
FINANCIAL REPORTING: ITS CONCEPTUAL FRAMEWORK

CHAPTER OBJECTIVES

After careful study of this chapter, students will be able to:

1. Explain the FASB conceptual framework.
2. Understand the relationship among the objectives of financial reporting.
3. Identify the general objective of financial reporting.
4. Describe the three specific objectives of financial reporting.
5. Discuss the types of useful information for investment and credit decision making.
6. Explain the qualities of useful accounting information.
7. Understand the accounting assumptions and principles that influence GAAP.
8. Define the elements of financial statements.
9. List the qualitative characteristics of useful information in the tentative FASB and IASB joint conceptual framework (Appendix).

SYNOPSIS

FASB Conceptual Framework

1. The FASB has been charged with developing a conceptual framework of accounting theory and with establishing standards for financial accounting practice. The conceptual framework, which is intended to provide a theoretical foundation for consistent accounting standards, has been essentially completed, with seven Statements of Financial Accounting Concepts issued.
2. The FASB divided the conceptual framework activities into projects: (a) objectives of financial reporting, (b) qualitative characteristics of accounting information, (c) accounting projects (accounting elements, recognition, and measurement), (d) reporting projects (financial statements and financial reporting, income, and cash flow and liquidity). The first two Statements of Financial Accounting Concepts (objectives and qualitative characteristics) are discussed in this chapter.

Objectives of Financial Reporting

3. FASB Statement of Financial Accounting Concepts No. 1 deals with the objectives of financial reporting. These objectives relate to general-purpose financial reporting of companies. That is, they are to meet the needs of a variety of external, rather than internal, users.
4. Three broad objectives of financial reporting, which proceed from the more general to the more specific, are identified in the Statement:
 - (a) The general objective is to provide information that is useful to present and potential investors, creditors, and other external users for decision-making. Users are expected to have a reasonable understanding of business and economic activities, and to be willing to study the information carefully.
 - (b) On a more specific level, the derived external user objective is to provide information useful in assessing the amounts, timing, and uncertainty of prospective cash flows to be received by external users. This information is important because individual and institutional decisions about outflows for investing and lending are made based on the potential for increasing their cash inflows.
 - (c) The derived company objective is to provide information useful in assessing the amounts, timing, and uncertainty of prospective net cash inflows of the company. The company's investment activities take place within its operating cycle. In the operating cycle goods and services are acquired, their value is increased, they are sold, and the selling price is collected. The company's success in generating cash inflows affects investors' and creditors' cash flows through market prices of the company's securities and the ability of the company to pay dividends and interest.
5. Additionally, three specific objectives are identified in FASB Statement of Financial Accounting Concepts No. 1:
 - (a) To provide information about a company's economic resources and the claims to those resources, i.e., its economic resources, obligations, and owners' equity.

- (b) To provide information about a company's comprehensive income and its components.
 - (c) To provide information about a company's cash flows.
6. According to the Statement, information about comprehensive income and its components is the primary focus of financial reporting. Comprehensive income should be measured with accrual accounting. That is, the financial effects of transactions, events, and circumstances having cash consequences should be reported in the period when they occur, rather than when cash is received or paid.
 7. Management is responsible for the custody and use of company resources. Financial reporting should provide information about that stewardship responsibility.
 8. Financial reporting is to be based on full disclosure. That is, reports should include management explanations and interpretations of benefit to external users, as well as quantitative information.
 9. The FASB has identified five types of information related to the financial reporting objective to help external users assess the amounts, timing, and uncertainty of the future net cash inflows of the company. They are:
 - (a) Investors expect a return on the capital they invest. Before a company can provide a return on capital, the company must achieve a return of its capital. That is, the company's capital must be maintained or recovered.
 - (b) Risk is the uncertainty or unpredictability of a company's future results. In general, the greater the risk of an investment, the higher the rate of return expected by investors and the higher the interest charged by the creditors.
 - (c) Financial flexibility is the ability of a company to respond to use its resources to adapt to change.
 - (d) Liquidity relates to how quickly a company can convert its assets into cash to pay its bills.
 - (e) A company's operating capability is its ability to maintain a given physical level of operations.

