

Financial accounting standards board framework analysis



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Introduction

The accounting conceptual framework has been criticized for not providing an adequate basis for standard setting. This inadequacy is evidenced through the FASB's standards becoming more and more rule-based. Nevertheless, no empirical evidence has been gathered to support the criticisms of the conceptual framework. We analyzed the five qualitative characteristics of accounting information from the conceptual framework in conjunction with an individual's intention to use/rely on financial statements. Using structural equation modeling, we found that only one qualitative characteristic, reliability, affected a person's intention to use financial statements. Additionally, it appears that the greatest factor that influences whether an individual rely on financial statements is their familiarity with accounting. Based on our findings, it appears that not only does the conceptual framework need to be altered, but it also needs to be changed to help create principle-based accounting standards that are useful to all people, regardless of their background.

The Financial Accounting Standards Board (FASB) has been criticized for not requiring firms to report information that is interpretable and useful for financial statements users (CICA, 1980). The FASB's conceptual framework is the core in which all accounting standards are derived. Therefore, the accounting conceptual framework must embody a set of qualitative characteristics that ensure financial reporting provides users of financial statements with adequate information for decision making. The U. S. financial accounting conceptual framework was established between late 1970's and early 1980's. Statement of Financial Accounting Concepts (SFAC) <https://assignbuster.com/financial-accounting-standards-board-framework-analysis/>

No. 2 (1980) indicates that there are five main qualitative characteristics of accounting information; understandability, relevance, reliability, comparability, and consistency.

Nature and Purpose of the Conceptual Framework

The conceptual framework was formed with the intention of providing the backbone for principle-based accounting standards (Nobes, 2005). However, the Securities and Exchange Commission (SEC) has recently criticized the accounting standards setting board for becoming overly rules-based, which paves the way for the structuring of transactions in the company's favor (SEC 108(d)). Critics of the framework have stressed that the move towards rule-based standards are a consequence of inadequacies in the accounting conceptual foundation. Nobes (2005) argues that the need for rule-based accounting standards is a direct result of the FASB trying to force a fit between standards and a conceptual framework that is not fully developed. A coherent and strong conceptual framework is vital for the development of principle-based accounting standards and the progression towards convergence in international accounting standards.

However, researchers are unaware of any empirical evidence that supports the criticisms of the current conceptual framework. Additionally, none of the critics have looked at the conceptual framework from the most important viewpoint, the user's perspective. Therefore, the purpose of this paper is to empirically analyze the adequacy of the conceptual framework, from a user's perspective, in relation to an individual's reliance on financial statements for decision making. We developed a survey instrument to analyze an

individual's intention to rely on financial statements using Ajzen's (1991)
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Theory of Planned Behavior. We found that the reliability characteristic of the conceptual framework represented the only significant dimension of a person's attitude affecting their intention to rely on financial statements. However, the understandability characteristic was approaching significance. Within the context of the theory of planned behavior, social pressures was not significant influence on the intention to use/rely on financial statements, yet familiarity with accounting was found to significantly influence intention.

The conceptual framework and potential financial statement user's intentions can be analyzed within the context of Ajzen's (1991) Theory of Planned Behavior. Ajzen (1991) indicates that empirical evidence suggests that we can determine an individual's intention to perform a behavior through analyzing their attitude, subjective norms, and perceived behavioral control. Within this perspective, we adapted Ajzen's (1991) theory of planned behavior to an individual's propensity to rely on accounting financial statements.

The purpose of this study was to provide an empirical analysis to the criticism against the FASB's conceptual framework. Our overall results suggest that the current conceptual framework does not adequately align the objectives of financing reporting with the users of financial statements. Nevertheless, available findings have some interesting implications for the conceptual framework and future standard setting. Reliability is the only qualitative characteristic that has a positive statistical significant relationship with intention. The accounting profession is facing a choice between reliability and relevance in financial reporting, as there is an inherent trade-off between reliability and relevance (Paton and Littleton, 1940; Vatter, <https://assignbuster.com/financial-accounting-standards-board-framework-analysis/>

1947). Reliable information possesses the characteristic of objectivity and verifiability, which is associated with historical cost accounting. Relevance, on the other hand, pertains to any information that will influence the users' financial decision.

