INTERMEDIATE ACCOUNTING

Chapter 2

Financial Reporting: Its Conceptual Framework

Objectives

1. Explain the FASB Conceptual Framework.
2. Explain the general and specific objectives of general purpose financial reporting.
3. Explain the qualitative characteristics of decision-useful information as identified in the FASB and IASB joint Conceptual Framework project.
4. Understand and apply the major principles and assumptions of financial reporting and U.S. GAAP.
5. Describe the financial reporting model in the FASB Conceptual Framework.
6. *(Appendix 2.1)* Understand the current status of the ongoing project by the FASB and IASB to develop a joint Conceptual Framework.

FASB Conceptual Framework

(Slide 1 of 2)

- The intent of FASB's Conceptual Framework is to establish a theoretical foundation of interrelated objectives, concepts, and definitions that leads to the establishment of consistent high-quality financial accounting standards in accounting practice, and the appropriate application of those standards in accounting practice.

FASB Conceptual Framework
(Slide 2 of 2)

- The Conceptual Framework is intended to:
  - Guide the FASB in establishing accounting standards
  - Provide a frame of reference for financial statement preparers and auditors for resolving accounting questions in situations where a standard does not exist
  - Establish objectives and conceptual guidelines that form the bounds for judgment in the preparation of financial statements
  - Increase users' understanding of and confidence in financial reporting
  - Enhance financial statement comparability across companies and over time

Accounting Principles

- Accounting principles are fundamental theories, truths and propositions that serve as the foundation for financial accounting and financial reporting.
- The most fundamental statements of these principles come from FASB's Statements of Financial Accounting Concepts
  - Also known as Concept Statements
- Generally broad and definitional