Qualitative Characteristics of Useful Accounting Information

10. FASB Statement of Financial Accounting Concepts No. 2 specifies qualitative characteristics of accounting information, or "ingredients" that accounting information should have to be most useful. The FASB hierarchy of qualitative characteristics is adapted in Exhibit 2-5 in the text.
11. The hierarchy shows two constraints to accounting information:
 - (a) Cost-benefit: the benefit of information must be greater than its cost.
 - (b) Materiality: the dollar amounts involved must be large enough to make a difference to decision makers. Since no quantitative guidelines were set by the FASB, materiality must be determined by judgment. However, the FASB suggested consideration of nature and relative size to separate material and immaterial items.

12. Understandability is a link between decision makers and the accounting information. Information should be understandable to broad classes of reasonably knowledgeable and diligent users.
13. Decision usefulness is the overall quality which accounting information must possess. The two primary qualities making accounting information useful are relevance and reliability.
14. Accounting information that can make a difference to decision makers is relevant. Relevance is closely linked to materiality: If an amount is large enough to affect the judgment of a reasonable person, that amount is material. If users have a need for information, that information is relevant. To be relevant, information must have (a) predictive value, or usefulness to decision makers in forecasting events more accurately; and/or (b) feedback value, or usefulness to decision makers in confirming or correcting prior expectations. In addition, relevant information must be timely.
15. Reliable information is reasonably free from error and bias and faithfully reports what it is intended to represent. To be reliable information must (a) be verifiable; (b) have representational faithfulness; and (c) be neutral. Information is verifiable (sometimes called objective) when it can be duplicated using the same measurement method. Verifiability is useful in reducing measurer bias. In auditing, verifiability is a primary concern when the independent accountant reviews the internal control and published financial statements of a company, i.e., performs the attest function. Accounting information has representational faithfulness when there is valid correspondence to the economic resources, obligations, transactions, and events it represents. A high degree of representational faithfulness is useful in reducing measurement bias. Neutral information is complete and free from intentional bias.
16. Comparability is a secondary characteristic of accounting information. Information is more useful if it can be compared with similar information from other companies (intercompany comparison) and with similar information from the same company over time (intracompany comparison). Comparability is closely linked to consistency, the use of unchanged accounting policies and procedures from period to period.
17. The hierarchy of qualitative characteristics in FASB Statement of Financial Accounting Concepts No. 2 does not rank the characteristics. All characteristics are required, to a minimum degree, in useful information. However, trade-offs between characteristics may be necessary.

Accounting Assumptions and Principles

18. Certain assumptions and principles have influenced the development of generally accepted accounting principles. The entity assumption distinguishes each business organization from its owners. For accounting purposes, the organization's financial records and reports are kept separate from those of the owners. Sometimes records from separate legal entities may be consolidated to more realistically report information about an overall economic entity.
19. Following the continuity (or going-concern) assumption, it is assumed that a company will continue to operate in the near future, unless substantial evidence to the contrary exists. This assumption is the basis for many accounting procedures. If, however, the company appears to be verging on bankruptcy, reports should be prepared on a liquidation basis.

