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Impact of FASB Qualitative Characteristics on the Promulgation of Statements of Financial Accounting Standards

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ABSTRACT

Generally Accepted Accounting Principles (GAAP) provide the basis for measuring, valuing, and presenting financial information to investors and creditors. The Financial Accounting Standards Board (FASB) promulgates GAAP through its Statements of Financial Accounting Standards (SFAS). To guide its thinking in the promulgation of SFAS, the FASB employs as conceptual framework, called Qualitative Characteristics of Accounting Information. This research effort uses content analysis to analyze the decision specific qualities of relevance and reliability captured from 120 SFAS issued by the FASB. The results provide us with an understanding of the relative importance of relevance and reliability in the promulgation of SFAS.

Keywords

FASB, SFAS, content analysis, relevance, reliability, promulgation

INTRODUCTION

The economic environment in the United States has become increasingly complex in recent decades due to globalization, advancing technology, changing business practices, and new financing arrangements. As a consequence, financial accounting and reporting has been challenged to meet the needs of investors and creditors in understanding today's dynamic corporate enterprises.

Generally Accepted Accounting Principles (GAAP) provide the basis for measuring, valuing, and presenting corporate financial information to investors and creditors. GAAP is promulgated primarily by the Financial Accounting Standards Board (FASB), a private sector organization which receives its rule-making authority from the Securities and Exchange Commission (SEC). The FASB promulgates GAAP through its Statements of Financial Accounting Standards (SFAS). Since its inception in 1973, the FASB has issued 154 SFAS.

For SFAS on various issues to result in coherent financial accounting and reporting, the fundamental underlying concepts need to constitute a framework that is sound, comprehensive and internally consistent (Bullen and Crook, 2005). To provide a guiding framework for its decision-making process and to assist practicing accountants in applying GAAP, the FASB issued seven Concept Statements. These concept statements deal the objectives of financial reporting, users of financial reporting, elements, measurement, valuation, and also provide a hierarchy of qualitative characteristics of financial information.

The conceptual framework defines a set of qualities of accounting information that make the information useful to investors and creditors in decision-making. These qualitative characteristics are used by the Board in their promulgation of SFAS and also by practicing accountants in applying GAAP in corporate financial accounting and reporting (FASB Concepts Statement No. 2, 1980). The purpose of this research effort is to generate an understanding of the relative importance of the individual qualitative characteristics in the FASB's promulgation of the 154 SFAS issued to date. This effort uses content analysis to capture the shifts of the relative importance of the decision specific qualities of relevance and reliability in individual SFAS over time. The results provide us with an understanding of the nature and the direction of the FASB decision-making process.

QUALITATIVE CHARACTERISTICS OF ACCOUNTING INFORMATION

The FASB is the current authoritative rule-making body promulgating GAAP. Prior authoritative bodies, including the Committee on Accounting Procedures (CAP) and the Accounting Principles Board (APB), lacked a conceptual framework to guide their decision-making. This led to GAAP pronouncements that were at times inconsistent with prior GAAP and a slow decision-making process. The absence of a conceptual framework may be one reason for the demise of both the CAP and the APB. In fact, Charles T. Horngren who was a member of the former APB has stated:

