CHAPTER 2 - THE CONCEPTUAL FRAMEWORK

1. What is The Conceptual Framework of Accounting?

   Your authors refer to it as a "Constitution".

   "...a coherent system of interrelated objectives and fundamentals."

2. What is the purpose?

   A. Define the boundaries of accounting by providing:

      1. The basic objectives and users
      2. Definitions of key terms
      3. Establish fundamental concepts

   B. Assist the FASB in standard setting by providing a basis for developing new and revised standards.

   C. Provide a description of current practice and a frame of reference for new issues.

   D. Assist accountants and others in selecting between acceptable accounting alternatives.

3. When was it issued?

   The process began in 1976 and was completed in 1985. Why so late?

4. What is included in the Conceptual framework?

   SFAC No. 1. "Objectives of Financial Reporting by Business Enterprises" presents the goals and purposes of accounting.

   SFAC No. 2. "Qualitative Characteristics of Accounting Information" examines the characteristics that make accounting information useful.

   SFAC No. 6. "Elements of Financial Statements," defines the broad classifications of items found in financial statements and replaces ***SFAC No. 3,*** expanding its scope to include not-for-profit organizations.

   SFAC No. 4. "Objectives of Financial Reporting for Nonbusiness Organizations" provides guidelines for not-for-profit and governmental entities.

   SFAC No. 5. "Recognition and Measurement in Financial Statements of Business Enterprises" giving guidance on what information should be formally incorporated into financial statements and when.

SFAC No. 1 "Objectives of Financial Reporting by Business Enterprises"

A. Defines the users of accounting information.

1. Present and potential investors and creditors
2. Defines the user as the average prudent user with a reasonable understanding of economic and business situations.

B. Defines the objectives of financial reporting.

1. To provide information that is useful in making rational investment, credit and similar decisions
2. To help users assess the timing and uncertainty of cash flows.
3. To provide information on economic resources, claims and changes in them.

SFAC No. 2. "Qualitative Characteristics of Accounting Information"

Concepts Statement #2 identifies primary and secondary qualitative characteristics of accounting information that distinguish better (more useful) information from inferior (less useful) information for decision-making purposes.

1. **Primary Qualities**

The **primary qualities** that make accounting information useful for decision making are **relevance** and **reliability**.

Relevance. Accounting information is relevant if it is capable of making a difference in a decision. For information to be relevant, it should have

a. predictive or feedback value, and
b. it must be presented on a timely basis.

Reliability. Accounting information is reliable to the extent that it is verifiable, is a faithful representation and is reasonably free of error and bias. To be reliable, accounting information must include:

a. verifiability,
b. representational faithfulness, and
c. neutrality.

Secondary Qualities

The **secondary qualities** identified are **comparability** and **consistency**.

Comparability. Accounting information that has been measured and reported in a similar manner for different enterprises is considered comparable.

Consistency. Accounting information is consistent when an entity applies the same accounting treatment to similar events from period to period.

SFAC No. 6. "Elements of Financial Statements"

Basic Elements

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

Liabilities. Probable future sacrifices of economic benefits that arise 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. Residual interest in the assets of an entity that remains after deducting its liabilities. In a business enterprise, the equity is the ownership interest.

Investment by Owners. Increases in net assets of a particular enterprise resulting from transfers to it from other entities of something of value 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 include services or satisfaction or conversion of liabilities of the enterprise.

Distribution to Owners. Decreases in net assets of a particular enterprise that result from transferring assets, rendering services, or incurring liabilities by the enterprise to owners. Distributions to owners decrease ownership interests (or equity) in an enterprise.

Comprehensive Income. Change in equity (net assets) of an entity during a period from transactions and other events and circumstances from nonowner sources. It includes all changes in equity during a period, except those resulting from investments by owners and distributions to owners.

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

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

Gains. 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 during a period except those that result from revenues or investments by owners.

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

SFAC No. 5 “Recognition and Measurement in Financial Statements of Business Enterprises”

Basic Assumptions

Economic Entity Assumption. The economic activities of an entity can be accumulated and reported in a manner that assumes the entity is separate and distinct from its owners or other business units.

Going-Concern Assumption. In the absence of contrary information, a business entity is assumed to remain in existence for an indeterminate period of time. The current relevance of the historical cost principle is dependent on the going-concern assumption.

Monetary Unit Assumption. In the United States, economic activities of an entity are measured and reported in dollars. These dollars are assumed to remain relatively stable over the years in terms of purchasing power. In essence, this assumption disregards any inflation or deflation in the economy in which the entity operates.

Periodicity Assumption. The life of an economic entity can be divided into artificial time periods for the purpose of providing periodic reports on the economic activities of the entity.

Basic Principles

Historical Cost Principle. Acquisition cost is the most objective and verifiable basis upon which to account for assets and liabilities of a business enterprise. Cost has been found to be more definite and determinable than other suggested valuation methods.

Revenue Recognition Principle. Revenue is recognized when the earning process is virtually complete and an exchange transaction has occurred. Generally, this takes place when a sale to another individual or independent entity has been confirmed. Confirmation is usually accomplished by a transfer of ownership in an exchange transaction.

Matching Principle. Accountants attempt to match expenses incurred while earning revenues with the related revenues. Use of **accrual accounting procedures** assists the accountant in allocating revenues and expenses properly among the fiscal periods that compose the life of a business enterprise.

Full Disclosure Principle. In the preparation of financial statements, the accountant should include sufficient information to permit the knowledgeable reader to make an informed judgment about the financial condition of the enterprise in question.

Constraints

Cost-Benefit Relationship. This constraint relates to the notion that the benefits to be derived from providing certain accounting information should exceed the costs of providing that information. The difficulty in cost-benefit analysis is that the costs and especially the benefits are not always evident or measurable.

Materiality. In the application of basic accounting theory, an amount may be considered less important because of its size in comparison with revenues and expenses, assets and liabilities, or net income. Deciding when an amount is material in relation to other amounts is a matter of judgment and professional expertise.

Industry Practices. Basic accounting theory may not apply with equal relevance to every industry that accounting must serve. The fair presentation of financial position and results of operations for a particular industry may require a departure from basic accounting theory because of the peculiar nature of an event or practice common only to that industry.

Conservatism. When in doubt, an accountant should choose a solution that will be least likely to overstate assets and income. The conservatism constraint should be applied only when doubt exists. An intentional understatement of assets or income is not acceptable accounting.