FASB CONCEPTUAL FRAMEWORK

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1. Overview

A. The conceptual framework provides a basis for considering the merits of alternative accounting methods and for developing financial accounting and reporting standards.

B. The FASB Statements of Financial Accounting Concepts set forth the FASB's conceptual framework:

- Objectives of Financial Reporting by Business Enterprises, Statement of Financial Accounting Concepts No.1 (CON 1).

- Qualitative Characteristics of Accounting Information, Statement of Financial Accounting Concepts No.2 (CON 2).

- Elements of Financial Statements, Statement of Financial Accounting Concepts No.6 (CON 6). CON 6 replaces CON 3, Elements of Financial Statements of Business Enterprises.

- Objectives of Financial Reporting by Nonbusiness Organizations, Statement of Financial Accounting Concepts No. 4 (CON 4).

- Recognition and Measurement in Financial Statements of Business Enterprises, Statement of Financial Accounting Concepts No. 5 (CON 5).

C. What benefits is the framework expected to achieve?

D. Note that SFACs do not establish GAAP. The FASB SFASs establish GAAP (see Chapter 1).

2. FASB Conceptual Framework: Definitions and Concepts

After completing this chapter, you should be able to provide definitions and discuss the characteristics or significance of each item listed below.

Objectives of Financial Reporting
Assumed User Characteristics
Understandability

Qualitative Characteristics

- **Relevance**
  - **Predictive Value**
  - **Feedback Value**
  - **Timeliness**
- **Reliability**
  - **Verifiability**
  - **Representational Faithfulness**
  - **Neutrality**
- **Comparability**
- **Consistency**

Basic Elements of Financial Statements

- **Assets**
- **Liabilities**
- **Equity**
- **Revenues**
- **Expenses**
- **Gains**
- **Losses**
- **Investments by Owners**
- **Distributions to Owners**
- **Comprehensive Income**

Recognition and Measurement Criteria:

Assumptions	**Principles**	**Constraints**
Economic Entity	**Historical Cost**	**Cost-benefit**
Continuity	**Revenue Recognition**	**Materiality**
Monetary Unit	**Matching**	**Industry Practice**
Time Period (Periodicity)	**Full Disclosure**	**Conservatism**

Other concepts covered in more depth in future chapters:

- **Accrual**
- **Deferral**
- **Allocation**
- **Bias**
- **Completeness**
- **Earnings**

- **Circumstance**
- **Event**
- **Transaction**

On the following pages, many of the definitions are provided so that you can focus on understanding and applying the concepts.

A. SFAC 1: Objectives of Financial Reporting

1. What are the three primary objectives of financial reporting? (See also chapter 1).

In summary form, financial information should provide information

(1) useful to present and potential investors and creditors and others in making rational investment and credit decisions,
(2) to help investors, creditors, and others assess the amounts, timing, and uncertainty of prospective net cash inflows to the related enterprise, and
(3) about the economic resources of an enterprise (assets), the claims to those resources (liabilities), and the effects of transactions, events, and circumstances that change resources and claims to those resources.

2. What characteristics of typical external users do we commonly assume? (Without these characteristics, no system of external financial reporting could hope to be successful.)

3. Give a brief definition of ***"understandability":***

The quality of information that enables users to perceive significance.

B. SFAC 2: Qualitative Characteristics of Accounting Information

Qualitative characteristics describe the qualities of information that can make accounting information useful.

1. Define each of the following qualitative characteristics:

Relevance: The capacity of information to make a difference in a decision by helping users to form predictions about the outcomes of past, present, and future events or to confirm or correct prior expectations.

Predictive value: Helps users to increase the likelihood of correctly forecasting the outcome of past or present events.

Feedback value: Enables users to confirm or correct prior expectations.

Timeliness: Having information available to a decision maker before it loses its capacity to influence decisions.

Reliability: Assures that information is reasonably free from error and bias and faithfully represents what it purports to represent.

Verifiability: The ability through consensus among measurers to ensure that information represents what it purports to represent or that the chosen method of measurement has been used without error or bias.

Representational faithfulness: Correspondence or agreement between a measure or description and the phenomenon that it purports to represent (sometimes called **validity**).

Neutrality: Absence in reported information of bias intended to attain a predetermined result or to induce a particular mode of behavior. This qualitative characteristics has proven to be *very* controversial and is often misunderstood.