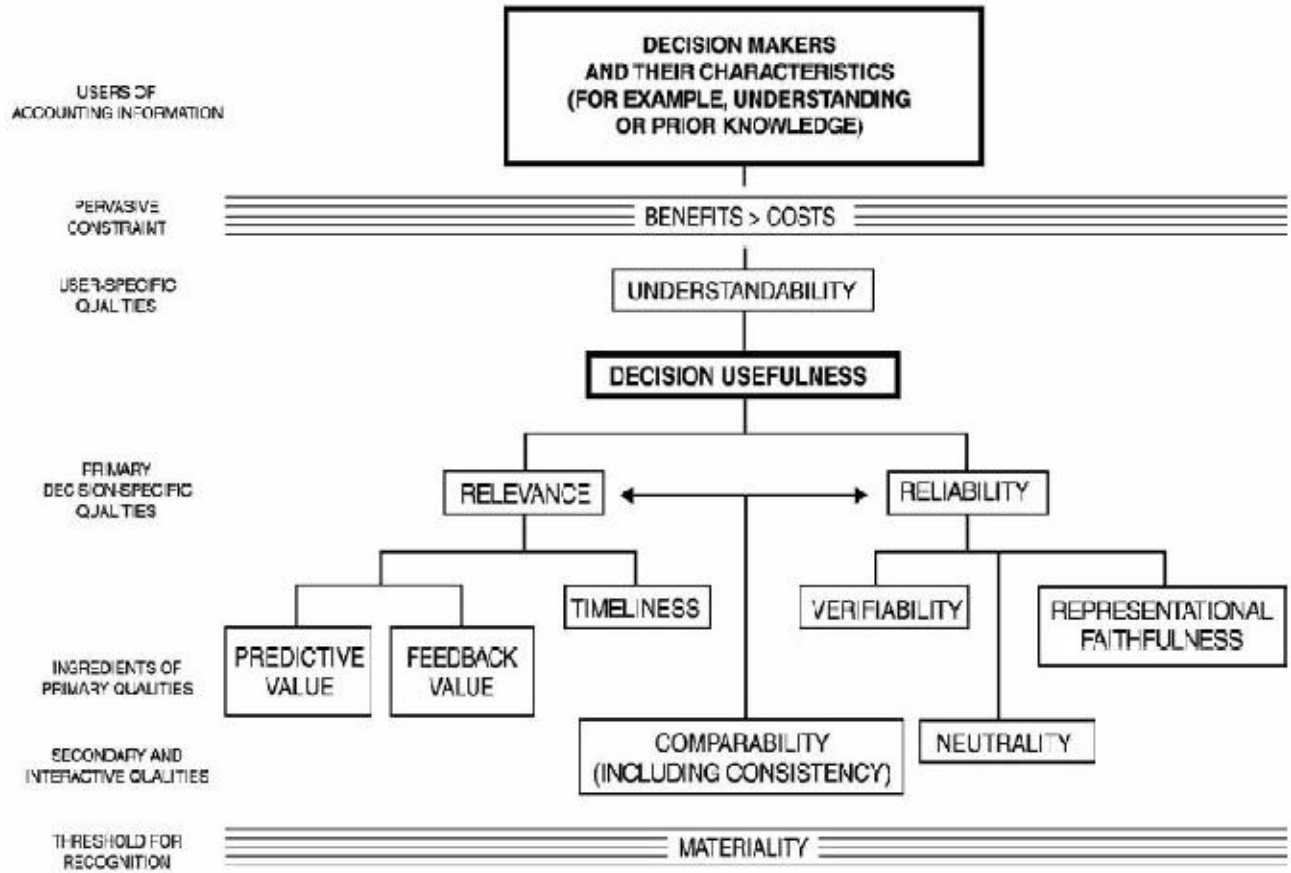
“As our professional careers unfold, each of us develops a technical conceptual framework. Some individual frameworks are sharply defined and firmly held; others are vague and weakly held; still others are vague and firmly held. . . . At one time or another, most of us have felt the discomfort of listening to somebody attempting to buttress a preconceived conclusion by building a convoluted chain of shaky reasoning. Indeed, perhaps on occasion we have voiced such thinking ourselves. . . . My experience as a member of the APB taught me many lessons. A major one was that most of us have a natural tendency and an incredible talent for processing new facts in such a way that our prior conclusions remain intact (Horngren, 1981).”

Comparability	The quality of information that enables users to identify similarities in and differences between two sets of economic phenomena
Conservatism	A prudent reaction to uncertainty to try to ensure that uncertainty and risks inherent in business situations are adequately considered
Consistency	Conformity from period to period with unchanging policies and procedures
Feedback Value	The quality of information that enables users to confirm or correct prior expectations
Materiality	The magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement
Neutrality	Absence in reported information of bias intended to attain a predetermined result or to induce a particular mode of behavior
Predictive Value	The quality of information that helps users to increase the likelihood of correctly forecasting the outcome of past or present events
Relevance	The capacity of information to make a difference in a decision by helping users to form predictions about the outcomes of past, present, and future events or to confirm or correct prior expectations
Reliability	The quality of information that assures that information is reasonably free from error and bias and faithfully represents what it purports to represent
Representational Faithfulness	Correspondence or agreement between a measure or description and the phenomenon that it purports to represent (sometimes called validity).
Timeliness	Having information available to a decision maker before it loses its capacity to influence decisions
Understandability	The quality of information that enables users to perceive its significance
Verifiability	The ability through consensus among measurers to ensure that information represents what it purports to represent or that the chosen method of measurement has been used without error or bias

Source: FASB Concepts Statement No. 2, Qualitative Characteristics of Accounting Information, May, 1980.

