**ATTACHMENT D**

# REVISITING THE FASB'S CONCEPTUAL FRAMEWORK

Financial Accounting Standards Advisory Council
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## Introduction

In its strategic plan, the Board concluded that the conceptual framework should be added to the Board's technical agenda as a standing item. In reaching that conclusion, the Board indicated that the goal of such a project should be to refine, update, and complete the conceptual framework. In undertaking that project, the Board will need to consider issues such as:

1. Whether to undertake the conceptual framework as a joint project with the IASB.
2. How to identify and prioritize the components of the framework that are to be refined, updated, and completed.

Accordingly, the Board seeks the views of FASAC members on those issues. The purpose of this paper is to provide some background and context for considering those issues.

## The Existing Framework

Most of the existing conceptual framework was developed over a period from the mid-1970s to the mid-1980s, with the exception of one component that was completed in 2000.

The existing framework is contained in a group of Concepts Statements, as follows:

- FASB Concepts Statement No. 1, *Objectives of Financial Reporting by Business Enterprises* (1978)
- FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information* (1980)
- FASB Concepts Statement No. 4, *Objectives of Financial Reporting by Nonbusiness Organizations* (1980)
- FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises* (1984)

- FASB Concepts Statement No. 6, *Elements of Financial Statements* (1985)
- FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements* (2000)[1]

The IASB's conceptual framework is similar to the FASB's framework in most respects. However, it does not address all of the issues that the FASB's framework addresses, and the guidance that it provides is less comprehensive. That framework is contained in a single document, *Framework for the Preparation and Presentation of Financial Statements* (1989).

**The Need for a Framework**

The FASB developed its conceptual framework because it concluded that its decisions must be soundly grounded in a unified set of concepts. The Board's mission cannot be fulfilled without a conceptual underpinning that provides direction and the means for deciding whether one solution to a financial reporting issue is better than the others. A conceptual framework provides the unity that is required, and with that, the direction and means to help in making those decisions. Without a set of unified concepts, standard setters are like a ship in a storm without an anchor.

The FASB's predecessor, the AICPA's Accounting Principles Board, lacked such a framework. In assessing why the APB ultimately was dissolved, one of its members (and later a member of the FASB) stated:

> The conditions most often identified with the problems of the APB were perceived conflicts of interests causing a waffling of positions and part-time effort where full-time effort was needed. In retrospect, those probably were not as significant as the absence of a structure of fundamental notions that would elevate the level at which debate begins and provide assurance of considerable consistency to the standards pronounced. The APB repeatedly argued fundamentals. The same fundamentals were argued in taking up projects near the end of its tenure as were argued in connection with early projects. Even the most fundamental of fundamentals—assets, liabilities, revenue, expense—were never

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[1] Concepts Statement 6 replaced FASB Concepts Statement No. 3, *Elements of Financial Statements of Business Enterprises,* which provided definitions of key financial statement elements (such as assets, liabilities, revenues, and expenses). It did so by expanding the scope of those definitions to encompass not-for-profit organizations as well. It also amended Concepts Statement 2 to apply it to both business enterprises and not-for-profit organizations.

> defined nor could the definitions be inferred from APB pronouncements. APB Statement No. 4 (1970) surveyed financial reporting at the time and concluded, for example, that some assets were assets solely because that standing was accorded them by generally accepted accounting principles.[2]

Thus, more than for anything else, it was for lack of a coherent and cohesive framework that the APB ultimately was unable to effectively fulfill its mission.

**The Fundamental Building Blocks**

Comprehensively reviewing the FASB's conceptual framework is not feasible in a briefing paper such as this. However, it may be useful to briefly consider one of the most frequently misunderstood aspects of the framework. That feature involves the "fundamental building blocks" of financial statements. Those building blocks are what the framework describes as the "elements" of financial statements (assets, liabilities, revenues, expenses, and so forth), which are defined in Concepts Statement 6.

