Environment and Theoretical Structure of Financial Accounting

THE CONCEPTUAL FRAMEWORK

The conceptual framework was developed to guide the FASB in developing financial accounting standards. It consists of a series of Statements of Financial Accounting Concepts which will be discussed below:

- **SFAC #1 “Objectives of Financial Reporting by Business Enterprises”**
  The objectives of the conceptual framework is to provide information
  1. Useful for decision making.
  2. That helps predict cash flows.
  3. About economic resources, claims to resources, and changes in resources and claims

- **SFAC #2 “Qualitative Characteristics of Accounting Information”**
  The qualitative characteristics of accounting information include:
  1. **User-Specific Quality-Understandability**, users must be able to understand the financial statements in the context of making investment and/or credit decisions. Users are expected to have some degree of knowledge and be willing to study the financial statements.
  2. **Overriding Objectives-Decision Usefulness** requires that the financial statements are useful in making investment and/or credit decisions.
  3. **Primary Qualities**
     A. **Relevance**-the accounting information must make a difference in the decision making process. The components of relevance are:
        (1) **Predictive value**, the information should be useful in predicting future cash flows.
        (2) **Feedback value**, the information should confirm investor expectations about future cash flows based on net income.
        (3) **Timeliness**, the information must be available in time to make investment and/or credit decisions.
     B. **Reliability**-the accounting information must be verifiable, representationally faithful and neutral.
        (1) **Verifiability**, the accounting information is objectively obtained.
        (2) **Representational Faithfulness**, there is agreement between the measure and what users would assume that the measure represents.
        (3) **Neutrality**, the information does not favor one particular group over other interested parties.
  4. **Secondary Qualities**
     A. **Comparability**-the information can be compared for similarities and differences among events and conditions.
     B. **Consistency**-the information allows comparisons between different time periods.
  5. **Constraints**
     A. **Cost Effectiveness**, the costs of providing accounting information must not exceed the benefits at the public level.
     B. **Materiality**, a subjective judgment as to whether the item would effect the decision of financial statement users.
C. **Conservatism**, a practical justification in making accounting choices taking into consideration uncertainties and risks.

- **SFAC #6 “Elements of Financial Statements”**
  The FASB identified 10 elements that comprise the classes of items reported in the financial statements.
  1. **Assets**, probable future economic benefits.
  2. **Liabilities**, obligations to other entities
  3. **Equity**, residual owners’ interest in the net assets of the business
  4. **Investments by owners**, transactions describing owner contributions
  5. **Distributions to owners**, transactions describing withdrawals by owners
  6. **Revenues**, gross inflows resulting from providing goods or services to customers
  7. **Gains**, inflows from transactions not related to sales to customers
  8. **Expenses**, gross outflows incurred in generating revenues
  9. **Losses**, outflows from transactions not related to operating activities
  10. **Comprehensive Income**, all changes in equity except those with owners

- **SFAC #5 “Recognition and Measurement in Financial Statements of Business Enterprises”**
  
  A. **Recognition**, the process of including data in the accounting information system and therefore the financial statements. The four criteria for recognition are:
    1. **Definition**: the item meets the definition of an element
    2. **Measurability**: the item has a relevant attribute measurable with sufficient reliability
    3. **Relevance**: the information is capable of making a difference in the decision making process
    4. **Reliability**: the information is representationally faithful, verifiable, and neutral.
  
  B. **Measurement**, the process of assigning numerical amounts to the elements.
    1. **Unit of measurement**: money without adjustments
    2. **Attributes**:
       a) Historical costs
       b) Net realizable value
       c) Present value of future cash flows

  C. **Assumptions**
    1. **Economic Entity Assumption**
       Financial information is reported about a unique economic entity and not the activities of the owners or of an entire industry.
    2. **Going Concern Assumption**
       Financial information is based on the assumption that the business will continue to operate and therefore the accruals and deferrals that are an integral part of accrual accounting will remain relevant.
    3. **Periodicity Assumption**
       Third party users need financial information in order to make investment and/or credit decisions. In order to provide timely information the activities of the
business enterprise are broken into accounting periods so that investors and creditors can assess the progress of the organization.

4. **Monetary Unit Assumption**  
U.S. dollars are the unit of measurement in reporting financial information in the United States.

D. **Principles**
1. **Historical Cost Principle**  
GAAP requires that assets and liabilities be measured at their original transaction value. This provides useful cash flow information and arms length exchanges between entities are both objective and verifiable.

2. **Realization Principle**  
For revenue to be recognized two criteria must be satisfied: 1) the earnings process must be complete, and 2) collection is reasonably assured.

3. **Matching Principle**  
Expenses are recognized in the period in which related revenues are generated. There are four approaches to recognizing expenses depending on the type of expense involved: 1) based on a direct relationship between the expense and related revenue, 2) based on the type period in which the expense is used, 3) based on a systematic and rational allocation to specific time periods, and 4) based on the period incurred without reference to the revenue generated.

4. **Full-Disclosure Principle**  
The full-disclosure principle specifies that information should be provided that would effect the investment and/or credit decisions of third party financial statement users.

**ETHICS IN ACCOUNTING**

In a professional setting, ethics involves the ability to distinguish between right and wrong. Professional accountants are faced with complex situations in which the appropriate decision is not always clear. Through membership in professional organizations the conduct of professional accountants is governed by a code of professional ethics. In addition, with the passage of the *Public Company Accounting Reform and Investor Protection ACT of 2002*, the SEC has jurisdiction over the behavior of professional accountants who work for publicly traded companies.

**AICPA CODE OF ETHICS**

**Preamble**  
A certified public accountant assumes an obligation of self-discipline above and beyond the requirements of laws and regulations.

**Article I-Responsibilities**  
In carrying out their responsibilities as professionals, members should exercise sensitive professional and moral judgments in all their activities.
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**Article II-The Public Interest**  
Members should accept the obligation to act in a way that will serve the public interest, honor the public trust, and demonstrate commitment to professionalism.

**Article III-Integrity**  
To maintain and broaden public confidence, members should perform all professional responsibilities with the highest sense of integrity.

**Article IV-Objectivity and Independence**  
A member should maintain objectivity and be free of conflicts of interest in discharging professional responsibilities. A member in public practice should be independent in fact and appearance when providing auditing and other attest services.

**Article V-Due Care**  
A member should observe the profession’s technical and ethical standards, strive continually to improve competence and the quality of services, and discharge professional responsibility to the best of the member’s ability.

**Article VI-Scope and Nature of Services**  
A member in public practice should observe the Principles of the Code of Professional Conduct in determining the scope and nature of services to be provided.

**GUIDANCE IN IDENTIFYING AND MANAGING ETHICAL DILEMMAS**

**Analytical Model for Ethical Decisions**

1. Determine the facts of the situation.
2. Identify the ethical issues and the stakeholders.
3. Identify the values related to the situation.
4. Specify the alternative courses of action.
5. Evaluate the alternative courses of action in terms of their consistency with the values identified above.
6. Identify the consequences of each possible course of action.
7. Make your decision and take any indicated action.