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Conceptual Framework and Financial Reporting

Module

Module 1 Standards and Conceptual Framework

FAR 1

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.

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.

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.

- **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.

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.