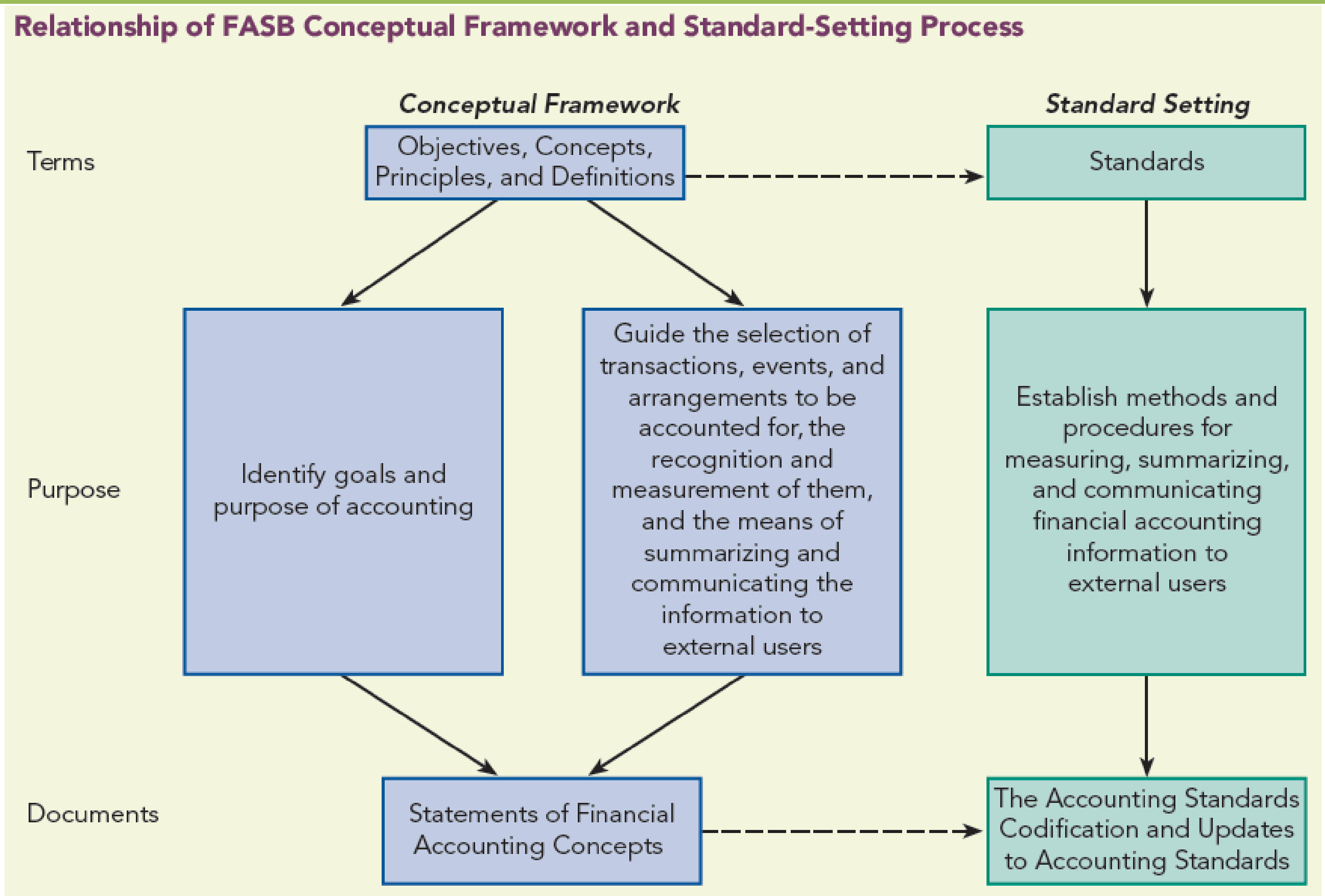
Accounting Concepts

- FASB's Statements of Financial Accounting Concepts are general proclamations that establish:
  - Fundamental principles of accounting
  - Objectives of financial reporting
  - Qualities of useful financial accounting information
  - Definitions of basic elements like assets and liabilities
  - Types of economic transactions, events, and arrangements to be recognized in financial statements
  - Measurement attributes to use to measure and report these transactions, events, and arrangements
  - How transactions, events, and arrangements should be presented and classified in financial statements
- Are the basis and objectives of GAAP

Accounting Standards

- Accounting standards
  - Establish the authoritative guidance on how companies should account for and report specific transactions, events, and arrangements in their financial statements.
  - Specific accounting standards in GAAP provide guidance on when and how to recognize and measure these elements in financial statements.
- Within accounting standards, rules exist, which are specific implementation procedures.