20. The total profit or loss of a company cannot be determined precisely while the company continues to operate. However, timely information is needed by users. The period-of-time assumption enables a company to report the results of its activities after short time periods (primarily one year), rather than at the end of the company's existence. Historically, the calendar year was used as a reporting period. However, many companies now choose fiscal years based on their annual business cycles.
21. Under the monetary-unit assumption accountants have traditionally treated the dollar, or other currency, as a stable unit of measure. However, values, as measured by a monetary unit, change over time for two reasons: (a) the real value of an item can change in relation to the real values of other goods and services, or (b) the purchasing power of the measuring unit (the dollar) can change. To enhance comparability, the FASB encourages companies to make supplemental disclosures relating to the impact of changing prices.
22. An economic activity or resource is initially measured by the exchange price (historical cost) of a transaction. Because the initial exchange price is reliable, verifiable, representationally faithful, and neutral, historical cost is usually retained as the value of an item until the item is removed from the accounting records. However, in some cases, GAAP requires the use of fair value of selected items. Also, recognizing that historical cost information may lack relevance, the FASB encourages companies to disclose supplemental fair value information in their annual reports.
23. Recognition is the process of formally recording and reporting an item in the financial statements. To be recognized, an item must: (a) meet the definition of an element, (b) be measurable, (c) be relevant, and (d) be reliable. Revenues should be recognized when (a) realization has taken place and (b) the revenues have been earned. Realization is the conversion of non-cash resources or rights into cash or rights to cash. Revenues most often are recognized at the point of sale, because this is usually when realization takes place, and when the earning process is substantially complete.
24. Occasionally a company recognizes revenue before or after the point of sale to more accurately reflect the nature of its operations. In these cases revenue is not recognized at the same time it is realized.
- (a) Revenue may be recognized during production under the percentage-of-completion method for certain long-term construction contracts and the proportional performance method for certain long-term service contracts.
 - (b) When a fixed selling price exists and there is no limit to the amount that can be sold, revenue may be recognized at the end of production. This method might be used for certain valuable minerals or for farm products sold on the futures market.
 - (c) When collectibility is highly uncertain, recognition may be postponed using either the installment method or the cost-recovery method. Under the installment method, a portion of each receipt is recognized as revenue. Under the cost-recovery method, no revenue is recognized until the cost of the product has been recovered.
25. The matching principle states that expenses involved in obtaining a period's revenues should be related to (matched against) the revenues recognized during the period. Three principles are used to match expenses to revenues: (a) association of cause and effect, (b) systematic and rational allocation, and (c) immediate recognition. Sales commissions and the product costs in cost of goods sold are recorded by associating cause and effect. Depreciation and amortization are recorded on the basis of systematic and rational allocation. Period costs (expenses related to a period of time), such as administrative salaries, are recognized immediately.

26. The principle of conservatism states that when alternative accounting valuations are equally possible, the alternative selected should be the one which is least likely to overstate assets and income in the current period. This convention counterbalances the normal optimism of management. However, conservatism has been criticized recently for distorting results in later periods, and for lack of neutrality. The FASB has rejected excessive conservatism and favors prudence in reporting information about business risks and uncertainties.

GAAP and Financial Statements

27. In the Conceptual Framework, the FASB identified four financial statements: the balance sheet, income statement, statement of cash flows, and statement of changes in equity. The elements of each statement are the broad classes of items comprising it. In practice, most companies prepare three primary financial statements, the balance sheet, income statement, and statement of cash flows, and present a schedule of changes in equity either as a separate statement or in a note to the financial statements.
28. The balance sheet (statement of financial position) summarizes the financial position of a company on a particular date. The three elements of the balance sheet are (a) assets, or economic resources; (b) liabilities, or economic obligations; and (c) equity, the owners' residual interest in a company's assets, after liabilities have been deducted.
29. The income statement summarizes the results of a company's operations for a period of time. The four elements of an income statement are (a) revenues, increases in assets and/or decreases in liabilities due to the company's ongoing primary operations; (b) expenses, decreases in assets and/or increases in liabilities due to the company's ongoing primary operations; (c) gains, increases in the equity of the company not related to its primary operations or to investments by owners; (d) losses, decreases in the equity of the company not related to its primary operations or to distributions to owners.
30. The statement of cash flows summarizes a company's cash inflows and outflows for a period of time, and reconciles the company's beginning and ending cash balances as reported on the balance sheets. The three elements of the statement of cash flows are (a) operating cash flows, cash inflows and outflows from acquiring, selling, and delivering goods, and providing services; (b) investing cash flows, cash inflows and outflows from acquiring and selling investments, property, plant, and equipment, and intangibles, as well as from making and collecting on loans; and (c) financing cash flows, cash inflows and outflows from investments by and distributions to owners, as well as receipts from and distributions to creditors.
31. The statement of changes in equity (for a corporation generally called the statement of changes in stockholders' equity) summarizes the changes in a company's equity for a period of time and reconciles the equity items a company reports on its beginning and ending balance sheets. Two key elements of the statement of changes in equity are (a) investments by owners and (b) distributions to owners.

