Revisiting the Concepts

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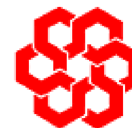

Financial Accounting Standards Board

International Accounting Standards Board

A New Conceptual Framework Project

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The FASB and IASB have just begun a new joint agenda project, to revisit their conceptual frameworks for financial accounting and reporting. Each Board bases its accounting standards decisions in large part on the foundation of objectives, characteristics, definitions, and criteria set forth in their existing conceptual frameworks. The goals of the new project are to build on the two Boards' existing frameworks by refining, updating, completing, and converging them into a common framework that both Boards can use in developing new and revised accounting standards.

This paper discusses:

a. The need for a conceptual framework

b. How the existing FASB Concepts Statements and IASB *Framework for the Preparation and Presentation of Financial Statements* fill part but not all of that need

c. The areas that the Boards are aiming to update and complete

d. The overall plan for the project that will lead to tomorrow's improved framework.

WHY WE NEED A CONCEPTUAL FRAMEWORK

A common goal of the FASB and IASB, shared by their constituents, is for their standards to be "principles-based." To be principles-based, standards cannot be a collection of conventions but rather must be rooted in fundamental concepts.For standards on various issues to result in coherent financial accounting and reporting, the fundamental concepts need to constitute a framework that is sound, comprehensive, and internally consistent.

Concepts? Conventions? What's the difference?

Concept, "a general notion or idea . . . of a class of objects," differs from *convention*, "a rule or practice based upon general consent." Those definitions are from the *Oxford English Dictionary, 2nd Edition* (Oxford: Clarendon Press, 1991), which goes on to quote Sir W. Hamilton defining conception as "the act of comprehending or grasping up into unity the various qualities by which an object is characterised."
For example, recognition of useful long-lived equipment as an asset is an accounting principle based on the concept of an asset as a source of future economic benefits, but straight-line depreciation of that asset is an accounting convention.

Without the guidance provided by an agreed-upon framework, standard setting ends up being based on the individual concepts developed by each member of the standard-setting body.

As former standard-setter Charles Horngren once noted:

> 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. [Footnote omitted.] (Horngren, p. 90, 1981)

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. 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.

The IASB *Framework* is intended to assist not only standard setters but also preparers of financial statements (in applying international financial reporting standards and in dealing with topics on which standards have not yet been developed), auditors (in forming opinions about financial statements), and users (in interpreting information contained in financial statements). Those purposes also are better served by concepts that are sound, comprehensive, and internally consistent. (In contrast, the FASB Concepts Statements state that they do not justify changing generally accepted accounting and reporting practices or interpreting existing standards based on personal interpretations of the concepts, one of a number of differences between the two frameworks.)

Another common goal of the FASB and IASB is to converge their standards. The Boards have been pursuing a number of projects that are aimed at achieving short-term convergence on specific issues, as well as several major projects that are being conducted jointly or in tandem. Moreover, the Boards plan to align their agendas more closely to achieve convergence in future standards. The Boards will encounter difficulties converging their standards if they base their decisions on different frameworks.

The FASB's current Concepts Statements and the IASB's *Framework,* developed mainly during the 1970s and 1980s, articulate concepts that go a long way toward being an adequate foundation for principles-based standards. Some of our constituents accept those concepts. Others do not. This paper discusses those concepts, why the Boards found them superior to alternatives, and how the Boards have found them helpful in making decisions.

Although the current concepts have been helpful, the IASB and FASB will not be able to realize fully their goal of issuing a common set of principles-based standards if those standards are based on the current FASB Concepts Statements and IASB *Framework*. That is because those documents are in need of refinement, updating, completion, and convergence.

TODAY'S FASB CONCEPTS STATEMENTS AND IASB *FRAMEWORK*

There is no real need to change many aspects of the existing frameworks, other than to converge different ways of expressing what are in essence the same concepts. Therefore, the project will not seek to comprehensively reconsider all aspects of the existing Concepts Statements and the *Framework*. Instead, it will focus on areas that need refinement, updating, or completing, particularly on the conceptual issues that are more likely to yield standard-setting benefits soon.

One aspect of the frameworks that is unlikely to change is the basic structure of the concepts. Both frameworks are organized similarly, beginning with the *objectives*, and then defining *qualitative characteristics* of financial information, *elements of financial statements* (including assets, liabilities, revenue, and expenses), criteria for *recognition* in financial statements, attributes and units for *measurement* of recognized assets and liabilities, and finally *display* in financial statements and *disclosure* in notes and other forms of financial reporting. The FASB presents its concepts in a series of separate documents. The IASB *Framework* has much the same structure, but all in a single document. This paper follows that same sequence, starting with objectives.

Several other national accounting standard setting bodies have also developed (Australia, Canada, New Zealand, the United Kingdom) or are developing (Japan, Germany) conceptual frameworks. Developing a converged IASB/FASB framework will include considering those other frameworks. For example, some of those frameworks were issued more recently than, and therefore probably improve on various aspects of, the FASB and IASB frameworks. See **Additional Reading** at the end of this paper.

Objectives

Both frameworks set forth similar objectives of financial reporting: to report information that is:

- **Useful in Making Economic Decisions**

  Usefulness in making economic decisions is the overriding objective of both frameworks. The IASB *Framework* focuses on the information needs of a wide range of users—investors, employees, lenders, suppliers, customers, governments, and the public—who, unlike management, have to rely on the financial statements as their major source of financial information about an entity. FASB Concepts Statement No. 1, Objectives of Financial Reporting by Business Enterprises, emphasizes usefulness in investment and credit decisions.

- **Useful in Assessing Cash Flow Prospects**

  Both frameworks then cite, in similar words, the general interest of external users of financial statements in assessing prospective net cash inflows to the enterprise. That objective follows from the first objective. The ability to generate net cash inflows ultimately determines the enterprise's capacity to pay its employees and suppliers, repay loans, and make distributions to its owners. External users' judgments about that ability and capacity affect their economic decisions, both in their dealings with the enterprise and in buying, selling, or holding the enterprise's securities.