All coherent and cohesive sets of rigorously defined concepts, regardless of the field of knowledge to which they apply, attach primacy to certain concepts. Those are the concepts that are used to define other concepts. Those concepts provide unity and prevent the set of concepts from being internally inconsistent. Those concepts are said to have *conceptual primacy.*

In establishing the elements definitions, the Board faced the challenge of deciding which of the definitions should have conceptual primacy. The principal alternatives were described as the "revenue and expense view" and the "asset and liability view." Simply stated, the former alternative would accord conceptual primacy to the definitions of revenues and expenses and base the definitions of assets and liabilities on those definitions. The latter alternative would do the converse.

[2] Oscar S. Gellein, "Financial Reporting: The State of Standard Setting," in *Advances in Accounting,* vol. 3, edited by Bill N. Schwartz, p. 13.

Seemingly, either alternative would be equally workable and yield essentially the same end result. However, the proponents of the two views have quite different perspectives on the matter.

Proponents of the asset and liability view focus on the reporting entity's wealth, as reflected in its economic resources and its obligations to transfer those resources. Income results from changes in those resources and obligations that increase the entity's wealth, and losses result from changes that decrease its wealth. Thus, revenues arise from increases in assets or decreases in liabilities, while expenses result from decreases in assets or increases in liabilities.

Proponents of the revenue and expense view focus on what they view as the performance of the reporting entity as depicted by its reported income. In their view, income (or loss) for a period would be distorted unless it results from the proper matching of revenues and expenses in the period. Consequently, many items that are regarded as nonmonetary assets and liabilities are byproducts of the matching process. Receipts of the current period that are deemed to be revenues of future periods are deferred to those periods by means of deferred credits that are treated as liabilities. Similarly, expenditures of the current period that are deemed to be expenses of future periods are deferred to those periods as deferred charges (debits) that are treated as assets. Thus, assets and liabilities are the residuals of the matching process, the debits and credits that remain on the books after they have been closed.

However, it was noted that:

> The Board's early experiences had convinced it that definitions of assets and liabilities that depended on definitions of income and its components did not work…[T]hose kinds of definitions proved to be of little help to the Board in deciding whether results of research and development expenditures qualified as assets or whether reserves for self insurance qualified as liabilities because they permit almost any debit balance to be an asset and almost any credit balance to be a liability.
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> In addition, the Board had attempted to test whether revenues and expenses could be defined without first defining assets and liabilities. It asked respondents to the [Conceptual Framework] Discussion Memorandum to submit for its consideration precise

> definitions of revenues and expenses that were wholly or partially independent of economic resources and obligations (assets and liabilities) and capable of general application in a conceptual framework…That no one was able to do that without having to resort to subjective guides, such as proper matching and nondistortion of income, was a significant factor in the Board's ultimate rejection of the revenue and expense view.[3]

Furthermore,

> … the Board found that definitions [based on the revenues and expense view] that made assets and liabilities essentially fallout of the process of matching revenues and expenses provided no anchor. They excluded almost nothing from income because they excluded almost nothing from assets and liabilities. The definitions were primarily conventional, not conceptual, and had made periodic income measurement largely a matter of individual judgment and personal opinion….That is, the Board found the revenue and expense view to be part of the problem rather than part of the solution.
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> In contrast, the Board's definitions of assets and liabilities limited what can be included in all of the other elements. The Board's choice of the asset and liability view limited the population of assets and liabilities to the underlying economic resources and obligations of an enterprise. The resulting definitions impose limits or restraints not only on what can be included in assets and liabilities but also on what can be included in income. The only items that can meet the definitions of income and its components—revenues, expenses, gains, and losses—are those that increase or decrease the wealth of an enterprise.[4]

The FASB's adoption of the assets and liabilities view as the basis for its framework has been affirmed by others. Standard setters around the world that have developed conceptual frameworks—those in Australia, Canada, New Zealand, the United Kingdom, and (as mentioned earlier) the IASB—all have based their frameworks on the asset and liability view.

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[3] Reed K. Storey and Sylvia Storey, FASB Special Report, *The Framework of Financial Accounting Concepts and Standards*, p. 79.

[4] Storey and Storey, p. 80.