Models of Business Reporting

32. The AICPA Committee on Financial Reporting issued a report on the relevance and usefulness of reporting by companies. In addition, the committee developed a comprehensive model of business reporting, identifying an integrated range of information, broader than that included in the FASB's conceptual framework.

33. The Comprehensive Business Reporting Model Subcommittee of the CFA Institute for Financial Market Integrity also has issued a report that includes a model of business reporting for investors. It argues that current financial statements are not useful to investors. The Subcommittee recommends a business reporting model that includes revised financial statements based on fair value, along with more extensive disclosures.

IASB Framework

34. The IASB framework states that the objective of financial statements is to provide information that is useful in making economic decisions. It has two assumptions; that a company is a going concern and uses accrual accounting. It identifies four qualitative characteristics of financial statements: understandability, relevance, reliability, and comparability. The constraints include: timeliness, balance between benefit and cost, and balance between the qualitative characteristics.
35. The IASB framework identifies the elements (e.g., assets, income) of the financial statements, and also discusses conceptual issues related to the recognition and measurement of these elements. The framework is designed to help the IASB develop international accounting standards.

Appendix: Joint FASB and IASB Conceptual Framework Project

36. As part of their convergence project, the FASB and IASB are working on a joint project to develop a common Conceptual Framework for Financial Reporting. The goal of the Boards is to develop a joint conceptual framework that is both complete and internally consistent. They decided to split this project 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, and (8) remaining issues (currently, only the first four phases are active). The Boards are furthest along on Phase 1 and have issued a related Exposure Draft.
37. The Boards have tentatively agreed on an objective of financial reporting that is very similar to the objective in the FASB conceptual framework. They state that the objective of general purpose external financial reporting is to provide useful financial information about a company (including the entities under its control) to the primary user group (the company's present and potential equity investors, lenders, and other creditors) in making decisions in their capacity as capital providers. The Boards continue to feel that financial reporting should be general purpose, should be useful in assessing a company's future cash flows, and should provide information about a company's resources, claims to those resources, and changes in these items using accrual accounting.
38. The tentative joint conceptual framework in the Exposure Draft identifies relevance and faithful representation as "fundamental qualitative characteristics" that must be present for financial reporting information to be useful. Relevant information must be capable of making a difference in the decisions made by external users in their capacity as capital providers. To be relevant, information must have predictive value, confirmatory value, or both. Faithful representation of economic phenomena occurs when the related information is complete, neutral, and free from material error.
39. The Boards identified comparability (including consistency), verifiability, timeliness, and understandability as "enhancing characteristics" that distinguish more useful information from less useful information, and increase the decision usefulness of information. These fundamental and enhancing qualities are subject to two constraints: (1) materiality and (2) benefits that justify the costs. Exhibit 2-9 in the text shows the relationships among the fundamental qualitative characteristics, enhancing characteristics, and constraints of the tentative joint conceptual framework.

