprise is primarily provided in an income statement or profit and loss account. The elements of an income statement or the elements that measure the financial performance are as follows:

Income

Income Increases in economic benefit during an accounting period in the form of inflows or enhancements of assets, or decrease of liabilities that result in increases in equity. However, it does not include the contributions made by the equity participants, i.e., proprietor, partners and shareholders.

Expense

Expense decreases in economic benefits during an accounting period in the form of outflows, or depletions of assets or incurrences of liabilities that result in decreases in equity.

Recognition of elements of financial statements

An item is recognized in the financial statements when:

- it is probable future economic benefit will flow to or from an entity.
- the resource can be reliably measured.

Review Question 7

Definitions of elements

Explain how you would account for the following items, justifying your answer by reference to the *Framework's* definitions and recognition criteria:

- a. A trinket of sentimental value only.
- b. You are guarantor for your friend's bank loan:
 - (i) You have no reason to believe your friend will default on the loan.
 - (ii) As your friend is in serious financial difficulties, you think it likely that he will default on the loan.
- c. You receive 1 000 shares in X Ltd, trading at \$4 each, as a gift from a grateful client.
- d. The panoramic view of the coast from your café's windows, which you are convinced attracts customers to your café.
- e. The court has ordered your firm to repair the environmental damage it caused to the local river system. You have no idea how much this repair work will cost.

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