FASB Conceptual Framework

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TRUST IN NUMBERS

Overview

1. Objective of Financial Reporting
2. Qualitative Characteristics of Accounting Information
3. 10 Basic Elements of Financial Accounting
4. Basic Assumptions
5. Basic Principles
6. Recognition Criteria
7. Fair Value Measurement
8. Constraints

Conceptual Framework

The Need for a Conceptual Framework

- To develop a coherent set of standards and rules.
- To solve new and emerging practical problems.

Keep in mind:

The conceptual framework is **not** part of authoritative US-GAAP

Development of Conceptual Framework

The **FASB** has issued seven **Statements of Financial Accounting Concepts** (SFAC) for business enterprises.

SFAC No.1 - Objectives of Financial Reporting.

SFAC No.2 - Qualitative Characteristics of Accounting Information.

SFAC No.3 - Elements of Financial Statements.

SFAC No.5 - Recognition and Measurement in Financial Statements.

SFAC No.6 - Elements of Financial Statements (replaces SFAC No. 3).

SFAC No.7 - Using Cash Flow Information and Present Value in Accounting Measurements.

SFAC No.8 - The Objective of General Purpose Financial Reporting and Qualitative Characteristics of Useful Financial Information (replaces SFAC No. 1 and No. 2)

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Conceptual Framework

Overview of the Conceptual Framework

- **First Level** = Basic Objectives
- **Second Level** = Qualitative Characteristics and Elements
- **Third Level** = Recognition, Measurement, and Disclosure Concepts.

INTERNATIONAL PERSPECTIVE

The IASB has also issued a conceptual framework. The FASB and the IASB have agreed on a joint project to develop a common and improved conceptual framework. The project is being conducted in phases. Phase A on objectives and qualitative characteristics was issued in 2010.

First Level: Basic Objectives

Objective of general-purpose financial reporting is:

To provide financial information about the reporting entity that is **useful to present and potential equity investors, and creditors in making decisions about providing resources to the entity**.

- ***Objective of financial accounting:***
  *help users assess the **amount, timing, and uncertainty** of future net cash inflows to the entity [OB3].*

$$V_t = \sum_{i=1}^{\infty} \frac{E_t[C_{t+i}]}{(1+r)^i}$$

V_t = Price or Value at time t
$E_t[C_{t+i}]$ = expected cash inflow to entity
r = the cost of capital (discount rate)

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Second Level: Fundamental Concepts

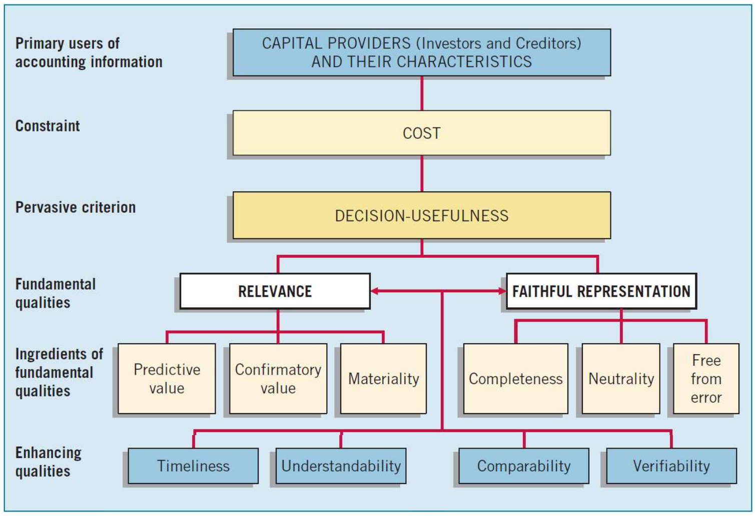
Qualitative Characteristics

"The **FASB** identified the **Qualitative Characteristics** of accounting information that distinguish better (more useful) information from inferior (less useful) information for *decision-making purposes*."

- What decision?