Many times the most relevant information is often current or prospective in nature. Thus, we cannot have accounting information that maximizes the characteristics of both relevant and reliable because relevant information is not always verifiable. We would have expected to see relevance as a significant factor in users' intention to use financial statements since the recent accounting standards have moved toward fair value accounting measures, which are considered to be more relevant than reliable information (Ciesielski & Weirich, 2006). However, our results show that reliability is a significant factor. The current accounting curriculum could be the cause of our results since it is rooted in Paton and Littleton's historical cost approach, which focuses on reliability of information.

In the context of the Theory of Planned Behavior, we found that familiarity to be a statistically significant factor to an individual's intention to use financial statements. Thus, as an individual becomes more familiar with financial statements, he or she is more likely to have the intention to use or rely on them when making decision. An ANOVA analysis provides further support for this as it indicates that intention to use or rely on financial statements is significantly different between accounting majors and non-accounting majors. This provides evidence that accounting could be becoming too difficult for individuals who are not proficient in accounting to understand.

It appears that the movement towards rule-based accounting standards could be a contributing cause of this disparity in intention. That is, the accounting standards have become so technical upon their execution that the average reader of accounting can no longer discern the main objective of each financial statement element. This finding is troubling to accounting since it contradicts the primary objective of accounting, which is to provide useful accounting information for decision making. Accounting information should be useful for all people who want to use it rather than only being useful to those who understand it. Additionally, under no circumstances, should accounting information provide an advantage to individuals who happen to be experts within the field. Accounting should be a tool and not a barrier

At the-present, the accounting profession is grappling with a problem, which it has identified as the need for a conceptual framework of accounting. This framework has been painstakingly developed over centuries, and it is merely the profession's task to fine tune the existing conceptual framework because of the need for continual development due to changing conditions. This conceptual framework has never been laid out in explicit terms; consequently, it is continually overlooked. A conceptual framework has been described as " a constitution," a coherent system of interrelated objectives and fundamentals that can lead to consistent standards and that prescribes the nature, function, and limits of financial accounting and financial statements.

For many accountants, the conceptual framework project is difficult to come to grips with because the subject matter is abstract and accountants are <https://assignbuster.com/financial-accounting-standards-board-framework-analysis/>

accustomed to dealing with specific problems. In resolving those problems, accountants may unconsciously rely on their own conceptual frameworks, but CPAs have not previously been called on to spell out their frameworks in systematic, cohesive fashion so that others can understand and evaluate them. It is essential that a framework be expressly established so that the FASB and those evaluating its standards are basing their judgments on the same set of objectives and concepts. An expressly established framework is also essential for preparers and auditors to make decisions about accounting issues that are not specifically covered by FASB standards or other authoritative literature.

It is considered that if the conceptual framework makes sense and leads to relevant information, and if financial statement users make the necessary effort to fully understand it, their confidence in financial statements and their ability to use them effectively will also be enhanced. No one who supports the establishment of a conceptual framework should be laboring under the illusion that such a framework will automatically lead to a single definitive answer to every specific financial accounting problem. A conceptual framework can only provide guidance in identifying the relevant factors to be considered by standard setters and managers and auditors in making the judgments that are inevitable in financial reporting decisions.

A Classical Model of Accounting: The Framework Expanded

Historically, the particularized information, which constituted the emergence of accounting, was embedded in a framework for control of human behavior.

