CHAPTER 2

Case 2-1

a. The FASB's conceptual framework study should provide benefits to the accounting community such as:

1. Guiding the FASB in establishing accounting standards on a consistent basis.
2. Determining bounds for judgment in preparing financial statements by prescribing the nature, functions, and limits of financial accounting and reporting.
3. Increasing users understanding of and confidence in financial reporting.

b. The two fundamental qualities that make accounting information useful for decision making are *relevance* and *faithful representation*.
Relevant financial information is capable of making a difference in the decisions made by users. Financial information is capable of making a difference in decisions if it has predictive value and confirmatory value and is material. Financial information has predictive value if it can be used as an input to processes employed by users to predict future outcomes. Financial information has confirmatory value if it provides feedback (confirms or changes) about previous evaluations. Information is material if omitting it or misstating it could influence decisions that users make on the basis of the financial information of a specific reporting entity. In other words, materiality is an entity-specific aspect of relevance based on the nature or magnitude or both of the items to which the information relates in the context of an individual entity's financial report. Consequently, the FASB was not able to specify a uniform quantitative threshold for materiality or predetermine what could be material in a particular situation.

Financial reports represent economic phenomena in words and numbers. To be useful, financial information not only must represent relevant phenomena but also must faithfully represent the phenomena that it purports to represent. A perfectly faithful representation has three characteristics: *completeness, neutrality,* and *free from error*. Although perfection is difficult or even impossible to achieve, the objective is to maximize those qualities to the extent possible.
A complete depiction should include all information necessary for a user to understand the phenomenon being depicted. For some items, a complete depiction also might entail explanations of significant facts about the quality and nature of the items, factors, and circumstances that might affect their quality and nature and the process used to determine the numerical depiction. A neutral depiction is without bias in the selection or presentation of financial information. A neutral depiction is not slanted, weighted, emphasized, deemphasized, or otherwise manipulated to increase the probability that financial information will be received favorably or unfavorably by users. Neutral information does not mean information with no purpose or no influence on behavior. On the contrary, relevant financial information is, by definition, capable of making a difference in users' decisions. Free from error means there are no errors or omissions in the description of the phenomenon, and the process used to produce the reported information has been selected and applied with no errors in the process. Information that is free from error will result in a more faithful representation of financial results.

Comparability, verifiability, timeliness, and *understandability* are the qualitative characteristics that enhance the usefulness of information that is relevant and faithfully represented. Comparability is the qualitative characteristic that enables users to identify and understand similarities in, and differences among, items. Consistency refers to the use of the same methods for the same items, either from period to period within a reporting entity or in a single period across entities. Comparability is the goal; consistency helps to achieve that goal.

Verifiability helps assure users that information faithfully represents the economic phenomena it purports to represent. Verifiability means that different knowledgeable and independent observers could reach consensus, although not necessarily complete agreement, that a particular depiction is a faithful representation. Quantified information need not be a single point estimate to be verifiable. A range of possible amounts and the related probabilities also can be verified.

Timeliness means having information available to decision makers in time to be capable of influencing their decisions. Generally, the older the information is, the less useful it is. However, some information can continue to be timely long after the end of a reporting period because, for example, some users might need to identify and assess trends. Understandability involves classifying, characterizing, and presenting information clearly and concisely.

Case 2-2.

a. i. The Conceptual Framework Project is an attempt by the FASB to develop concepts useful in guiding the board in establishing standards and in providing a frame of reference for resolving accounting issues. Over the years this project first attempted to develop principles or broad qualitative standards to permit the making of systematic rational choices among alternative methods of financial reporting. Subsequently the project focused on how well these overall objectives could be achieved. The FASB has stated that it intends the Conceptual Framework Project to be viewed not as a package of solutions to problems but rather as a common basis for identifying and discussing issues, for asking relevant questions, and for suggesting avenues for research. The Conceptual Framework Project has resulted in the issuance of eight statements of Financial Accounting Concepts that impact upon financial accounting: No.1-Objectives of Financial Reporting by Business Enterprises (superseded); No.2-Qualitative Characteristics of Accounting Information (Superseded); No.3-Elements of Financial Statements of Business Enterprises (Superseded); No.5-Recognition and Measurement in Financial Statements of Business Enterprises; No.6-Elements of Financial Statements;" No. 7-"Using Cash Flow Information and Present Value in Accounting Measurements" and No. 8 "Conceptual Framework for Financial Reporting (Chapters 1 & 3).

ii. The FASB has been criticized for failing to provide timely guidance on emerging implementation and practice problems. During 1984 the FASB attempted to respond to this criticism by (1) establishing a task force to assist in identifying issues and problems that might require action, the Emerging Issues Task Force, and (2) expanding the scope of the FASB Technical Bulletins in an effort to offer quicker guidance on a wider variety of issues.

Emerging issues arise because of new types of transactions, variations in accounting for existing types of transactions, new types of securities, and new products and services. They frequently involve the company's desire to achieve "off balance sheet" financing or "off income statement" accounting.
The Emerging Issues Task Force was formed to assist the FASB in issuing timely guidance on these emerging issues. That is, the task force's responsibility is to identify emerging issues as they develop, investigate and review them, and finally to advise the board whether the issue merits its attention.

The members of the task force all occupy positions that make them aware of emerging issues. The current members include the directors of accounting and auditing from 11 public accounting firms (including all of the "Big Four"), two representatives from the Financial Executives Institute, one from the National Association of Accountants and the Business Roundtable, and the FASB's Director of Research who serves as Chairman.

b. The Financial Accounting Standards Board, the Securities and Exchange Commission, and the American Institute of Certified Public Accountants have been criticized for imposing too many accounting standards on the business community. The Standards overload problem has been particularly burdensome on small businesses that do not have the necessary economic resources to research and apply all of the pronouncements issued by these sources Those who contend that there is a standards overload problem base their arguments on two allegations.

