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Conceptual Framework and Financial Reporting

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Standards and Conceptual Framework

1 Financial Accounting Standards

1.1 Standard-Setting Bodies in the United States

In the United States, the Securities and Exchange Commission (SEC) has the legal authority to establish U.S. generally accepted accounting principles (GAAP). However, in most instances, the SEC has allowed the accounting profession to establish GAAP and self-regulate. The SEC and three different bodies of the accounting profession have determined GAAP since 1934.

1.1.1 Securities and Exchange Commission (SEC)

The SEC was established by the Securities Exchange Act of 1934. All companies that issue securities in the United States are subject to SEC rules and regulations. The SEC has issued public company specific accounting rules and regulations in Regulation S-X, Financial Reporting Releases (FRR), Accounting Series Releases (ASR), Interpretative Releases (IR), Staff Accounting Bulletins (SAB), and EITF Topic D and SEC Observer comments.

1.1.2 Committee on Accounting Procedure (CAP)

The Committee on Accounting Procedure (CAP) was a part-time committee of the American Institute of Certified Public Accountants (AICPA) that promulgated Accounting Research Bulletins (ARB), which determined GAAP from 1939 until 1959.

1.1.3 Accounting Principles Board (APB)

The Accounting Principles Board (APB) was another part-time committee of the AICPA. It issued Accounting Principles Board Opinions (APBO) and APB Interpretations, which determined GAAP from 1959 until 1973.

1.1.4 Financial Accounting Standards Board (FASB)

In 1973, an independent full-time organization called the Financial Accounting Standards Board (FASB) was established, and it has determined GAAP since then. Through 2009, the FASB issued Statements of Financial Accounting Standards (SFAS), FASB Interpretations (FIN), FASB Technical Bulletins (FTB), Emerging Issues Task Force Statements (EITF), FASB Staff Positions, FASB Implementation Guides, and Statements of Financial Accounting Concepts (SFAC).

The FASB has seven full-time members, who serve for five-year terms and may be reappointed to one additional five-year term. The Board members must sever connections with firms or institutions before joining the Board.

1.2 U.S. GAAP: FASB Accounting Standards Codification®

The vast number of standards issued by the Committee on Accounting Procedures, the Accounting Principles Board, and the Financial Accounting Standards Board, as well as additional guidance provided by the SEC and the AICPA, made it difficult for users to access the full body of U.S. GAAP. Effective July 1, 2009, the FASB *Accounting Standards Codification®* became the single source of authoritative nongovernmental U.S. GAAP. Accounting and financial reporting practices not included in the codification are not GAAP.

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1.3 Private Company Council (PCC)

The Financial Accounting Foundation (FAF) created the Private Company Council (PCC) to improve standard setting for privately held companies in the U.S. The goal of the PCC is to establish alternatives to U.S. GAAP, where appropriate, to make private company financial statements more relevant, less complex, and cost-beneficial. Accounting alternatives for private companies are incorporated into the relevant sections of the *Accounting Standards Codification* (ASC).

1.4 Ongoing Standard-Setting Process

The FASB updates the *Accounting Standards Codification* for new U.S. GAAP issued by the FASB and for amendments to the SEC content with Accounting Standards Updates.

Proposed FASB amendments to the ASC are issued for public comment in the form of exposure drafts. A majority vote of the Board members is required to approve an exposure draft for issuance. At the end of the exposure draft public comment period, the FASB staff analyzes and studies all comment letters and position papers and then the Board re-deliberates the issue. When the Board is satisfied that all reasonable alternatives have been adequately considered, the FASB staff prepares an Accounting Standards Update for Board consideration. A majority vote of the Board members is required to amend the ASC.

Accounting Standards Updates are not authoritative literature, but instead provide background information, update the codification, and describe the basis for conclusions on changes in the codification. All new GAAP and SEC amendments are fully integrated into the existing structure of the codification.

1.5 International Financial Reporting Standards (IFRS)

The International Accounting Standards Board (IASB) was established in 2001 as part of the International Financial Reporting Standards (IFRS) Foundation.

When the IASB was created, it adopted the International Accounting Standards (IAS) that had been issued by its predecessor, the Board of the International Accounting Standards Committee. The IASB issues International Financial Reporting Standards (IFRSs) and related documents, including the *Conceptual Framework for Financial Reporting*, exposure drafts, and other discussion documents. The term International Financial Reporting Standards includes IFRSs, IASs, and Interpretations developed by the IFRS Interpretations Committee (IFRIC) and the former Standard Interpretations Committee (SIC).