Table 1 Qualitative Characteristics of Accounting Information

Standard setting that is based on the personal conceptual frameworks of individual standard setters can produce agreement on specific standard-setting issues only when enough of those personal frameworks happen to intersect on that issue. However, even those agreements may prove transitory because, as the membership of the standard-setting body changes over time, the mix of personal conceptual frameworks changes as well. As a result, that standard-setting body may reach significantly different conclusions about similar (or even identical) issues than it did previously, with standards not being consistent with one another and past decisions not being indicative of future ones (Bullen and Crook, 2005). That concern is not merely hypothetical: substantial difficulties in reaching agreement in its first standards projects was a major reason that the original FASB members decided to devote substantial effort to develop a conceptual framework. One result of their efforts was Concept Statement No. 2, issued in May, 1980. Figure 1 presents a diagram of the Concept Statement No. 2's Hierarchy of Qualitative Characteristics showing the relationships among the individual qualities, constraints, and thresholds for recognition. Table 1 presents the basic definitions of the individual Qualitative Characteristics of the Hierarchy. This research effort generates an understanding of the relative importance of the decision specific qualities of relevance and reliability in the FASB's promulgated GAAP, the SFAS. Although we can never know the exact nature of the FASB's decision-making processes we can gain some understanding of their rationale through their use of the Qualitative Characteristics in explaining the pronouncements.



Source: FASB Concepts Statement No. 2, Quantitative Characteristics of Accounting Information, May, 1980.

Figure 1 A Hierarchy of Accounting Quality

RESEARCH HYPOTHESIS

This study is designed to examine whether there is significant difference over time in the relative importance of relevance and reliability in the FASB’s decision-making process. While this hypothesis is rather simple, there are significant implications for understanding the FASB’s decision-making.

METHODOLOGY

Content analysis is used to generate an understanding of the relative importance of relevance and reliability in the promulgation of SFAS. Content analysis has been defined as a systematic, replicable technique for compressing many words of text into fewer content categories based on explicit rules of coding (GAO, 1996; Krippendorff, 1980). Holsti (1969) defines content analysis as “any technique for making inferences by objectively and systematically identifying specified characteristics of messages.” It can be a useful technique for enabling the researcher to discover and describe the focus of individual, group, institutional, or social attention (Weber, 1990). It is oftentimes used to infer from symbolic data, such as trends and patterns in documents.

Content analysis is an appropriate methodology for this study for several reasons. First, the Qualitative Characteristics are well-defined by the FASB. Both the FASB and practicing accountants are keenly aware of the definitions of these specific characteristics and it is unlikely they would use substitute terminology. Second, this study uses the population and not a sample of SFAS that have been issued since the issuance of Concept Statement No. 2. Therefore, we do not have the inherent problems associated with sampling a population, including randomness, response rates, and representativeness, etc. Third, we do not have the reliability problems associated with using independent raters to determine the presence or absence of characteristics or themes in the documents. The characteristics are well-defined and can be easily captured through the use of basic features of word processing software.

CONDUCT OF THE STUDY

Data for this research effort was collected from SFAS 36 through 154. The source of the Hierarchy of Accounting Qualitative Characteristics, Concept Statement No. 2 was issued by the FASB concurrently with the issuance of SFAS 36 (May, 1980). Therefore, the prior 35 SFAS are excluded from this study since the qualitative characteristics had not been formally adopted by the FASB at the time of their issuance. A total of 120 SFAS (including two revised SFAS, 123R and 132R) are included in this effort.

For each individual SFAS, a search was made of the individual the primary decision specific qualities of relevance and reliability plus their ingredients. The ingredients for relevance include predictive value, feedback value, and timeliness while the ingredients for reliability include verifiability, neutrality, and representational faithfulness. A tally was made of the frequency of occurrences of these qualities and these tallies were classified based on FASB leadership and time period. There have been four chairmen since the issuance of Concept Statement No. 2. The reign of each of these chairmen represents a different period in the existence of the FASB and possibly a different focus in their decision processes. SFAS 36-92 were issued during the period of Donald Kirk; SFAS 93-131 were issued during the period of Dennis Beresford; SFAS 132-146 were issued during the period of Edmund Jenkins; and SFAS 147-154 were issued during the period of Robert Herz.

RESULTS

To measure the quality of relevance, we use the total frequency for relevance including its ingredients of predictive value, feedback value and timeliness. To measure the quality of reliability, we use the total frequency for reliability including its ingredients of verifiability, neutrality, and representational faithfulness. Since the length of a SFAS varies from statement to statement, instead of using absolute frequency, the number of occurrences per SFAS paragraph is used for analysis purposes. Table 2 presents the descriptive statistics generated using SPSS 14.0.

