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Standards and Conceptual Framework

Financial Accounting Standards

1) Standard-Setting Bodies in the United States

In the United States, the Securities and Exchange Commission SEC has the legal authority to establish U.S. generally accepted accounting principles (GAAP). However in most instances, the SEC has allowed the accounting profession to establish GAAP and self-regulate. The SEC and three different bodies of the accounting profession have determined GAAP since 1934.

- Securities and Exchange Commission (SEC)

The SEC was established by the Securities Exchange Act of 1934. All companies that issue securities in the United States are subject to SEC rules and regulations. The SEC has issued public company specific accounting rules and regulations in Regulation S-X, Financial Reporting Releases (FRR), Accounting Series Releases (ASR), Interpretative Releases (IR), Staff Accounting Bulletins (SAB), and EITF Topic D and SEC Observer comments.

Source: Becker Professional Education Corporation

Standards and Conceptual Framework (Cont)

- Committee on Accounting Procedure (CAP)

The Committee on Accounting Procedure (CAP) was a part-time committee of the American Institute of Certified Public Accountants (AICPA) that promulgated Accounting Research Bulletins (ARB), which determined GAAP from 1939 until 1959.

- Accounting Principles Board (APB)

The Accounting Principles Board (APB) was another part-time committee of the AICPA. It issued Accounting Principles Board Opinions (APBO) and APB Interpretations, which determined GAAP from 1959 until 1973.

- Financial Accounting Standards Board (FASB)

In 1973 an independent full-time organization called the Financial Accounting Standards Board (FASB) was established, and it has determined GAAP since then. Through 2009, the FASB issued statements of Financial Accounting Standards (SFAS), FASB Interpretations (FIN), FASB Technical Bulletins (FTB), Emerging Issues Task Force Statements (EITF), FASB Staff Positions, FASB Implementation Guides, and Statements of Financial Accounting Concepts (SFAC). The FASB has seven full-time members, who serve for five-year terms and may be reappointed to one additional five-year term.

Source: Becker Professional Education Corporation

Standards and Conceptual Framework (Cont)

2) U.S. GAAP: FASB Accounting Standards Codification®

The vast number of standards issued by the Committee on Accounting Procedures, the Accounting Principles Board, and the Financial Accounting Standards Board, as well as additional guidance provided by the SEC and the AICPA, made it difficult for users to access the full body of U.S GAAP. Effective July 1, 2009, the FASB Accounting Standards Codification® became the single source of authoritative nongovernmental U.S GAAP. Accounting and financial reporting practices not included in the codification are not GAAP.

3) Private Company Council (PCC)

The Financial Accounting Foundation (FAF) created the Private Company Council (PCC) to improve standard setting for privately held companies in the U.S. The goal of the PCC is to establish alternatives to U.S. GAAP, where appropriate, to make private company financial statements more relevant, less complex, and cost-beneficial. Accounting alternatives for private companies are incorporated into the relevant sections of the Accounting Standards Codification (ASC).

Source: Becker Professional Education Corporation

Standards and Conceptual Framework (Cont)

4) Ongoing Standard-Setting Process

The FASB updates the Accounting Standards Codification for new U.S. GAAP issued by the FASB and for amendments to the SEC content with Accounting Standards Updates.

Proposed FASB amendments to the ASC are issued for public comment in the form of exposure drafts. A majority vote of the Board members is required to approve an exposure draft for issuance. At the end of the exposure draft public comment period, the FASB staff analyzes and studies all comment letters and position papers and then the Board re-deliberates the issue. When the board is satisfied that all reasonable alternatives have been adequately considered, the FASB staff prepares an Accounting Standards Update for Board consideration. A majority vote of the Board members is required to amend the ASC.

Accounting Standards Updates are not authoritative literature, but instead provide background information, update the codification, and describe the basis for conclusions on changes in the codification. All new GAAP and SEC amendments are fully integrated into the existing structure of the codification.

Source: Becker Professional Education Corporation

Conceptual Framework for Financial Reporting

The FASB has created a conceptual framework (set forth in pronouncements called Statements of Financial Accounting Concepts, or SFAC) that serves as a basis for all FASB pronouncements. The SFAC are not GAAP, but they provide a basis for financial accounting concepts for business enterprises and not-for-profit entities. The framework is a coherent system of interrelated objectives and concepts that prescribe the nature, function, and limits of financial accounting and reporting that is expected to lead to consistent standards.

1) SFAC No. 8, Conceptual Framework for Financial Reporting- Chapter 1: "The Objective of General Purpose Financial Reporting":
The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to the primary users of general purpose financial reports in making decisions about providing resources to the reporting entity.

- Primary Users:

The primary users of general purpose financial reports are existing and potential investors, lenders and other creditors. Other parties, including regulators and members of the public who are not investors, lenders, and other creditors, may also use general purpose financial reports, but are not considered to be primary users.

Source: Becker Professional Education Corporation

Conceptual Framework for Financial Reporting

- Financial Information Provided in General Purpose Financial Reports:

Financial information needed by primary users includes information about the resources of the entity, the claims against the entity, the changes in the resources and claims, and how efficiently and effectively the entity's management and governing board have discharged their responsibilities to use the entity's resources. Financial Information should be presented using the accrual basis of accounting. Accrual accounting includes the effects of transactions in the period in which they occur, regardless of the timing of the related cash receipt of payment. This provides a better basis for a financial statement user for assessing past and future performance.

Existing and potential investors, lenders, and other creditors use financial information to assess the reporting entity's prospects for future net cash inflows to the entity. Such information may be used to estimate the value of the reporting entity.

