Theoretical framework of Financial Accounting Standards Board (FASB) and new theoretical framework as the product of revolution in accounting model

Elias Sarvi, Ali Fayaz, Mohsen Sarvi

1MA students in the field of accounting Science and Research Branch, Azad University, Yazd, Iran
2MA of accounting Science and Research Branch, Islamic Azad University, Yazd, Iran
3MA students in the field of accounting faculty of management from Tehran University

ABSTRACT

Many changes are made since the appearance of accounting and financial reporting in this scientific field. Formulating the theoretical framework is the turning point of the changes. Now, fundamental changes are made for the theoretical framework of financial accounting standards board. The present study aimed to present a framework to understand this phenomenon and it helps the information needs of the users for usefulness of information to decision making leads into the presentation of a good theoretical framework.

INTRODUCTION

After the USA crisis in 1929, with the failure of the banks failed and New York stock exchange market crash, most of the stockholders lost their wealth and there was the big loss 15 billion. The accounting was blamed for not having the rules and standards and their negligence in accounting information disclosure emphasized on the formulation of theoretical framework. Also, by the increase of investment in stock exchange market, the demand for standard procedures was increased by the decision makers and users. By holding the meeting between the securities commission of New York and American accounting association, the information disclosure was considered and the standards and procedures with great influence on accounting change and presentation of new standards to improve the accounting job and meeting the demands were required.

Theoretical framework of FASB:

The reports and statements issued had important role in formulating the theoretical framework of FASB. The theoretical framework was the gradual process and it was based on the previous reports. Despite the criticism on expecting improvement and formulating suitable standards.

Statement No. 1 was aimed at reporting based on True blood report and quality characteristics of accounting information. Statement NO.2 were based on ASOBAT. The most important statement is that accounting standard board presented conceptual statements of theoretical framework of rules with SFAC and the standards with executional procedure that led into the issuance of 7 statements as accounting concepts.

<table>
<thead>
<tr>
<th>Statement No.</th>
<th>Issuance year</th>
<th>Subject</th>
</tr>
</thead>
<tbody>
<tr>
<td>SFAC 1</td>
<td>1978</td>
<td>Objectives of Financial Reporting by Business Enterprises</td>
</tr>
<tr>
<td>SFAC 2</td>
<td>1980</td>
<td>Qualitative characteristics of accounting information</td>
</tr>
<tr>
<td>SFAC 3</td>
<td>1980</td>
<td>The elements of financial statements of Business Enterprises</td>
</tr>
<tr>
<td>SFAC 4</td>
<td>1980</td>
<td>Objectives of financial reporting by not-for-profit organizations</td>
</tr>
<tr>
<td>SFAC 5</td>
<td>1984</td>
<td>Recognizing and measurement of financial statements</td>
</tr>
<tr>
<td>SFAC 6</td>
<td>1985</td>
<td>Financial statements elements (alternative No.3 and SFAC2)</td>
</tr>
<tr>
<td>SFAC 7</td>
<td>2000</td>
<td>Applying the information relevant to cash flow and current value and accounting measurement</td>
</tr>
</tbody>
</table>

FASB attempts to declare reporting objectives, the qualitative characteristics of financial information, and the elements of financial reporting, how its measurement evaluated as is linked consecutively. Also, it emphasizes on the role of common basis for formulating the accounting standards. The conceptual statement

Corresponding Author: Elias Sarvi, MA students in the field of accounting Science and Research Branch, Azad University, Yazd, Iran.
Phone no: +989121773011 & Email: eliassarvi@yahoo.com
doesn’t affect the accounting activity and record directly and it is guidance for accounting standards and financial reporting.

**The nature and components of theoretical framework:**
The accounting standards board stated: Financial reporting should provide information that is useful to current and potential investors and creditors and other users in making investment, credit, and similar decisions.

*a. The objectives of financial reporting of theoretical framework:*
1. Usefulness
2. Understandability
3. The decision makers of their characteristics (users)
5. Evaluation of economic resources (providing information on assets, debts and equity)
6. Focusing on profit

*b. Qualitative characteristics of accounting information:*
1. Benefits exceeding the costs
2. Relevance (timing as secondary aspect and usefulness in prediction and usefulness of evaluation of two main characteristics)
3. Reliability (verifiability, representational faithfulness [Completeness, correctness, preference of content to form], neutrality).
4. Comparability (comparing with the information of other companies, industries and time period of company) [procedure stability, adequate disclosure].
5. Materiality
6. Conservatism

**Strengths of theoretical framework:**
FASB is consisting of qualified people with the best decision making power and they were the best in collection organizing and linking the main accounting concepts.
1. The definitions of statement No. 6 have maximum power.
2. The objectives of statement NO. 1 has considerable respect.
3. Statement No. 2 is the most important statement.