And just last year, in a study that it submitted to Congress,[5] the SEC staff explicitly supported the asset and liability view and rejected the revenue and expense view as the basis for the conceptual framework and accounting standards. The staff stated:

> We believe that the revenue/expense view is inappropriate for use in standard setting…In establishing an accounting standard, the standard setter is attempting to define and establish the accounting principles for the underlying substance of the class of transactions under consideration…[F]rom an economic perspective, income represents a flow of, or change in, wealth during a period. Without first having an understanding of the wealth at the beginning of the period, it is not possible to determine the change in wealth during the period. The accounting equivalent to identifying "wealth" is identifying the assets and liabilities related to the class of transactions. This identification of wealth acts as a conceptual anchor to determining the revenues and expenses that result from the flow of wealth during the period. Historical experience suggests that without this conceptual anchor, the revenue/expense approach can become ad hoc and incoherent.

Although some continue to believe that the asset and liability view emphasizes the balance sheet and de-emphasizes the income statement, that is not the issue. Instead, the issue is how income is manifested. As the SEC staff noted, income represents a change in wealth during a period. Thus, without an increase in wealth (as evidenced by an increase in assets or a decrease in liabilities), there is no income.

**The Need to Revisit the Framework**

The Board continues to utilize the framework in making decisions in its current agenda projects, such as liability and equity, purchase method procedures, and revenue recognition. However, as noted previously, most of the framework was developed 20 or more years ago. Because the framework has not kept up with changing times and changing business practices, it needs updating and refining. Moreover, certain aspects of the framework are inconsistent with others, and those inconsistencies need to be eliminated. Furthermore, some parts of the

[5] *Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System* (2003). As reprinted on the SEC website; available from www.sec.gov/news/principlesbasedstand.htm.

framework that originally were planned were not ultimately completed, even though the need for conceptual guidance in those areas continues to be evidenced in the Board's agenda projects. Lacking that guidance, individual Board members must resort to their own internal (and unstated) conceptual frameworks, which may not be consistent with those of other Board members. However, doing so may lead to decisions that are not durable, but rather that are susceptible to change with Board member turnover. For those reasons, the framework is gradually becoming less helpful in providing guidance to the Board for making standard-setting decisions.

The need to revisit the framework has become more pronounced with the Board's decision to move toward producing accounting standards that are "principles-based." Such standards, by their very nature, must be soundly grounded in a coherent and cohesive set of concepts that is up to date, internally consistent, and comprehensive. Indeed, in the aforementioned study submitted to Congress, the SEC staff stated that in its vision of an optimal principles-based standard, "each standard is drafted in accordance with the objectives set by an overarching, coherent conceptual framework meant to unify the accounting system as a whole." The SEC staff also acknowledged the need to improve the framework and address deficiencies in it.

**How to Go About Revisiting the Framework**

Since there is ample evidence of the need to revisit the framework, the question is not whether to revisit it, but rather how best to go about doing so. In that regard, two of the main issues are:

1. Whether to undertake the conceptual framework as a joint project with the IASB.
2. How to identify and prioritize the components of the framework that are to be refined, updated, and completed.

**Whether to Revisit the Framework Jointly with the IASB**

The IASB, like the FASB, has acknowledged that its conceptual framework is in need of improvement and is considering how best to improve it. The two Boards will meet jointly in London in April. One of the topics for discussion will be

agenda planning, including agenda planning for their respective conceptual frameworks. Accordingly, that meeting will provide the Boards with the opportunity to discuss whether they should revisit their frameworks together in a joint project.

### *Advantages of Having a Common Framework*

An important reason for the Boards to consider revisiting their frameworks jointly is that they have certain common goals for the standards that they will issue.

One of those goals is for their standards to be "principles-based," which means that the standards must be rooted in a coherent and comprehensive framework of concepts. That framework must clearly identify the economic phenomena that are relevant to investors, creditors, and other users in making investment, credit, and similar decisions. It also must clearly articulate the Boards' understanding of those phenomena. Having a common conceptual framework that is up to date, internally consistent, and complete would help the Boards achieve their goal of issuing principles-based standards.