- **About Enterprise Resources, Claims to Those Resources, and Changes in Them.**

  Both frameworks conclude that the first two objectives are best met with information about enterprise resources and claims to those resources and about changes in them. Those changes are subdivided by the IASB *Framework* into performance and changes in financial position, and by FASB's Concepts Statement 1 into (a) performance and comprehensive income and (b) liquidity, solvency, and funds flows. Both frameworks describe similar financial statements, commonly referred to as statements of accrual basis income and financial position and of cash or funds flows. Both frameworks also cite the need for notes and supplementary information. Concepts Statement 1 goes beyond financial *statements* to discuss how financial *reporting* also

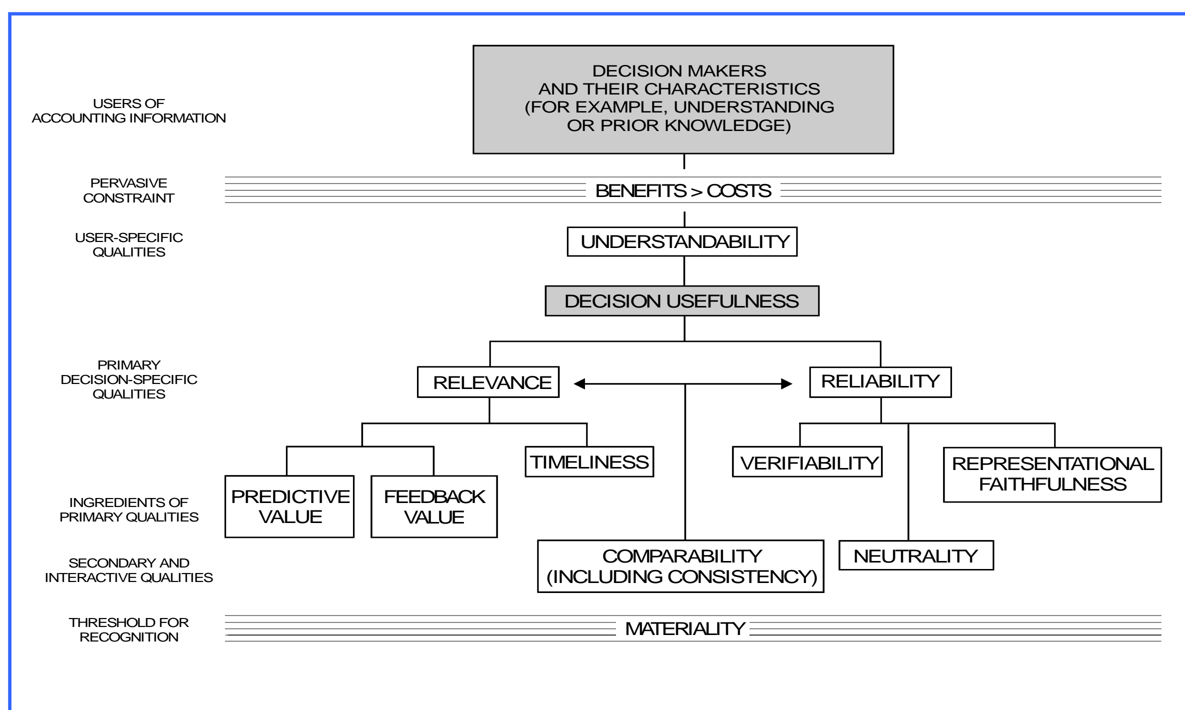
includes management's explanations and interpretations.

Thus, both frameworks set essentially the same overriding objective: decision-usefulness. Both then develop that overriding objective into further objectives of providing information about cash flow prospects and information about real-world economic phenomena: an entity's resources, claims on those resources, and changes in them. Although those objectives aroused some controversy when first proposed in the 1970's (for example, about the precedence of (a) usefulness for decision-making by a wide range of investors over (b) reporting to existing shareholders on management's stewardship), they are accepted today and regularly cited by the Boards and their constituents in discussions about proposed standards.

Some issues about the objectives of financial statements and financial reporting remain unresolved. One issue to be addressed in the project is convergence about *which* external decisions and decision-makers should be the primary focus. Another issue is whether those who make investment, credit, and similar decisions about smaller, privately held entities, not-for-profit organizations, or public sector bodies need more, less, or differently focused financial reporting information than those making decisions about large, publicly traded companies. Still another, related issue is whether concepts calling for a single kind of general-purpose external financial report, primarily focused on the needs of one set of decision-makers, continue—in the light of recent developments in information technology—to be the best way to provide the financial information needed by a wide range of decision-makers.

Qualitative Characteristics

Both frameworks define a set of qualities of accounting information that make the information provided useful to users in making economic decisions. Both frameworks include similar principal qualitative characteristics: understandability to decision-makers, relevance, reliability, and comparability, as well as aspects of those qualities. The two frameworks array them in a slightly different manner. The IASB *Framework* ranks understandability, relevance, reliability, and comparability equally as the main characteristics. FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*, places the characteristics in a hierarchy, illustrated using the following diagram:



- **Understandability**

  Understandability is user-specific: what is readily understandable to someone intimately familiar with business matters may be beyond the understanding of others. It also can be topic-specific: users may expend the effort to become knowledgeable about certain topics of particular concern. Both frameworks focus on financial statement users who have a reasonable understanding of business and economic activities and are willing to study the information with reasonable diligence.

- **Relevance**

  Both frameworks say that accounting information is relevant if it has the capacity to make a difference in a decision, through helping users either (a) to form expectations about the outcomes of past, present, and future events—*predictive value*—or (b) to confirm or correct prior expectations—*feedback or confirmatory value*.

- **Reliability**

  Both frameworks say that, to be useful, accounting information also needs to be reliable. Both discuss several aspects of reliability, beginning with the need for *faithful representation*, defined in Concepts Statement 2 as correspondence or agreement between an accounting measure or description and the economic phenomenon it purports to represent. In accounting reports, the phenomena to be represented are economic resources and obligations that exist in the real world and the real-world transactions and other events that change those resources and obligations. The IASB *Framework* also discusses the related quality of accounting for *substance over form*. FASB's Concepts Statement 2 notes that reliability does not imply certainty or precision, and it discusses *verifiability*—the likelihood that several independent measurers would obtain similar measures.