2 Conceptual Framework for Financial Reporting

The FASB has created a conceptual framework (set forth in pronouncements called Statements of Financial Accounting Concepts, or SFAC) that serves as a basis for all FASB pronouncements. The SFAC are not GAAP, but they provide a basis for financial accounting concepts for business and nonbusiness enterprises. As phases of this project are completed, the FASB will issue each component of the conceptual framework as a chapter in Statement of Financial Accounting Concepts No. 8, *Conceptual Framework for Financial Reporting*. The chapters of SFAC No. 8 that have been issued replaced SFAC No. 1, "Objectives of Financial Reporting by Business Enterprises," and SFAC No. 2, "Qualitative Characteristics of Accounting Information."

2.1 SFAC No. 8, *Conceptual Framework for Financial Reporting*—Chapter 1: "The Objective of General Purpose Financial Reporting"

The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to the primary users of general purpose financial reports in making decisions about providing resources to the reporting entity.

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2.1.1 Primary Users

The primary users of general purpose financial reports are existing and potential investors, lenders, and other creditors. Other parties, including regulators and members of the public who are not investors, lenders, and other creditors, may also use general purpose financial reports, but are not considered to be primary users.

2.1.2 Financial Information Provided in General Purpose Financial Reports

Financial information needed by primary users includes information about the resources of the entity, the claims against the entity, the changes in the resources and claims, and how efficiently and effectively the entity's management and governing board have discharged their responsibilities to use the entity's resources. Financial information should be presented using the accrual basis of accounting.

Existing and potential investors, lenders, and other creditors use financial information to assess the reporting entity's prospects for future net cash inflows to the entity. Such information may be used to estimate the value of the reporting entity.

2.2 SFAC No. 8, *Conceptual Framework for Financial Reporting—* Chapter 3: "Qualitative Characteristics of Useful Financial Information"

The qualitative characteristics of useful financial information are the characteristics that are likely to be most useful to existing and potential investors, lenders, and other creditors in making decisions about the reporting entity based on financial information.

2.2.1 Fundamental Qualitative Characteristics

The fundamental qualitative characteristics of useful financial information are relevance and faithful representation. Both characteristics must be present for financial information to be useful.

- **Relevance:** Financial information is relevant if it is capable of making a difference in the decisions made by users. To be relevant, financial information must have predictive value and/or confirming value, and must be material.
  - **Predictive Value:** Information has predictive value if it can be used by users to predict future outcomes.
  - **Confirmatory Value:** Information has confirmatory value if it provides feedback about evaluations previously made by users.
  - **Materiality:** Information is material if an omission or misstatement of the information could affect the decisions made by users based on financial information. Materiality is an entity-specific aspect of relevance. The FASB and IASB have not specified a uniform quantitative threshold for materiality and have not specified what would be material in specific situations.
- **Faithful Representation:** To be useful, financial information must faithfully represent the reported economic phenomena. Faithful representation requires the financial information to be complete, neutral, and free from error. Although perfect faithful representation is generally not achievable, these characteristics must be maximized.
  - **Complete:** A complete depiction of financial information includes all information necessary for the user to understand the reported economic event, including descriptions and explanations.
  - **Neutral:** A neutral depiction of financial information is free from bias in selection or presentation.

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- **Free From Error:** Free from error means that there are no errors in the selection or application of the process used to produce reported financial information and that there are no errors or omissions in the descriptions of economic events. Free from error does not require perfect accuracy because, for example, it is difficult to determine the accuracy of estimates.

2.2.2 Steps to Apply the Fundamental Qualitative Characteristics

The most efficient and effective process for applying the fundamental characteristics of useful financial information is:

1. Identify the economic event or transaction that has the potential to be useful to the users of a reporting entity's financial information.
2. Identify the type of information about the event or transaction that would be most relevant.
3. Determine whether the information is available and can be faithfully represented.

If the information is available and can be faithfully represented, then the fundamental qualitative characteristics have been satisfied. If not, the process is repeated with the next most relevant type of information.

2.2.3 Enhancing Qualitative Characteristics

Comparability, verifiability, timeliness, and understandability enhance the usefulness of information that is relevant and faithfully represented. These characteristics can be used to determine how an economic event or transaction should be depicted if two ways are equally relevant and faithfully represented. The enhancing qualitative characteristics should be maximized.

- **Comparability:** Information is more useful if it can be compared with similar information about other entities or from other time periods. Comparability enables users to identify similarities and differences among items. Consistency, which is the use of the same methods for the same items either from period to period within an entity or in a single period across entities, helps to achieve comparability.
- **Verifiability:** Verifiability means that different knowledgeable and independent observers can reach consensus that a particular depiction is faithfully represented. Verifiability does not require complete agreement.
- **Timeliness:** Timeliness means that information is available to users in time to be capable of influencing their decisions.
- **Understandability:** Information is understandable if it is classified, characterized, and presented clearly and concisely. However, even well-informed and diligent users may need the assistance of advisors to understand complex and difficult transactions.