Relationship of Principles, Concepts, Standards, and Rules



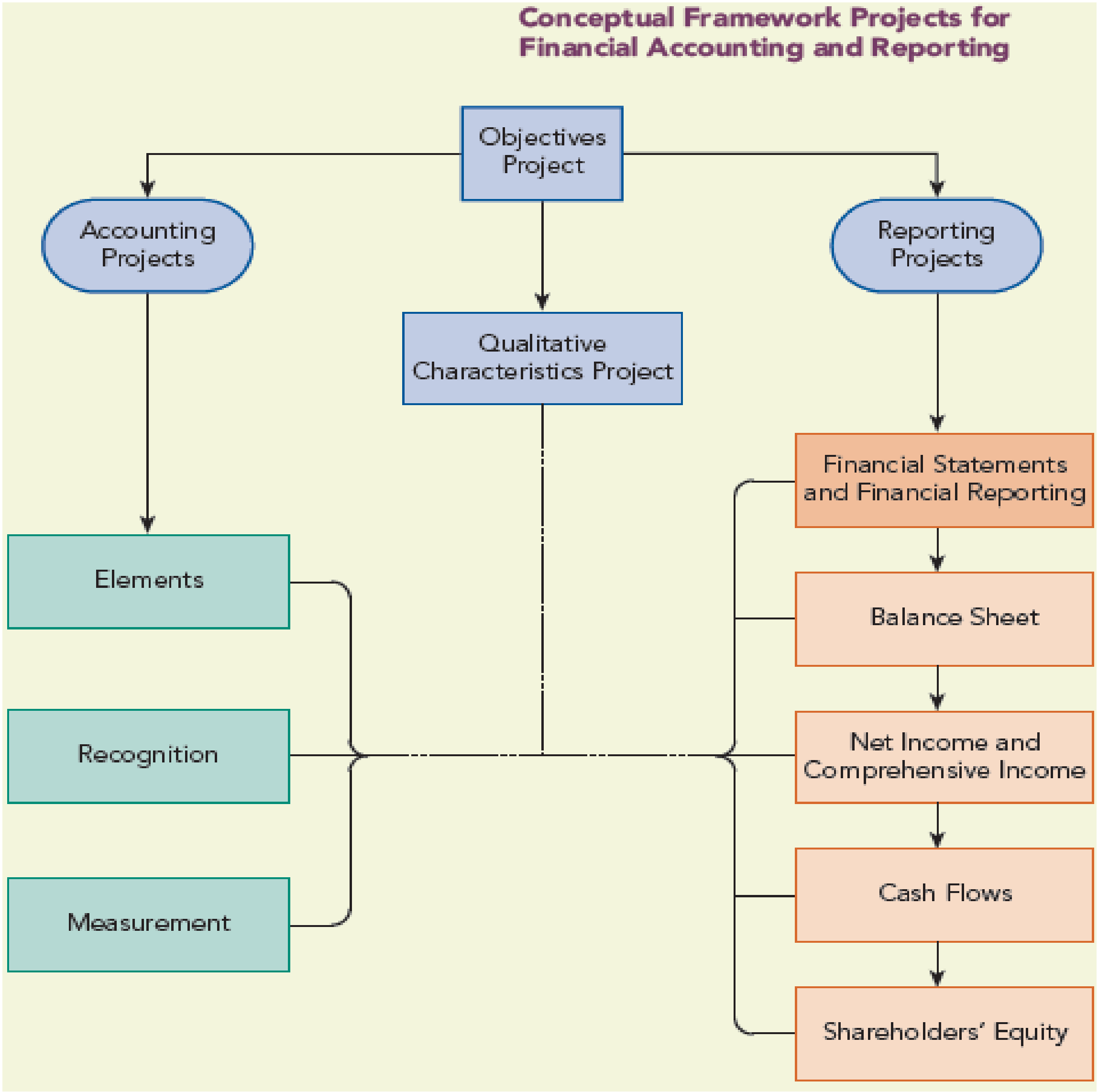
Conceptual Framework: Brief History

- *Statement of Financial Accounting Concepts No. 1* "Objectives of Financial Reporting by Business Enterprises" (1978)
  - Established primary objectives of financial accounting
- *Statement of Financial Accounting Concepts No. 2* "Qualitative Characteristics of Accounting Information" (1980)
  - Accounting projects define the accounting elements and identify which elements should be recognized in financial statements, when they should be reported, and how they should be measured.
  - Reporting projects deal with how elements of financial reports are classified and presented, what information should be provided, and where information should be presented.

Conceptual Framework: Current Status

- FASB and IASB are working closely together to develop a common Conceptual Framework.
- Goal is to develop standards that are objectives-based , internally consistent, and internationally converged.
- Eight phase process with one phase complete and three other phases in process
- *Statement of Financial Accounting Concepts No. 8* "Conceptual Framework for Financial Reporting" – 2010

