



PNU University

English for The Students of Accounting 2

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To The Student

How to Study Accounting Successfully

Whether you are majoring in accounting or in another business discipline, your introductory course is one of the most important classes you will take, because it is fundamental to the business curriculum and to your success in the business world beyond college. What are your goals in studying accounting? Being clear about your goals can contribute to your success in this course.

Success in this class also depends on your desire to learn and your willingness to work hard. And it depends on your understanding of how the text complements the way your instructor teaches and the way you learn. A familiarity with how this text is structured will help you to study more efficiently make better use of classroom time, and improve your performance on examinations and other assignments.

To be successful in the business world after you graduate, you will need broad set of skills, which may be summarized as follows:

Technical/Analytical Skills

A major objective of your accounting course is to give you a firm grasp of the essential business and accounting terminology and techniques that you will need to succeed in a business in environment. With this foundation, you then can begin to develop the higher-level perception skills that will help you to acquire further knowledge on your own.

An even more crucial objective of this course to help you develop analytical skills that will allow you to evaluate data. Well-developed analytical and decision-making skills are among the professional skills most highly valued by employers, and will serve you well throughout your academic and professional careers.

Communication Skills

Another skill highly prized by employers is the ability to express oneself in a manner that is understood correctly by others. This can include writing skills, speaking skills, and presentation skills. Communication skills are developed through particular tasks and assignments and are improved through constructive criticism. Reading skills and listening skills support the direct communication skills.

Interpersonal Skills

Effective interaction between two people requires a solid foundation of interpersonal skills. The success of such interaction depends on empathy, or the ability to identify with and understand the problems, concerns, and motives of others. Leadership, supervision, and interviewing skills also facilitate a professional's interaction with others.

Personal/Self Skills

Personal/Self Skills form the foundation for growth in the use of all other skills. To succeed, a professional must take initiative, possess self-confidence, show independence, and be ethical in all areas of life. Personal/Self Skills can be enhanced significantly by the formal learning process and by peers and mentors who provide models upon which you can build. Accounting is just one course in your entire curriculum, but it can play an important role in your development of the above skills. Your instructor is interested in helping you gain both a knowledge of accounting and the more general skills you will need to succeed in the business world. The following sections describe how you can get the most out of this course.

The Teaching/Learning Cycle

Both teaching and learning have natural and mutually compatible cycle. This teaching/learning cycle, shown in Figure 1.

The Teaching Cycle:

The inner circle in Figure 1 shows the steps an instructor takes in teaching a chapter. Your teacher assigns material, presents the subject in lecture, explains by going over assignments and answering questions, reviews the subject prior to an exam, and tests your knowledge and understanding using examinations and other means of evaluation.

The Learning Cycle:

The outside circle in Figure 1 shows the steps you should take in studying a chapter. You should preview the material, read the chapter, apply your understanding by working the assignments, review the chapter, and recall and demonstrate your knowledge and understanding of the material on examinations and other assessments.

Why Students succeed:

Students succeed in their accounting course when they coordinate their personal learning cycle with their instructor's cycle. Students who do a good job of previewing their assignments, reading the chapters before the instructor is ready to present them, preparing homework assignments before they are discussed in class, and reviewing carefully will ultimately achieve their potential on exams. Those who get out of phase with their instructor, for whatever reason, will do poorly or fail. To ensure that your learning cycle is synchronized with your instructor's teaching cycle, check your study habits against these suggestions.

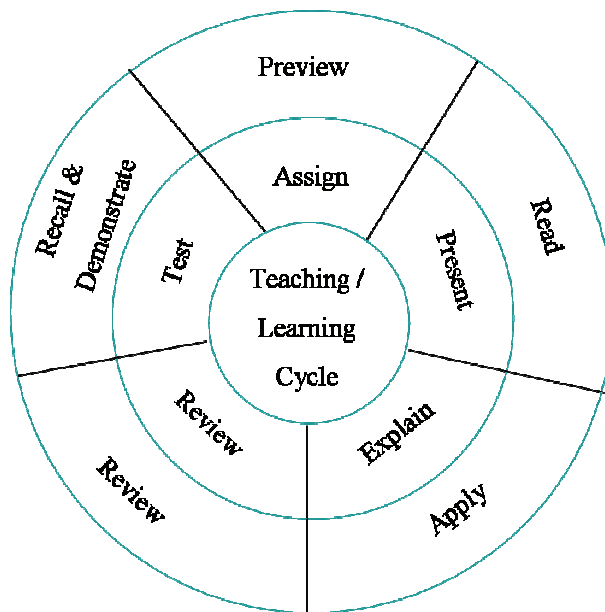


Figure 1. The Teaching/Learning Cycle

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CHAPTER 1

Underlying Conceptual Framework: An Introduction

Learning Objectives:

