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The Project to Revisit the Conceptual Framework

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Introduction

At their October 2004 joint meeting, the Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB) decided to add to their respective agendas a joint project to develop a common conceptual framework—a single framework that is based on and builds on their existing frameworks. As a result, many of the Boards' constituents may have questions, like the following:

- What is the conceptual framework?
- Why is a framework needed?
- Who benefits from the framework?
- How does the framework affect practice?
- Why revisit the framework?
- Why conduct the project jointly with the IASB?
- How will the project be conducted?

The answers to those questions follow.

What Is the Conceptual Framework?

The conceptual framework is a coherent system of interrelated objectives and fundamentals that prescribes the nature, function, and limitations of financial reporting. The objectives identify the goals and purposes of financial reporting, and the fundamentals are the underlying concepts of financial accounting and reporting. Those concepts provide guidance in selecting the transactions, events, and circumstances to be accounted for, how they should be recognized and measured, and how they should be summarized and reported.

The FASB's efforts to develop the conceptual framework have resulted in seven Concepts Statements (one is a replacement of an earlier Concepts Statement to include nonprofit organizations in addition to business enterprises). Those Concepts Statements cover:

- The objectives of financial reporting by both business enterprises[1] and nonprofit organizations[2]
- The qualitative characteristics of useful accounting information[3]
- The elements of financial statements (that is, the definitions of assets, liabilities, revenues, expenses, and so forth)[4]
- The criteria for recognizing and measuring those elements[5]
- The use of cash flow and present value information in accounting measurements.[6]

The first Concepts Statement was issued in 1978 and all were issued by 1985 except the most recent one, which was issued in 2000.

Why Is a Framework Needed?

The FASB concluded that it needed a framework to provide direction and structure to financial accounting and reporting. The Board's mission cannot be fulfilled without a sound and unified 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 and consistency 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.

Without the guidance provided by the framework, standard setting becomes based on the (unstated) concepts held by individual Board members. As Charles Horngren (former member of the Accounting Principles Board [APB], former member of the Financial Accounting Standards Advisory Council [FASAC], and former trustee of the Financial Accounting Foundation [FAF]) 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."[7] He added that:

> *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 . . .*
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> *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.]*

Standard setting that is based on the conceptual frameworks held by individual Board members will produce agreement on specific issues only if the individual frameworks of enough Board members intersect. And even those agreements may be transitory because as Board membership changes, the mix of individual conceptual frameworks also changes. Thus, the Board may reach significantly different conclusions about similar (or even identical) issues than it did earlier, with standards not being consistent with one another and past decisions not being indicative of future ones. As a result, standard setting becomes more or less *ad hoc*. That was the case with the AICPA's Committee on Accounting Procedure, which preceded the APB, and it largely was true of the APB as well.

In assessing why the APB ultimately was dissolved, one of its members (and later an FASB Board member) 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 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.*[8]

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.[9]

The FASB was not alone in concluding that it needed a sound conceptual framework to guide its standard setting. Standard setters outside the United States also have developed their own frameworks. Canada and the IASB's predecessor, the International Accounting Standards Committee, were the first to do so, followed by Australia, New Zealand, and most recently (in 1999), the United Kingdom. Their frameworks, like the FASB's, are based on the fundamental objective that financial reporting should provide information that is useful to investors and creditors in making investment and credit decisions. Not surprisingly, those frameworks are similar to the FASB's framework.[10]

Who Benefits from the Framework?

The FASB is the most apparent beneficiary of the framework. The framework provides concepts for the Board to use as tools for resolving accounting and reporting questions, as well as a basic reasoning on which to consider the merits of alternatives. Although the framework does not provide all the answers, it points the way. It also reduces the influence of individual Board member views and biases, as well as political pressures in making accounting judgments. For that reason, it has become an indispensable part of the FASB's standard-setting process. In reflection of that, each new standard the Board issues now includes (in the basis for conclusions and in the summary) a discussion of the concepts utilized in developing the standard.

The FASB's constituents also benefit from the framework. The use of objectives and concepts to help develop standards enhances the credibility of financial reporting by producing a body of standards that is more internally consistent and less *ad hoc*. That structure helps users of financial reporting information to better understand that information and its limitations. It also is useful to preparers who apply those standards, auditors who examine the resulting reports, and faculty and students who study accounting.

How Does the Framework Affect Practice?

