The FASB Conceptual Framework

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FASB FINANCIAL ACCOUNTING STANDARDS BOARD

Conceptual Framework

"Some individual frameworks are sharply defined and firmly held; others are vague and weakly held; still others are vague and firmly held."

(Chuck Horngren—formerly of Stanford University and former FAF Trustee)

Conceptual Framework

Criticisms that led to the formation of the FASB (1970 AAA Special Committee)

Seven areas of criticism of the APB included:

- Its use of fire fighting, not a conceptual approach
- The fact that many opinions were compromises rather than coherent positions
- The lack of research of a satisfactory quality

Conceptual Framework

Source of the Early Debates

- Initial FASB Board Agenda [1]
  - ✓ Research and Development Costs (SFAS-2)
  - ✓ Accounting for Future Losses (SFAS-5)
- Board had great difficulty because of a lack of a workable asset or liability definition.
- Costs ≠ assets

[1] Also included: reporting by diversified companies, criteria for determining materiality, accounting for leases, broad qualitative standards for financial reporting, foreign currency translation

Conceptual Framework

Source of the Early Debates (continued)

- Need for “proper” matching to avoid “distorting” periodic earnings (net income)
- Argument often used to not recognize an item if recognition would “distort” earnings (profit and loss)
- Argument also used to justify recognition of an item to avoid “distortion” of earnings
- Assets, liabilities, or “what-you-may-call-its”

Conceptual Framework

APB Statement No. 4—Assets

- *Assets—economic resources* of an enterprise that are recognized and measured in conformity with generally accepted accounting principles. *Assets also include certain deferred charges that are not resources but that are recognized* and measured in conformity with generally accepted accounting principles.

APB Statement No. 4—Liabilities

- *Liabilities—economic obligations* of an enterprise that are recognized and measured in conformity with generally accepted accounting principles. *Liabilities also include certain deferred credits that are not obligations but that are recognized* and measured in conformity with generally accepted accounting principles.

APB Statement No. 4—Observations

- “General objectives do not specify which resources and obligations and changes should be measured and reported as assets, liabilities, revenues and expense in financial reporting” (para. 84)
  - ✓ No discussion of what items that are not resources or obligations should be recognized or what would be the basis for recognition

Conceptual Framework

SFAS 2—Accounting for Research and Development Costs

- Focused on defining and describing research and development costs
- Concluded those costs as defined should be expensed and observed:

  “Criteria for identifying those economic resources that should be recognized as the assets of an enterprise for accounting purposes have not been specified in the official accounting literature.” para. 43

SFAS 2—Accounting for Research and Development Costs (continued)

- Basis for conclusions states that the Board concluded costs should be expensed after considering:
  - ✓ Uncertainty of future benefit
  - ✓ Lack of causal relationship between Expenditures and Benefits
- Interestingly, para. 47 of the Basis for Conclusion observes: “APB statement 4 explicitly avoids using the term ‘matching’ because it has a variety of meanings in the accounting literature” (1970!)

Conceptual Framework

SFAS 5—Accounting for Contingencies

- Focused on contingencies defined so that liabliltiy recognition and impairment measurement were based on the same criteria
- With respect to liability recognition, the Board based its conclusion on APB Statement No. 4

  The economic obligations of an enterprise are defined (SIC) in paragraph 58 of APB Statement No. 4 as 'its present responsibilities to transfer economic resources or provide services to other entities in the future" *(SFAS 5, para. 70)*

Conceptual Framework—FASB

Element Definitions

Assets:

"Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events." *(Con. 6, para.25)*

Liabilities:

"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 as a result of past transactions or events." *(Con. 6, para.35)*

Conceptual Framework

Revenues

"Revenues are inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations." *(Con 6, paragraph 78)*

Conceptual Framework

Expenses

"Expenses are outflows or other using up of assets or incurrences of liabilities (or a combination of both) from delivering or producing goods, rendering services, or carrying out other activities that constitute the entity's ongoing major or central operations." *(Con 6, paragraph 80)*