		N	Mean	Std. Deviation
relevance	SFAS 36-	57	.02154	.04846
	SFAS 93-	39	.00908	.01722
	SFAS 132-	15	.00698	.01136
	SFAS 147-	10	.01277	.01225
	Total	121	.01499	.03544
reliability	SFAS 36-	57	.03001	.06545
	SFAS 93-	39	.01527	.03030
	SFAS 132-	15	.01090	.02001
	SFAS 147-	10	.01215	.01516
	Total	121	.02142	.04922

Table 2 Descriptive Statistics

Figure 2 presents the mean occurrences per SFAS paragraph for each period and, therefore, indicates the relative importance between relevancy and reliability over the four periods of FASB leadership. In the first three periods of FASB leadership (Kirk, Beresford, and Jenkins) reliability was a more important quality than relevance in explaining the rationale of the SFAS. However, in the current leadership (Herz) which began in 2001 we see a more a balance between reliability and relevance. Also, the early years (Kirk) reliability and relevance were frequently mentioned in explaining the rationales of the SFAS. In recent years these qualities are mentioned less frequently by the FASB in conveying an understanding of GAAP.

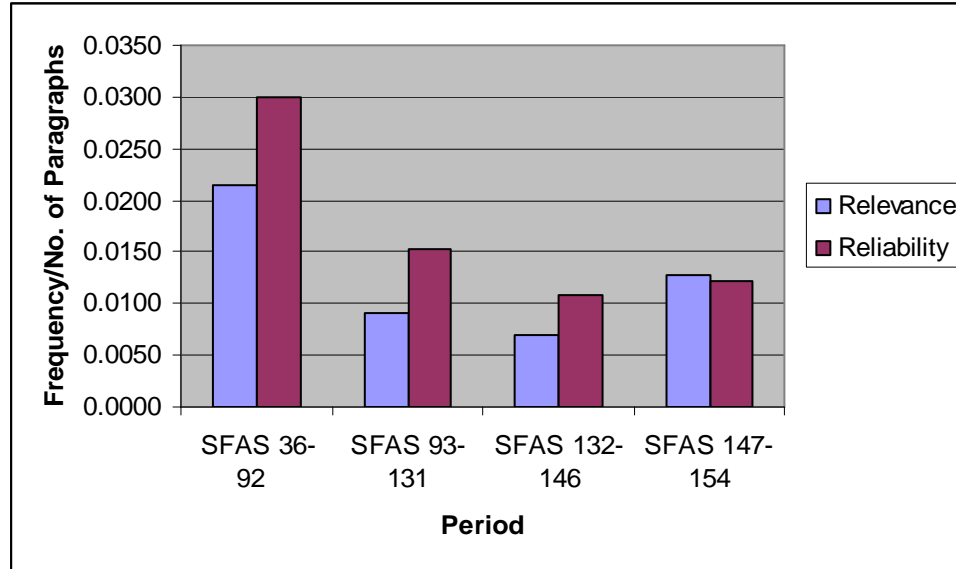


Figure 2 Relevance vs. Reliability

In addition, a one-way analysis of variance (ANOVA) was conducted to capture the differences in importance in relevance and reliability across the four periods. The results are presented in Table 3. Statistically significant differences are not detected for each of the four periods for both relevance and reliability. For relevance, the F-stat. is 1.288 and the p-value is 0.282 while for reliability the F-stat. is 1.132 and the p-value is 0.339. These results indicate that there is little difference in the FASB’s use of the qualitative characteristics of relevance and reliability over time.

		Sum of Squares	df	Mean Square	F	Sig.
relevance	Between Groups	.005	3	.002	1.288	.282
	Within Groups	.146	117	.001		
	Total	.151	120			
reliability	Between Groups	.008	3	.003	1.132	.339
	Within Groups	.282	117	.002		
	Total	.291	120			

Table 3 ANOVA Results

DISCUSSION

When making decisions accountants oftentimes are confronted with a choice of relevance or reliability. Should we strive to provide investors and creditors with the most accurate, objective, verifiable, and reliable, financial accounting and reporting? Or should we provide a financial accounting and reporting that is timely, has predictive value, and is the most relevant for investors and creditors? To have a financial reporting that is relevant for decision-making the information must be forward looking. This means that projections and estimates are difficult to verify and, therefore, a sacrifice of reliability. However, the most reliable and verifiable information may not be the most useful for forecasting and decision-making by investors and creditors. This trade-off is a critical issue for not only practicing accountants but also the FASB in the promulgation of GAAP. From the results of this study it is apparent the FASB has taken a more balanced approach in recent years in response to the needs of investors and creditors. Investors and creditors need information that is not only reliable but also information that is useful for decision-making. This is also critical for the significance of the role of financial reporting in investing and lending decisions. With the rise of the Internet and the speed of communications investors and creditors can quickly and easily obtain information other than financial reporting to assist them to make decisions. For financial reporting and the FASB to remain significant the emphasis must be on relevance. The results of this effort do indicate that the shift has begun to occur in the last few years.

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