1. Describe a service that accounting provides through measurement of and communication about economic activities.
2. Identify the environment of financial accounting and explain role of financial accounting and reporting
3. Identify the objectives of financial reporting
4. Explain the need for accounting standards
5. Ethics in the Environment of Financial Accounting
6. Describe the usefulness of a conceptual framework
7. Describe the effort to develop a conceptual framework
8. define the basic elements of financial statements

In this chapter we explain the environment of financial reporting and the many factors affecting it and discusses the basic concepts underlying the conceptual framework.

Accounting provides a service through measurement of and communication about economic activities

Accounting is a service activity. Its function is to provide useful financial information about economic entities to interested parties, such as managers,

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investors, and creditors. Accounting also may be described as a measurement-communication activities. The usefulness of accounting information depends on effective measurement of the economic activities of entities and on effective communication of those measurements to users of that information.

Accounting information can be divided into two broad categories, according to the type of decision maker who uses it. *Management accounting information* is primarily for decision makers who are inside the economic entity. These internal users of accounting information are managers at various organizational levels of entity. *Financial accounting information* is primarily for decision makers who are outside the economic entity, such as investors, creditors, and governmental agencies. Financial accounting information also is used by top-level management inside the economic entity.

The term *financial accounting and reporting* encompasses the dual role of the financial accountant: (1) measuring and recording the economic activities of an entity and (2) communicating the record data to users outside the entity. Those who prepare accounting reports presume that users have a reasonable understanding of business and economic activities and are willing to study the reported data with reasonable diligence.

The Environment of Financial Accounting and Role of Financial Accounting and Reporting

Like other human activities and disciplines, accounting is largely a product of its environment. The environment of accounting consists of social-economic-political-legal conditions, restraints, and influences that vary from time to time. As a result, accounting objectives and practices are not the same today as they were in the past. *Accounting theory has developed to meet changing demands and influences.*

The economic environment in which business operates, as well as the information needs of those who use financial accounting data, changes continuously. There are many examples of changes or conditions in the economic environment that have influenced the amount of attention given to particular accounting and reporting issues. An example of the influence of economic environment on accounting and reporting issue is provided by the inflationary period of the 1970s and early 1980s, which was followed by a period of comparatively little inflation. In the 1970s considerable attention, research, and standard-setting effort were directed at how to report accounting data in periods of inflation. The culmination of much of this activity was the FASB's 1979 *Statement of Financial Accounting Standards No. 33*, "Financial Reporting and Changing Prices". This document required that both historical cost/constant dollar data and current cost data be disclosed in order for financial statements to conform to generally accepted accounting principles. As inflation began to subside in the mid-1980s and the cost of preparing changing prices data disclosures in financial statements became more apparent, enthusiasm for changing prices data declined. In 1986, the FASB issued *Statement of Standards No. 89*, which superseded its 1979 statement and made supplementary reporting of changing prices data voluntary.

Just as financial accounting and reporting standards and practices are affected by aspects of and changes in the economic environment, so also the economic environment may be affected by financial accounting and reporting practices. Occurrences of this sort are sometimes referred to as the economic consequences of accounting and reporting practices. Examples of circumstances in which particular accounting or reporting practices have been viewed as economic consequences are numerous, including the areas of oil and gas accounting, accounting for troubled debt restructurings, employer accounting for promised postretirement benefits other than pensions,

accounting for investments in debt securities, and accounting for executive stock options.

Objectives of Financial Reporting

In an attempt to establish a foundation for financial accounting and reporting, the accounting profession identified a set of *objectives of financial reporting by business enterprises*. Financial reporting should provide information:

(a) that is useful to present and potential investors and creditors and other *users in making rational investment, credit, and similar decisions*. The information should be comprehensible to those who have a reasonable understanding of business and economic activities and are willing to study the information with reasonable diligence.