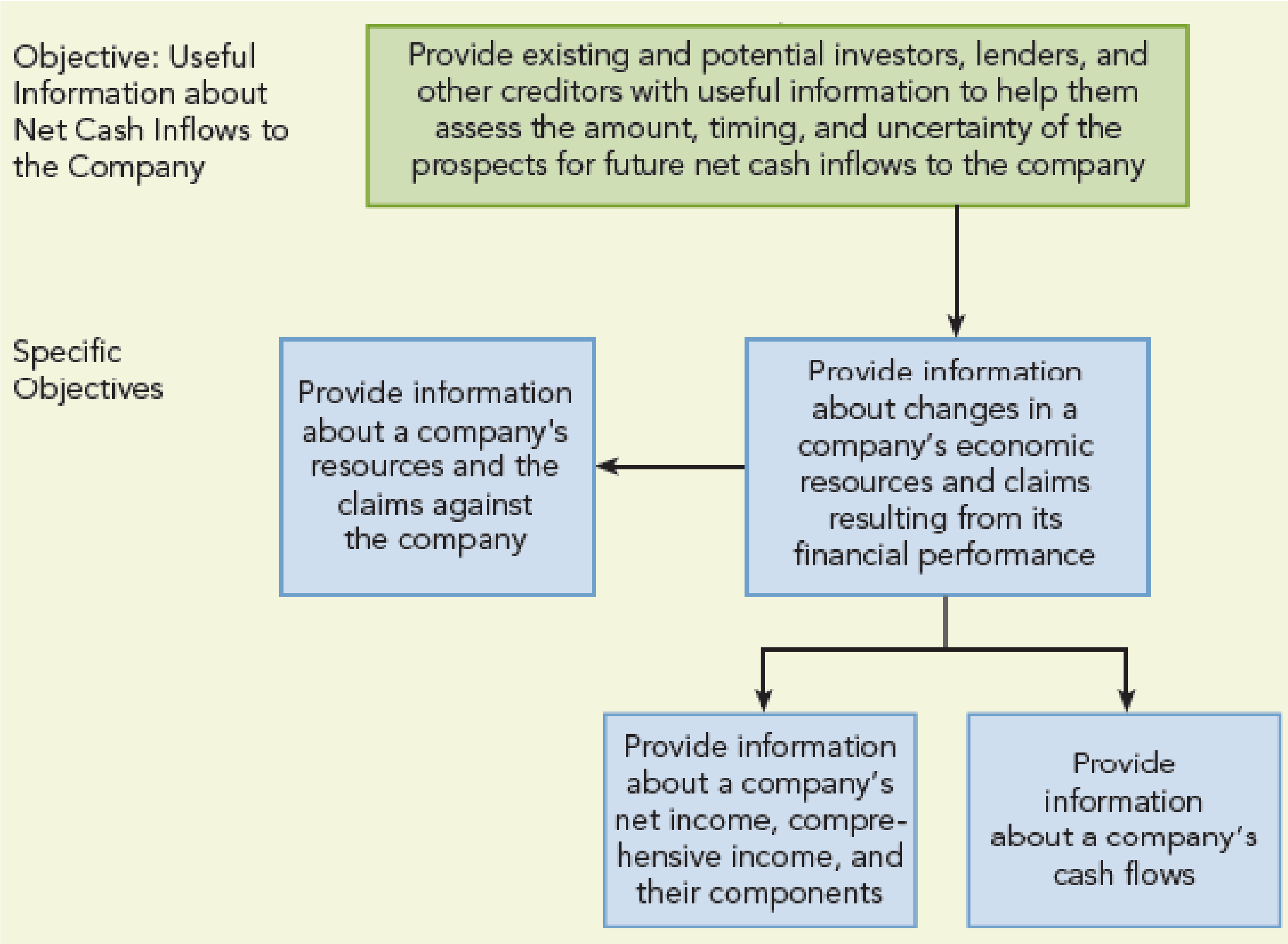
Conceptual Framework Projects



What are the Objectives of Financial Reporting? (Slide 1 of 2)

Primary Objective: Provide Useful Information	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
Objective: Useful Information for Expected Returns to Investors, Lenders, and Creditors	Provide useful information for: • Decisions by existing and potential investors about buying, selling, or holding equity instruments; such decisions depend on the returns that they expect from an investment in those instruments, such as dividends and market price increases, relative to the riskiness of those investments • Decisions by existing and potential lenders and other creditors about buying, selling, or holding debt instruments or providing or settling loans and other forms of credit; such decisions depend on the principal and interest payments or other returns that they expect, relative to the inherent risk of those debt instruments and loans
Objective: Useful Information about Net Cash Inflows to the Company	Provide existing and potential investors, lenders, and other creditors with useful information to help them assess the amount, timing, and uncertainty of the prospects for future net cash inflows to the company

What are the Objectives of Financial Reporting? (Slide 2 of 2)



Objective 1:
Information Useful in Decision Making

- Financial reporting should provide useful information about the reporting entity for:
  - Existing and potential investors – shareholders, equity fund managers, and analysts
  - Lenders – banks, lending institutions, bondholders, and credit rating agencies
  - Other creditors who make decisions about providing resources to the entity – suppliers, customers, and employees with claims

Objective 2: Information Useful to External Users in Assessing Expected Returns

- Information needs of investors, lenders, and other creditors
  - Suppliers of financial capital are primarily interested in the amounts, timing, and uncertainty of the prospective cash flows they will receive.
    - Need to assess the expected returns from buying, selling, or holding a company's equity, debt or other financial instruments
  - External users need financial information to form expectations about the timing and amount of prospective cash receipts and assess the risk involved.