Second Level: Qualitative Characteristics

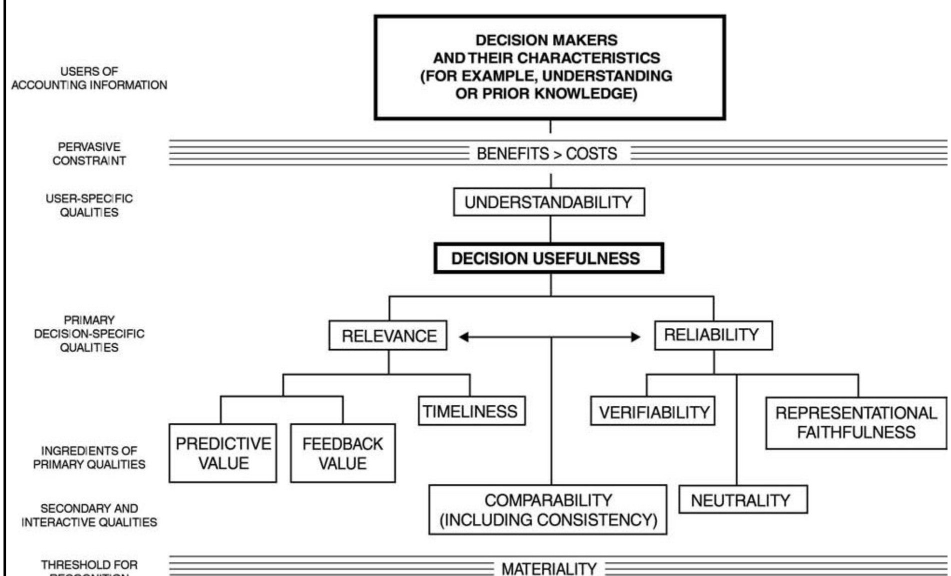
The chart below is based on SFAC No. 8, which superseded SFAC No. 1 and No. 2



Faithful Representation used to be called *Reliability* in SFAC No. 2

Second Level: Qualitative Characteristics

Figure 1 from SFAC No. 2, p. 20



Fundamental Qualitative Characteristics

Relevance: To be *relevant,* accounting information must be capable of making a difference in a decision.

- **Predictive value:** Financial information has predictive value if it has value as an input to predictive processes used by investors to form their own expectations about the future.
- **Confirmatory value:** Relevant information also helps users confirm or correct prior expectations.
- **Materiality:** Information is material if omitting it or misstating it could influence decisions that users make on the basis of the reported financial information.

Fundamental Qualitative Characteristics

Faithful representation: means that the numbers and descriptions match what really existed or happened.

- **Completeness:** means that all the information that is necessary for faithful representation is provided.
- **Neutrality:** means that a company cannot select information to favor one set of interested parties another.
- **Free from error:** Information that is free from error will be a more accurate representation of a financial item.

Enhancing Qualitative Characteristics

The following are qualitative characteristics that enhance the relevance and faithful representation of accounting information.

- **Timeliness:** means having information available to decision-makers before it loses its capacity to influence decisions.
- **Understandability:** is the quality of information that lets reasonably informed users see its significance.
- **Comparability**: Information that is measured and reported in a similar manner for different companies is considered comparable.
- **Verifiability:** occurs when independent measures, using the same methods, obtain similar results.

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Second Level: 10 Basic Elements

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

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

Equity or net assets is the residual interest in the assets of an entity that remains after deducting its liabilities. In a business enterprise, the equity is the ownership interest.

Second Level: 10 Basic Elements

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

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

Second Level: 10 Basic Elements

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

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

Second Level: 10 Basic Elements

Comprehensive income is the change in equity of a business enterprise during a period from transactions and other events and circumstances **from non-owner sources**. It includes all changes in equity during a period except those resulting from investments by owners and distributions to owners.

Second Level: 10 Basic Elements

Investments by owners are increases in equity of a particular business enterprise resulting from transfers to it from other entities of something valuable to obtain or increase ownership interests (or equity) in it. Assets are most commonly received as investments by owners, but that which is received may also include services or satisfaction or conversion of liabilities of the enterprise.

Distributions to owners are decreases in equity of a particular business enterprise resulting from transferring assets, rendering services, or incurring liabilities by the enterprise to owners. Distributions to owners decrease ownership interest (or equity) in an enterprise.

What is an Accounting Asset?

Which of those items are accounting assets for Illy? Explain.

1. A bag of raw coffee
2. $500 cash
3. Coffee machine
4. Building
5. Corporate jet
6. A nice painting in the corporate headquarters
7. Customer's promise to pay $100 cash for coffee he picked up today
8. A strong brand image
9. Two really talented employees
10. A star employee
11. NFL Football Player

Keep in mind:

Element:

1. **Control (~ownership)**
2. **Probable future benefits**

Criteria for Recognition:

1. **Element**
2. **Reliably measured**

Standard Financial Statements

A standard set of financial statements includes:

1. Balance sheets for the 2 most recent fiscal year ends
2. Stmt. of comprehensive income for the 3 most recent fiscal years
3. Stmt. of cash flows for the 3 most recent fiscal years
4. Stmt. of changes in equity for the 3 most recent fiscal years

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Third Level: 4 Basic Assumptions

Economic Entity – The Company keeps its activity separate from its owners and other businesses.