2. Discuss the tradeoffs that must be made between relevance and reliability and the implications of those tradeoffs for financial reporting:

3. Define *"comparability"* and *"consistency"* and explain the difference between these two concepts:

C. SFAC 6: Definitions of Financial Statement Elements

The elements are the building blocks with which financial statements are constructed. They depict in words and numbers an entity's resources, claims to those resources, and the transactions and events that result in changes in those resources and claims.

1. Define ***"assets":***

   Probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.

2. Define ***"liabilities"***:

   Probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.

3. Define ***"equities"***:

   The residual interest in the assets of an entity that remains after deducting its liabilities. Also called **net assets**.

4. Give some examples of assets and liabilities that are not formally recognized in the financial statements and discuss their implications for *"representational faithfulness"*:

5. Some assets are recognized in the financial statements (e.g., organizational costs and goodwill) that probably will not yield future economic benefits. What implications does this have for *"representational faithfulness"*?

6. Define ***"Revenues"***:

Inflows or other enhancements of assets of an entity or settlement of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations.

7. Define ***"Gains"***:

Increases in equity (or net assets) from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity except those that result from revenues or investments by owners.

8. Why do accountants distinguish between *"revenues"* and *"gains"*?

9. Define ***"Expenses"***:

Outflows or other using up of assets or incurrences of liabilities (or a combination of both) from delivering or producing goods, rendering services, or carrying out other activities that constitute the entity's ongoing major or central operations.

10. Define ***"Losses"***:

Decreases in equity (net assets) from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity except those that result from expenses or distributions to owners.

11. Why do accounts distinguish between *"expenses"* and *"losses"*?

12. Define ***"Investments by Owners"***:

    Increases in equity of a particular business enterprise resulting from transfers to it from other entities of something valuable, to obtain or increase ownership interests (or equity) in it.

13. Define ***"Distributions to Owners"***:

    Decreases in equity of a particular business enterprise resulting from transferring assets, rendering services, or incurring liabilities by the enterprise to owners.

14. What is ***"Comprehensive Income"***?

    The total change in equity of a business enterprise during a period from transactions and other events and circumstances, except those involving distributions to or from owners.

    (We'll examine comprehensive income issues in more depth in Chapter 4.)

D. SFAC 5: Recognition and Measurement

1. Define ***"recognition"***:

   The process of formally recording or incorporating an item into the financial statements of an entity as an asset, liability, revenue, expense, or the like.

2. What are the four recognition criteria?

   An item and information about it should meet four fundamental recognition criteria to be recognized and should be recognized when the criteria are met, subject to a cost-benefit constraint and a materiality threshold:

   a. Definition: The item meets the definition of a financial statement element
   b. Measurability: The item is measurable
   c. Relevance
   d. Reliability

3. What two additional criteria must be met for revenue to be recognized?

   In addition to the four recognition criteria listed above, the item must also be (a) realized or realizable and (b) earned.

   Revenue is realized if it has already been converted into cash; it is realizable if it is probable that it will be converted into cash (e.g., accounts receivable). Revenue is earned if the seller has substantially fulfilled its obligations to the buyer.

4. What is ***"measurement"*** in financial accounting?

Quantification of financial statement elements in monetary units.

5. What are ***"measurement attributes"***?

These are the features of an element which accountants attempt to quantify.

6. Understand the five measurement attributes that are commonly used in financial reporting:

a. historical cost
b. current cost
c. current market value
d. net realizable value (settlement value)
e. present (or discounted) value of future cash flows.

Which of the above attributes do you believe is the most reliable?

Which of the above attributes do you believe is the most relevant?

7. What role do assumptions play in financial reporting?

Assumptions provide a pragmatic basis for establishing financial accounting and reporting standards, even if the assumptions do not perfectly specify their target phenomena.

8. Discuss the role of each of the following assumptions:

A. **Economic entity**:

All financial statement elements are defined in relation to a particular entity, which may be a business enterprise, an educational or charitable organization, a natural person, or the like.

B. **Continuity (going concern assumption)**:

The reporting entity is not expected to liquidate in the foreseeable future. It supports accounting accruals and deferrals.

C. **Monetary Unit**:

The monetary unit or measurement scale in financial statements currently is in nominal units of money, unadjusted for changes in purchasing power over time. It assumes price stability.

D. **Time period (periodicity)**:

For timeliness, entities report changes in their financial position over a series of short time periods (e.g., quarterly or annually).

9. PRINCIPLES provide guidelines for implementing particular financial accounting and reporting standards.

10. Describe the role of the following principles:

A. **Historical cost**:

This is the amount of cash (or its equivalent) paid or received in a transaction. While it has generally been favored over the other measurement attributes because of its reliability, it is gradually being replaced by other more relevant attributes such as fair value and discounted future cash flows.