1. Not all GAAP requirements arc relevant to small business financial reporting needs.

2. Even when they are relevant, they frequently violate the pervasive cost benefit constraint.

Critics of the standard-setting process for small business also assert that GAAP were developed primary to serve the needs of the securities market. Many small businesses do not raise capital in these markets therefore, it is contended that GAAP were not developed with small business needs in mind.

Some of the consequences of the standards overload problem to small business are as follows.

1. If a small business omits a GAAP requirement from audited financial statements, a qualified or adverse opinion may be rendered.

2. The cost of complying with GAAP requirements may cause a small business to forgo the development of other, more relevant information.

3. Small CPA firms that audit smaller companies must keep up to date on all of the same requirements as large international firms, but cannot afford the specialists that are available on a centralized basis in the large firms.

Many accountants have argued for differential disclosure standards as a solution to the standards overload problem. That is, standards might be divided into two groups. One group would apply to business regardless of size. The second group would be applied selectively only to large businesses, small businesses, or particular industries. For example, the disclosure of significant accounting policies would pertain to all businesses, whereas a differential disclosure such as earnings per share would be applicable only to large businesses.

Case 2-3

b. Quantitative data are helpful in making rational economic decisions. Stated differently, quantitative data aid the decision maker in making choices among alternatives, so that the actions are correctly related to consequences.

c. i. ASOBAT defined accounting as "the process of identifying, measuring, and communicating economic information to permit informed judgments and decision by users of the information." Both this definition and Sprouse and Moonitz believe that communicating information is helpful for users to make rational decisions and informed judgments'.

ii. Similarly, *SFAC No. 8* states that accounting information should be useful for investment decision-making. The user should be able to use accounting information to make decisions about investing in a company.

Case 2-4

a. In describing continuity, Sprouse and Moonitz stated that in the absence of evidence to the contrary, the entity should be viewed as remaining in operation indefinitely. In the presence of evidence that the entity has a limited life, it should not be viewed as remaining in operation indefinitely.

b. No. Since a business is presumed to continue indefinitely, the value relevant to a purchaser is fair market value. This value measures the present value of future cash flows to the buyer. It is relevant for the buyer because the buyer presumes that the business will continue and thus will generate those future cash flows.

c. No. A bankruptcy provides evidence that the business is not expected to remain in operation indefinitely. In this case, the assets that are reported in the company's balance sheet should be measured at net realizable value.

Case 2-5

a. *SFAC No. 6* defines assets as "probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events." If your company is using a building to produce automobiles, the probable future economic benefit is the expected inflow of resources from the sales of automobiles. This benefit accrues to the company who may then use them, if it wishes, to make more automobiles. The prior transaction that caused the asset to exist is the acquisition of the building.

b. In this case, the probable future economic benefit is the net realizable value that the company will receive when it sells the building. Again, the acquisition of the building is the result of a prior transaction or event.

c. In this case, the probable future economic benefit is the inflow of resources that will eventually flow into the company when it produces the automobiles. The transaction that caused the asset to exist was the acquisition of the building.

Case 2-6

a. Employees meet the definition of an asset. An asset has three essential characteristics: (a) it embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows, (b) a particular entity can obtain the benefit and control others' access to it, and (c) the transaction or other event giving rise to the entity's right to or control of the benefit has already occurred. Employees embody a probable future benefit that will contribute to future net cash flows. They will work so that the company can have revenues. The company will benefit because they control what the employees do on the job. Employment of the employees gave rise to the entity's right to control the benefit.

b. No. According to *SFAC No. 5*, to report an asset in the balance sheet, it not only must meet the definition of an asset, but it must be capable of being measured.

c. i. The value would be more relevant because it would measure the expected future cash flows that the employees would be expected to generate. It would be less reliable because there is no precise method to measure the value of human capital. It can only be estimated. Therefore two measurements made by two different measurers are unlikely to be the same.

ii. Yes. Representational faithfulness means that the items in the balance reflect what they purport to be. If human capital is an asset then reporting its estimated value would reflect the value of that asset and would as a result provide representational faithfulness.

Case 2-7

a. According to *SFAC No. 7* the bonds are distinguished by the uncertainty of their future cash flows. The bonds would sell at the present value of their future cash flows, discounted at the market rate of interest. The company with the better credit rating would yield a lower market rate, assuming that the stated rates for both companies are the same. So, if the stated rates are the same, Company A's bond might be more valuable it its credit rating were better than Company B's.

b. If both companies have the same credit rating, then the one reason that Company A's bond would have a higher market value than would Company B's bond would be that Company A's bond has a shorter term than Company B's bond. If they both have the same term, then Company A's bond would sell for more than Company B's bond if Company A were offering a higher stated interest rate.

FASB ASC

FASB ASC 2-1 Use of Present Value

The information on present value is contained in the FASB ASC at FASB ASC 820-10-55. It can be accessed through the glossary.

FASB ASC 2-2

Search conceptual framework

Found under 605 Revenue Recognition
10 Overall
S99 SEC Materials

FASB ASC 2-3

Search decision maker

10 hits

FASB ASC 2-4

Search understandability

Found under 715 compensation—Retirement Benefits > 10 Overall > 10 Objectives

FASB ASC 2-5

Search relevance – 15 hits

FASB ASC 2-6

Search recognition and measurement-over 70 hits

FASB ASC 2-7

Reporting Comprehensive Income is contained in sections FASB ASC 220-10. It is found by searching comprehensive income.