LECTURE OUTLINE

- I. FASB conceptual framework
 - A. Purpose
 - B. Relationship between statements of concepts and statements of standards
 - C. Interrelated projects
 - 1. Accounting projects (elements, recognition, measurement)
 - 2. Reporting projects (financial statements, income, funds flow)
- II. Objectives of financial reporting (to provide:)
 - A. Information useful in decision making
 - B. Information useful in assessing external users' cash receipts
 - C. Information useful in assessing company cash flows
 - D. Information about economic resources and claims to those resources
 - E. Information about comprehensive income and its components
 - F. Information about cash flows

G. Other issues

III. Types of useful information

A. Return on investment

B. Risk

C. Financial flexibility

D. Liquidity

E. Operating capability

IV. Qualitative characteristics of accounting information

A. Hierarchy of qualitative characteristics

B. Understandability

C. Decision usefulness

D. Relevance

1. Predictive value

2. Feedback value

3. Timeliness

E. Reliability

1. Verifiability

2. Representational faithfulness

3. Neutrality

F. Comparability and consistency

G. Constraints to hierarchy

1. Benefits greater than costs

2. Materiality

V. Accounting assumptions and principles

A. Entity (economic)

B. Continuity (going-concern)

C. Period of time

D. Monetary unit

E. Historical cost

F. Recognition and realization

G. Matching and accrual accounting

H. Conservatism (prudence)

VI. GAAP and financial statements

A. Balance sheet

1. Assets

2. Liabilities

3. Equity

B. Income statement

1. Revenues

2. Expenses

3. Gains

4. Losses

C. Statement of cash flows

1. Operating cash flows

2. Investing cash flows

3. Financing cash flows

D. Statement of changes in equity

1. Investments by owners

2. Distributions to owners

VII. Models of business reporting

1. AICPA Committee

2. CFA Subcommittee

VIII. IASC framework

IX. Appendix: Joint FASB and IASB Conceptual Framework Project

A. Objective of financial reporting

B. Fundamental qualitative characteristics

1. Relevance (including predictive value, confirmatory value, or both)
 2. Faithful representation (complete, neutral, free from material error)
- C. Enhancing qualitative characteristics: comparability (including consistency), verifiability, timeliness, and understandability
- D. Constraints: materiality and benefits that justify the costs
- E. Tentative FASB and IASB Joint Conceptual Framework (see Exhibit 2-10 in text)

INSTRUCTIONAL NOTES

1. Students should have an appreciation of the FASB Conceptual Framework and its interrelationship with and impact on the standard setting process. Exhibit 2-1 and Exhibit 2-2 of the text provide a useful frame of reference.
2. Students often get so involved in the mechanics of financial reporting, that they lose sight of the Information Needs of external users and the related Qualitative Characteristics of Useful Accounting Information. Time should be taken in class to review informational needs regarding return on investment, risk, financial flexibility, liquidity, and operating capability and the "ingredients" of relevant and reliable information, namely predictive value, feedback value, and timeliness, verifiability, representational faithfulness, and neutrality, as well as comparability.
3. The Objectives of Financial Reporting should be tied to external users' investment and credit granting decision making (buy-hold-sell). It is also helpful to students to logically proceed through the objectives from the more general to the more specific so that students understand the reasons for accounting information. Exhibit 2-3 of the text is useful for this purpose.
4. In future chapters of the text, reference is often made back to the Qualitative Characteristics in regard to a particular accounting method or practice. It is important, therefore, that students have a thorough understanding of each of the qualitative characteristics and their interrelationship, as presented in Exhibit 2-5 of the text. Stress should be placed on the tradeoffs, particularly between relevance and reliability. Note also that the FASB's term "verifiability" instead of "objectivity" is generally used in future chapters.
5. The Assumptions and Principles of accounting play an important role in the development of GAAP, and are also frequently referred to in future chapters. Students, therefore, should have an understanding of each of the assumptions and conventions, as well as their impact on accounting methods and practices. Exhibit 2-6 provides a useful frame of reference.
6. Perhaps the two most influential conventions in accounting are Revenue Recognition (Realization) and Matching (Accrual). Revenue recognition and realization, as well as matching and accrual accounting, are briefly introduced here from a conceptual standpoint. These discussions are extended in Chapters 5 and 18.
7. Students frequently think that the basic financial statements are the only source of information for investment decisions. Because later parts of the book emphasize Alternative Disclosures, it is helpful to introduce students to the various disclosure mechanisms as summarized in Exhibit 2-8.
8. Although they are extensively covered in Chapters 4 and 5, a review of the Elements of Financial Statements and their "linkage" to the conceptual framework helps students feel more comfortable with the issues discussed in this chapter.
9. (Appendix). Students should be aware of the tentative FASB and IASB Joint Conceptual Framework. In particular, they should understand the fundamental qualitative characteristics and the enhancing qualitative characteristics in this framework and be able to contrast this joint framework to the FASB's framework. A good way of doing so is to compare Exhibit 2-10 to Exhibit 2-5 in the text.