Concepts Statement 2 illustrates *faithful representation* with an analogy to maps. Road maps use "…symbols bearing no resemblance to the actual countryside, yet they communicate a great deal of information about it…" that is useful to travelers. Just as the lines on a road map represent roads and rivers in the real world, the descriptions and amounts in financial statements represent the cash, property, payables, sales, and salaries of a real-world enterprise. And just as a map-maker would impair the usefulness of a road map by adding roads or bridges where none exist or leaving out roads that do exist, an accountant who adds imaginary items to financial statements or leaves out real-world economic resources, obligations, or events would impair their representational faithfulness, and ultimately their decision-usefulness (Storey and Storey, p.105, 1998).

Some FASB and IASB constituents have questioned some of the trade-offs between relevance and reliability that the Boards have made in setting particular accounting standards. For example, those constituents have questioned the appropriateness of trade-offs made in requiring financial statement measures that reflect fair values rather than historical costs. Their underlying presumption seems to be that historical costs, although arguably not as relevant as fair values, are more reliable. In those instances, those constituents assert that the trade-off between relevance and reliability should favor historical costs rather than fair values or, more generally, that reliability should be the dominant characteristic of financial statement measures.

Some of the concern about trade-offs may reflect unavoidably different points of view: preparers or auditors might emphasize reliability in view of their legal exposures, whereas investors might place greater emphasis on the relevance of those measures in forecasting the entity's future net cash inflows or assessing its financial position. But the concern also may arise from misunderstandings or disagreements about the meaning of *reliability*. The new conceptual framework project will give further attention to that meaning and the trade-offs within aspects of reliability and with relevance.

Both frameworks emphasize the need for *neutrality*—freedom from bias—and the trade-offs between that characteristic and the traditions of prudence or conservatism. The frameworks both note that caution is a reasonable reaction to the uncertainties and risks inherent in business situations, but emphasize that it does not justify creation of hidden reserves, excessive provisions, or the deliberate understatement of assets

or income. That emphasis did not end controversy about conservatism, and therefore the new project is likely to consider whether and how to refine the wording and related discussion.

- **Comparability and Other Qualities**

  Both frameworks also emphasize the importance of *comparability* between entities, including *consistency* from year to year. They also discuss *completeness*, *timeliness*, the threshold of *materiality,* and the constraint of *cost-benefit* considerations. All of those concepts are likely to be reaffirmed in the new project, but their relative importance is an issue for updating and convergence. The Boards may need to consider trade-offs that exist between these characteristics as well: for example, ruling out a "short-cut" alternative to a complex accounting method may improve comparability and reduce users' costs but raise verifiability concerns and increase preparer's costs.

- **Underlying Assumptions**

  The IASB *Framework* also makes two underlying assumptions: first, that financial statements are prepared on the *accrual basis* and second, that the reporting entity is normally a *going concern*. The FASB's Concepts Statements extensively discuss the need for accrual accounting procedures, and briefly discuss going concern, but do not identify either as underlying assumptions. Converging the accrual assumption difference likely will be just a matter of emphasis in drafting, but the going concern assumption difference could be more challenging.

Elements of Financial Statements and their Definitions

Both Boards concluded that it was essential to identify and define the interrelated set of building blocks with which financial statements are constructed: the *elements of financial statements*. That financial statements depict assets, liabilities, equity, revenues, expenses, and so forth, and that they interrelate and articulate, has been well understood by accountants for centuries. The key achievement of this part of the frameworks is (a) to specify just how those elements are interrelated and (b) to set forth similarly interrelated definitions of those elements, so that financial statements composed of depictions of those elements faithfully represent real-world economic phenomena and also exclude items that do not represent real-world economic phenomena.

The frameworks begin by defining *assets* in terms of real-world phenomena. In the FASB version, in brief, assets are "probable future economic benefits obtained or controlled by a particular entity as the result of past transactions or [other] events. (FASB Concepts Statement No. 6, *Elements of Financial Statements*, paragraph 25, footnote reference omitted.)" *Future economic benefit*, *obtaining or controlling*, *particular entity*, and *events* are all phenomena observable in the real world, as distinct from accounting procedures such as accrual, deferral, allocation, and matching of costs with revenues that are abstractions observable only in accounting records and financial statements. That definition contrasted with earlier efforts that included deferred debits among assets even though deferred debits could not be observed in the real world.

The Boards then defined *liabilities* as another class of real-world phenomena. In the FASB version, liabilities are "probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events." (Concepts Statement 6, paragraph 35, footnote reference omitted) The only accounting abstractions in that definition are *assets*, which are already defined. That definition of liabilities excludes deferred credits, again because they could not be observed in the real world. *Equity* is defined as the residual interest in the *assets* of an entity that remains after deducting its *liabilities*.

The IASB *Framework* defines assets, liabilities and equity in a similar way. The definitions for the other elements also are built largely on the defined term *assets*, which is what is meant (and all that is meant) by saying that assets have "conceptual primacy" in the FASB and IASB frameworks.

Two Views about Income

In both frameworks, the definitions of the elements are consistent with an "asset and liability view," in which income is a measure of the increase in the net resources of the enterprise during a period, defined primarily in terms of increases in assets and decreases in liabilities.

> Income in this sense is called *all-inclusive income* in pronouncements of the U.S. Accounting Principles Board, *earnings* in Concepts Statement 1, and *comprehensive income* in later Concepts Statements and in FASB Statement No. 130, *Reporting Comprehensive Income*. In the IASB *Framework*, it is not directly defined or explicitly named, but is the difference between two defined elements, *income* (which comprises revenues and gains) and *expenses.*

That definition of income is grounded in a theory prevalent in economics: that an entity's income can be objectively determined from the change in its wealth plus what it consumed during a period (Hicks, pp. 178-179, 1946).. That view is carried out in definitions of liabilities, equity, and income that are based on the definition of assets, that is, that give "conceptual primacy" to assets. That view is contrasted with a "revenue and expense view," in which income is the difference between outputs from and inputs to the enterprise's earning activities during a period, defined primarily in terms of revenues (appropriately recognized) and expenses (either appropriately matched to them or systematically and rationally allocated to reporting periods in a way that avoids distortion of income.)