FASB ASC 2-8

Search present value-over 100 hits

Room for Debate

Debate 2-1

Team 1: Arguments for capitalization of boxes.

1. Objectives of financial reporting

   Decision usefulness requires that companies report the status of enterprise resources. The boxes provide future service potential. As such, they meet the definition of an asset found in SFAC No. 6. Hence, they are a resource that should be reported.

2. Definition of assets

   SFAC No. 6 defines assets as probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.

   The boxes are assets. They will provide future economic benefits for a particular entity (Roper Co). The company will use them for at least 10 years. They result from past transaction - a purchase.

3. Qualitative Characteristics

   Relevance

   Capitalization is relevant because it provides information about outcomes of past transactions or events. The user is informed that the boxes are assets. They were purchased by the company, and the company intends to use them over an extended period of time. Hence their cost is not a current period expense.

   Faithfull Representation

   Capitalization provides reliability. Because the boxes will be used over an extended period of time, they meet the definition of an asset found in SFAC No. 6. Hence, capitalization presents the economic facts and provides information that is representationally faithful. If they are assets, they should be reported as such, rather than expensed, a representation that would not report them as they purport to be. Also, capitalization of the cost would be neutral because it would provide an unbiased representation of the economic substance of the purchase transaction.

Team 2 Arguments against the capitalization of the boxes.

1. Materiality

   Materiality is the threshold for recognition. When the dollar amount is small, the particular accounting treatment will not affect the decisions of an informed user. In this case, the cost of boxes is clearly immaterial, implying that they need not be capitalized as assets.

2. Cost Constraint

   The benefits derived from capitalization should exceed the cost of capitalization. Since the cost of the boxes is not material, capitalization would not provide sufficient benefit, in terms of decision usefulness, to warrant this accounting treatment. Capitalization would require depreciation over the useful life of the boxes. This would require adjusting entries for a ten-year period. The amount of depreciation reported each period would be trivial and would have essentially no effect on earnings. Hence, the cost of the bookkeeping effort would be greater than the benefits, if any, derived.

3. Objectives of financial reporting

The primary objective of financial reporting is decision usefulness. Accounting information should provide information that is useful to investors, creditors and other users in making decisions regarding investing, lending, etc. This implies that accounting information is relevant to the decision-maker. Even though the boxes will last 10 years, the cost is immaterial and hence irrelevant.

4. Qualitative Characteristics of accounting information

Relevance

As stated above, relevance means that the information provided will make a difference in the decisions of investors, creditors and other users. The expenditure is immaterial and as such, the accounting treatment is irrelevant, and capitalization is irrelevant.

Debate 2-2 The need for a universally accepted theory of accounting

Team 1:

A universally accepted theory of accounting is needed for the development of internally consistent accounting principles. Accounting practices have developed in response to changing economic conditions and, in some cases, in response to what are perceived as crises. For example, SFAS No. 114, was prompted to inconsistent practices of reporting impaired loans, and SFAS No. 94 was prompted by off-balance sheet recognition of lease liabilities. This piece-meal, reactionary approach to accounting has resulted in standards that are not only internally inconsistent, but are also inconsistent with international standards.

A theory of accounting would provide a common basis for identifying and discussing issues. This is the goal of the FASB's conceptual framework project. Such a theory could be used to help narrow the number of accounting choices currently available to management, thereby reducing management's ability to manipulate financial statements to suit their personal, or company goals. As such, it could help guide the development of neutral standards, which aids in the allocation of scarce resources and the efficient functioning of capital markets

In addition to helping reduce managerial bias in reporting results of operations and financial position, a universally accepted theory of accounting could serve to reduce personal biases in the standard setting process itself. Reliance on such a theory could result in the development of those standards that are consistent with the theory itself.

A universal theory of accounting would be consistent with the concepts-based approach to accounting standards described by the American Accounting Association. A universally accepted accounting theory could provide a basis for standard setting that would satisfy the following.

1. Economic substance, not the form, of a given transaction should guide its *financial* reporting.

2. The mapping between economic substance of a transaction and its financial statement representation could be supported by a common theoretical basis, thereby providing understandability and a common basis of comparison across companies and over time.

Team 2:

To date, no standard setting body has developed a universally accepted theory of accounting. An argument against a universal theory of accounting can be based on the complexity of the phenomena that financial statements purport to represent. According to *SATTA*, while there has been general agreement that the purpose of financial accounting is to provide economic data about accounting entities, divergent theories have emerged because of the way different theorists specified users of accounting data and the environment. For example, *users* might be defined either as the owners of the accounting entity or more broadly to include creditors, employees, regulatory agencies, and the general public. Similarly, the environment might be specified as a single source of information or as one of several sources of financial information.

SATTA discussed why none of the approaches to theory had gained general acceptance, *SATTA* raised six issues.

1. *The problem with relating theory to practice*. The real world is much more complex than the world specified in most accounting theories. For example, most theory descriptions begin with unrealistic assumptions such as holding several variables constant.

2. *Allocation problem*. Allocation is an arbitrary process. For example, the definition of depreciation as a *rational* and *systematic* method of allocation has led to a variety of interpretations of these terms.

3. *The difficulty with normative standards.* Normative standards are desired states; however, different users of accounting information have different desired states. As a result, no set of standards can satisfy all users.

4. *The difficulties in interpreting security price behavior research*. Market studies (such as the efficient market studies discussed in Chapter 4) attempt to determine how users employ accounting numbers. These studies have attempted to control for all variables except the one of interest, but there have been disagreements over whether their research designs have actually accomplished this goal.

5. *The problem cost-benefit considerations accounting theories*. A basic assumption of accounting is that the benefits derived from adopting a particular accounting alternative exceed its costs. However, most existing theories do no indicate how to measure benefits and costs.