2.2.4 The Cost Constraint

The cost constraint is a pervasive constraint on the information provided in financial reporting. The benefits of reporting financial information must be greater than the costs of obtaining and presenting the information. The FASB and IASB consider costs and benefits in relation to financial reporting in general and not at the individual reporting entity level.

2.3 SFAC No. 3, *Elements of Financial Statements of a Business*

This statement was replaced by SFAC No. 6.

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2.4 SFAC No. 4, *Objectives of Financial Reporting by Nonbusiness Organizations*

This statement outlines the characteristics that distinguish nonbusiness organizations from business organizations, describes the users of the financial information provided by nonbusiness organizations, and sets forth the objectives of external financial reporting by nonbusiness organizations.

2.4.1 Characteristics of Nonbusiness Organizations

The following characteristics distinguish nonbusiness organizations from business organizations:

- A significant portion of their resources come from contributions and grants.
- Their operating purposes are other than to provide goods or services for profit.
- They lack ownership interests that can be sold, transferred, or redeemed, or that allow a claim on resources upon liquidation.

Nonbusiness organizations include most human service organizations, churches, foundations, and other organizations, such as not-for-profit hospitals and not-for-profit educational institutions that receive a significant portion of their resources from contributions and grants.

2.4.2 Users of Financial Information of Nonbusiness Organizations

The following groups are interested in the financial information reported by nonbusiness organizations:

- Resource providers, including lenders, suppliers, employees, members, contributors, and taxpayers.
- Constituents who use and benefit from the services provided by nonbusiness organizations.
- Governing and oversight bodies that are responsible for setting policies and for overseeing and evaluating the managers of nonbusiness organizations.
- Managers who are responsible for carrying out the policy mandates of the governing bodies and managing the day-to-day operations of the nonbusiness organization.

2.4.3 Objectives of Financial Reporting of Nonbusiness Organizations

The objectives of the financial reporting of nonbusiness organizations are to provide:

- Information useful in making resource allocation decisions.
- Information useful in assessing services and the ability to provide services.
- Information useful in assessing management stewardship and performance.
- Information about economic resources, obligations, and net resources; organization performance; the nature of and relationship between inflows and outflows; service efforts and accomplishments; and liquidity.

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2.5 SFAC No. 5, *Recognition and Measurement in the Financial Statements*

This statement sets forth the recognition criteria and guidance on what and when information should be incorporated in the financial statements.

2.5.1 Full Set of Financial Statements

- Statement of financial position (the balance sheet)
- Statement of earnings (the income statement)
- Statement of comprehensive income
- Statement of cash flows
- Statement of changes in owners' equity

2.5.2 Fundamental Recognition Criteria

Recognition is the process of formally recording or incorporating an item in the financial statements of an entity and classifying it as asset, liability, equity, revenue, or expense.

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

2.5.3 Measurement Attributes for Assets and Liabilities

Items reported in the financial statements are currently measured using different attributes, including those listed below.

- Historical cost
- Current cost
- Net realizable value
- Current market value
- Present value of future cash flows

2.5.4 Fundamental Assumptions and Principles

- **Entity Assumption:** Economic activity can be accounted for when considering an identifiable set of activities (e.g., a separate corporation or division).
- **Going Concern Assumption:** For financial accounting, it is presumed (subject to rebuttal by evidence to the contrary) that the entity will continue to operate in the foreseeable future.
- **Monetary Unit Assumption:** It is assumed that money is an appropriate basis by which to measure economic activity. The assumption is that the monetary unit does not change over time; thus, the effects of inflation are not reflected in the financial statements.
- **Periodicity Assumption:** Economic activity can be divided into meaningful time periods.
- **Measurement Principle:** Financial statements use a mixed attribute system that allows assets and liabilities to be measured at various bases, including historical cost, fair value, net realizable value, and present value of future cash flows. As a general rule, however, financial information is accounted for and based on cost, not on current market value.

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- **Accrual Accounting:** Revenues are recognized when the performance obligation is satisfied and expenses are recognized in the same period as the related revenue, not necessarily in the period in which the cash is received or expended by the company.
  - **Revenue Recognition Principle:** As a general rule, revenues are recognized when an entity satisfies a performance obligation by transferring either a good or a service to a customer.
  - **Expense Recognition Principle:** Expenses are necessarily incurred to generate revenue. Expenses incurred to generate a specific amount of revenue in a period are matched against that revenue (for example, cost of goods sold). Expenses that do not have a direct link with revenue may be recognized when cash is spent or liabilities are incurred (for example, selling, general and administrative expenses). Other expenses are allocated by systematic and rational procedures to the periods in which the assets provide benefit (for example, depreciation expense). Losses may result when it is evident that future economic benefits of an asset have been reduced or eliminated.
- **Full Disclosure Principle:** It is important that the user be given information that would make a difference in the decision process, but not so much information that the user is impeded in analyzing what is important.