(b) to help present and potential investors and creditors and other users *in assessing the amounts, timing, and uncertainty of prospective cash receipts* from dividends or interest and the proceeds from the sale, redemption, or maturity of securities or loans. Since investors' and creditors' cash flows are related to enterprise cash flows, financial reporting should provide information to help investors, creditors, and others assess the amounts, timing, and uncertainty of prospective net cash inflows to the related enterprise.

(c) about the economic resources of an enterprise, the claims to those resources (obligations of the enterprise to transfer resources to other entities and owners' equity), and the effects of transactions, events, and circumstances that changes its resources and claims to those resources.

In brief, the objectives of financial reporting are to provide (1) information that is useful in investment and credit decisions, (2) information

that is useful in assessing cash flow prospects, and (3) information about enterprise resources, claims to those resources, and changes in them.

The emphasis on "assessing cash flow prospects" might lead one to suppose that the cash basis is preferred over the accrual basis of accounting. That is not the case. Information based on *accrual accounting generally provides a better indication of an enterprise's present and continuing ability to generate favorable cash flows* than does information limited to the financial effects of cash receipts and payments.

The Need to Develop Standards

The main controversy in setting accounting standards is "Whose rules should we play by, and what should they be?" The answer is not immediately clear because the users of financial accounting statements have both coinciding and conflicting needs for information of various types. To meet these needs, and to satisfy the fiduciary reporting responsibility of management, a single set of *general-purpose financial statements* is prepared. These statements are expected to present fairly, clearly, and completely the economic facts of existence and operations of the enterprise. *In preparing financial statements, accountants are confronted with the potential dangers of bias, misinterpretation, inexactness, and ambiguity.* In order to minimize these dangers, the accounting profession has attempted to develop a set of standards that is generally accepted and universally practiced. Without these standards, each enterprise would have to develop its own standards, and readers of financial statements would have to familiarize themselves with every company's peculiar accounting and reporting practices. As a result, it would be almost impossible to prepare statements that could be compared. The accounting profession has adopted a common set of standards and procedures called generally accepted accounting principles (GAAP).

The Nature and Content of Financial Accounting and Reporting

In this section we discuss the nature of financial accounting and reporting under GAAP, explain why financial accounting and reporting standards are important, and describe how financial accounting information relates to other information used in decision making.

GAAP consist of the financial accounting and reporting conventions, rules, and procedures that a business entity must use in preparing external financial statements that are subject to audit by an independent certified public accountant. They are based on practical as well as theoretical considerations and often represent a consensus among accountants as to what is considered acceptable practice at a given time. GAAP help increase the confidence of financial statement users that the statements are representation ally faithful. GAAP are extremely important to independent auditors. GAAP require many estimates, assumptions, and professional judgments by management and by accountants. Calculations of depreciation expense and estimates of uncollectible accounts receivable are two examples. Personal bias, misstatements of facts, errors in estimation, and ambiguity may affect the measurement and communication of economic events. Financial statements must have credibility to external users. In addition, given accounting's service nature, it is essential that the information in financial statements be useful in decision making. The existence of standards or principles for financial accounting and reporting is very important to the credibility and usefulness of financial data. Historically, setting standards for financial accounting and reporting has proven to be in the public interest.

As you study financial accounting and reporting standards and procedures, you will begin to see that ethical considerations often arise. Accountants must be aware of potential ethical issues associated with

financial accounting and reporting and must be prepared to formulate response to those issues. Performing their role in an ethical manner requires accountants to make decisions and take actions that contribute positively to the public good, in addition to being consistent with GAAP.

Ethical behavior typically is viewed as acting in a manner that is consistent with the values of society. The basic issue is whether the decision or action is defensible in a public forum. Ethical behavior requires an assessment of whether a decision or action is "right or wrong, given the values of society", rather than a determination of whether the decision or action is legal or illegal. Accountants should consider the impact of their actions, as well as the effects of accounting standards and procedures and their applications on the public good. To do otherwise would be to fail to fulfill the public service aspect of financial accounting and reporting.

Financial Reporting and Other Information used in Decision Making

Exhibit (1-1) shows the total set of information that may be used in making investments, credit, and similar decisions (reading from the left side of exhibit). As you see, financial reporting is not the only information source used in decision making. Notice that the financial information subject to an independent auditor's opinion includes not only the financial statements but also the notes to the financial statements. Preparation and dissemination of the financial statements of a business entity are the responsibility of the management of the entity. Because of the importance of the financial statements, managements often engage independent auditors to attest to the fairness of the statements.