Those contrasting views were set forth and discussed at length in the December 1976 FASB Discussion Memorandum, *Scope and Implications of the Conceptual Framework Project*. Paragraph 66 of that document noted that critics of the revenue and expense view contend that unless vital concepts—such as income, revenues, expenses, appropriate matching, and distortion of periodic net income—are clearly defined, income under the revenue and expense view is almost completely subjective. In that document and other communications, critics of the asset and liability view who favored the revenue and expense view were challenged to define revenue, expense, or income directly, without reference to assets or liabilities or recourse to highly subjective terminology like *proper matching*. Some tried, in letters, articles, and public meetings with the FASB, but none could meet the challenge.

After extensive deliberations, the FASB adopted the asset and liability view. The IASB *Framework* also adopted the asset and liability view, as did the frameworks of other national standard-setters.

The definitions of assets and liabilities discussed earlier were the basis for the definitions of the other elements of financial statements, now in Concepts Statement 6 and the IASB *Framework*. The procedures of accounting can then be arrayed as a sequence of questions, as illustrated in the box to the right.

> The result of applying the asset and liability view is an internally consistent, well-defined system of elements in Concepts Statement 6 that make it clear that in accounting for a transaction or other event, these are the right questions to ask, and this is the right order in which to ask them:
>
> What is the asset?
> What is the liability?
> Did an asset or liability change, or did its value change?
> - Increase or decrease?
> - By how much?
> - Did the change result from:
>   - An investment by owners?
>   - A distribution to owners?
>   - If not, the change must be comprehensive income
>   - Was the source of comprehensive income what we call:
>   - Revenue?
>   - Expense?
>   - Gain?
>   - Loss?
>
> To start at the bottom and work up the list will not work.
>
> Storey & Storey, p. 87

Although two decades have passed since the FASB and IASC (the IASB's predecessor body) decided to ground their definitions of elements in the asset and liability view, misunderstandings and controversy persist. (For example, The United Kingdom's Accounting Standards Board encountered similar misunderstandings and controversy during the 1990s in developing their *Statement of Principles for Financial Reporting*, which also adopted the asset and liability view.)

Some critics state that the asset and liability view focuses on reporting financial position rather than income. However, the 1976 Discussion Memorandum and Concepts Statements FASB says that all parties agree that the information in a statement of income is likely to be more useful to investors and creditors than the information in a statement of financial position (1976 FASB Discussion Memorandum, paragraph 45 and Concepts Statement 1, paragraph 43), and the IASB *Framework* emphasises that information about the performance of an enterprise, in particular its profitability, is required (IASB *Framework*, paragraph 17.).

Other critics contend that the asset and liability view portends recognizing all assets and liabilities and measuring them at current prices (fair value), to show the value of the entity. However, both frameworks set forth various measurement attributes. And the Concepts Statements explain, and the IASB *Framework* implies, that the statement of financial position does not purport to show the value of a business enterprise (Concepts Statement 1, paragraph 41, IASB *Framework*, paragraph 100, and Concepts Statement 5, paragraph 27).

Some recent critics advocate a shift back to the revenue and expense view. However, in a recent study about principles-based standards, mandated by the 2002 Sarbanes-Oxley legislation, the U.S. Securities and Exchange Commission said the following:

> . . . the revenue/expense view is inappropriate for use in standard-setting—particularly in an objectives-oriented regime. . . . Historical experience suggests that the asset/liability approach most appropriately anchors the standard setting process by providing the strongest conceptual mapping to the underlying economic reality. " (page 30).

> . . . the FASB should maintain the asset/liability view in continuing its move to an objectives-oriented standard setting regime" (page 42).

In its response to that study, the FASB said:

> As noted in the Study, FASB Concepts Statement No. 6, Elements of Financial Statements, gives priority (conceptual primacy) to the definitions of assets and liabilities by defining the other elements (equity, revenues, expenses, gains, and losses) in terms of changes in assets and liabilities. The Board agrees with the view expressed in the Study that analyzing the assets and liabilities and the changes in assets and liabilities in a given arrangement is the most appropriate approach to setting financial reporting standards and intends to continue to apply the asset-liability view in its standard-setting projects. The Board notes that application of the asset-liability view is not inconsistent with, and can accommodate, the development of financial reporting standards for aggregation, classification, and display of information about the components of enterprise performance.

For those reasons, the Boards are likely to retain the primacy of assets as the foundation for defining the elements of financial statements, rather than attempting to base the definitions on one of the other elements.

How the Boards Have Used the Current Definitions

The FASB and IASB have found the definitions of assets and liabilities helpful in resolving many standard-setting issues. For example, the definition of liabilities helped the FASB and IASB decide (in Statement 5 and IAS 37) that a contingency or provision should be recognized only if a present obligation (legal or constructive) arises from a past event, thereby ruling out premature recognition of "reserves" for possible losses from events that have not yet occurred. The definitions helped both Boards decide (in Statement 133 and IAS 39) that derivative instruments result in assets or liabilities that should be recognized. The definitions also helped the Boards determine (in IAS 32 and Statement 150) that certain mandatorily redeemable preferred shares are liabilities, not equity. The basic relationship that equity is the residual of assets less liabilities helped the Boards conclude that a noncontrolling interest in a subsidiary, because it does not meet the definition of a liability, should be presented in equity (in IAS 27 and, tentatively, in a FASB exposure draft issued in 2000).

Difficulties with the Current Definitions

However, the Boards have encountered difficulties in using the definitions to deal with other standard-setting issues. For example, both *asset* definitions hinge on *control*, but neither framework has proved sufficiently helpful in resolving some issues in which two parties seem to have *some* control over the same asset, such as assets subject to call options or forward purchase contracts, or expected inflows that are not legally enforceable. For another example, the current definitions of *liability* in both frameworks exclude increasingly common financial instruments that obligate an entity to issue a variable number of shares equal in value to a fixed amount, which were classified as equity. The Boards found it necessary to issue pronouncements in 2003 (Statement 150 and IAS 32) that classified such obligations as liabilities notwithstanding the current definitions. In considering standards for obligations that result from a series of events (such as certain environmental liabilities), the Boards have sometimes struggled to identify which of a series of "past transactions or events" is *the* obligating event. Also, the Boards recently have found their definitions of *liability* insufficiently helpful in distinguishing revenues from liabilities (for example, when payment for products or services is received in advance.) Those matters are currently being considered in standards-level projects, but they have broader implications that are likely to be addressed in the conceptual framework project.