With the advent of exchange replacing a sustenance society, and with

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exchange ultimately producing a private economy, accounting derived its second, and in modern times considered its most important, function as a planning instrument. The classical model simply states that behavioral patterns do exist in the structural development of accounting; that is, given a stimulus there will be a response which is direct reaction (an expected reaction) to that stimulus. One can relate this model to the classical model in economics, in which supply and demand for a commodity react in an expected manner due to a change in price. Figure 3 is a geometric illustration of the classical model. The special features of the model are:

(a) Stimulus (S) = Demand; Response (R) = Supply

(b) Equilibrium (E) = Stimulus = Response

(c) Environmental Condition (EC) = Price

(d) Accounting Concept (AC) = Product

A Test of the Validity of the Model

If the classical model does exist in accounting, the historical observations (see table I) should then bear testimony to its existence. The evidence to support this model is purely historical. However, no parallel should be drawn between this thesis (stimulus/Response) and Toynbee's (1946, 88) line of inquiry: "Can we say that the stimulus towards civilization grows positively stronger in proportion as the environment grows more difficult?"

Consequently, the criticism directed at his work should not be considered even remotely as applicable to this inquiry (Walsh 1951, 164-169). On the other hand, only in the extreme can the accusation leveled at Kuhn [1962]

be directed here, that the conceptual framework (classical model of accounting) as presented “ may subsume too many possibilities under a single formula (Buchner 1966, 137).” More appropriately, this study is undertaken along the lines suggested by Einthoven (1973, 21): Accounting has passed through many stages: These phases have been largely the responses to economic and social environments. Accounting has adapted itself in the past fairly well to the changing demands of society. Therefore, the history of commerce, industry and government is reflected to a large extent in the history of accounting.

What is of paramount importance is to realize that accounting, if it is to play a useful and effective role in society, must not pursue independent goals. It must continue to serve the objectives of its economic environment. The historical record in this connection is very encouraging. Although accounting generally has responded to the needs of its surroundings, at times it has appeared to be out of touch with them. The purpose of this line of inquiry is to put into perspective concepts which have emerged out of certain historical events. (In this treatise, accounting concepts are considered to be interlocking with accounting measurement and communication processes; thus, whenever the term concept is used herein, it is to be understood that accounting measurement and communication processes are subsumed under this heading.)

These concepts collectively constitute, or at least suggest, a conceptual framework of accounting. The classical model is postulated as follows: For any given environmental state, there is a given response function which maximizes the prevailing socio-economic objective function. This response

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function cannot precede the environmental stimulus but is predicated upon it; when such response function is suboptimal, the then existing objective function will not be maximized. In a dysfunctional state, a state in which environmental stimulus is at a low level – a level below pre-existing environmental stimuli, disequilibrium would ensue. In any given environment, the warranted response may be greater or less than the natural or actual response.

When environmental stimuli cease to evoke response, then the socio-economic climate will be characterized by stagnation as the least negative impact of disequilibrium conditions, and decline when such environmental stimuli are countercyclical.

Stage 1 – In this period, (1901 to 1920) the environmental stimulus was corporate policy of retaining a high proportion of earnings [(Grant 1967, 196-197); (Kuznets 1951, 31); (Mills 1935, 361, 386-187)]. This period is the beginning of corporate capitalism. The term ‘corporate capitalism’ is used because it emphasizes the role in capital formation which corporations have ascribed to themselves. Hoarding of funds by corporations has reduced the role and importance of the primary equity securities market. The resource allocation process has been usurped by corporations (Donaldson 1961, 51-52, 56-63). The implication of such a condition is accentuated in the following statement: “It is the capital markets rather than intermediate or consumer markets that have been absorbed into the infrastructure of the new type of corporation.” (Rumelt 1974, 153).

The hard empirical evidence of this condition was revealed by several tests of the Linter Dividend Model, which maintains that dividends are a function of profit, and are adjusted to accommodate investment requirements [(Kuh 1962, 48); (Meyer and Kuh 1959, 191); (Brittain 1966, 195); (Dhrymes and Kurz 1967, 447)]. Given the new role assumed by the corporation in capital formation, the investment community (investing public) became concerned with the accounting measurement process. The accounting response was verifiability (auditing) – to demonstrate the soundness of the discipline. Productivity of existing measurements had to be verified to satisfy the investors and creditors. The Companies Act 1907 required the filing of an audited annual balance sheet with the Registrar of Companies [(Freer 1977, 18); (Edey and Panitpadki 1956, 373); (Chatfield 1956, 118)]. Thus, auditing became firmly established. The function of auditing measurements is the process of replication of prior accounting.