IASB and FASB Frameworks

- Basic conclusion as to the conceptual primacy of assets and secondarily liabilities: “Every conceptual structure builds on a concept that has primacy. That is simply another way of saying some element must be given meaning before meaning can be attached to others.” *(Oscar Gellein)*
  - ✓ “That assets and liabilities are the fundamental elements of financial statements still is undoubtedly the most controversial, and the most misunderstood and misrepresented, concept in the entire conceptual framework” *(Storey and Storey)*

Conceptual Framework

Fundamental misstatements and misunderstandings concerning the FASB and IASB Frameworks:

- That the Boards have adopted a balance-sheet approach (misunderstanding).
  - ✓ In fact, Frameworks conclude items that fail definitions of assets and liabilities should not be recognized as such and that comprehensive income is measured by changes in assets and liabilities
- That the Frameworks favor a fair value measure of assets and liabilities (misrepresentation)
  - ✓ In fact, Frameworks fail in any significant way to address measurement beyond description of practice.

Conceptual Framework

If the Frameworks are considered to be a “balance sheet approach” could there be an Income Statement Approach? For the income statement view to have any intellectual rigor, proponents must either:

- Define revenue and expense without regard to assets and liabilities.
- Accept that a balance sheet will contain a debit or credit necessary to achieve the “appropriate” amount of net income and provide guidance as to what is the appropriate amount of income.

Conceptual Framework Project[1]

A. Objectives and qualitative characteristics (done)
B. Elements, recognition and derecognition
C. Measurement
D. Reporting entity (Exposure Draft March 2010)
E. Presentation and disclosure
F. Framework purpose and status
G. Applicability to the not-for-profit sector (IASB)
H. Entire framework

(1) Once a joint project but now the IASB has said they intend to proceed not as a joint project but with the FASB and others as advisors.

FASB FINANCIAL ACCOUNTING STANDARDS BOARD

Conceptual Framework

The FASB and IASB:

- Achieved general agreement on the objectives of financial reporting *(Con. 8: 2010)*[1]
- Achieved basic agreement on the fundamental and enhancing characteristics of decision-useful information *(Con. 8: 2010)*

[1] Focus of both the FASB and IASB objectives document was on business enterprises as FASB has a separate document (Con.4) on nonbusiness enterprises.

Objective of Financial Reporting

- "The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to *existing and potential investors, lenders, and other creditors* in *making decisions about providing resources to the entity*. Those decisions involve buying, selling, or holding equity and debt instruments, and providing or settling loans and other forms of credit." *(OB-2)*
- Seems to be fundamental agreement if one accepts:
  - ✓ General purpose financial reporting
  - ✓ Not management accounting
  - ✓ Not regulatory accounting
  - ✓ Reasonable business knowledge for users of financial statements

Qualitative Characteristics

Fundamental qualitative characteristics

- Relevance (Information capable of making a difference to a decision maker)
  - ✓ Predictive value or confirmatory or both
  - ✓ If not material (an entity-specific aspect of relevance), it does not make a difference and not relevant
- Faithful representation (Faithfully represents what it purports to represent)
  - ✓ Neutrality
  - ✓ Completeness
  - ✓ Freedom from error

Qualitative Characteristics

Enhancing qualitative characteristics

- Comparability[1]
- Verifiability
- Timeliness
- Understandability

Cost (not consequences) as a pervasive constraint

[1] One of the most important reasons that reporting standards are needed is to increase comparability of reported information. *(QC–BC 3.33)* Comparability of relevant, faithfully represented information aids in proper allocation of resources.

FINANCIAL ACCOUNTING STANDARDS BOARD

Qualitative Characteristics

Sources of Non-Comparability

- Explicit choices
- Implicit choices
- Scope issues
  - Same economics different answer
  - “Business model”

Are principles-based standards capable of producing comparable information?

Conceptual Framework Project

- Significant work begun but not completed:
  - ✓ Elements, recognition and derecognition
  - ✓ Measurement
  - ✓ Reporting entity (consolidation)
- These areas have long been the most controversial and are related to the short history lesson today about early Framework Development

Assets

"Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events."

