

2.4: What principles does the FASB follow in setting accounting standards?

Learning Objectives

At the end of this section, students should be able to meet the following objectives

- Identify the conceptual framework of accounting
- Explain how the conceptual framework informs the setting of standards in accounting
- Give examples of the application of principles contained in the conceptual framework

Question: What kind of framework does the FASB use to guide the setting of accounting standards in the United States?

Many of you are familiar with the concept that organizations or countries are governed by constitutions or general principles that guide leaders in those organizations or countries as they make important decisions. Those decisions include the laws that affect all the citizens or members of those organizations. The constitution provides overall guidance for the making of laws and regulations. To be consistent in the making of rules, the FASB has established a sort of constitution or **conceptual framework** that is to be used to help in deliberating what the accounting rules should look like in a world of ever changing business needs.

This conceptual framework helps to define the elements of accounting (which will be discussed in the next section) and describes additional principles that should help the FASB as they make important decisions. This framework includes broad principles rather than specific descriptions so that they can be adapted to the wide range of situations encountered in making accounting rules. Generally accepted accounting principles (GAAP) refers to both the broad principles (constitution) and the more specific rules as found in the codification mentioned earlier.

Question: What broad principles could be considered part of Generally Accepted Accounting Principles?

Answer: General principles about who the financial information is for and what they will look for in that information are as follows:

- The primary audience for financial information reported under these principles is **investors** – those looking to make a return on their money by either loaning or buying stock in a company. While there are lots of other users of financial information (government, employees, etc) the most important is considered to be **investors**. Their needs tell us generally what should and should not be included in the financial statements.
- To be helpful, financial information must be **understandable** and **useful for making decisions**
- Useful information is both **relevant** to decisions that need to be made (future cash flows) and **reliable** (you can trust it when making those decisions)
- To be relevant, financial information must be **timely** (cannot be too old) and provide information needed to either **evaluate** past performance or **predict** future performance.
- To be reliable, financial statements and the amounts they show must be **verifiable**, free from error (at least close) and **neutral** (not favoring one decision over another).
- To summarize and report the information, the **cost** to find and calculate the information cannot be greater than the **benefit** of that information and amounts need to be material (as discussed earlier in this chapter)

To guide accountants in providing **relevant** and **reliable** information, the following more specific assumptions and principles are used in most situations:

1. Business Entity Assumption

An understanding is needed of what business entity is providing the financial information to decision makers. This is so important because transactions that affect the separate owners of a business and not the business itself will be left out of our accounting for the business. Two businesses that may be closely related may need to be accounted for separately because they have different ownership. Other businesses may be combined for financial reporting because they have the same ownership – it depends on the business entity assumption that is being made.

2. Monetary Unit Assumption

Economic activity is measured in U.S. dollars, and only transactions that can be expressed in U.S. dollars are recorded. This monetary unit will be different if we are operating in Denmark or Japan.

Because of this basic accounting principle, it is assumed that the dollar's purchasing power has not changed over time. As a result accountants ignore the effect of inflation on recorded amounts.

3. Time Period Assumption

This accounting principle assumes that it is possible to report the complex and ongoing activities of a business in relatively short, distinct time intervals such as the five months ended May 31, 2023, or the 5 weeks ended May 1, 2023. The shorter the time interval, the more likely the need for the accountant to estimate amounts relevant to that period. Most typical accounting periods are one month, one quarter (three months) and one year (12 months).

It is *imperative* that the time interval (or period of time) be shown in the heading of each income statement, statement of stockholders' equity, and statement of cash flows. Labeling one of these **financial statements** with "December 31" is not good enough—the reader needs to know if the statement covers the *one week* ended December 31, 2023 the *month* ended December 31, 2023 the *three months* ended December 31, 2023 or the *year ended* December 31, 2023. This heading of the financial information helps the reader know how **timely** the financial information is.

4. Objectivity Principle

The principle of objectivity backs up the idea that to be provide information that can be relied on by investors to make decisions, that information should be objective not subjectively based on the opinion of the accountant. The accountant should be able to point to information that can be **verified** to back up recorded amounts. There will be estimates but even in those cases there should be evidence that backs up the estimate and that could be verified by another person. To maintain objectivity, accountants record many financial statement items at their **cost** – what was actually paid. This is an amount that should be able to be easily verified by looking at evidence of the transaction like a cash payment or invoice.