Accounting is differentiated from other scientific disciplines in this aspect of replication. Replication is a necessary condition in sound disciplines; however, replication is generally undertaken in rare instances. In accounting, on the other hand, replication is undertaken very frequently for specified experiments – business operations – at the completion of the experiments – business (operating) cycle. These experiments – business operations, cover one year; at the end of the year, the experiments are reconstructed on a sampling basis. Auditing is the process by which replication of accounting measurements are undertaken. Publicly held and some privately held corporations are required to furnish audited annual financial statements which cover their business activities on an annual basis.

Stage 2- This period, (1921 to 1970) witnessed the reinforcement of corporate retention policy. This condition shifted the emphasis of the investor to focus on the Securities market in the hope of capital gains, because of the limited return on investment in the form of dividends. Indubitably, investors' concern was shifted to market appreciation through stock price changes reflecting the earnings potential of the underlying securities (Brown 1971, 36-37, 40-41, and 44-51).

With the securities market valuation of a company's share (equity) inextricably linked to the earnings per share, the emphasis is placed on the dynamics of accounting as reflected in the income statement. The Companies Act of 1928 and 1929 explicitly reflect this accounting response by requiring an income statement as a fundamental part of a set of financial statements [(Freer 1977, 18); (Chatfield 1974, 118)]; Although an audit of such statement was not explicitly stipulated, it was implied. The accounting response of this period is extension of accounting disclosure [(Chatfield 1974, 118); (Blough 1974, 4-17)].

The Wall Street Crash of 1929 and subsequent market failures constitutes the environmental stimulus. In the U. S. A., the Securities Act of 1933 and then the Securities and Exchange Act of 1934 were enacted, providing for a significant involvement of the government in accounting. Stage 3- This period is characterized by the social awareness that business as well as government must be held socially accountable for their actions. Business can transfer certain costs to other segments of society, thus business benefits at the expense of society; and government can not only squander hard earned

dollars but through its policies affect adversely the welfare of various segments of society.

This awareness is epitomized in the thesis posited by Mobley [1970, 763]: “The technology of an economic system imposes a structure on its society which not only determines its economic activities but also influences its social well-being. Therefore, a measure limited to economic consequences is inadequate as an appraisal of the cause-effect relationships of the total system; it neglects the social effects.”

The environmental stimulus of corporate social responsibility evoked the accounting response of socio-economic accounting – a further extension of accounting disclosure. The term socio-economic accounting gained prominence in 1970, when Mobley broadly defined it as “the ordering, measuring and analysis of the social and economic consequences of governmental and entrepreneurial behavior.” Accounting disclosure was to be expanded beyond its existing boundaries – beyond the normal economic consequences “to include social consequences as well as economic effects which are not presently considered” (Mobley 1970, 762).

Approaches to dealing with the problems of the extension of the systemic information are being attempted. It has been demonstrated that the accounting framework is capable of generating the extended disclosures on management for public scrutiny and evaluations [(Charnels, Colantoni, Cooper, and Kortanek 1972); (Aiken, Blackett, Isaacs 1975)]. However, many measurement problems have been exposed in this search process for means to satisfy the systemic information requirement of this new environmental

stimulus [(Estes 1972, 284); (Francis 1973)]. Welfare economics, as a discipline, has always been concerned with the social consequences of governmental and entrepreneurial actions, but the measurement and communication problems are, and always have been that of the discipline of accounting (Linowes 1968; 1973).