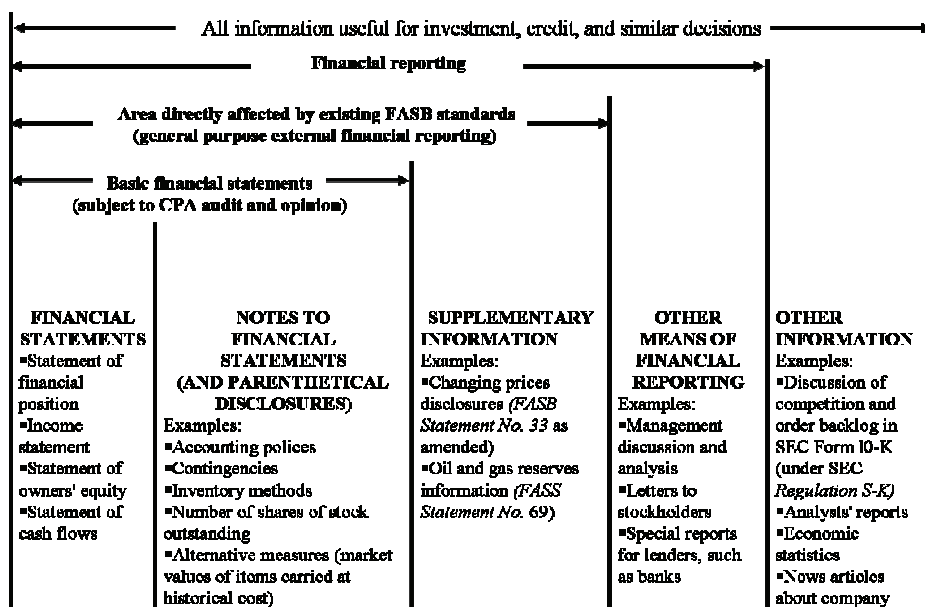


EXHIBIT 1-2. INFORMATION USED IN INVESTMENT, CREDIT, AND SIMILAR DECISIONS

Financial statements are a central component of financial reporting and serve as a principal means of communicating the effects of transactions and other economic events. A financial statement is a formal tabulation of account names and dollar amounts derived from accounting records maintained by a business entity. Financial statements display either the financial position of the entity at a point in time or one kinds of changes in financial position of the entity during a period of time. The individual financial statements of a entity articulate (interrelate) with each other and are derived from the same underlying economic data. The financial statements are interrelated because they report different aspects of the same transactions or other economic events affecting an entity. Because each financial statement presents different information, no individual statement is likely to serve a single purpose or provide all the financial information necessary for a particular decision.

Information provided in notes to the financial statements or shown parenthetically on the face of the financial statements (such as information about significant accounting policies, pension plan description, or segment financial data) enhances or explains information reported in the financial statements. In addition, supplementary information, such as disclosures of the effects of changing prices on the company's financial statements, along with voluntary management discussion and analysis, adds support and explanation to the financial statements and notes to the financial statements.

Many companies voluntarily disclose certain financial information, such as expenditures for employee training and social welfare expenditures. This information, along with the financial statements, notes to the financial statements, and supplementary data, is useful for investment, credit, and similar decisions.

As exhibit (1-1) shows, the FASB's area of interest is *general purpose external financial reporting*. General purpose financial reporting is designed to serve the needs of external users of financial information as a whole, rather than the needs of particular user groups. General purpose external financial reporting is directed toward what appears to be a common interest among external users of financial information in a company's ability to generate positive net cash flows from operating activities. This common interest in information about cash flows from is the basis for the financial reporting objectives and other concepts of financial accounting theory that are discussed in later of the chapter.

As exhibit (1-1) further indicates, financial reporting may go beyond what is included in general purpose external financial reporting. Financial reporting may include the preparation of special reports for specific users who are in a position to request special information. For example, a potential lender, such as a bank, often can demand additional financial information before making a lending decision.