The definitions of elements in the two frameworks differ, which is an impediment to convergence in the Boards' standards. The IASB's definition of assets begins with "resources" and only later refers to "future economic benefits expected to flow" from those resources, whereas the FASB's definition of assets begins with "probable future economic benefits" and does not mention resources. Is the asset the resource or the future benefit from the resource? Similarly, the IASB's definition of liabilities begins with "present obligations" and later refers to expected outflows of resources, whereas the FASB's definition of liabilities begins with "probable future sacrifices of economic benefits" and later mentions "present obligations." Is the liability the present obligation, or is it the future sacrifice to satisfy the obligation? Also, the term *probable* is used in the FASB's definitions but not in its conceptual recognition criteria and is used (with a different meaning) in the IASB's recognition criteria but not in its definitions; that term has caused difficulties for both Boards in resolving various issues hinging on uncertainty.

Difficulties about How Many Elements

Another difference between the frameworks lies in how many elements must be defined. One such difference arises from the concept of capital maintenance. The IASB *Framework* allows an entity to choose, based on its assessment of the needs of its users, a *physical capital maintenance* concept. Under that concept, profit is determined by the extent to which the physical productive capacity of the entity at the end of the period exceeds its physical productive capacity at the start of the period (excluding contributions from owners and distributions to owners during the period.) The physical capital maintenance concept requires subsequent measurement of assets at current cost and requires an additional financial statement element, *capital maintenance adjustments*, to be reported separately from income. The IASB *Framework* also allows an entity to choose, based on its assessment of the needs of its users, *financial capital maintenance*, under which profit is determined by the extent to which the entity's net assets at the end of the period exceeds its net assets at the beginning of the period, however measured (again excluding contributions from owners and distributions to owners during the period.) In contrast, the FASB's framework adopts financial capital maintenance and rejects physical capital maintenance.

The existing frameworks also have other differences about elements. The IASB *Framework* identifies only two elements for changes in assets and liabilities: *income* and *expenses*. The FASB's framework classifies changes in assets and liabilities that affect equity into *investments by owners*, *distributions to owners*, and *comprehensive income*, and subdivides comprehensive income into *revenues*, *expenses*, *gains*, and *losses*. The FASB's framework indicates that most gains and losses are included in *earnings* and the rest are *other comprehensive income*, without clearly defining either term.

To converge their frameworks, the Boards will need to refine and clarify their definitions of *asset* and *liability*, reconcile their different uses of *probable*, come to a single view on capital maintenance, and resolve other differences about elements and their definitions. That is likely to be one of the most challenging parts of the conceptual framework project.

Recognition in Financial Statements

Both frameworks contain recognition criteria that must be satisfied before items are recognized in the financial statements, that is, actually incorporated into one or more of the individual statements, depicted in words and numbers, and with the amount included in the statement totals. Both frameworks acknowledge that meeting the definition of an element of financial statements is necessary, but not sufficient, for recognition.

The frameworks have some recognition criteria in common. In both frameworks, to be recognized an item must both:

- Meet the definition of an element
- Have a cost or value (measurement attribute) that can be measured with (sufficient) reliability.

The second criterion means that when an item is recognized depends on whether it can be measured reliably. It also means that the timing of recognition may depend on what attribute is being measured: an item measured by a value attribute might be recognized sooner, or later, than if it were measured by a cost attribute. While both frameworks include that criterion, the issue of its effect on the timing of recognition raises issue that may need to be reconsidered in this project.

There also are other differences:

- The IASB *Framework* includes the criterion that it must be probable that any future economic benefit associated with the item will flow to or from the entity. The FASB's framework does not include probability as a recognition criterion.
- The FASB's framework includes the criterion that the item must be relevant—information about it needs to be capable of making a difference in user decisions. Some critics have questioned that criterion, on the grounds that it is redundant because meeting the definition of an element means that an item is relevant. Relevance also affects the measurement attribute criterion mentioned above—the item must have a relevant attribute that can be measured reliably. The IASB *Framework* does not include relevance either as a separate recognition criterion or as a qualifier of the measurement attribute criterion.

There also are other issues to consider. For example, neither framework discusses *de*recognition, that is, the removal from the financial statements of a previously recognized asset or liability. One might conclude that that would be superfluous—an item should be derecognized if it no longer meets all the criteria for recognition. However, both Boards have standards on financial instruments that require *other things* to occur before financial assets can be derecognized (and *different* other things to occur before liabilities can be derecognized.) (IAS 39, *Financial Instruments: Recognition and Measurement* and FASB Statement No.140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*.) The derecognition issue may affect other present or potential standards-level projects beyond financial instruments, for example, revenue recognition and leases.

The Boards likely will need to revise their recognition criteria concepts to eliminate those differences and provide a basis for resolving issues such as derecognition.

Measurement

The IASB *Framework* defines measurement as "the determination of the monetary amounts at which the elements of financial statements are to be recognized and carried in the balance sheet and income statement." The FASB's framework separates measurement into (a) selection of the monetary unit and (b) choice of attribute. Measurement is one of the most underdeveloped areas of the two frameworks.

As to the monetary unit, the FASB's framework adopts nominal units of money over the alternative, which is units of constant general purchasing power that are more appropriate if inflation is high. The IASB *Framework* discusses those alternatives, but does not select one. That measurement issue may not be as controversial today as it was when the frameworks were developed, because most major economies are currently experiencing little or no inflation, although countries with highly inflationary economies may disagree.

The second aspect of measurement, the choice of attribute, is more difficult. Both frameworks contain lists of measurement attributes used in practice. The lists are broadly consistent, comprising historical cost, current cost, gross or net realizable (settlement) value, current market value, and present value of expected future cash flows. Both frameworks indicate that use of different measurement attributes is expected to continue. However, neither provides guidance on how to choose between the listed measurement attributes or consider other theoretical possibilities. In other words, the frameworks lack fully developed measurement concepts.