The Conceptual Framework: A Continuing Process

Presented above, the stimulus/response framework – exhibiting structural adequacy, internal consistency and implemental practicality – has demonstrated, unequivocally, its effectiveness over the centuries. The systemic information of financial accounting is the connective tissue of time in a financial perspective. The systemic information of managerial accounting is non-connective, but rather reflects events in a decision-making perspective. This can be best illustrated in the table below:

(Draw a table)

The process of concept-formation is a special type of learning. The formation takes time and requires a variety of stimuli and reinforcements. The process is never fully determinate for even when the concept is well, it can suffer neglect or inhibition and it can be revived by further reinforcement or modified by new stimulation (Emphasis added.) (Meredith; 1966, 79-80). A body of concepts and interlocking measurement and communication processes (types of information – stocks and flows; constraints on information – allowable values and methods of measurement; media of communication – quantitative and qualitative) has been developed over the centuries.

This set of concepts and interlocking measurement and communication processes has emerged as responses to specific stimuli at specific points in time to satisfy specific information needs. It is this body of concepts and interlocking measurement and communication processes, which is subject to amplification and modification that constitutes the conceptual framework of accounting. Possibly, with other modifications or amplifications deemed necessary, the conceptual framework as presented above can serve as an “ expressly established framework” to enable “ preparers and auditors to make decisions,” which would conform and be upheld, “ about accounting issues that are not specifically covered by FASB standards or authoritative literature.”

A conceptual framework is necessary because in the first place, to be useful, standard setting should build on and relate to an established body of concepts and objectives. A soundly developed conceptual framework should enable the FASB to issue more useful and consistent standards over time. A coherent set of standards and rules should be the result, because they would be built upon the same foundation. The framework should increase financial statement users’ understanding of and confidence in financial reporting, and it should enhance comparability among companies’ financial statements. Secondly, new and emerging practical problems should be more quickly solved by reference to an existing framework of basic theory. It is difficult, if not impossible, for the FASB to prescribe the proper accounting treatment quickly for situations like this. Practicing accountants, however, must resolve such problems on a day-to-day basis.

Through the exercise of good judgment and with the help of a universally accepted conceptual framework, practitioners can dismiss certain alternatives quickly and then focus on an acceptable treatment. Over the years numerous organizations, committees, and interested individuals developed and published their own conceptual frameworks. But no single framework was universally accepted and relied on in practice. Recognizing the need for a generally accepted framework, the FASB in 1976 began work to develop a conceptual framework that would be a basis for setting accounting standards and for resolving financial reporting controversies. The FASB has issued six Statements of Financial Accounting Concepts that relate to financial reporting for business enterprises. They are:

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

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

_ SFAC No. 3, " Elements of Financial Statements of Business Enterprises," provides definitions of items in financial statements, such as assets, liabilities, revenues, and Expenses

_ SFAC No. 5, " Recognition and Measurement in Financial Statements of Business Enterprises," sets forth fundamental recognition and measurement criteria and Guidance on what information should be formally incorporated into financial statements and when.

_ SFAC No. 6, “ Elements of Financial Statements,” replaces SFAC No. 3 and expands its scope to include not-for-profit organizations.

_ SFAC No. 7, “ Using Cash Flow Information and Present Value in Accounting Measurements, “ provides a framework for using expected future cash flows and present values as a basis for measurement.

At the first level, the objectives identify the goals and purposes of accounting. Ideally, accounting standards developed according to a conceptual framework will result in accounting reports that are more useful. At the second level are the qualitative characteristics that make accounting information useful and the elements of financial statements (assets, liabilities, and so on). At the third level are the measurement and recognition concepts used in establishing and applying accounting standards. These concepts include assumptions, principles, and constraints that describe the present reporting environment.

First Level: Basic Objectives

As we discussed in Chapter 1, the objectives of financial reporting are to provide information that is: (1). Useful to those making investment and credit decisions who have a reasonable understanding of business and economic activities. (2). Helpful to present and potential investors, creditors, and other users in assessing the amounts, timing, and uncertainty of future cash flows and (3). about economic resources, the claims to those resources, and the changes in them. The objectives therefore, begin with a broad concern about information that is useful to investor and creditor decisions.