Objective 3: Information Useful in Assessing Company Cash Flows

- Financial reporting should provide information to help external investors, lenders, and other creditors in assessing the amounts, timing and uncertainty of the prospective net cash inflows to the company.
  - Company's ability to generate net cash inflows determines both its ability to pay dividends and interest and the market prices of its securities.
  - These affect the cash flows to investors, lenders, and creditors.

Information about Economic Resources and Claims on the Company

- Financial reporting should provide information about a company's economic resources and the claims on the company.
- This information is useful to external users for the following reasons:
  - To identify the company's resources, obligations, financial strengths and weaknesses, and to assess its liquidity and solvency
  - To specify the types of resources in which the company has invested, as well as the types and timing on the claims of the company
  - To indicate the potential future cash flows from the company's resources and the ability of the resources to satisfy the claims on the company

Information about Financial Performance Changes in the Company's Resources and Claims

- Financial reporting should provide information about the financial performance which causes the company's resources and the claims on the company to change during the period.
- Information concerning the company's net income, comprehensive income, and their components is useful to external users in:
  - Evaluating management's performance
  - Estimating the company's "earning power" or other amounts that are representative of persistent long-term income-producing ability
  - Predicting future income and net cash flows
  - Assessing the risk of investing in or lending to the company

Accrual Accounting

- Accrual accounting measures and reports the economic effects of a company's transactions, events, and circumstances on a company's economic resources and claims in the period in which those effects occur, even if the related cash receipts and payments occur in a different period.
  - Provides a better basis for assessing the company's past and future performance than information solely about cash receipts and payments.

Information about Cash Flow Changes in the Company’s Resources and Claims

- Financial reporting should provide information about how a company’s cash flows cause changes in the company’s resources and claims.
- Cash flow information shows how a company obtains and spends cash for its operating, investing, and financing activities.
- Investors, lenders, and other creditors use cash flow information about a company to:
  - Help understand its operations and its cash-generating ability
  - Evaluate its strategic sourcing and use of cash for financing and investing activities
  - Assess its liquidity and solvency
  - Interpret other information about financial performance

Information about Management and the Governing Board as they Relate to Resources

- Financial reporting should provide information about how efficiently and effectively the company's management and governing board have discharged their responsibilities to use the company's resources.
  - Referred to as management's stewardship responsibility
    - Management is responsible to the owners for:
      - The custody and safekeeping of the resources
      - Their efficient and profitable use
      - Their protection against unfavorable economic impacts, technological advances, and social changes
- *Provided in Statement of Financial Accounting Concepts No. 8*