Better measurement concepts would need to address both initial measurement and subsequent measurement. The most challenging issue is which attributes to use for subsequent measurement. Subsequent measurement includes revaluations, impairment, and depreciation, and gives rise to issues about the classification of gains or losses in statements of income and changes in equity. A related issue is whether recognition or derecognition criteria might differ depending on the measurement attribute.

The Boards also will consider whether the converged framework should include not only measurement concepts, but also guidance on measurement techniques. For example, the FASB's framework includes Concepts Statement 7, on the use of cash flow information and the present value measurement technique to estimate fair value for the purposes of initial recognition and fresh-start accounting; the IASB *Framework* has no equivalent.

One unresolved concept that recurs in various ways in Board discussions about measurement issues is the *unit of account*—whether items should be grouped at some level of aggregation, or disagreggated, rather than being measured individually. Different units of account result in different measures of impairment if the measurement attribute is historical cost. That is because, if the unit is a large group of assets, the impairment of one asset may be countered by appreciation of another asset. Different units of account also result in different measures of fair value if the price for a single item is higher or lower than the per-unit price for a group of similar items. Or perhaps what appears to be a single item should be subdivided for accounting purposes. (The unit of account presents unresolved challenges that go beyond measurement. For example, neither framework resolves whether a fully executory contract such as a forward purchase contract should be recognized as two items—an asset and a liability—or as a single net item.) Several standards projects turn at least in part on the unit of account, and neither framework provides useful guidance.

The long-standing unresolved controversy about which measurement attribute to adopt—particularly between historical-price and current-price measures—and the unresolved puzzle of unit of account are likely to make measurement one of the most challenging parts of this project.

Reporting Entity and Control over Other Entities

Modern business arrangements are commonly conducted by entities interrelated by ownership, contract, common management, joint venture, formal and informal partnership, or other linkages. Those complex arrangements raise issues of what sorts of entities should (or should not) issue financial statements, which other entities should be included in consolidated or combined financial statements, and how to accomplish such inclusion.

The FASB attempted to develop a concept of the reporting entity during the 1980s and 1990s, proposing an "economic unit" concept rather than a "parent company" concept, but was not able to complete a Concepts Statement. The IASB's framework defines a reporting enterprise, but does not choose between those two concepts. Although International Financial Reporting Standards and US standards both require the preparation of consolidated financial statements and provide guidance on how to do that, both sets of standards have conceptual inconsistencies and gaps (for example, in dealing with special-purpose entities) that are difficult to resolve without an adequate concept of the reporting entity. (The Australian accounting standards boards did issue in 1990 a concepts statement, *Definition of the Reporting Entity,* that defined an economic entity as a group of entities under common control with users who depend on general purpose financial reports to make resource allocations decisions regarding the collective operation of the group and examined the implications of that concept. The Boards may find that Concepts Statement useful in developing a complete, converged concept of reporting entity.)

Display and Disclosure

Display (presentation) in financial statements and disclosure in notes and other means of financial reporting are discussed only in the most general terms in both frameworks. Those matters clearly need attention in the project.

Both frameworks briefly describe the statements that comprise a full set of financial statements and discuss the different types of information those statements present and how users may find them helpful in making decisions. But the description and discussion are in very general terms. They provide no guidance on such long-standing, troublesome issues as classification within the statement of financial position and level of detail and appropriateness of subtotals (for example, whether operating earnings, net income, other comprehensive income, or other amounts should be displayed and what should or should not be included in them) within the income statement. Neither framework discusses earnings per share or other summary indicators. The FASB considered such issues but was able to resolve them into concepts only with respect to the cash flow statement. (FASB Concepts Statement 5, paragraphs 52–54 calls for a cash flow statement to take the place of the former statement of changes in financial position and indicates that it should provide information about cash flow from operating, financing, and investing activities. The IASB *Framework* does not discuss a cash flow statement in any detail.)

Both frameworks briefly discuss disclosure in notes, in supplementary schedules, and in other means of financial reporting, but give only a few examples of the sort of information disclosed in present practice. Neither provides useful conceptual guidance about what information should be (or need not be) disclosed, where to disclose it, or how to present it.

Concepts of display and disclosure clearly need considerable attention in the project. However, the Boards have tentatively decided that, although concepts of display and disclosure need to be addressed in the project, priority should be given to developing updated, improved, and converged objectives for financial statements and concepts of qualitative characteristics, elements and their definitions, recognition, measurement, and the reporting entity.

TOWARDS TOMORROW'S IMPROVED FRAMEWORK

As discussed above, a few aspects of the frameworks are inconsistent and some others are not as clear as they might be. Other aspects are dated and do not fully reflect accounting thought as it has developed since the FASB Concepts Statements and the IASB *Framework* were issued. Still other aspects of the FASB's framework that were originally planned were not ultimately completed. Additionally, the IASB *Framework* is less developed than the FASB's, often alluding in few words to fundamental concepts that need further elaboration to provide robust guidance for resolving financial reporting issues. As a result, the Concepts Statements and *Framework* have been less useful than originally planned as tools for the FASB and IASB in setting standards and provide the Boards with less-than-comprehensive guidance for many standard-setting issues. Furthermore, the two frameworks differ on some concepts. Thus, the shortcomings of the present conceptual guidance constitute an impediment to realizing the goal of having converged accounting standards that are principles-based.

The planned approach in the joint project will identify troublesome issues that seem to reappear time and time again in a variety of standard-setting projects and often in a variety of guises. That is, the focus will be on issues that cut across a number of different projects. Because it is not possible to address those *cross-cutting* issues comprehensively in the context of any one standards-level project, the conceptual framework project provides a better way to consider their broader implications, thereby assisting the Boards in developing standards-level guidance.

The Boards have identified the cross-cutting issues. The table below indicates some—not all—of the identified issues.

SOME CROSS-CUTTING ISSUES

Objectives:
(a) Are financial statements produced for the existing common shareholders, or for a wide range of users?
(b) Is usefulness in decision-making predominant, or does stewardship (accountability) still have a role?