6. *Limitations of data expansion*. At the time *SATTA* was published, a view was emerging that more information is preferable than less. Subsequent research has indicated that users have a limited ability to process accounting information. (The issue of information processing is discussed in Chapter 4.)

The FASB's conceptual framework project (CPF) cannot be viewed as a universally accepted theory of accounting, nor does the FASB purport that it is. The FASB intends the CFP to be viewed not as a package of solutions to problems but rather as a common

basis for identifying and discussing issues. For example, *SFAC Nos. 1* and *2* can be described as the goals to guide practice. It does not even directly affect practice. Rather, the *SFAC*s affect practice only by means of their influence on the development of new accounting standards.
So, rather than a universally accepted theory of accounting, we have settled for the CFP, which does not provide all the answers, but has been relied upon to aid the standard-setting process. And, it has provided a basis to narrow alternatives and to eliminate those that are inconsistent with it. It also is used to guide the development of neutral standards, which aids in the allocation of scarce resources and the efficient function of capital markets
In other words we can operate with concept-based accounting standards by relying upon the CFP rather than a universally accepted theory of accounting. The CFP has been criticized and will evolve to address criticism from the SEC that the objectives of the standards that are derived from it need to be more clearly defined, implementation guidance needs to be improved, scope exceptions need to be reduced and the asset-liability approach to standard setting should be retained

WWW

Case 2-8

The conceptual framework contains three levels. The apex, the first level, identifies the **objective of financial reporting** —that is, the purpose of financial reporting. The second level outlines the fundamentals, which are the **qualitative characteristics** that make accounting information useful, and the **elements of financial statements** (assets, liabilities, and so on). The third level identifies the implementation guidelines of **recognition, measurement, and disclosure** used in establishing and applying accounting standards and the specific concepts to put into practice the objective. These guidelines include the assumptions, principles, and constraints that describe the present reporting environment.

Case 2-9

The qualitative characteristics of accounting information are:

Primary Users
The primary users of financial information are existing or potential investors, lenders, and other creditors, that is, its capital providers.

Cost Constraint
Cost is described in *SFAC No. 8* as a pervasive constraint on the information that can be provided by financial reporting. The measurement, summarization, and reporting of financial information imposes costs, and it is important that those costs are justified by the benefits of reporting that information.

Qualitative Characteristics
The qualitative characteristics are described in Chapter 3 of SFAC *No. 8* and distinguish between better (more useful) information and inferior (less useful) information. These qualitative characteristics are either fundamental or enhancing characteristics, depending on how they affect the decision usefulness of information. The two fundamental qualities

that make accounting information useful for decision making are *relevance* and *faithful representation.*

Case 2-10

The answer to this case requires a visit to the FASB's home page at the time it is assigned.

Case 2-11

The answer to this case requires a visit to the FASB's home page at the time it is assigned.

Case 2-12

The answer to this case requires a visit to the FASB's home page at the time it is assigned.

Case 2-13

During the early 2000s, the FASB noted that concerns were being expressed about the quality and transparency of accounting information. One of the main concerns was the increasing complexity of FASB standards. The Board concluded that much of the detail and complexity associated with accounting standards was the result of rule-driven implementation guidance, which allows "accounting engineering" to get around the rules thereby allowing companies to circumvent the intent and spirit of the standards.

Additionally, the FASB noted that its Conceptual Framework has not provided all of the necessary tools for resolving accounting problems. This deficiency was attributed to the fact the certain aspects of the Conceptual Framework are internally inconsistent and incomplete. As a result, the Board is considering the need to develop an overall reporting framework similar to *International Accounting Standard No. 1*. Such a framework would provide guidance on issues such as materiality assessments, going concern assessments, professional judgment, consistency and comparability. It would also allow few, if any, exceptions and fewer implementation guidelines.

To illustrate the difference between rules based and principles based standards, the standard setting process can be viewed as a continuum ranging from highly rigid standards on one end to general definitions of economics-based concepts on the other end. For example, consider accounting for the intangible asset goodwill. An example of the extremely rigid end of the continuum is the previously acceptable practice:
Goodwill is to be amortized over a 40 year life until it is fully amortized.

This requirement leaves no room for judgment or disagreement about the amount of amortization expense to be recognized. Comparability and consistency across firms and through time is virtually assured under such a rule. However, the requirement lacks relevance because it does not reflect the underlying economics of the reporting entity, which differ across firms and through time.

At the opposite end of the continuum is the FASB's new rule:
Goodwill is not amortized. Any recorded goodwill is to be tested for impairment

and if impaired, written down to its current fair value on an annual basis.

This requirement necessitates the application of judgment and expertise by both managers and auditors. The goal is to record the economic deterioration of the asset, goodwill

Case 2-14

At a joint meeting in Norwalk, Connecticut, on September 18, 2002, the FASB and the IASB both acknowledged their commitment to the development of high-quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting (the Norwalk Agreement). The two boards pledged to use their best efforts to (1) make their existing financial reporting standards fully compatible as soon as is practicable and (2) coordinate their future work programs to ensure that once it is achieved, compatibility is maintained. The international convergence project has three major aspects: (1) the Financial Statement Presentation Project, (2) the Conceptual Framework Project, and (3) the Standards Update Project.

Case 2-15

The purpose of the financial statement presentation project is to establish a standard that will guide the organization and presentation of information in the financial statements. The boards' goal is to improve the usefulness of the information provided in an entity's financial statements to help users make decisions in their capacity as capital providers Accordingly, as a part of the Norwalk Agreement, the FASB and IASB committed to (1) undertake a short-term project aimed at removing a variety of individual differences between U.S. GAAP and International Financial Reporting Standards (IFRSs, discussed in Chapter 3; (2) remove other differences between IFRSs and U.S. GAAP that remained on January 1, 2005, through coordination of their future work programs; that is, through the mutual undertaking of discrete, substantial projects that both boards would address concurrently; (3) continue progress on the joint projects that they are currently undertaking; and (4) encourage their respective interpretative bodies to coordinate their activities.