So when purchasing an asset, typically to be objective the amount recorded in the financial information will be the amount paid (**cost**) because it is easily verified and reliable and not an opinion of how much the asset is worth which would be subjective.

5. Full Disclosure Principle

If certain information is important to an investor or lender using the financial statements, that information should be disclosed within the statement or in the notes to the statement. It is because of this basic accounting principle that numerous pages of "footnotes" are often attached to financial statements.

As an example, let's say a company is named in a lawsuit that demands a significant amount of money. When the financial statements are prepared it is not clear whether the company will be able to defend itself or whether it might lose the lawsuit. As a result of these conditions and because of the full disclosure principle the lawsuit will be described in the notes to the financial statements.

A company usually lists its significant accounting policies as the first note to its financial statements.

6. Going Concern Assumption

This assumes that a company will continue to exist long enough to carry out its objectives and commitments and will not liquidate in the foreseeable future. If the company's financial situation is such that the accountant believes the company will *not* be able to continue on, the accountant is required to disclose this assessment.

Without the going concern assumption, the definition of an asset that we will look at later – resources that will bring future benefit would not have meaning since there is no future to benefit.

7. Matching Principle

This accounting principle requires companies to use the **accrual basis of accounting**. The matching principle requires that expenses be matched with revenues. For example, sales commissions expense should be reported in the period when the sales were made (and not reported in the period when the commissions were paid). Wages to employees are reported as an expense in the week when the employees worked and not in the week when the employees are paid. If a company agrees to give its employees 1% of its 2022 revenues as a bonus on January 15, 2023, the company should report the bonus as an expense in 2022 and the amount unpaid at December 31, 2022 as a liability. (The expense is occurring as the sales are occurring.)

8. Revenue Recognition Principle

Under the accrual basis of accounting, **revenues** are recognized as soon as a product has been sold or a service has been performed, regardless of when the money is actually received. Under this basic accounting principle, a company could earn and report \$20,000 of revenue in its first month of operation but receive \$0 in actual cash in that month.

For example, if ABC Consulting completes its service at an agreed price of \$1,000, ABC should recognize \$1,000 of revenue as soon as its work is done—it does not matter whether the client pays the \$1,000 immediately or in 30 days.

9. Conservatism

If a situation arises where there are two acceptable alternatives for reporting an item, conservatism directs the accountant to choose the alternative that will result in less net income and/or lower asset amount. Conservatism helps the accountant to “break a tie.” It does not direct accountants to be conservative. Accountants are expected to be unbiased and objective.

The basic accounting principle of conservatism leads accountants to anticipate or disclose losses, but it does not allow a similar action for gains. For example, *potential* losses from lawsuits will be reported on the financial statements or in the notes, but *potential* gains will not be reported. Also, an accountant may write inventory *down* to an amount that is lower than the original cost, but will not write inventory *up* to an amount higher than the original cost.

10. Consistency

For information to be useful for decision makers, it is helpful to be able to use comparisons especially between the financial information from one accounting period and the financial information for a different accounting period. Thus when applying accounting rules, the accountant should be consistent from year to year. Where one assumption or application of the rules is made in 2022, the same should be made in 2023 so that comparisons can be made. If a change in those applications is justified, then careful disclosure of why the change was made and how it made the financial information different is needed.

Examples

How would an accountant apply the above described principles to the following business situations?

1. ABC Inc. purchases a used sophisticated mixing machine from a dealer in another state. ABC pays \$32,000 for the machine. The production manager tells the accounting department that he thinks a similar machine is worth \$40,000 from his experience. What amount should be used to record the machine and why?

*In order to remain objective and to provide information that is reliable and verifiable, an accountant would use \$32,000 the cost paid for the machine rather than use the subjective opinion of the production manager. The **cost** could be easily **verified** by looking at the evidence of the cash being transferred to the dealer but it would be difficult to verify the opinion of the production manager.*

2. Harley Davidson makes a change in the way it applies an accounting rule to its motorcycle inventory so that 2023 application will be different than previous year. They are wondering what needs to be done about this in their financial information.