Going Concern – Unless stated otherwise, every business is assumed to be a going concern that will continue operating indefinitely.

Monetary Unit – Money is the common denominator. Any changes in the purchasing power of the monetary unit is assumed to be insignificant.

Periodicity - company can divide its economic activities into time periods.

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Third Level: Basic Principles

1. Revenue Recognition Principle
2. Expense Recognition Principle
3. Measurement principle

Third Level: Basic Principles

Revenue Recognition – refers to the timing and measurement of revenues.

Generally, revenue is recognized when it is

(1) realized or realizable and

(2) earned

Third Level: Basic Principles

Revenue Recognition – refers to the timing and measurement of revenues.

➢ **When should Great Deal Inc. recognize revenue?**

- Jan 1st 20x1, customer buys gift card for $1,000. This card will expire 5 years after the issue date.
- Aug 10th 20x1, customer uses the gift card to purchase a $700 computer monitor.
- Jan 1st 20x5, the card expires.

Third Level: Basic Principles

Expense Recognition – refers to the timing and measurement of expenses. The question is *when* does a firm consume an asset or incur a liability.

- **Matching:** Synonymous with cause and effect. Let the expenses follow the revenues. (e.g. Cost of Goods Sold)
- **Systematic and rational allocation:** If unable to directly relate costs and revenues. This method is applied when a causal relationship is generally but not specifically identified. (e.g. depreciation).
- **Immediate recognition**: Applies when the benefits of these costs are used up in the same period (e.g. utilities expense). This method can also apply when the period(s) in which future benefits will materialize are not feasibly determinable (e.g. R&D or advertising expense).

Third Level: Basic Principles

Measurement Principle – The most commonly used measurements are based on **historical cost** and **fair value**.

Issues:

- **Historical cost** provides a reliable benchmark for measuring historical trends.
- **Fair value** information may be more useful.
- Recently the FASB has taken the step of giving companies the option to use fair value as the basis for measurement of financial assets and financial liabilities.
- Reporting of fair value information is increasing.

➢ *See SFAC No. 5 – paragraph 67 for a list of 5 measurement attributes.*

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Four fundamental recognition criteria

1) Definitions:
the item meets the definition of an element of financial statements

2) Measureability:
the item has a relevant attribute which can be measured with sufficient reliability

3) Relevance:
the information about the item is capable of making a difference in user decisions

4) Reliability:
the information is representationally faithful, verifiable, and neutral

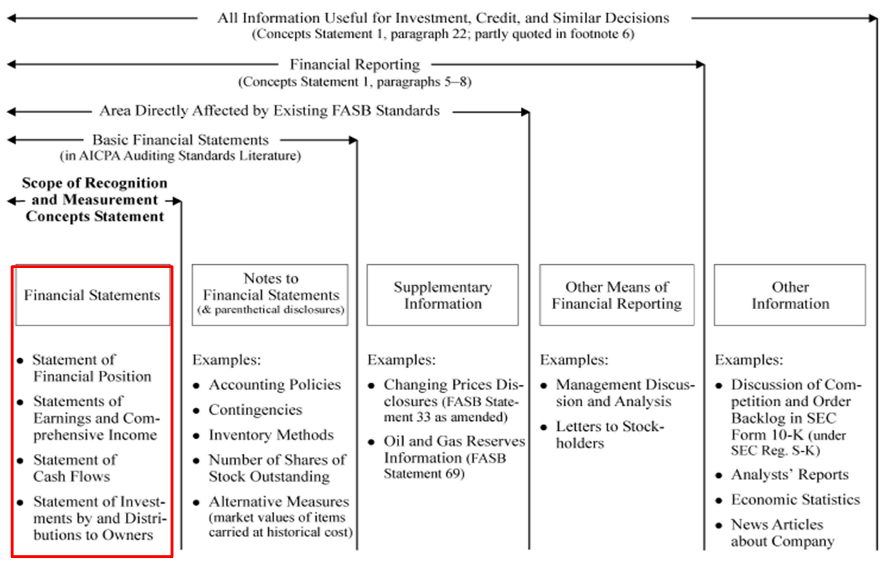
- *See SFAC No. 5 – paragraph 63.*

Measurement attributes in SFAC No. 5

a) Historical cost / historical proceeds
b) Current replacement cost
c) Current market value (exit value)
d) Net realizable value / settlement value
e) Present value of future cash flows