In April 2004, the FASB and IASB decided to combine their respective projects on the reporting and classification of items of revenue, expense, gains, and losses. This project was undertaken to establish a common, high-quality standard for the presentation of information in financial statements, including the classification and display of line items and the aggregation of line items into subtotals and totals. The goal is to present information in individual financial statements (and among financial statements) in ways that improve the ability of investors, creditors, and other financial statement users to

1. Understand an entity's present and past financial position
2. Understand the past operating, financing, and other activities that caused an entity's financial position to change and the components of those changes
3. Use that financial statement information, along with information from other sources, to assess the amounts, timing, and uncertainty of an entity's future cash flows

The project is being conducted in three phases. Phase A addresses what constitutes a complete set of financial statements and requirements to present comparative information.

Phase B addresses the more-fundamental issues for presentation of information on the face of the financial statements, including

1. Developing principles for aggregating and disaggregating information in each financial statement
2. Defining the totals and subtotals to be reported in each financial statement (which might include categories such as business and financing)
3. Deciding whether components of other comprehensive income/other recognized income and expense should be recycled to profit or loss and, if so, the characteristics of the transactions and events that should be recycled and when recycling should occur
4. Reconsidering *SFAS No. 95*, "Statement of Cash Flows," and IAS 7, *Cash Flow Statements*, including whether to require the use of the direct or indirect method

Some preliminary decisions regarding the presentation of the financial statements have been published by the FASB. These decisions are discussed and illustrated in Chapters 6 and 7.
Phase C addresses the presentation and display of interim financial information in U.S. GAAP, including

1. Which financial statements, if any, should be required to be presented in an interim financial report
2. Whether financial statements required in an interim financial report should be allowed to be presented in a condensed format, and if so, whether guidance should be provided related to how the information may be condensed
3. What comparative periods, if any, should be required to be allowed in interim financial reports and when, if ever, should twelve month-to-date financial statements be required or allowed to be presented in interim financial reports
4. Whether guidance for nonpublic companies should differ from guidance for public companies

The boards completed their deliberations on Phase A in December 2005. On March 16, 2006, the IASB published its Phase A exposure draft, "Proposed Amendments to IAS 1 Presentation of Financial Statements: A Revised Presentation." The FASB decided to consider phases A and B issues together and therefore did not publish an exposure draft on phase A. After considering the responses to its exposure draft, the IASB issued a revised version of *IAS No. 1* in September 2007 Chapter 3for a discussion of *IAS No. 1*). The revisions to *IAS No. 1* affected the presentation of changes in equity and the presentation of comprehensive income, bringing *IAS No. 1* largely into line with *FASB Statement No. 130, Reporting Comprehensive Income* (FASB ASC 220).

In February 2006, the two boards reaffirmed their commitment to the process of convergence in a Memorandum of Understanding (MoU) and voiced the shared objective of developing high-quality, common accounting standards for use in the world's capital markets. The MoU outlines a road map for eliminating the reconciliation requirement for non-U.S. companies that use IFRSs and are registered in the United States (discussed in Chapter 3). The MoU maintains that trying to eliminate differences between standards is not the best use of resources; rather, new common standards should be developed. Convergence will proceed as follows: First, the boards will reach a conclusion about whether major differences in focused areas should be eliminated through one or more short-term standard-setting projects, and, if so, the goal was to complete or substantially complete work in those areas by 2008. Second, the FASB and the IASB will seek to make continued progress in other areas identified by both boards where accounting practices under U.S. GAAP and IFRSs are regarded as candidates for improvement.

In November 2009 the IASB and the FASB published a progress report describing their plans for completing the major projects on the MoU. This plan included milestone targets for each project. To provide transparency and accountability regarding those milestones, the two boards committed to reporting quarterly on the progress on convergence projects and to making those reports available on their respective websites. Additionally, they committed to hosting monthly joint board meetings and to provide quarterly updates on their progress on convergence projects. These milestones are discussed within their topic areas throughout the text.

In an effort to comply with the goals of the Norwalk Agreement, the FASB issued four new statements to bring U.S. GAAP into consistency with IFRSs (*SFAS No.151* (superseded), SFAS No. 153 (superseded), *SFAS No. 154* (FASB ASC 250-10), and *SFAS No. 163* (FASB ASC 944). Additionally, it issued a revised *SFAS No. 141* (FASB ASC 805). The IASB published new standards on borrowing costs (*IAS No. 23* revised) and segment reporting (*IFRS No. 8*).

Phase B is being conducted with the following principles in mind:
Financial statements should present information in a manner that

1. Portrays a cohesive financial picture of an entity
2. Separates an entity's financing activities from its business and other activities
3. Helps a user access the liquidity of an entity's assets and liabilities
4. Disaggregates line items if that disaggregation enhances the usefulness of that information in predicting future cash flows
5. Helps a user understand
    - how assets and liabilities are measured.
    - the uncertainty and subjectivity in measurements of individual assets and liabilities.
    - what causes a change in reported amounts of individual assets and liabilities.

The project has adopted cohesiveness as a standard for assessing its ability to attain these principles. That is, each financial statement should contain the same sections and categories, and the classification of assets and liabilities will drive the classification of the related changes in the statement of cash flows and comprehensive income statements. This process is expected to obtain more clarity in the relationships between statements and to facilitate financial analysis.