Qualitative Characteristics:
(a) How do we trade off characteristics, for example, if highly *relevant* information is difficult to *verify*.
(b) Is the meaning of *reliability* clear? Should we separate *representational faithfulness* from *verifiability*?
(c) Does *conservatism* (prudence, abuse avoidance) conflict with *neutrality*?
(d) Is *comparability* as important as relevance and reliability?

Defining *Asset*:
(a) Should *control* remain in the asset definition or become part of the recognition criteria?
(b) What does *control* mean? E.g. does the holder of a call option control the underlying asset?
(c) What is the *event* that results in an entity "obtaining or controlling" an asset? Is that the right question?

Defining *Liability*:
(a) Is the liability (1) the future sacrifice itself or (2) the obligation to make that sacrifice.
(b) What is the *past* transaction or other *event* that gives rise to the *present obligation*?
(c) What are *equitable or constructive obligations*—promises enforceable at law or something broader? For example, preferred dividends, employee bonuses, and projected benefit obligations.

Distinguishing *Liabilities* from *Equity*:
(a) How should we treat instruments that could be either liabilities or equity, for example, shares puttable at fair value, obligations settled in shares, and minority interests in subsidiaries?
(b) Should there be three or even more elements—debt, equity and "quasi-equity"?
(c) Should all elements be defined explicitly, or should one be a residual (if so, is that residual *equity*)?

MORE CROSS-CUTTING ISSUES

The Effect of *Uncertainty*:

(a) If an uncertain future event will determine whether *any* economic benefits flow to or from the entity, is there an asset or a liability? What if the entity can influence whether that future event occurs?

(b) The role of 'probable' or 'expected' in the definition of elements, recognition criteria, and measurement. For example, does a flow of economic benefits to or from the entity need to be 'probable' or 'expected' to meet the definition of an asset or liability, or to be recognized? If so, what is the meaning of 'probable' or 'expected'?

(c) Should reporting be based on what an entity expects to occur, instead of what a contract requires?

Recognition:

What is the recognition event? For example, if an asset or liability does not meet recognition criteria when acquired or incurred, what later event causes the asset or liability to be recognized?

Derecognition:

(a) Is it the opposite of recognition (derecognize when recognition criteria are no longer met) or does history matter?

(b) Is it based on legal ownership or control, who has the risks or rewards, or separation into components?

(c) Does it depend in part on the subsequent measurement attribute?

Measurement:

(a) What do *historical cost, fair value, current cost, deprival value,* and other currently used or proposed measurement attributes really mean? (For example, how should transaction costs be treated?)

(b) What are the desirable characteristics of an attribute? Relevance? Reliability? What is "sufficiently reliable"?

(c) Should a single measurement attribute be adopted, or should the attributes used be different for:
- initial measurement vs. subsequent measurement?
- assets vs. liabilities?
- different types of assets, or different liabilities?

(d) If measured based on historical transaction prices:
- Should impairments be recognized? Why? When?
- Should revaluations be required or allowed? Why? When?

(e) If measured based on current prices:
- Which price: fair value, current cost, deprival value . . .?
- Prices in which market, and for which asset or liability?
- Prices assuming going concern or liquidation?

(f) Is a point estimate sufficient to represent a distribution of possible measures, or should we report an indication of the dispersion? If the latter is needed, how to do it?

Unit of Account–(What is the thing being accounted for?):

(a) In what circumstances do we account for "similar" things together, rather than separately?

(b) When should measurement reflect the "law of large numbers," volume discounts, or synergies?

(c) Should an entity recognize assets and/or liabilities for contracts that are still fully executory? If so, what are the assets and liabilities and should the entity account for and report them separately or account for them as a single net item?

(d) Should some "related" assets and liabilities be accounted for together or netted? If so, when to *un*link?

To what extent should financial statements reflect **management intentions**? For example, should the measurement of assets reflect the best possible use or management's intended use? Should the measurement of a liability reflect the least-cost settlement or management's intended method of settlement?

Reporting Entity :

Which legal entities or economic units are reporting entities?
Which entities should be consolidated?

(a) If consolidation is based on control, what does *control* mean?

(b) If consolidation is based on control, what about entities or assets under joint control?

Now that the cross-cutting issues have been identified, they will be prioritized. That prioritization will establish the detailed work plan for the project. One consideration will be how frequently and how soon those issues would be likely to arise in standards-level projects. Another consideration will be the interdependencies between cross-cutting issues, so that higher priority would be assigned to issues on which the resolution of other issues depend. Still another consideration in setting priorities will be whether resolving the issue would foster convergence of the FASB's and IASB's frameworks.

After prioritization, concurrent Board deliberations will begin, focusing on each cross-cutting issue and working toward improved concepts. The Boards will also begin work at the same time on converging the texts of the frameworks, some of which may call only for reconciling slightly different ways of expressing what are in essence the same concepts.The IASB and FASB staff will work together, with assistance from other national standard setters, resource groups, and other constituents. The ultimate goal is to produce a single final document that will be the Boards' common framework. However, to achieve that goal, it is likely that several initial discussion documents, each covering part of the framework, may be issued, followed by exposure draft(s).

This joint project is a major undertaking for both Boards and will take several years. In the intervening period, the Boards will look to their existing frameworks for guidance in setting standards. However, the thinking emerging in the new project will surely also have an effect on the standards-level views of individual Board members and the Boards' constituents.

Upon completion of the improved, converged framework, some existing FASB and IASB financial reporting standards inevitably will conflict with the concepts. That also is the case today: for a variety of reasons, some current standards conflict with the current concepts. Such conflicts will not result in immediate changes to those accounting standards, because both Boards' standards have hierarchical priority over concepts in their application to financial reporting. The Boards likely will continue to give priority to standards. However, as new, converged, principles-based standards are developed based on the improved, converged concepts, conflicts between standards and concepts will become infrequent.

CONCLUSION

The IASB and FASB have set out on a challenging task in deciding to update, complete, and converge their conceptual frameworks. Many of the issues are both difficult to resolve and controversial. The project will require significant resources from both Boards and substantial input from their constituents. But the project will help in resolving critical accounting standards issues, both while it progresses and when it reaches fruition in a single, refined, updated, completed framework underlying consistent principles-based standards that promote decision-useful financial reporting.