- www.FASB.org > Standards > Concepts Statements

Scope of Measurement and Recognition Principles



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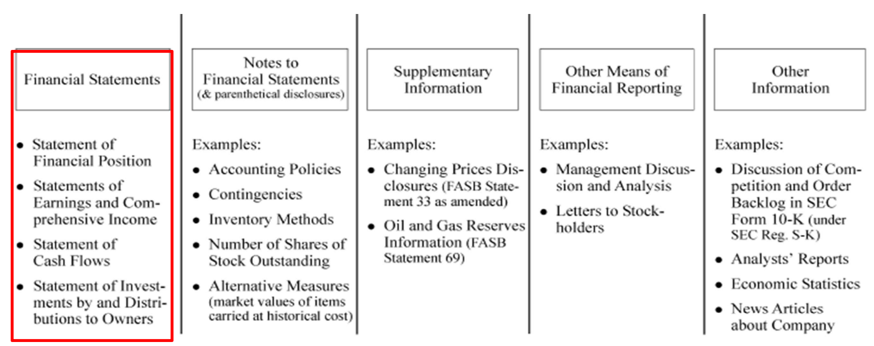
SFAC-5, page 8. downloaded from: http://www.fasb.org/jsp/FASB/Page/SectionPage&cid=1176156317989

Scope of Measurement and Recognition Principles

Accounting can help you separate what you know from speculation



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SFAC-5, page 8. downloaded from: http://www.fasb.org/jsp/FASB/Page/SectionPage&cid=1176156317989

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Fair Value Measurement

SFAS No. 157 (ASC 820):

- Before SFAS 157 was issued GAAP included inconsistent definitions of fair value
- SFAS 157 standardizes the definition of fair value and establishes a framework for measuring fair value
- SFAS 157 is effective for fiscal years commencing after Nov. 15, 2007

Fair Value Measurement

Definition: Fair Value

Fair value (FV) is the price to sell an asset (A) or transfer a liability (L) in an orderly transaction between market participants at the measurement date

- For specific A/L or group of A/L
- FV is a **market specific**, not an entity specific measure
- FV is an **exit price**, not an entrance price
- FV is measured in the *principal, or most advantageous market** for A/L
- **FV does not include transaction costs**
- FV of an asset assumes the highest or best use of the asset
- FV measure should reflect all the assumptions that market participants would use in pricing the A/L, including assumptions about risk
- FV of a liability should include the liability's nonperformance risk

** Note: The most advantageous market is the market with the best price for the A or L <u>after considering transaction costs</u>.*

Fair Value Measurement

Valuation Techniques in SFAS 157 (ASC 820)

Market approach

- uses prices and other relevant information from market transactions involving identical or comparable assets or liabilities to measure fair value

The income approach

- converts future amounts, including cash flows or earnings, to a single discounted amount to measure fair value of A or L

The cost approach

- Uses current replacement cost to measure the fair value of assets

Fair Value Measurement

Hierarchy of Inputs

Level 1 inputs

- are quoted prices in active markets for *identical* Assets (A) or Liabilities (L) that the reporting entity has access to on the measurement date.

Level 2 inputs

- are inputs other than quoted market prices (level 1) that are directly or indirectly observable for the A or L. Level 2 inputs include:
  - Quoted prices for *similar* A or L in active markets
  - Quoted prices for identical or similar A or L in markets that are *not active*
  - Inputs other than quoted prices that are observable for the A or L
  - Inputs that are derived from or verified by observable market data

Fair Value Measurement

Hierarchy of Inputs

Level 3 inputs

- are *unobservable* inputs for the A or L.
- Unobservable inputs reflect the reporting entity's *assumptions* and should be based on the best available information.

- **Discuss the trade-off between relevance and reliability for FV measures.**
- **Under what circumstances would FV be a good measure?**

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Third Level: Constraints

Cost Constraint – cost of providing information must be weighed against the benefits that can be derived from using it. The costs must be smaller than the benefits.

Conservatism Constraint – conservatism is the accountant's response to uncertainty. More timely recognition of bad news than good news. Higher tolerance for uncertainty with bad news.

Industry Practice - the peculiar nature of some industries and business concerns sometimes requires departure from basic accounting theory. E.g. banks and insurers heavily rely on fair value measurement

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