The Statements of Comprehensive Income, Financial Position, and Cash Flows will each contain a Business Section that reports operating activities and investing activities of the specific statement. For example, in the Statement of Comprehensive Income, the Business Section will contain operating income and expenses as well as investing income and expenses; in the Statement of Financial Position, the Business Section will report operating assets and liabilities and investing assets and liabilities. In addition to the Business Section, in three of the four statements (excluding the Changes in Equity Statement), a Financing Section is provided as well as a section on taxes and discontinued operations (net of taxes). Each financial statement will contain the two primary sections *business* and *financing*. The following guidelines were adopted for displaying the items in each section:

1. The **business section** *should* have two defined categories: operating and investing. These categories require an entity to make a distinction between business activities that are part of an entity's day-to-day business activities (and the business activity

generates revenue through a process that requires the interrelated use of the net resources of the entity) (operating category) and business activities that generate nonrevenue income (and no significant synergies are created from combining assets) (investing category).

2. The **financing section** will include items that are part of an entity's activities to obtain (or repay) capital and consist of two categories: debt and equity (a change from their decisions in September).
   a. The debt category will include liabilities where the nature of those liabilities is a borrowing arrangement entered into for the purpose of raising (or repaying) capital.
   b. The equity category will include equity as defined in either IFRS or U.S. GAAP.

Case 2-16

In October 2004, the FASB and IASB decided to add to their agendas a joint project to develop an improved and common conceptual framework that is based on and builds on their existing frameworks; that is, the IASB's *Framework for the Preparation and Presentation of Financial Statements* and the FASB's Conceptual Framework Project (CFP). The goal of this project is to create a sound foundation for future accounting standards that are principles based, internally consistent, and internationally converged. The boards also intend to improve some parts of the existing frameworks, such as recognition and measurement, as well as to fill some gaps in the frameworks. For example, neither framework includes a robust concept of a reporting entity.

The project

1. Focuses on changes in the environment since the original frameworks were issued, as well as omissions in the original frameworks, to efficiently and effectively improve, complete, and converge the existing frameworks.
2. Gives priority to addressing and deliberating those issues within each phase that are likely to yield benefits to the boards in the short term; that is, crosscutting issues that affect a number of their projects for new or revised standards. Thus work on several phases of the project will be conducted simultaneously, and the boards expect to benefit from work being conducted on other projects.
3. Initially considers concepts applicable to private-sector business entities. Later, the boards will jointly consider the applicability of those concepts to private sector not-for-profit organizations. Representatives of public sector (government) standard-setting boards are monitoring the project and, in some cases, are considering what the consequences of private sector deliberations might be for public-sector entities.

The project is being developed in eight phases and has resulted in the release of Statement of Financial Accounting Concepts No. 8.
The objectives and summary of the decisions reached for each phase of the project at the time this text was published are outlined in the following paragraphs.

Objectives and Qualitative Characteristics Phase

The aim of the Objectives and Qualitative Characteristics phase of Financial Reporting is to consider the following issues:

- The objective of financial reporting
- The qualitative characteristics of financial reporting information
- The tradeoffs among qualitative characteristics and how they relate to the concepts of materiality and cost–benefit relationships

As discussed above, in 2010, the FASB and IASB jointly published Chapters 1 and 3 of the CFP as *SFAC No. 8.*

Definitions of Elements, Recognition and Derecognition Phase

The objectives of the Elements and Recognition phase are to refine and converge the boards' frameworks in the following manner:

1. *Revise and clarify the definitions of asset and liability*. The boards have agreed that the FASB and IASB definitions of these elements have several shortcomings and have tentatively agreed on the following working definitions:
   a. An *asset* of an entity is a present economic resource to which the entity has a right or other access that others do not have.
   b. A *liability* of an entity is a present economic obligation for which the entity is the obligor.
2. *Resolve differences regarding other elements and their definitions*. The FASB Concepts Statements currently identify more elements than does the IASB Framework, and the two frameworks define differently those elements that are common. The boards' approach will focus initially on converging and defining only those key elements that are defined today in the FASB and IASB Frameworks. Additionally, the boards will need to consider how to define elements that are not currently defined, such as comprehensive income.
3. *Revise the recognition criteria concepts to eliminate differences and provide a basis for resolving issues such as derecognition and unit of account*. Each board's current framework describes specific recognition criteria, some of which are similar and some of which are different. Neither board's frameworks contain criteria to determine when an item should be derecognized. The boards plan to revise their recognition criteria concepts to eliminate those differences and provide a framework for resolving derecognition issues. The boards' current frameworks provide little or no guidance on how the unit of account should be determined. Although a discussion paper was expected to be issued in late 2010, it was not forthcoming at the time this text was published, and the project is currently inactive.

Measurement Phase

The objective of the Measurement phase is to provide guidance for selecting measurement bases that satisfy the objectives and qualitative characteristics of financial reporting. It consists of the following milestones:

- *Milestone I* will inventory and defines a list of measurement basis candidates that might be used as a basis for measurement on financial statements.
- *Milestone II* will evaluate the basis candidates identified in Milestone I.
- *Milestone III* will draw conceptual conclusions from Milestones I and II, while addressing practical issues.
-

During its deliberations of Milestone I, the boards addressed the following five issues:

1. **What are the measurement basis candidates?** The boards agreed to a list of nine candidates: *past entry price, past exit price, modified past amount, current entry price, current exit price, current equilibrium price, value in use, future entry price, and future exit price.*
2. **How are the measurement bases defined?** The boards agreed to provide two definitions for each candidate—one from the perspective of an asset and one from the perspective of a liability. They further decided to focus on the concepts behind entry and exit prices, without respect to the way they are measured.
3. **What are the basic properties of the measurement bases?** The boards concluded

that most candidates are either prices or values and that each candidate provides information primarily about a specific time frame.