Another of the common goals of the FASB and IASB is for their standards to be converged. The Boards have been pursuing a number of projects that are aimed at achieving short-term convergence, as well as several major projects that are being conducted either jointly or in tandem with one another. Moreover, the Boards are planning to align their future agendas more closely with one another in order to achieve convergence in future standards that they issue. Achieving convergence is more likely to be achieved if future standards are based on a common conceptual framework rather than different ones.

### *Advantages of Revisiting the Frameworks Jointly*

If having a common conceptual framework is desirable, it also is desirable that such a framework be developed jointly. Conducting the project jointly would assure that both Boards consider the same issues at the same time. It also would facilitate resolving any differences arising out of their respective deliberations on a timely basis. By doing so, the likelihood of being able to agree on a common framework would be heightened.

Moreover, by pooling their staff resources, the two Boards could move more quickly than they could if each revisited its framework independently with its own staff. That is because the staff resources assigned would be effectively doubled.

**How to Conduct the Framework Project**

The other main question is how best the Board should go about conducting the project. Which issues should be addressed, and how should they be prioritized? There are several ways of doing so, including the way the Board originally approached the project and how it is currently addressing certain conceptual issues.

***The Original ("Top Down") Approach***

When the Concepts Statements were first being developed in the 1970s and 1980s, the Board used what might be described as a "top-down approach."[6] That approach was depicted schematically by means of a pyramid, as illustrated in the Appendix. That is, the Board divided the project into a number of distinct (but related) component projects, and then proceeded to address each of those components in essentially a serial order.

The Board started at the top of the pyramid, at the "objectives level," addressing the objectives of financial reporting for business entities. That component resulted in the issuance of Concepts Statement 1 in 1978.

The Board then moved down the pyramid, focusing next on the "fundamental level," and pursuing two additional components more or less concurrently. One of those components addressed qualitative characteristics (such as decision usefulness, relevance, reliability, and comparability) and resulted in the issuance of Concepts Statement 2 in May 1980. The other component addressed the definitions of key economic phenomena such as assets, liabilities, revenues, and expenses, and resulted in the issuance of Concepts Statement 3 in December 1980.

[6] Concepts Statement 7, which was issued in February 2000, was not part of the original project plan.

As work on those components winded down, the Board began pursuing three additional components, which were described as guidance at the "operational level." One component focused on developing the criteria for recognizing items meeting the definitions in Concepts Statement 3. Another component focused on developing the guidance for measuring those items. However, given the concerns about inflation and price changes at that time, much of that effort morphed into what became FASB Statement No. 33, *Financial Reporting and Changing Prices.* As a result, the (sparse) conceptual guidance on measurement was combined with that on recognition, and issued in Concepts Statement 5 in December 1984. The third component focused on what information should be required to be provided, who should be required to provide it, and where it should be presented (that is, in the main body of the financial statements, in the notes to financial statements, or in some other means of financial reporting). That effort produced an FASB Invitation to Comment, *Financial Statements and Other Means of Financial Reporting.* However, concerns at the time about financial reporting by smaller business entities led to a focus on the issue of "big GAAP and little GAAP," which ultimately was not resolved generally. As a result, only some limited conceptual guidance resulted from that effort, which also was included in Concepts Statement 5.

The bottom level of the pyramid contained three components, which were collectively described as the "display level." One of those components focused on reporting earnings, another on reporting funds flow and liquidity, and a third was reserved for other display issues, such as those relating to the statement of financial position or the statement of changes in owners' equity. Those three components collectively resulted in a single FASB Exposure Draft, *Reporting Income, Cash Flows, and Financial Position of Business Enterprises.* However,

that Exposure Draft ultimately did not result in a Concepts Statement.[7]

### *The Current ("Add-on") Approach*

The Board currently is conducting several standards-level projects, the scope of which includes possible amendments to certain of the Concepts Statements. One is the liabilities and equity project, which, in addition to developing an accounting standard, would amend the definitions of liabilities and equity in Concepts Statement 6. Another is the revenue recognition project, which, in addition to developing an accounting standard, would amend the criteria for revenue recognition in Concepts Statement 5, and possibly also amend the definitions of revenues, gains, assets, and liabilities in Concepts Statement 6.