Expressions of individual views by members of the FASB, the IASB, and their staff are encouraged. The views expressed in this article are those of Mr. Bullen and Ms.Crook. Official positions of the FASB and IASB are determined only after extensive due process and deliberations.

ADDITIONAL READING

Accounting Standards Board, *Statement of Principles for Financial Reporting* (London: 1999). As part of its due process, the United Kingdom's accounting standard setter issued several exposure drafts and discussion drafts on particular concepts topics during the 1990's, including:

- Exposure Draft: *The Objectives of Financial Statements & the Qualitative Characteristics of Financial Information* (1991)
- Exposure Draft: *Statement of Principles for Financial Reporting* (1995)
- Revised Exposure Draft: *Statement of Principles for Financial Reporting* (1999) accompanied by *Some Questions Answered* and a *Technical Supplement to the Revised Exposure Draft*

American Accounting Association, *A Statement of Basic Accounting Theory* (Evanston: 1966). ASOBAT, developed by a committee chaired by Charles T. Zlatkovich, identified four basic standards as criteria for evaluating potential accounting information: relevance, verifiability, freedom from bias, and quantifiability. Those standards are early ancestors of the qualitative characteristics in the IASB and FASB frameworks.

Australian Accounting Standards Boards, *Statements of Accounting Concepts* (Melbourne/Caulfield: AASB/AARF):

1. *Definition of the Reporting Entity* (1990)
2. *Objective of General Purpose Financial Reporting* (1990)
3. *Qualitative Characteristics of Financial Information* (1990)
4. *Definition and Recognition of the Elements of Financial Statements* (1995)

FASB Concepts Statements (Stamford/Norwalk, CT: FASB):

1. *Objectives of Financial Reporting by Business Enterprises* (1978)
2. *Qualitative Characteristics of Accounting Information* (1980)
3. *Elements of Financial Statements of Business Enterprises* (1980)
4. *Objectives of Financial Reporting by Nonbusiness Organizations* (1980)
5. *Recognition and Measurement in Financial Statements of Business Enterprises* (1984)
6. *Elements of Financial Statements* (1985) — replaces Concepts Statement 3. The Statement notes that the 22 words that "define" assets in paragraph 25 only summarize the concept of assets. The entire discussion of the characteristics of assets in paragraphs 26–34, 171–191, and 246–250 of Concepts Statement 6 are part of the definition of assets. Similarly, the 34 words in paragraph 35 are only a one-sentence summary of the extended discussion of the characteristics of liabilities, in paragraphs 36–48, 54–59, 192–211, and 232–245.
7. *Using Cash Flow Information and Present Value in Accounting Measurements* (2000)

As part of its due process on the conceptual framework, in December 1976 the FASB issued a major discussion memorandum, *An analysis of issues related to Conceptual Framework for Financial Accounting and Reporting: Elements of Financial Statements and Their Measurement*. The FASB issued other discussion memorandums analyzing issues related to objectives and particular concepts in 1974, 1975, 1978, 1979, 1980, and 1990, as well as three research reports on recognition issues in 1980, 1981, and 1982.

Horngren, Charles T., "Uses and Limitations of a Conceptual Framework," *Journal of Accountancy,* April 1981, p. 90. Professor Horngren was a member of the U.S. Accounting Principles Board (APB), the Financial Accounting Standards Advisory Council (FASAC), and the Financial Accounting Foundation Board of Trustees.

Hicks, J.R., *Value and Capital*, Second Edition (Oxford: Clarendon Press, 1946). Hicks defines an "income *ex post*" as the value of an entity's consumption plus the increment in the value of its prospects during the period, and notes that it has "one supremely important property. . . . [That kind of income] *ex post* is not a subjective affair, like other kinds of income; it is almost completely objective." By subtracting the entity's capital value—in accounting terms, its assets less its liabilities—at the beginning of the period from its capital value at the end of the period and adding its consumption during the period, the"income *ex post* can be directly calculated." pp. 178–179.

IASB, *Framework for the Preparation and Presentation of Financial Statements*, (London: IASC, 1989). The International Accounting Standards Committee (IASC), predecessor to the IASB, began the process that led to the *Framework* at a conference sponsored by the American Accounting Association and Klynveld Main Goerdeler, reported in detail in *IASC News*, October 1986. The IASC then appointed a steering committee, chaired by J. Michael Dawson of Canada with members from Australia, France, Italy, Nigeria, South Africa, and the United Kingdom, which prepared an exposure draft during 1987 and 1988. The IASC issued that exposure draft for public comment on 1 May 1988, as reported in *IASC News*, June 1988. *IASC News*, July 1989 reported that the substantial majority of commentators expressed broad support for the Exposure Draft and, consequently, there were no major changes between the Exposure Draft and the Framework.

Kenley, W. John, and George J. Staubus, *Objectives and concepts of financial statements*, Research Study No. 3 (Melbourne: Accountancy Research Foundation, 1972). This research study, a precursor to the Australian framework, proposed that the objective of accounting is "to provide financial information about the economic affairs of an entity for use in making decisions," perhaps the earliest formal statement of that objective published by a standards-setting body. It also proposed criteria of useful financial information, including relevance, reliability, comparability, and neutrality, and concepts for measurement and reporting.

Rosenfield, Paul, 'The Focus of Attention in Financial Reporting", *Abacus*, Vol.41, No.1, 2005, pp. 1–20. The former director at the AICPA and Secretary General of the IASC suggests an alternative approach to the difficult objectives issue of for whom the financial statements are prepared..

Solomons, David, *Making Accounting Policy: the Quest for Credibility in Financial Reporting*, (New York: Oxford University Press, 1986). Chapters 4,5, and 6 of this book by the drafter of FASB Concepts Statement 2 provide insights on objectives, qualitative characteristics, and recognition and measurement.

Sterling, Robert R., "The Conceptual Framework: an Assessment," *Journal of Accountancy*, November 1982, pp.103–108. The author worked on concepts issues as a Senior Fellow at the FASB and critiques the results.

Storey, Reed K. and Sylvia Storey, FASB Special Report, *The Framework of Financial Accounting Concepts and Standards,* January 1998. This is the definitive history of the FASB's conceptual framework project and explanation of the framework, by the man who initially led and later advised the staff working on that project, written with his daughter.