4. **Are the measurement issues appropriate for both assets and liabilities?** The boards concluded that all the candidates were appropriate for use with assets and liabilities.
5. **Should any measurement basis candidates be eliminated from consideration for evaluation in Milestone II?** The boards agreed not to eliminate any of the nine candidates identified at the end of Milestone I. However, they did eliminate some other candidates in the earlier stages of Milestone I deliberations.

Although a discussion paper was expected to be issued in late 2010, it was not forthcoming at the time this text was published, and the project is currently inactive.

Reporting Entity Concept Phase

The objective of the Reporting Entity phase is to determine what constitutes a reporting entity for the purposes of financial reporting.

On March 11, 2010, the boards issued an exposure draft titled *Conceptual Framework for Financial Reporting: The Reporting Entity* (ED). This document notes that the objective of general-purpose financial reporting is to provide financial information about reporting entities that is useful in making decisions about providing resources to the entity and in assessing whether the management and the corporate officers of that entity have made efficient and effective use of the resources provided. The ED defines a reporting entity as a circumscribed area of economic activities whose financial information has the potential to be useful to existing and potential equity investors, lenders, and other creditors who cannot directly obtain the information they need in making decisions about providing resources to the entity and in assessing whether management and the corporate officers of that entity have made efficient and effective use of the resources provided.

The ED noted that a reporting entity has three features:

1. Economic activities of an entity are being conducted, have been conducted, or will be conducted.
2. Those economic activities can be objectively distinguished from those of other entities and from the economic environment in which the entity exists.
3. Financial information about the economic activities of that entity has the potential to be useful in making decisions about providing resources to the entity and in assessing whether the management has made efficient and effective use of the resources provided.

As a result, identifying a reporting entity in a specific situation requires consideration of the boundary of the economic activities that are being conducted, have been conducted, or will be conducted. The existence of a legal entity is neither necessary nor sufficient to identify a reporting entity. A reporting entity can include more than one entity, or it can be a portion of a single entity.

The ED also notes a single legal entity that conducts economic activities and does not control any other entity is likely to qualify as a reporting entity and that most, if not all, legal entities have the potential to be reporting entities. However, a single legal entity may not qualify as a reporting entity if, for example, its economic activities are commingled with the economic activities of another entity and there is no basis for objectively distinguishing their activities. But a portion of an entity could qualify as a reporting entity if the economic activities of that portion can be distinguished objectively from the rest of the entity and financial information about that portion of the entity has the potential to be useful in making decisions about providing resources to that portion of the entity. For example, a potential equity investor could be considering a purchase of a branch or division of an entity. Comments on this exposure draft were to be received by July 11, 2010.

During its November 19, 2010 Joint Board Meeting, the Boards discussed some of the issues raised in comment letters on the ED and concluded that significant time will be required to satisfactorily address those issues. Owing to the priority placed on other projects, the Boards concluded that they could not devote the time necessary to properly address those issues in the near future. The FASB and IASB discussed some of the issues raised in the comment letters on the Exposure Draft and concluded that significant time would be required to satisfactorily address those issues. Because of the priority placed on other projects, the Boards concluded that they could not devote the time necessary to properly address those issues in the near future, and the project is currently inactive

Boundaries of Financial Reporting, and Presentation and Disclosure Phase

An objective of the Presentation and Disclosure, including Financial Reporting Boundaries, phase is to determine the concepts underlying the display and disclosure of financial information and to identify the boundaries of such information that will achieve the objective of general-purpose financial reporting. This phase is currently inactive. The boards have not yet deliberated or made decisions regarding concepts for financial presentation and disclosure of financial information.

Purpose and Status of the Framework Phase

The objective of the Purpose and Status of the Framework phase is to consider the framework's authoritative status in the GAAP hierarchy. The goal is to develop a framework that is of comparable authority for the use of both boards in the standard-setting process.

At present, there are differences in the status of the boards' existing frameworks. For an entity preparing financial statements under International Financial Reporting Standards, the IASB's *Framework* provides guidance when there is no standard or interpretation that specifically applies to a transaction or other event or condition, or that deals with a similar and related issue. In those situations, the entity's management is required to consider the definitions, recognition criteria, and measurement concepts for assets, liabilities, income, and expenses in the *Framework.* Under U.S. GAAP, the FASB's Concepts Statements have a much lower status—they are ranked no higher than accounting textbooks, handbooks, and articles and are ranked below widely recognized and prevalent general or industry practices.

The FASB has decided that the authoritative status of the framework within the U.S. GAAP hierarchy should be considered once the framework is more substantially complete. However, for the purposes of providing comments on documents issued by the boards, respondents will be asked to assume that the framework's authoritative status will be elevated in the U.S. GAAP hierarchy to have a status comparable to the IASB's current *Framework.*

The FASB and the IASB agreed that each board, within the context of its current GAAP hierarchy, will finalize the common framework as parts are completed and that later parts may include consequential amendments to earlier parts. The boards noted that the decision of how to finalize the joint framework might need to be readdressed when the boards discuss the placement of the framework within the IASB and FASB hierarchies. This phase of the Conceptual Framework Project is currently inactive.

Application of the Framework to Not-for-Profit Entities Phase

The objective of this phase of the Conceptual Framework Project is to consider the applicability of the concepts developed in earlier phases to not-for-profit entities in the private sector. This phase is currently inactive. The boards have not yet deliberated or made decisions regarding the applicability of particular concepts to not-for-profit entities.

Remaining Issues, If Any, Phase

The objective of the Remaining Issues phase is to consider remaining issues that have not been addressed by the previous seven phases. This phase is currently inactive. The boards will not deliberate or make decisions regarding final issues until the first seven phases are complete.