Source: Becker Professional Education Corporation

Conceptual Framework for Financial Reporting (Cont)

2) SFAC No. 8, Conceptual Framework for Financial Reporting- Chapter 3: "Qualitative Characteristics of Useful Financial Information"

The qualitative characteristics of useful financial information are the characteristics that are likely to be most useful to existing and potential investors, lenders, and other creditors in making decisions about the reporting entity based on financial information.

- Fundamental Qualitative Characteristics:

The fundamental qualitative characteristics of useful financial information are relevance and faithful representation. Both characteristics must be present for financial information to be useful.

- **Relevance**: Financial information is relevant if it is capable of making a difference in the decisions made by users. To be relevant, financial information must have predictive value and/or confirming value, and must be material.

- **Faithful Representation**: To be useful, financial information must faithfully represent the reported economic phenomena. Faithful representation requires the financial information to be complete, neutral, and free from error.

Source: Becker Professional Education Corporation

Conceptual Framework for Financial Reporting (Cont)

- Enhancing Qualitative Characteristics:

Comparability, verifiability, timeliness, and understandability enhance the usefulness of information that is relevant and faithfully represented. These characteristics can be used to determine how an economic event or transaction should be depicted if two ways are equally relevant and faithfully represented. The enhancing qualitative characteristics should be maximized.

- The Cost Constraint:

The cost constraint is a pervasive constraint on the information provided in financial reporting. The benefits of reporting financial information must be greater than the costs of obtaining and presenting the information. The FASB considers costs and benefits in relation to financial reporting in general and not at the individual reporting entity level.

Source: Becker Professional Education Corporation

Conceptual Framework for Financial Reporting (Cont)

3) SFAC No. 8, Conceptual Framework for Financial Reporting- Chapter 4: “Elements of Financial Statements”

Elements are the components of the financial statements, and the definitions below focus on the essential characteristics. Other areas of the conceptual framework focus on recognition and measurement in the financial statements.

- **Assets**: An asset is a present right of an entity to an economic benefit. The right must be present, meaning it must exist at the financial statement date.

- **Liabilities**: A liability is a present obligation of an entity to transfer or provide an economic benefit to others.

- **Equity (or Net Assets)**: Equity is the residual interest in the assets of the entity that remains after deducting the entity’s liabilities.

- **Investments by Owners**: Investments by owners are increases in the equity of an entity resulting from transferring something valuable to obtain or increase ownership interests (or equity) in the entity.

Source: Becker Professional Education Corporation

Conceptual Framework for Financial Reporting (Cont)

- **Distributions to Owners**: Distributions to owners are decreases in the equity of an entity from transfers of cash, property, or services, or the incurrence of a liability to owners.

- **Comprehensive Income**: Comprehensive income includes any change in equity other than investments by owners and distributions to owners (Eg: Net income plus other comprehensive income).

- **Revenues**: Revenues are inflows or enhancements of assets, or settlements of liabilities from delivering or producing goods or services.

- **Expenses**: Expenses are outflows or uses of assets, or incurrences of liabilities from delivering or producing goods or services.

- **Gains**: Gains are increases in equity from transactions and other events, except those that result from revenues and investments from owners.

- **Losses**: Losses are decreases in equity from transactions and other events, except those that result from expenses and distributions to owners.

Source: Becker Professional Education Corporation

Conceptual Framework for Financial Reporting (Cont)

4) SFAC No. 8, Conceptual Framework for Financial Reporting- Chapter 7: “Presentation”

This chapter of the framework describes the information to be included in general purpose financial reporting and how presentation can contribute to achieving the objective of financial reporting. General purpose financial reporting is defined as a full set of financial statements (statement of financial position, statement of earnings, Statement of comprehensive income, statement of cash flows, and statement of owner’s equity) and the notes to financial statements. Presentation refers to the display of line items of the financial statements, including totals and subtotals.

- **Assets, Liabilities, and Equity**: Information about an entity’s assets, liabilities, equity, and their relationship to each other at a point in time helps financial statement users to assess items such as liquidity, financial flexibility, net resources available, capability of generating future net cash flows, risk exposures, and the entity’s ability to meet its long-term financial obligations.

Source: Becker Professional Education Corporation

Conceptual Framework for Financial Reporting (Cont)

- **Revenues, Expenses, Gains, and Losses- Components of Comprehensive Income**: Revenues, expenses, gains, and losses provide information about how and to what extent an entity has been able to increase or decrease overall equity without the consideration of investments from and distributions to owners. Financial statement users can evaluate how assets and other resources were used and how efficiently the entity financed or supported its activities.

- **Cash Flows**: Information about an entity's cash receipts and payments helps financial statement users to assess the entity's financial flexibility and risk. An understanding of the type of transaction causing the inflow or outflow of cash may help a resource provider to assess the prospects for future net cash flows.

- **Investments by and Distributions to Owners**: Investments by and distributions to owners reflects the changes in equity resulting from transactions with owners and may help a user of the financial statement, in conjunction with other information, to assess the entity's financial flexibility, capacity for future cash flow generation, and risk.

Source: Becker Professional Education Corporation

Conceptual Framework for Financial Reporting (Cont)

- **Comprehensive Income and Net Income**: Comprehensive income summarizes the net effects of all recognized changes in equity during a period, except those resulting from transactions with owners. For entities without owners, such as not-for-profit entities, comprehensive income represents all changes in net assets.

- **Presentation Considerations**: Financial information must be condensed and aggregated into meaningful line items, subtotals, and totals without losing useful information about the underlying data. The following are important considerations when determining line-item presentation of individual items:

- ❑ Cause, activity, and frequency
- ❑ Expected timing and form of realization or settlement
- ❑ Response to changes in economic conditions or other factors
- ❑ Method of measurement
- ❑ Relationship with other information

Source: Becker Professional Education Corporation

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Thank You!

For queries, write to us at: care@edupristine.com