*Investors expect **consistency** in the application of the accounting rules because they will want to compare 2022 results with 2023 results. This is to evaluate 2023 performance against 2022 performance and try to predict future performance. Because the change in accounting application may hinder this comparison, Harley Davidson will need to disclose the impact of the change in a footnote to the financial statement explaining what happened and why.*

3. The manager of a health club runs a special deal for new members. If they sign up and pay for 2 years of membership up front, the discount will be 30% off the regular price for this up front special. Many new members take advantage of the special and pay for 2 years during the month of January. The manager instructs the accountant to record the amount of the cash received as revenue. Does that sound correct to you?

According to the revenue recognition principle the relevant information that should be recorded as revenue is the amount earned. The membership payment received is not revenue until the health club provides the promised services over the next 2 years. Thus recording the amount received in January in payment for the next two years as revenue is a violation of the revenue recognition principle and would not provide investors with the information needed to evaluate the performance of the health club.

4. The Picadilly Company is owned by Jane and Michael as shareholders. Picadilly Company shares an office building and does much of its business with the FineLine Corporation that is owned by Hector and Anton. FineLine borrows a significant amount of money from the bank that it will use to make substantial upgrades to its part of the building. This could result in Picadilly's part of the building becoming worth more. Also, Michael purchases a boat that will be kept at his house but that might sometimes be used for Picadilly Company outings for employees. Who should record what?

The Picadilly Company and FineLine Corporation are owned and controlled by separate shareholders so they will be considered separate business entities under the business entity principle. FineLine will record the obligation to pay back the loan even though it may have an indirect impact on Picadilly. Because the business owners are also considered separate from the business entity, Michael's boat would not be recorded under the financial information for Picadilly. Neither the boat nor the loan would be

relevant to making decisions about Picadilly and thus would not be included. The significant amount of business done between Picadilly and FineLine might be enough that some description of the arrangement could be included in the footnotes explaining that if something negative happened to FineLine especially in light of their significant new loan, this could negatively impact Picadilly's business. This would be in keeping with the full disclosure principle.

5. Company Q has a lawsuit that they anticipate they will win and will pay them \$5 million dollars. Company Z has a lawsuit they anticipate losing and would probably result in them paying \$2 million. Company Z is going to record a loss for \$2 million but Company Q is not going to record anything for their lawsuit. Is this right?

The conservatism principle states that when losses are probable they should be recorded in the financial information. This information is considered more relevant to decision making and should meet the standard of full disclosure. Gains or any other positive information that is only probable will not be recorded as a way to be conservative. Full disclosure may allow some description of the situation in the footnotes, but actually showing an amount on the financial statements would not be in keeping with the accounting principles.

6. UWE has two pieces of information that it thinks might be relevant for investors about its business. The first is that some items they bought several years ago would cost 20% more today because of inflation in their area. They would like to increase the amount shown in the financial statements by 20%. The other is the hiring of a brilliant engineer who has substantial expertise not found anywhere else. UWE anticipates this new hire will result in new products worth several millions of dollars and would like to put this information in the financial report. What would the accounting principles say?

Not all relevant information can be included in the financial reports of a company. Only those that can be measured in a stable monetary unit like the dollar will be accounted for directly. Thus changes in the value of items based on inflation is not accounted for under the monetary unit assumption and neither is the speculative value of the new engineer. Good news could be shared with investors but until amounts are actually paid to or earned by our new employee that can be measured in dollars – they would not be included in the financial statements.

Test yourself

Which of the following examples is a good illustration of how different accounting principles trade off in helping accountants communicate financial information to investors?

- A. An estimated amount is considered more relevant even though it is not as reliable as the exact amount that can be determined later (less timely).
- B. A bonus that was earned by employees in 2020 is recorded in 2020 to match the expense to the time of the employee effort rather than in 2021 when it is objectively paid.
- C. A potential gain is described in the footnotes but the estimated amount is not included in the financial statements until received in order to be conservative.
- D. All of the above are correct illustrations of the conceptual framework application.

The correct answer is D. All of these are situations where general principles from the conceptual framework seem to be in conflict and judgment needs to be applied to determine what application will provide the most relevant information to investors.

Key Takeaway

The FASB has adopted a conceptual framework or general principles that are broad enough to guide not only the setting of specific accounting rules but also help guide accountants in recording, summarizing and communicating financial information. These include a focus on communicating with investors, consistency, revenue recognition, reliability among others.