Concepts Statements do not affect practice directly. They do not require a change in GAAP; amend, modify, or interpret existing accounting or disclosure standards; require changes in accounting procedures; or require disclosure of practices that might be in conflict with the concepts. Concepts Statements are not intended to invoke application of Rule 203 or 204 of the AICPA's Rules of Conduct of the Code of Professional Ethics. The framework affects practice only by means of its influence in the development of new accounting standards.

Why Revisit the Framework?

Although the Board continues to utilize the framework in making decisions, 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 other aspects of it, and those inconsistencies need to be eliminated. Furthermore, some parts of the framework that originally were planned were not ultimately completed, even though conceptual guidance in those areas continues to be needed. 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.

In a recent study submitted to Congress,[11] the staff of the Securities and Exchange Commission (SEC) 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's staff also acknowledged the need to improve the framework and address deficiencies in it.

Why Conduct the Project Jointly with the IASB?

Like the FASB, the IASB has acknowledged that its conceptual framework is in need of improvement. Additionally, the Boards have certain common goals for the future standards that they issue.

One of those goals is for those standards to be "principles-based." Having a common conceptual framework that is up to date, internally consistent, and complete would help the Boards achieve that goal.

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 aligning their future agendas more closely with one another in order to achieve convergence in the future standards that they issue. Convergence is more likely to be achieved if future standards are based on a common conceptual framework rather than different ones.

If having a common conceptual framework is desirable, it also is desirable that such a framework be developed jointly. Conducting the project jointly assures that both Boards consider the same issues at the same time. It also facilitates 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 is heightened. Moreover, the two Boards can effectively leverage their resources by pooling their staff resources.

How Will the Project Be Conducted?

When the FASB first developed its Concepts Statements in the 1970s and 1980s, it used what might be described as a "top-down approach."[12] That approach was depicted by means of a pyramid, as in Figure 1. 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, starting at the top of the pyramid, at the "objectives level," and then moving down to the "fundamental level," "operational level," and the "display level."

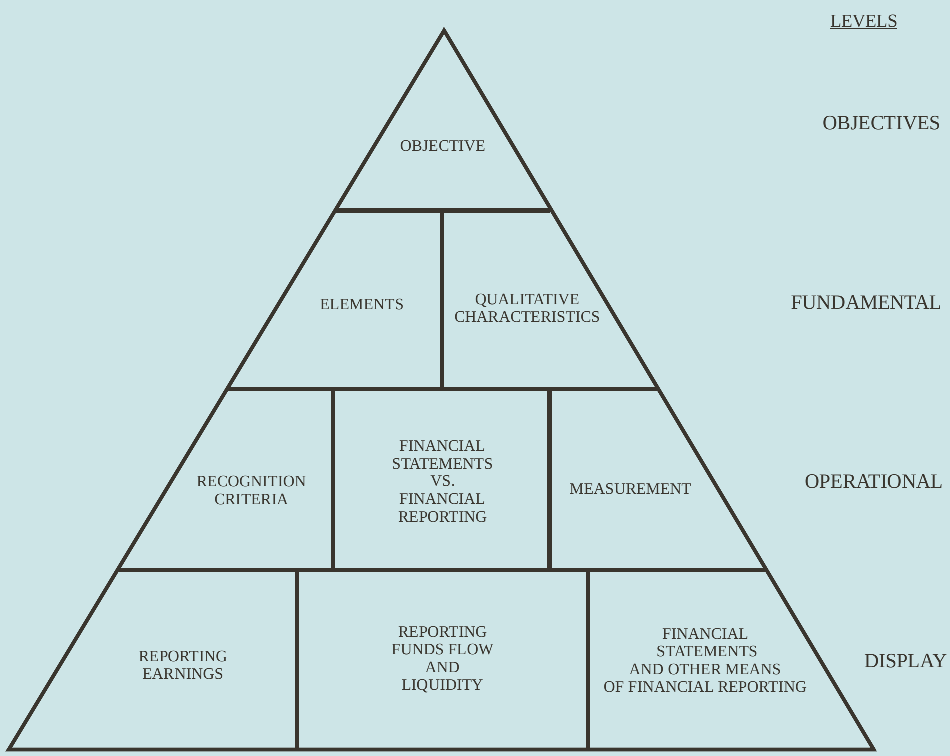
That "top-down approach" was both comprehensive and systematic. However, the Boards have concluded that revisiting the framework in that manner would not be an efficient use of their resources because many aspects of their frameworks are not in need of improvement.