B. **Revenue recognition** (what criteria must be satisfied for a revenue item to be recognized?):

This is worth repeating because we rely heavily on it in the chapter on revenue and expense recognition.

In addition to the four recognition criteria listed above, the item must also be (a) realized or realizable and (b) earned.

Revenue is realized if it has already been converted into cash; it is realizable if it is probable that it will be converted into cash (e.g., accounts receivable). Revenue is earned if the seller has substantially fulfilled its obligations to the buyer.

C. **Matching**:

Simultaneous or combined recognition of the revenues and expenses that result directly and jointly from the same transactions or other events.

Examples: Sales revenue is matched in the same period with bad debt expense, warranty expense, and depreciation expense.

D. **Full disclosure**:

All relevant information should be recognized or disclosed in the financial statements so that external users can make informed investment and credit decisions.

11. Various CONSTRAINTS modify whether and how particular items are recognized and disclosed. Describe each of the following constraints in financial reporting:

A. **Cost-benefit**:

The expected benefits from recognizing a particular item should justify the perceived costs of providing and using the information.

B. **Materiality**:

The magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement.

Comment on how the characteristics of an item, besides absolute dollar magnitude, can make an item material:

C. **Industry Practices**:

The unique nature of some industries sometimes requires departure from basic financial accounting theory. Industry practices also provide guidance when existing GAAP is lacking.

D. **Conservatism**:

A prudent reaction to uncertainty to try to ensure that uncertainty and risks inherent in business situations are adequately considered.

E. Other Concepts

1. Define and give examples of ***"accrual"***, ***"deferral"***, and ***"allocation"*** in financial reporting:

Accrual is concerned with expected future cash receipts and payments. It is the accounting process of recognizing elements based on the amounts expected to be received or paid, usually in cash, in the future.

> **Examples**: Bad debt expense is accrued before the specific customers' accounts are actually written off as uncollectible; revenues are accrued before cash is received.

Deferral is concerned with past cash receipts and payments. It is the accounting process of recognizing a liability from a current cash receipt (or the equivalent) or an asset resulting from a current cash payment (or the equivalent) with deferred recognition of revenues, expenses, gains, or losses.

> **Examples**: Cash received before a sale takes place is not recognized as revenue until the revenue is earned; cash paid for long-lived assets is recognized as depreciation expense in future years over the asset's expected useful life.

Allocation is the accounting process of assigning or distributing an amount according to a plan or formula. It includes amortization, which is the accounting process of reducing an amount by periodic payments or writedowns.

> **Example**: The historical cost of a long-lived asset is gradually recognized as expense, in a systematic fashion, over the expected life of the asset.

2. Consider the FASB definition of ***"bias in measurement"***: *"The tendency of a measure to fall more often on one side than the other of what it represents instead of being equally likely to fall on either side. Bias in accounting measures means a tendency to be consistently too high or too low."*

What implications do the historical cost principle and conservatism constraint have for bias (and representational faithfulness) in financial reporting?

3. Define ***"earnings"*** and compare it to ***"comprehensive income"***:

Earnings is a measure of performance for a period. It is concerned with the extent to which asset inflows exceed asset outflows associated, directly or indirectly, with completed operating cycles.

Comprehensive income is a measure of the total change in equity of a business enterprise during a period from transactions and other events and circumstances, except those involving distributions to and from owners.

Comprehensive income is therefore more inclusive than earnings. *SFAS* 130 sets forth the requirements of comprehensive income (see Chapter 4).

4. Financial reporting identifies, measures, and communicates information about the circumstances, events, and transactions that affect the reporting entity. Understand the following definitions:

A. **Circumstance**: A condition or set of conditions that develop from an event or a series of events, which may occur almost imperceptibly and may converge in random or unexpected ways to create situations that might otherwise not have occurred and might not have been anticipated. (see CON 6, par. 136)

B. **Event**: A happening or consequence to an entity. Events may be internal (e.g., using raw materials or equipment in production) or external (e.g., interaction of an entity with its environment, such as a transaction with another entity, a change in price of a good or service that an entity buys or sells, a flood or other catastrophic loss, or an improvement in technology by a competitor. (see CON 6, par. 135)

C. **Transaction**: A particular kind of external event involving transfer of something of value (future economic benefit) between two (or more) entities. The transaction may be reciprocal or nonreciprocal. (See CON 6, par. 137)