2.6 SFAC No. 6, *Elements of Financial Statements*

Elements are the components of the financial statements. They must be measurable and meet the recognition requirements previously discussed.

2.6.1 Assets

Assets are probable future economic benefits to be received by the company as a result of past transactions or events. Valuation accounts may be used to show reductions to or increases in an asset that reflect adjustments beyond the historical cost or carrying amount of the asset.

2.6.2 Liabilities

Liabilities are probable future sacrifices of economic benefits arising from a present obligation of the company to transfer assets or provide services to other entities in the future as a result of past transactions or events.

2.6.3 Equity (or Net Assets)

Equity is the residual interest in the assets of the company that remains after deducting its liabilities.

2.6.4 Investments by Owners

Investments by owners are increases in the equity of an entity resulting from transfers of cash, property, or services from owners.

2.6.5 Distributions to Owners

Distributions to owners are decreases in the equity of an entity from transfers of cash, property, or services, or the incurrence of a liability to owners.

2.6.6 Comprehensive Income

Comprehensive income includes any change in equity other than investments by owners and distributions to owners (i.e., net income plus other comprehensive income).

2.6.7 Revenues

Revenues are inflows or enhancements of assets, or settlements of liabilities from delivering goods or services as a part of normal operations. Recognize revenue at the gross amount (less allowances for returns and discounts given).

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2.6.8 Expenses

Expenses are outflows or uses of assets, or incurrences of liabilities from delivering goods or services as part of normal operations.

2.6.9 Gains

Gains are increases in equity from peripheral transactions and other events, except revenues and investments from owners.

2.6.10 Losses

Losses are decreases in equity from peripheral transactions and other events, except expenses and distributions to owners.

2.7 SFAC No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*

SFAC No. 7 provides a framework for accountants to employ when using future cash flows as a measurement basis for assets and liabilities, especially when the factors to consider in the measurement are complex. It also provides a set of principles that govern the use of present value, especially when the timing and/or amount of future cash flows are uncertain.

2.7.1 Measurements Based on Future Cash Flows Only

SFAC No. 7 applies only to measurement issues for assets and liabilities that are determined using future cash flows only.

2.7.2 Five Elements of Present Value Measurement

The FASB identified five elements of present value (or economic value) measurement that were used as the basis for determining the measurement objective of SFAC No. 7.

1. Estimate of future cash flow
2. Expectations about timing variations of future cash flows
3. Time value of money (the risk-free rate of interest)
4. The price for bearing uncertainty
5. Other factors (e.g., liquidity issues and market imperfections)

2.7.3 Fair Value Objective

If fair value cannot be determined in the marketplace, the objective must be to obtain an estimate of fair value by using the present value of future cash flows.

2.7.4 Present Value Computations

SFAC No. 7 allows the use of two approaches to determine present value (each considering the interest method of allocation), depending on the circumstances.

- **Traditional Approach:** The traditional approach (i.e., one discount rate used to take the present value of a future cash flow stream) to present value computations may be used when assets and liabilities have contractual (i.e., fixed) cash flows that are not expected to vary. In this approach, interest rate selection is paramount.

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- **Expected Cash Flow Approach:** In more complex cases, the expected cash flow approach is to be used. Rather than focusing on the interest rate selection, this approach uses only the risk-free rate of return as the discount rate and then turns its attention to the expected future cash flows, considering uncertainties (e.g., default risk) as adjustments to the future cash flows.
  - **Expected Cash Flow:** The expected cash flow approach considers a range of possible cash flows and assigns a (subjective) probability to each cash flow in the range to determine the weighted average, or "expected," future cash flow.
  - **Risk and Uncertainty Adjustments to Cash Flows:** Adjustments to the expected cash flows used in complex present value computations (rather than interest rate adjustments) are required for uncertainties (e.g., default risk).

2.7.5 Liability Measurement Considers Additional Factors

The FASB determined that, when using present value, the objective of estimating the fair value of a liability must consider certain other factors, including:

- Costs to settle
- Credit standing of the company

2.7.6 Changes in Estimated Cash Flows Using the Catch-up Approach

To use this approach, simply adjust the carrying amount of the asset or liability to the present value determined using the revised estimates and discount using the original effective interest rate.

Question 1 **MCQ-00010**

According to the FASB and IASB conceptual frameworks, completeness is an ingredient of:

	Relevance	*Faithful Representation*
a.	Yes	No
b.	No	Yes
c.	Yes	Yes
d.	No	No

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