Instead, the Boards will pursue an approach that does not comprehensively reconsider all components of the framework in the pyramid, but rather focuses principally on those issues that are more likely to yield standard-setting benefits in the near term. That is, it will focus on troublesome conceptual issues that reappear time and time again in different standard-setting projects and in a variety of different guises. Therefore, the aim is to identify and resolve those issues that cut across several standards-level projects prior to when the conceptual guidance is needed.

There are numerous examples of such "crosscutting issues." One is the matter of the meaning of *probable,* which appears in the FASB's definitions of assets and liabilities and in the IASB's recognition criteria. Another concerns the liabilities definition, which is not as crisp and as clear as it needs to be. Yet another relates to how contractual rights and obligations should be accounted for, both in fully executory and partially executed contracts. Still another concerns the "unit of account," which

Figure 1

Conceptual Framework for Financial Accounting and Reporting



involves both aggregation (including linkage) and disaggregation. Issues relating to measurement in accounting (e.g., historical cost versus fair value) and relevance versus reliability also will be key concerns. The crosscutting issues will be prioritized, based on (a) how often and how soon those issues are likely to arise in standards-level projects, (b) interdependencies among the crosscutting issues, with higher priority being assigned to issues on which the resolution of other cross-cutting issues depend, and (c) issues that would foster convergence of the FASB's and IASB's frameworks.

Resolution of those issues is expected to yield the most favorable cost-benefit ratio in terms of resources expended to produce beneficial conceptual guidance.

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[1]FASB Concepts Statement No. 1, *Objectives of Financial Reporting by Business Enterprises* (November 1978).

[2]FASB Concepts Statement No. 4, *Objectives of Financial Reporting by Nonbusiness Organizations* (December 1980).

[3]FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information* (May 1980).

[4]FASB Concepts Statement No. 6, *Elements of Financial Statements* (December 1985) (which supersedes FASB Concepts Statement No. 3, *Elements of Financial Statements of Business Enterprises,* [December 1980]).

[5]FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises* (December 1984).

[6]FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements* (February 2000).

[7]Charles T. Horngren, "Uses and Limitations of a Conceptual Framework," *Journal of Accountancy,* April 1981, p. 90 and 92.

[8]Oscar S. Gellein, "Financial Reporting: The State of Standard Setting," in *Advances in Accounting,* vol. 3, ed. by Bill N. Schwartz (Greenwich, Conn.: JAI Press Inc, 1992), p. 13.

[9]That is not to say that the APB was not urged to develop a sound framework. The AICPA special committee whose 1958 report resulted in the creation of the APB had urged the APB to work on both concepts and standards on the grounds that such concepts would provide a meaningful foundation for standards. In response, the APB commissioned two research studies on the "postulates" and "broad principles" of accounting. However, after reviewing the studies, the APB concluded that the recommendations contained therein were "too radically different" from generally accepted accounting principles (GAAP) for acceptance at that time.

As a result of problems that emerged from the Opinions that the APB subsequently issued, the AICPA appointed another special committee in 1964 to reexamine the program for establishing accounting principles. Among its major recommendations was that the APB develop a conceptual framework to guide its decision making. The APB responded by publishing APB Statement 4, *Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises,* in 1970. However, the APB itself acknowledged that APB Statement 4 was "primarily descriptive, not prescriptive," focusing on what financial accounting was at the time rather than what it ought to be. Because Statement 4 reflected only past practices, some of which were inconsistent with one another, it did not prove to be a helpful tool to use in setting standards.

Soon afterward, due to the criticism the APB was receiving, the AICPA appointed two study groups—one chaired by Francis M. Wheat and the other chaired by Robert M. Trueblood—to consider the establishment of accounting principles and the objectives of financial statements. The recommendations of those groups laid the foundation for the FASB and for its conceptual framework project.

[10]The G4+1 (a group of standard setters originally consisting of standard setters from Australia, Canada, the United Kingdom, and the United States, plus the IASC) came into being in 1993 largely because all of its members share the view that the objective of financial reporting is to provide decision-useful information. Therefore, it was fruitful for group members to meet to discuss common conceptual and standard-setting issues. With the reorganization of the IASC into the new IASB, which has direct liaison relationships with those standard setters, the G4+1 was disbanded.

[11]*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/studies/principlesbasedstand.htm.

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