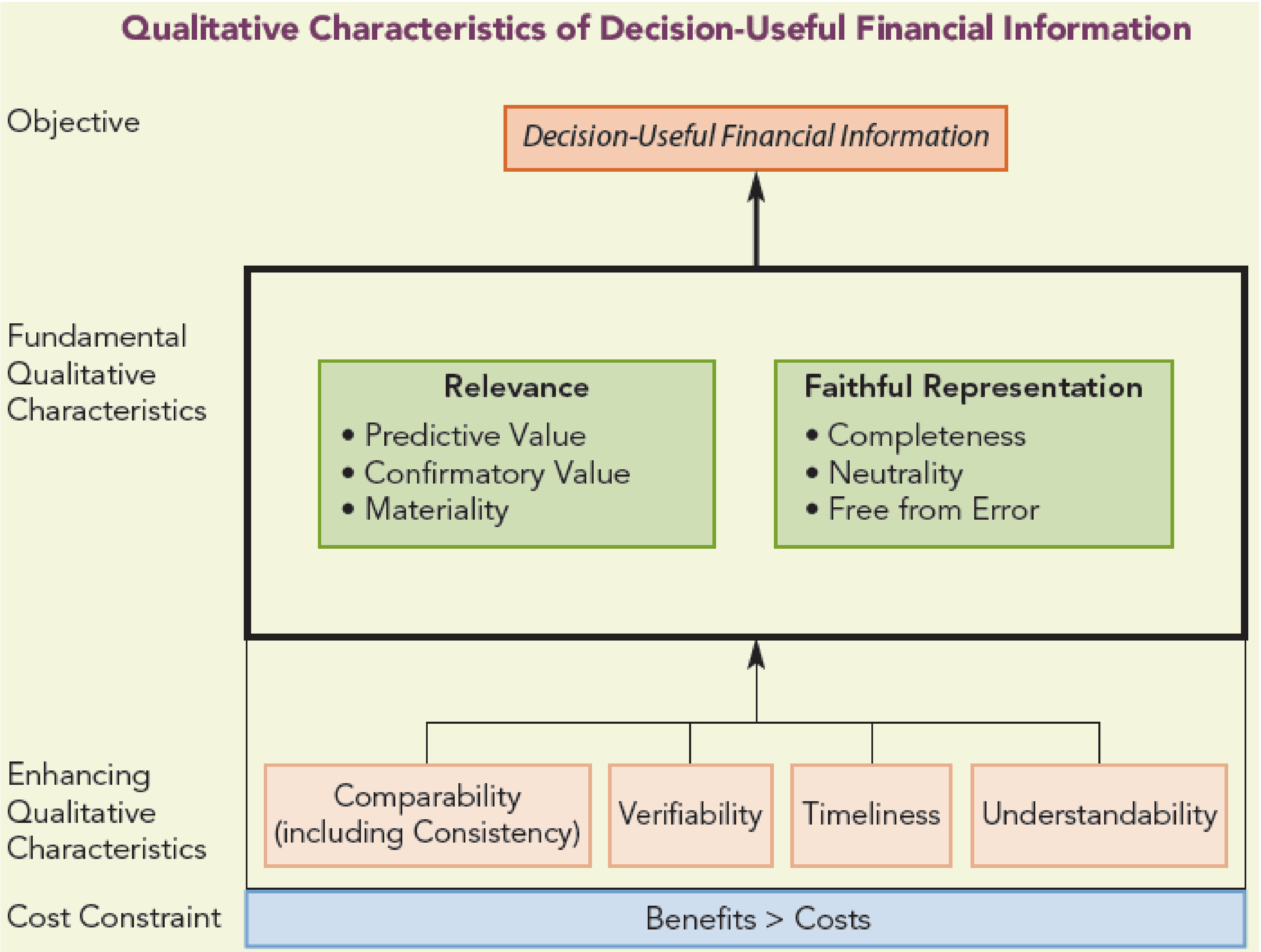
Types of Useful Information for Investors, Lenders, and Other Creditors

- The following types of information are helpful in assessing the amounts, timing, and uncertainty of expected future cash flows to a company:
  - Return on investment – measure of overall company performance for equity shareholders
  - Risk – the uncertainty or unpredictability of future profitability of a company
  - Financial flexibility – the ability of a company to use its financial resources to adapt to change and to take advantage of opportunities
  - Liquidity – refers to how quickly a company can convert its assets into cash to meet short-term obligations and cover operating costs
  - Operating capability – refers to the ability of a company to produce goods and services for customers

What Qualities Make Accounting Information Useful?

- Decision-useful information
  - Defined by the joint Conceptual Framework in terms of fundamental qualitative characteristics and enhancing qualitative characteristics
- Qualitative characteristics guide standard setters and financial statement preparers when choosing among accounting alternatives
  - Qualities distinguish more-useful from less-useful information.

Qualitative Characteristics



Decision Usefulness

- Decision usefulness is the ultimate objective of accounting information.
  - It can be achieved if the information has a sufficient degree of the fundamental characteristics of relevance and faithful representation.