Ethics in the Environment of Financial Accounting

In accounting, as in other areas of business, ethical dilemmas are encountered frequently. Some of these dilemmas are simple and easy to resolve. Many, however, are complex, and solutions are not obvious. Businesses' concentration on "maximizing the bottom line," "facing the challenges of competition," and "stressing short-term results" places accountants in an environment of conflict and pressure. Basic questions such as: "Is this way of communicating financial information good or bad?" "Is it right or wrong?" "What should I do in the circumstance?" cannot always be answered by simply adhering to GAAP or following the rules of profession. Technical competence is not enough when ethical decisions are encountered. Doing the right thing, making the right decision, is not always easy. Right is not always evident. In the circumstance decision making is more difficult because a public consensus has not emerged to formulate a comprehensive ethical system to provide guidelines. However, "applied ethics" is still necessary and possible. Here are the steps that you might apply in the process of ethical awareness and decision making:

- A. Recognize an ethical situation or ethical dilemma.
- B. Move toward an ethical resolution by identifying and analyzing the principal elements in the situation.
- C. Identify the alternatives and weigh the impact of each alternative on various stakeholders.
- D. Select the best or most ethical alternative, considering all the circumstances and the consequences.

Theoretical Structure

Accounting theory has been defined as "a coherent set of logical principles that (1) provides a better understanding of existing practices to petitioners,

investors, managers, and students; (2) provides a conceptual framework for evaluating existing accounting practices; and (3) guides the development of new practices and procedures." This chapter discusses the basic concepts underlying this conceptual framework.

A conceptual framework is like a constitution: It is "a coherent system of interrelated objectives and fundamentals that can lead to consistent standards and that prescribes the nature, function, and limits of financial accounting and financial statements." Many have considered the FASB's real contribution – and even its continued existence – to depend on the quality and utility of the conceptual framework.

Need for Conceptual Framework

Why is a conceptual framework necessary? First, to be useful, standard setting should build on and relate to an established body of concept and objective. A soundly developed conceptual framework should enable the FASB to issue more useful and consistent standards in the future. *A coherent set of standards and rules should be the result*, because they would be built upon the same foundation. The framework should increase financial statement users' understanding of and confidence in financial reporting, and it should enhance comparability among companies' financial statements. Second, new and emerging *practical problems should be more quickly solved by reference to an existing framework of basic theory*.

Development of Conceptual Framework

Over the years numerous organizations, committees, and interested individuals developed and published their own conceptual frameworks. But no single framework was universally accepted and relied on in practice. Perhaps the most successful was *Accounting Principles Board statements*

No. 4, "Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises," which described existing practice but did not prescribe what practice ought to be. Recognizing the need for a generally accepted framework, the FASB in 1976 issued a massive three-part Discussion Memorandum entitled *Conceptual Framework for Financial Accounting and Reporting: Elements of Financial Statements and Their Measurement*. It set forth the major issues that must be addressed in establishing a conceptual framework that would be a basis for setting accounting standards and for resolving financial reporting controversies. Since the publication of that document, the FASB has issued five Statements of Financial Accounting Concepts that relate to financial reporting for business enterprises. They are:

1. **SFAC No. 1**, "Objectives of Financial Reporting by Business Enterprises," presents the goals and purposes of accounting.
2. **SFAC No. 2**, "Qualitative Characteristics of Accounting Information," examines the characteristics that make accounting information useful.
3. **SFAC No. 3**, "Elements of Financial Statements of Business Enterprises," provides definitions of items in financial statements, such as assets, liabilities, revenues, and expenses.
4. **SFAC No. 5**, "Recognition and Measurement in Financial statements of business Enterprises," sets forth fundamental recognition and measurement criteria and guidance on what information should be formally incorporated into financial statements and when.
5. **SFAC No. 6**, "Elements of Financial Statements," replaces SFAC No. 3 and expands its scope to include not-for-profit organizations.