CONTENT ANALYSIS OF CASES

<u>Number</u>	<u>Content</u>	<u>Time Range (minutes)</u>
C2-1	<u>Qualitative Characteristics</u> . Matching of definitions to the qualities of useful accounting information.	10-20
C2-2	<u>Accounting Assumptions and Principles</u> . Matching of a list of descriptive statements with a list of assumptions and principles.	5-15
C2-3	<u>Objectives of Financial Reporting</u> . Discuss general through specific objectives.	15-30
C2-4	<u>Qualitative Characteristics</u> . Identify and discuss qualities of useful accounting information.	20-40
C2-5	(AICPA adapted). <u>Cost and Expense Recognition</u> . Rationale for expense recognition at time of sale, in an accounting period, or due to systematic and rational allocation.	15-30
C2-6	(CMA adapted). <u>Characteristics of Useful Information</u> . Define relevance and reliability (and their ingredients), as well as comparability, consistency, and materiality.	20-30
C2-7	(CMA adapted). <u>Objectives, Users, and Stewardship</u> . Discuss the primary objectives of financial reporting, the sophistication level of users, and the stewardship responsibilities of management.	20-30
C2-8	<u>Segment Reporting</u> . Discuss what types of useful information for investment decision making is provided by a company's disclosures of the revenues, operating profits, and assets of its lines of business.	10-15
C2-9	<u>Relevance Versus Reliability</u> . Define relevance and reliability, and ingredients of each. Discuss which is most important.	10-15
C2-10	(AICPA adapted). <u>Inconsistent Statements about GAAP</u> . Evaluate and discuss two statements containing fallacies, half-truths, circular reasoning, errors, and inconsistencies.	15-30
C2-11	(AICPA adapted). <u>Accounting Entity</u> . Define and discuss an accounting entity; give illustrations.	15-30

<u>Number</u>	<u>Content</u>	<u>Time Range (minutes)</u>
C2-12	(AICPA adapted). <u>Timing of Revenue Recognition</u> . Discuss why point-of-sale recognition is usual. Discuss merits of alternative revenue recognition bases.	20-40
C2-13	(AICPA adapted). <u>Accruals and Deferrals</u> . Discuss accrual accounting, including accruals and deferrals. Contrast with cash accounting.	10-15
C2-14	<u>Revenue Recognition</u> . Describe when revenue should be recognized in four cases, and indicate what method should be used.	15-20
C2-15	<u>Violation of Assumptions and Conventions</u> . For seven situations, identify what accounting assumption or convention each procedure or practice violates. Indicate what should be done to rectify each violation.	15-25
C2-16	(CMA adapted). <u>Conceptual Framework</u> . Describe and discuss benefits of FASB conceptual framework and qualities of useful accounting information.	20-30
C2-17	(Appendix). <u>FASB and IASB Joint Conceptual Framework</u> . Define the objective of financial reporting. Discuss the qualitative characteristics (and constraints) of useful information.	15-20
C2-18	<u>Ethics and Income Reporting</u> . Discuss the financial reporting and ethical issues regarding revenue and expense recognition based on cash receipts and payments.	10-15