Relevance

- Relevance – information that is capable of making a difference in decisions made by financial statement users
  - Predictive Value – information that should help users form expectations about the future
  - Confirmatory Value – information that provides feedback to confirm or correct prior predictions and expectations
  - Materiality – refers to the nature and magnitude of an omission or misstatement of accounting information that would influence the judgment of a reasonable person relying on that information

Faithful Representation

- **Faithful representation** – when the words and numbers accurately predict the economic substance of what they purport to represent
  - **Complete representation** – provides a user with full disclosure of all information necessary to understand the information being reported, with all necessary facts, descriptions, and explanations
  - **Neutral representation** – not biased, slanted, emphasized or otherwise manipulated to achieve a predetermined result or to influence users' behavior in a particular direction
  - **Free from error** – the information is measured and described as accurately as possible, using a process that reflects the best available inputs

The Relation between Relevance and Faithful Representation

- Accounting information is most useful when it is both relevant and faithfully represented.
- Both characteristics should be maximized.
  - To provide users with the most decision-useful information possible

Process of Applying Fundamental Qualitative Characteristics

Step 1 – Identify an economic transaction, event, or arrangement that needs to be recognized in the financial statements.

Step 2 – Identify the type of information about that phenomenon that would be most relevant – material and capable of making a difference in decision makers' predictions of future outcomes/or confirmations of past predictions.

Step 3 – Determine whether that information can be faithfully represented in a manner that is complete, neutral, and free from error.

Step 4 – Determine whether the benefits of that information are likely to exceed its cost. What are the possible outcomes?

Enhancing Characteristics

(Slide 1 of 2)

- **Comparability** – enables users of accounting information to identify and explain similarities and differences between two or more sets of economic facts
  - **Consistency** – means that accounting methods and procedures are applied in the same manner from period to period
- **Verifiability** – accounting information is verifiable when different knowledgeable and independent observers can reach consensus that a particular representation is faithful

Enhancing Characteristics
(Slide 2 of 2)

- Timeliness – accounting information is timely when it is available to decision makers in time to influence their decisions
- Understandability – the accounting information should be comprehensible to users who have a reasonable knowledge of business and economic activities and who are willing to study the information carefully

What single, pervasive constraint bounds the qualitative characteristics of the financial information disclosed in a company's financial reports?

Cost Constraint: Benefit > Costs

Accounting Assumptions and Principles

- Certain accounting assumptions and principles have had an important impact on the development of GAAP:
  - Reporting Entity or Economic Entity Assumption
  - Going Concern Assumption
  - Period-of-Time Assumption
  - Monetary Unit Assumption
  - Mixed Attribute Measurement Model
  - Recognition
  - Accrual Accounting
  - Conservatism

Reporting Entity or Economic Entity Assumption

- This assumption states that a business enterprise is a legally and economically distinct entity so that financial statements can be prepared and reported specifically for that entity.
- For the purposes of financial accounting, the size of a business is irrelevant.
  - May vary from sole proprietorships to multi-national corporations with subsidiary companies

What differences may exist between these types of companies when reporting financial information?

Going Concern or Continuity Assumption

- The assumption is that the company will continue to operate in the foreseeable future.
- Without substantial evidence to the contrary, the company can be reasonably expected to operate long enough to realize economic benefits from its assets and satisfy its existing obligations.

Do companies that appear to be going bankrupt meet the going concern assumption? Why or why not?

Period-of-Time Assumption

- The period-of-time assumption requires that financial statement users prepare and report financial statements in an annual report with the SEC.
  - Provides timely information to decision makers
- The annual reporting period is often referred to as the accounting period or fiscal year which may or may not mirror the calendar year.
- Some companies choose a fiscal year that more closely approximates their annual business cycle, which is the yearly period from lowest sales through highest sales and back to lowest sales.

Monetary Unit Assumption

- Accountants generally use the national currency of the reporting entity as the monetary unit of measure in preparing financial statements.

Is the United States dollar considered to be a stable monetary unit for preparing a company's financial statements? Why or why not?

Mixed Attribute Measurement Model

(Slide 1 of 2)

- This model seeks to measure assets, liabilities, revenues, expenses, and other elements of the financial statements with the most relevant and faithful measurement available.
- What types of measurements would be included?
  - Historical costs
  - Allocated historical costs
  - Fair values
  - Present values of future cash flows
  - Net realizable values

Mixed Attribute Measurement Model

(Slide 2 of 2)

- The economic activities and resources of a company initially are measured using the exchange price or historical cost at the time each transaction occurs.
  - This cost is the most relevant and faithful representation of the value of the exchange.
  - The historical cost provides evidence that independent parties have willingly agreed on the value of the items exchanged at the time of the transaction.
  - What are the qualities of historical cost?
    - Relevance
    - Representational faithfulness (Neutrality)
    - Verifiability
- What are the differences between historical cost and fair value?