**The weaknesses of theoretical framework:**
1. The deficit of theoretical framework is not due to its content. 2-It doesn’t solve accounting problems. 3- The explanations of measurement criteria are inadequate. 4- There is no guidance regarding the reduction of contrast and balance between qualitative characteristics and information for relevance and reliability. 5- Income recognition was explained. In statement No. 5, by defining the assets and debts, it was not consistent with statement NO. 6. The estimations and judgments are allowable. 7- Focusing on allocation.
Statement No. 5 is the weakest FASB statement due to its emphasis on fixed price.

**Theoretical framework a revolution in accounting:**
In the late decades, the theoretical framework was revised. The financial reporting should be changed. In 2004, FASB stated that the framework will be revised and the reason is the consistency and convergence with theoretical framework of International Accounting Standards Board (IASB) and replacing principle-based standards with rules-based standards.

According to Thomas Cohen (1970), the structure of scientific revolution defines the factors changing the knowledge in the model, what is occurred in the change process and the effect on performance as the result of the changes.

According to Cohen, the changes are made by two forms: Gradual and revolutionary evolution is occurred when the set of knowledge is promoted over the time. Accounting follows this model via evolutionary standards being propagated gradually in response to the changes of act. Revolutionary change is occurred when an abnormality or crisis leads into the movement out of specific thought flow and it is as the set of knowledge. Now, accounting is fundamentally changed in its thought. The changes are made in the bases of financial accounting. The reasons of such change are as:
- Moving from an industrial economy to the information –based economy
- Development of globalization
The theoretical framework of FASB-industrial model based on fixed price measurement, historical and rule-based and it was focused on financial events of allocation. In this model, the estimations and judgments are allowable.

New model:

The new model of information model that is based on theoretical framework is the rules-based new model and emphasizes on fair value and economical events.

Accounting as social knowledge, the change in economic environment leads into the change in accounting and as accounting is not completed with the same speed of economic environment, the abnormality of financial reporting is occurred. Then, the inefficiencies of accounting lead into the dissatisfaction of accounting information based on industrial model. The inefficiencies show how economical progresses affect accounting. Why the new model is formed in accounting. Finally, by Cohen theories regarding the changes stages in financial reporting revolution, the lack of acceptance of past procedures, the changes in the problems should be solved and the changes in the job are discussed.

The 10 reasons for the modification of theoretical framework:

1. The clarification of the social objectives of financial reporting (generally economy and final beneficiaries of financial reporting defining the background of the characteristics) on increasing the economical productivity via the development of efficient capital markets and make the users aware are possible.
2. The explanation of useful information in financial report
3. Explaining that the debts and assets are the main elements.
4. Determining the specific item that should be measured.
5. Clarification of the reliability as one of the useful information characteristics
6. Modification of the definition of the costs (the costs of considering stock option)
7. Modification of debts definition
8. Clarification of timeliness concept as one of the useful information characteristics
9. Transparency of costs and benefits of financial reporting
10. Clarification of the importance of the reporter commercial enterprise as one of the useful information resources and formulating the common theoretical framework is done in 8 states and in the first stage in 2006, on reporting objectives and qualitative characteristics of accounting information to reach an agreement (FASB, IASB). The decisions taken in two boards to Feb 28, 2006 regarding the financial reporting objectives were as following. The financial reporting objective instead of focus on information needs of users, ordinary stock holders to information needs of a great range of users.

Qualitative characteristics:

The change in fundamental principles of theoretical framework of financial reporting is done. The hierarchy of qualitative characteristics of accounting information created by FASB in concepts statement of financial accounting No. 2 is as following

In this hierarchy, relevance and reliability are primary qualitative characteristics of accounting information for decision making.

FASB never attempted to consider reliability with accuracy or reliance. But gradually, information reliability was equal to measures verifiability. Most people believed that accounting information was precise. This is considerably shown in the business books and articles as by referring to the accounting information in
these articles and books were are faced with a precise term. But accounting information is not precise but shows the assuming realities, estimations and judgments fairly. The implicit meaning in the historical fixed price information promotes the gap of the expectations between what is reported in the form of information and what the users expect of the information.