That concern narrows to the investors’ and creditors’ interest in the prospect

of receiving cash from their investments or loans to business enterprises. Finally, the objectives focus on the financial statements that provide information useful in the assessment of prospective cash flows to the business enterprise. This approach is referred to as decision usefulness. It has been said that the golden rule is the central message in many religions and the rest is elaboration.

Similarly, decision usefulness is the message of the conceptual framework and the rest is elaboration. In providing information to users of financial statements, general-purpose financial statements are prepared. These statements provide the most useful information possible at minimal cost to various user groups. Underlying these objectives is the notion that users need reasonable knowledge of business and financial accounting matters to understand the information contained in financial statements. This point is important. It means that in the preparation of financial statements, a level of reasonable competence on the part of users can be assumed. This has an impact on the way and the extent to which information is reported.

Second Level: Fundamental Concepts

The objectives of the first level are concerned with the goals and purposes of accounting. Later, we will discuss the ways these goals and purposes are implemented in the third level. Between these two levels it is necessary to provide certain conceptual building blocks that explain the qualitative characteristics of accounting information and define the elements of financial statements. These conceptual building blocks form a bridge between the why of accounting (the objectives) and the how of accounting (recognition and measurement).

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Qualitative Characteristics of Accounting Information

Choosing an acceptable accounting method, the amount and types of information to be disclosed, and the format in which information should be presented involves determining which alternative provides the most useful information for decision making purposes (decision usefulness). The FASB has identified the qualitative characteristics of accounting information that distinguish better (more useful) information from inferior (less useful) information for decision making purposes. In addition, the FASB has identified certain constraints (cost-benefit and materiality) as part of the conceptual framework. These are discussed later in the chapter. The characteristics may be viewed as a hierarchy.

Decision Makers (Users) and Understandability

Decision makers vary widely in the types of decisions they make, how they make decisions, the information they already possess or can obtain from other sources, and their ability to process the information. For information to be useful there must be a connection (linkage) between these users and the decisions they make. This link, understandability, is the quality of information that permits reasonably informed users to perceive its significance. To illustrate the importance of this linkage; assume that IBM Corp. issues a three-month' earnings report (interim report) that shows interim earnings way down. This report provides relevant and reliable information for decision making purposes. Some users, upon reading the report, decide to sell their stock. Other users do not understand the report's content and significance. They are surprised when IBM declares a smaller year-end dividend and the value of the stock declines. Thus, although the

information presented was highly relevant and reliable, it was useless to those who did not understand it.

Primary Qualities: Relevance and Reliability

Relevance and reliability are the two primary qualities that make accounting information useful for decision making. As stated in FASB Concepts Statement No. 2, “ the qualities that distinguish ‘ better’ (more useful) information from ‘ inferior’ (less useful) information are primarily the qualities of relevance and reliability, with some other characteristics that those qualities imply.”

Relevance

To be relevant, accounting information must be capable of making a difference in a decision. If certain information has no bearing on a decision, it is irrelevant to that decision. Relevant information helps users make predictions about the ultimate outcome of past, present, and future events; that is, it has predictive value. Relevant information also helps users confirm or correct prior expectations; it has feedback value. For example, when UPS (United Parcel Service) issues an interim report, this information is considered relevant because it provides a basis for forecasting annual earnings and provides feedback on past performance. For information to be relevant, it must also be available to decision makers before it loses its capacity to influence their decisions. Thus timeliness is a primary ingredient. If UPS did not report its interim results until six months after the end of the period, the information would be much less useful for decision making purposes. For information to be relevant it should have predictive or feedback value and it must be presented on a timely basis.

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Reliability

Accounting information is reliable to the extent that it is verifiable, is a faithful representation, and is reasonably free of error and bias. Reliability is a necessity for individuals who have neither the time nor the