Those efforts are being undertaken in what might be described as an "add-on" approach. That is, the reconsiderations of those Concepts Statements are limited to the amendments that are necessitated by, and are a function of, the accounting standards being developed. The conceptual issues being reconsidered are focused narrowly and other aspects of those Concepts Statements are not being reconsidered.

### *Analysis of the Approaches*

The top-down approach is more comprehensive and systematic. Basing the revisitation of the framework on that approach would entail reconsidering each of the major components of the conceptual framework on a serial basis, beginning with the objectives of financial reporting. In the end, all components would be reconsidered. However, that approach would be more time-consuming and would not likely produce helpful results in the near term in setting accounting standards. As a result, it would require more staff resources.

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[7] This discussion relates to the plan for the Conceptual Framework Project as it applied to business entities, and those entities were the project's primary focus. However, related conceptual guidance pertaining to nonbusiness entities also was developed as a follow-on to the guidance for business entities. One component of that guidance focused on the objectives of financial reporting for not-for-profit entities, which resulted in the issuance of FASB Concepts Statement No. 4, *Objectives of Financial Reporting by Nonbusiness Organizations,* in December 1980. The other component principally added guidance pertaining to nonbusiness entities to Concepts Statement 3, as discussed in footnote 1.

In contrast, the add-on approach would require less staff resources because it would address only those matters for which there is a clear and immediate need for conceptual guidance in order to complete standards-level projects on the agenda. However, issuance of standards-level guidance may be delayed because the necessary concepts-level guidance was not already in place ready to use. Additionally, because the conceptual issues inevitably would be considered on only a piecemeal basis, the "fix" may have unintended consequences. Moreover, the approach might impede convergence if the standards-level projects to which the concepts work was an add-on were not joint projects with the IASB. Furthermore, the add-on approach would appear to turn the standard-setting process on its head, with standards appearing to determine the concepts rather than the other way around.

***A Third ("Combined" or "Hybrid") Approach***

After considering the advantages and disadvantages of both the original "top-down" approach and the current "add-on" approach, Board members have expressed a preference for a third approach that combines the more desirable aspects of the other two approaches and avoids some of their less desirable aspects.

Under this "combined" or "hybrid" approach, the framework revisitation project would be treated as a free-standing project rather than as only an add-on to standards-level projects, thereby permitting conceptual issues to be considered more comprehensively. However, this approach would not comprehensively reconsider all components of the framework in the pyramid, but rather would focus principally on the issues that are more likely to yield standard-setting benefits in the near term.

The approach would identify troublesome issues that reappear time and time again in different standard-setting projects and in a variety of different guises. Therefore, the focus would be on issues that cut across different projects, or "crosscutting issues." The approach would aim to identify and resolve those

issues in advance of when the conceptual guidance is needed in standards-level projects.

There are numerous examples of crosscutting issues. One is the matter of *probable,* as noted above. Another relates to the liabilities definition, which is not as crisp and as clear as it needs to be. Yet another relates to the accounting for contractual rights and obligations. Still another concerns the "unit of account," which involves both aggregation (including linkage) and disaggregation.

Once the crosscutting issues have been identified, those issues would be prioritized, with one of the determinants being how often and how soon those issues are likely to arise in standards-level projects. Another determinant would relate to interdependencies among the crosscutting issues, with higher priority being assigned to issues on which the resolution of other cross-cutting issues depend. Still another determinant would involve issues that would foster convergence of the FASB's and IASB's frameworks.

The staffing needs of this combined or hybrid approach would be between those of the top-down and add-on approaches. It would require fewer staff resources than the former and more staff resources than the latter.

**Questions for FASAC Members**

1. Do FASAC members agree that the Board should undertake its revisitation of the conceptual framework as a joint project with the IASB with the goal of developing a common framework?
2. Do FASAC members agree that conducting the project by means of the "combined" or "hybrid" approach is preferable to the original "top-down" approach or the current "add-on" approach?

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