Recognition

- Recognition is the process of formally recording and reporting an item in the financial statements of a company.
- A recognized item is shown in both words and numbers, with the amount included in the financial statement totals.
- To be recognized, an item must:
  - Meet the definition of an element (asset, liability, etc.)
  - Be measurable
  - Be relevant
  - Be representationally faithful

Accrual Accounting

- Accrual accounting is the process of measuring and reporting the economic effects of transactions, events, and arrangements in the period when those effects occur, even though cash flows may occur in a different period.
  - Accruals – when economic effects are recognized in the current period even though the cash flows will occur in a later period
  - Deferrals – when cash flows occur in the current period but economic effects will be recognized in a later period
- What are some examples of accruals and deferrals?

Principles of Accrual Accounting

- The Revenue Recognition Principle – determines the appropriate period in which a company creates economic benefits and can recognize revenues in income
- The Expense Recognition Principle – determines the appropriate period in which a company has consumed economic resources in conducting business operations
- The Matching Principle – matches the expense to the period in which the economic benefits are consumed by generating revenues

Conservatism

- Conservatism is an approach that accountants use to avoid overstating net assets and net income when these amounts are uncertain.
  - Results in the reporting of lower assets values or higher liability values when those values are uncertain
- Conservatism is a practical approach accountants take to avoid misleading investors, lenders, and other creditors when valuations are uncertain.
- What is another name for conservatism?
  - Prudence – conservatism is a prudent reaction to uncertainty to ensure, to the extent possible, that the uncertainties and risks inherent in the business situations are adequately considered.

Sources of Information Used in External Decision Making

All Information Useful for Investment, Credit, and Similar Decisions

Financial Reporting

Area Directly Affected by Existing FASB Standards

Basic Financial Statements

Specific Statements

Financial Statements

- Statement of Financial Position Statements of Net
- Income and Com-prehensive Income Statement of Cash Flows
- Statement of Shareholders' Equity

Notes to Financial Statements (and Parenthetical Disclosures)

Examples:

- Accounting Policies
- Contingencies
- Inventory Methods
- Number of Shares of Stock Outstanding

Supplementary Information

Examples:

- Changing Prices Disclosures *(FASB ASC 255)*
- Oil and Gas Reserves Information *(FASB ASC 932)*

Other Means of Financial Reporting

Examples:

- Management Discussion and Analysis
- Letter to Shareholders

Other Information

Examples:

- Analyst Reports
- Economic Statistics
- News Articles about Company

Status of the Joint FASB and IASB Conceptual Framework

- This project is split into eight phases:
  - 1 – Objective and qualitative characteristics
  - 2 – Elements and recognition
  - 3 – Measurement
  - 4 – Reporting entity
  - 5 – Presentation and disclosure
  - 6 – Framework for a GAAP hierarchy
  - 7 – Applicability to the not-for-profit sector
  - 8 – Remaining issues
- Each phase will involve extensive planning, research, and deliberations.

Phase One: Objective and Qualitative Characteristics

- Phase 1 is complete and resulted in the FASB and IASB jointly issuing:
  - *Statement of Financial Accounting Concepts No. 8* - "Conceptual Framework for Financial Reporting"
    - Chapter 1 – "The Objective of General Purpose Financial Reporting"
    - Chapter 2 – "Qualitative Characteristics of Useful Financial Information"
- These chapters supersede FASB Concepts Statements No. 1 and No. 2.

Ongoing Phases

- The Boards have temporarily placed the Conceptual Framework on hold while they focus on finalizing convergence on several major specific standards.
- Three other active phases were put on hold.
  - Phase Two: Elements and Recognition – exploring potential ways to refine and improve definitions of assets and liabilities
  - Phase Three: Measurement – evaluating various measurement techniques for assets and liabilities that satisfy the objective and qualitative characteristics
  - Phase Four: Reporting Entity – working on refining the definition of a reporting entity and the appropriate presentation in financial statements for a group entity