In the proposed theoretical framework that is reviewed by FASB, in this hierarchy, the useful information for decision is relevance, presented with faithfulness, comparable and understandable. As using this information is logical, the characteristics should be sorted in determining the information to be reported. The first and the most characteristic is relevance, relevance helps to find which economical phenomenon should be reported. The
relevant information is having prediction value and verifiability value and they are timely, when the information is identified.

The second qualitative characteristics obliges that the information should be presented faithfully. It means that the information represents the economical phenomenon faithfully. The information represented faithfully is verifiable, neutral and complete.

In theoretical framework 1980, faithful representation is a part of reliability and in the proposed theoretical framework; it is replaced by reliability term. The third characteristics of proposed theoretical framework are comparability of relevant information and faithfully represented information. The information should be comparable. Comparability is qualitative characteristics of information making the users able to identify the similarities and differences between two economical phenomena. This characteristic defined that a procedure is used as stable over the time in various positions. The fourth characteristic is understandability. In theoretical framework 1980, this characteristic was used for the information users. In the proposed theoretical framework FASB, it is stated that understandable information should be classified, defined and presented clearly and briefly.

There are other changes that in accordance with the changes of theoretical framework, the change to the measurements based on fair value, the emphasis on the principles against the rules and the focus on economic events vs. financial events. FASB with the collaboration of IASB revised the current theoretical framework and it leads into a new set of principles. One of the most fundamental changes is the relevance and reliability. In the past, relevance and reliability were used as qualitative characteristics leading into useful information for decision making. In industrial period model, the reliability or verifiability was similar. In the proposed, theoretical framework, the reliability with representational faithfulness and relevance were in the secondary position. The proposed plan is aimed to change the financial reporting from the financial events-based accounting (focusing on verifiability) to the emphasis on to be honest (showing the economical nature to its form). Moving toward the faithful representation of economical nature made the employed more reliant on professional judgment. Thus, instead of focusing on one rule, the employed are required to understand the economical nature of an event as the phenomenon is presented with faithfulness in financial statements. Also, moving toward the standards based on principles with the attempt to achieve convergence is consistent with the international standards. With revision in theoretical framework, financial statements are evaluated fundamentally. The primary principles made by FASB,IASB show that financial statements should present information as separating financing activities of commercial enterprise from the other operational activities. This principle leads into financial stamen and profit and loss statement consisting of operational, investment and financing parts. The number of the last row is disappeared in profit and loss (elimination). The movement of non-acceptance indicates the past traditions and new ideas. The important issue in information model is how to determine fair value. To solve this issue, FASB published statement NO. 7 as using cash flow information and current value in accounting measurements and Statement No. 157 as measuring the fair value. The statement No. 157 didn’t oblige using fair value in financial statements. But presented a definition of fair value and three hierarchies for measuring the fair value.

Another important problem in information model is the identification of the income in profit and loss statement. In industrial model economy, the income is achieved when it is identified in profit and loss statement. The method of identification of the change in fair value in profit and loss statement is one of the important issues. In industrial model, some of the fair value changes are identified in balance sheet (in other comprehensive profit) and others are identified in profit and loss. Finding a solution for these issues is finding income for successful movement to the vital information model.

Briefly, different kinds of estimations and judgments in determining fair value are different from the estimations being applied in costs allocation. David Lore's, member of board of directors and Daf Philips said although the estimation of fair value is hard, using uniform approaches in the estimations show the main improvement of historical fixed price. In the past due to the characteristics of historical fixed price-based measurements, it was possible the accountants are called allocator but now it is better to be identified as estimator.

Conclusion:

According to Cohen framework, the change of model in accounting follows a set of stages and by identification of the anomaly rules and dissatisfaction of the theoretical framework lead into the development of new ideas about the solution of current deficits and gradually the old model is turned into the new thought model. Accounting changes as social knowledge is having extra aspects of human behaviors affecting the accounting model. Most of the discussions complete the behavioral dimensions. Although accounting should respond to the changes in economic environment, it cannot control the individual behaviors as controlling the economic environment. Both of them are unpredictable. Thus, the models can be adaptable well in the texture of a changing environment.
Based on the rapid changes in business, the need to the changes in accounting standards is unavoidable.

REFERENCES