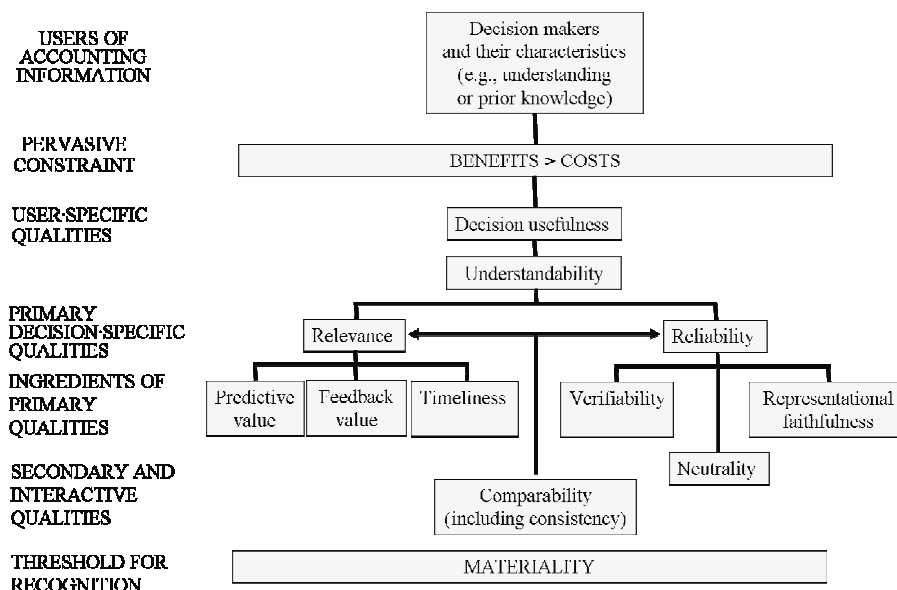


EXHIBIT 2-2. A HIERARCHY OF ACCOUNTING QUALITATIVE CHARACTERISTICS

Exhibit (2-1) provides an overview of the conceptual framework. At the first level, the *objectives* identify the goals and purposes of accounting and are the building blocks for the conceptual framework. At the second level are the *qualitative characteristics* that make accounting information useful and the *elements* of financial statements (assets, liabilities, and so on). At the final or third level are the *measurement and recognition* concepts used in establishing and applying accounting standards. These concepts include assumptions, principles, and constraints that describe the present reporting environment.

First Level: Basic Objectives

As we discussed in previous chapter, the objectives of financial reporting are to provide information that is: (1) useful to those making investment and credit decisions who have a reasonable understanding of business and

economic activities; (2) helpful to present and potential investors, creditors, and other users in assessing the amounts, timing and uncertainty of future cash flows; and (3) about economic resources, the claims to those resources, and the changes in them.

Second Level: Fundamental Concepts

The objectives (first level) are concerned with the goals and purposes of accounting. Later, we will discuss the ways these goals and purposes are implemented (third level). Between these two levels it is necessary to provide certain conceptual building blocks that explain the qualitative characteristics of accounting information and define the elements of financial statements. These conceptual building blocks form a bridge between the *why* of accounting (the objectives) and the *how* of accounting (recognition and measurement).

Qualitative Characteristics of Accounting Information

Choosing an acceptable accounting method, the amount and types of information to be disclosed, and the format in which information should be presented involves determining which alternatives provides the most useful information for decision making purposes (*decision usefulness*). The FASB has identified the *qualitative characteristics* of accounting information that distinguish better (more useful) information from inferior (less useful) information for decision making process. In addition, The FASB has identified certain constraints (*cost-benefit and materiality*) as part of the conceptual framework. The characteristics may be viewed as a hierarchy, as shown in Exhibit (2-2).

Decision Makers and Understandability

Decision makers vary widely in the types of decisions they make, the methods of decision making they employ, the information they already possess or can obtain from other sources; and their ability to process the information. For information to be useful there must be a connection (linkage) between these users and the decisions they make. This link, understandability, is the quality of information that permits reasonably informed users to perceive its significant.

Primary Qualities: Relevance and Reliability

Relevance and *reliability* are the two primary qualities that make accounting information useful for decision making.

Relevance. To be relevant, accounting information must be capable of making a difference in a decision. If certain information has no bearing on a decision, it is irrelevant to that decision. Relevant information helps users make predictions about the ultimate outcome of past, present, and future events; that is, it has *predictive value*. Relevant information also helps users confirm or correct prior expectations; it has *feedback value* for information to be relevant, it must also be available to decision makers before it loses its capacity to influence their decisions. Thus *timeliness* is a primary ingredient. On the other word, for information to be relevant, it should have predictive or feedback value, and it must be presented on a timely basis.

Reliability. Accounting information is reliable to the extent that it is verifiable, is a faithful representation, and is reasonably free of error and bias. Reliability is a necessity for individuals who have neither the time nor the expertise to evaluate the factual content of the information.

Verifiability is demonstrated when independent measures, using the same measurement methods, obtain similar results. For example, would several independent auditors come to the same conclusion about a set of