Standards Update Project

The FASB and IASB are also working on a number of individual standard issues, such as discontinued operation, financial instruments, fair value measurements, comprehensive income, consolidations, leases, revenue recognition, earnings per share, income taxes, and postretirement benefits. The overall objective of the standards update project is to make FASB and IASB standards more comparable.

In April 2011, the FASB and IASB issued a joint statement on the progress archived in the standards update program. The boards reaffirmed the changes made to the work plan in June 2010 to allow broad-based and effective stakeholder outreach, which they believe is critical to the quality of the standards. That plan gave priority to the major MoU projects for which they believed the need for improvement of IFRSs and U.S. GAAP is the most urgent. Those priority projects include the joint projects on financial instruments, revenue recognition, leasing, insurance contracts, the presentation of other comprehensive income, fair value measurement, and the consolidation of investment companies. In addition, the IASB also assigned priority to improved disclosures about derecognized assets and other off–balance sheet risks (aligning with recently issued U.S. GAAP requirements) and consolidations (particularly in relation to structured entities).

The boards also provided a report on the progress of their joint convergence work that stated the FASB and the IASB have taken the following actions:

1. **Completed five projects:** The boards have reached important decisions on a number of projects, reducing the number of remaining priority MoU projects to three (revenue recognition, leasing, and financial instruments) for continued work. Reflecting the completion of MoU projects, publication of standards that are converged or substantially converged on fair value measurement, consolidated financial statements (including disclosure of interests in other entities), joint arrangements, other comprehensive income, and postemployment benefits was expected in the near future.
2. **Priority given to the remaining MoU areas and insurance accounting:** In November 2010 the boards decided to give priority to their joint work on three MoU projects—financial instruments, revenue recognition and leases—and accounting for insurance contracts in order to permit timely completion.
3. **Extended the completion target beyond June 2011:** At their meeting in April, the boards extended the timetable for the remaining priority MoU convergence projects and insurance beyond June 2011 to permit further work and consultation with stakeholders. The boards revised their work plan to focus on completing the three remaining priority convergence projects in the second half of 2011, in a manner

consistent with an open and inclusive due process. For insurance contracts, the IASB planned to complete its project in the second half of 2011, and the FASB plans to issue an exposure draft in a similar timeframe.

4. **Agreed that the decisions that will be made on effective dates will give entities sufficient time to implement changes:** The boards have emphasized that they will set effective dates that will allow those who use IFRSs and U.S. GAAP adequate time to prepare for implementation of the standards.

The boards also indicated that with the progress made since their last report, they are approaching the completion of their MoU program. Specifically:

- The short-term projects identified for action in their 2006 MoU and updated 2008 MoU have been completed or are close to completion.
- Of the longer-term projects, only three of the priority convergence projects remain for which the boards have yet to finalize the technical decisions—financial instruments, revenue recognition and leasing.

Finally, the boards outlined the priority and timing of the remaining convergence work indicating that in 2008 the boards set the target date of 30 June 2011 to finalize the MoU projects. However, at their meeting in April 2011 the boards agreed that they will need to spend additional time beyond June 2011 to complete this joint work. The boards stated that they will use the additional time to consult those affected by the proposed changes and work through concerns and issues being raised by stakeholders. Before each standard is issued, the boards will consider

- whether reexposure is necessary; and
- whether they have undertaken sufficient outreach on the proposed standard to assure the boards that the proposed standard is operational and will bring improvements to financial reporting.

The optimism expressed in this communiqué was considerably dampened by subsequent statements by FASB and IASB officials. In December 2011 the heads of the U.S. and international accounting boards that have been working to resolve standards differences agreed that their current convergence process should be replaced by one that is more manageable and effective. Speaking at the AICPA National Conference on Current SEC and PCAOB Developments, FASB Chair Leslie Seidman said that side-by-side convergence is not the optimal model in the long run. She said FASB would like to work with the IASB to complete the current priority convergence projects on revenue recognition, leasing, financial instruments, and insurance. But she said indefinite convergence is not a viable option, politically or practically.
Hans Hoogervorst, chair of the International Accounting Standards Board (IASB), spoke immediately after Seidman at the conference and echoed her sentiments. Hoogervorst said the IASB's convergence history with FASB has been extremely useful in bringing IFRS and U.S. GAAP closer together. But he said that two boards of independently thinking professionals sometimes simply reach different conclusion.

Case 2-17

a. FASB's Conceptual Framework should provide benefits to the accounting community such as:

1. Guiding the FASB in establishing accounting standards on a consistent basis.

2. Determining bounds for judgment in preparing financial statements by prescribing the nature, functions and limits of financial accounting and reporting.
3. Increasing users' understanding of and confidence in financial reporting.

b. The most important quality for accounting information as usefulness for decision making. Relevance and faithful representation are the primary qualities leading to this decision usefulness. Usefulness is the most important quality because, without usefulness, there would be no benefits from information to set against its costs.

c. There are a number of key characteristics or qualities that make accounting information desirable. The importance of three of these characteristics or qualities is discussed below. Understandability—information provided by financial reporting 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. Financial information is a tool and, like most tools, cannot be of much direct help to those who are unable or unwilling to use it, or who misuse it.
Relevance—the accounting information is capable of making 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 expectations (including is material).
Faithful representation—the faithful representation of a measure rests on whether the numbers and descriptions matched what really existed or happened, including completeness, neutrality, and free from error.

(Note to instructor: Other qualities might be discussed by the student, such as enhancing qualities. All of these qualities are defined in the textbook).

Financial Analysis Case

The solutions to the financial analysis depend upon the company and year selected.