(Con 6, paragraph 25)

Problems:

- Probable[1]
- Future economic benefits
- Controlled
- Past transactions or events

[1]See footnote 18 (Con 6)

Liability

"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."
(Con 6, paragraph 35)

Problems:

- Probable[(1)]
- Future sacrifice of economic benefits
- Obligations (uncertainties)
- Past transactions or events

[(1)]See footnote 21 (Con 6)

Conceptual Framework Issues

Asset/Liability Definitions

- Where is the focus with respect to an asset:
  - ✓ Present right
    - ➢ A right either exists or does not exist
  - ✓ Probable future benefit (cash inflow)
    - ➢ The outcome of having a right (which could be zero)
  - ✓ Contingent asset?
- Where is the focus with respect to a liability:
  - ✓ Present obligation
    - ➢ An obligation either exists or does not exist
  - ✓ Probable future sacrifice (cash outflow)
    - ➢ The outcome of having an obligation (which could be zero)
  - ✓ Contingent liability?

Discussions of contingent assets/contingent liabilities are really discussions about arrangements with uncertain outcomes

Conceptual Framework Issues

Asset Liability Definitions

Observations

- Some virtually certain in or out bound cash flows are not assets or liabilities
- "Risks and rewards" are *not* liabilities and assets; they are the results of having assets and liabilities
- Risks and rewards affect the measurement of both assets and liabilities, not their existence
- We don't know what to do with forward (executory) contracts that appear to meet definitions of assets and liabilities

Conceptual Framework Issues

Questions about Assets and Liabilities

- Can writing an option (by definition, a liability) result in an asset?
- Can one have a liability without any present obligation if non-payment is sufficiently consequential?
- Can one have a liability based on a contract to refrain from a given activity or did one just sell an unrecognized right?

Fundamental: Can one have a liability if presently obligated to deliver an equity instrument of the entity rather than an asset?

Conceptual Framework Issues

Questions about Assets and Liabilities

- Does a forward contract to acquire an asset convey control of that asset?
- Does an option to acquire an asset convey control of that asset?
- Does the owner of an asset subject to a forward contract to sell or a call option still control that asset?
- Why do we think an option or a forward contract suggests control of an asset is retained but not obtained? (derecognition, revenue recognition)

Conceptual Framework Issues

Recognition

- "Recognition is the process of formally incorporating an item in the financial statements of an entity as an asset, liability, revenue, expense, or the like" *(Con 5, para 6)*
  - ✓ Are any recognition criteria necessary other than the recognized item meet the definition of an element?

Derecognition

- Should items be derecognized when the item fails the definition of an element?
  - ✓ Asset issues for example involve securitization
  - ✓ Liability issues for example involve extinguishment of debt
  - ✓ Derecognition often suggests to many recognition of items that fail asset or liability definitions

Conceptual Framework

Measurement

- One phase of the Conceptual Framework project is intended to address measurement attributes and measurement issues
  - ✓ Measurement of assets is of course controversial
  - ✓ Measurement of liabilities seems to pose even more issues especially nonfinancial liabilities
- We seldom really measure anything, we make calculations
  - ✓ Best estimate
  - ✓ Present value of expected cash flows

Conceptual Framework

Framework is essential:

1. To resolve accounting debates in a consistent manner
2. To defend accounting standard-setting process as in fact neutral
3. To achieve principles-based standards
4. To reduce complexity:
   - Asset/Liability uncertainty (comparability)
   - Measurement uncertainty (comparability)
   - Scope uncertainty (comparability)
   - Is the consequence of the above uncertainties "disclosure overload"?
5. Alternatives suggested just won't work:
   - Consensus
   - Compromise
   - Consequences

Conceptual Framework

Asking the Right Questions

What is the asset?
What is the liability?
Did an asset or liability or its value change?
- Increase or decrease?
- By how much?
- Did the change result from what we call:
  - Investment by owners?
  - Distribution to owners?
  - Comprehensive income?
  - Revenue?
  - Expense?
  - Gain?
  - Loss?

(Storey & Storey)