The Association of Accountants and Financial Professionals in Business

November 12, 2020

Ms. Hillary Salo
Technical Director
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116

Re: File Reference No. 2020-500, Proposed Statement of Financial Accounting Concepts, *Concepts Statement 8—Conceptual Framework for Financial Reporting, Chapter 4: Elements of Financial Statements*

Dear Ms. Salo:

The Financial Reporting Committee (FRC) of the Institute of Management Accountants (IMA) is writing to share our views on the Financial Accounting Standards Board's (FASB or Board) Proposed Statement of Financial Accounting Concepts, *Concepts Statement 8—Conceptual Framework for Financial Reporting, Chapter 4: Elements of Financial Statements* (ED).

The IMA is a global association representing over 140,000 accountants and finance team professionals. Our members work inside organizations of various sizes, industries and types, including manufacturing and services, public and private enterprises, not-for-profit organizations, academic institutions, government entities, and multinational corporations. The FRC is the financial reporting technical committee of the IMA. The committee includes preparers of financial statements for some of the largest companies in the world, representatives from the world's largest accounting firms, valuation experts, accounting consultants, academics and analysts. The FRC reviews and responds to research studies, statements, pronouncements, pending legislation, proposals and other documents issued by domestic and international agencies and organizations. Additional information on the FRC can be found at www.imanet.org (About IMA, Advocacy, Financial Reporting Committee).

The FRC is supportive of the Board's efforts to update the language in the Conceptual Framework for Financial Reporting (Framework) so it reflects the views of the Board and is most helpful for the Board's use in standard setting. However, we question the reason for some of the proposed changes, and believe it would be helpful for the Board to demonstrate through examples how it might deliberate differently in future standard setting if the proposed changes are adopted. At the time of a previous update of the Framework, the FASB published cases demonstrating the changes, *The FASB Cases on Recognition and Measurement*. While recognition and measurement may be a step beyond elements, we believe similar explanations would be helpful.

The Framework can also be used to help preparers understand existing standards and, in the rare cases when there is no guidance, help them develop an appropriate accounting policy. Recently, this was the case with the accounting for government grants by businesses who received CARES Act assistance. In some instances, the wording in the ED might suggest a change in practice for preparers who use the Framework in this way. We believe this may occur in some areas, including applying the proposed

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definition of revenue to a transaction that is outside the scope of ASC 606, such as the accounting for collaborative arrangements in ASC 808.

Some of the proposed wording changes, for example, the proposed changes to the definition of a liability, seem to justify standards-level decisions the Board has made recently, rather than creating or expanding upon concepts. In addition, there are concepts not included in the Framework that may be helpful to the Board and to preparers, such as unit of account and executory contracts. While the unit of account might or might not fit within the elements chapter, we believe it should be addressed.

Although the Basis for Conclusions and Questions for Respondents indicate that the Board believes the proposed changes would not result in differences in future deliberations, future boards may interpret different words in a different way. Without further analysis and examples from the Board, and in the absence of a specific reason to change, we suggest further outreach with preparers and practitioners to understand the potential consequences of the proposed changes. We recommend that substantive wording changes, such as the proposed change to the definition of revenue, not be made. If the Board continues to believe these changes are necessary, examples or other illustrations demonstrating interpretation of the new wording should be provided.

The Framework provides concepts supporting a series of steps: defining the objective of financial reporting, defining elements, determining when to recognize and derecognize elements, measuring the elements, and finally presenting them. The ED references presentation as separate from elements. However, we believe presentation is more closely related than the ED suggests, and as such, we believe the ED on presentation should be redeliberated along with this one. In general, understanding how the changes proposed to the definitions of elements may impact other parts of the Framework would help stakeholders evaluate them.

Finally, the Framework was at one time converged with the IFRS Framework. Although the boards decided to deliberate changes independently, we suggest that convergence—particularly on the definitions of the elements—is a worthwhile goal. To that end, we suggest re-examining areas of divergence, such as removal of the term “control” from the definition of an asset.

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Our answers to the specific questions in the ED are included in the Appendix. We would be pleased to discuss our comments at your convenience.

Sincerely,

NSchroeder

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APPENDIX

Question 1: The Board expects that most assets that met the definition of an asset in FASB Concepts Statement No. 6, *Elements of Financial Statements*, will continue to qualify as assets under the definition of an asset in this proposed chapter. Do you agree that the definition of an asset in this proposed chapter is consistent with the Board's assertion? If not, please provide examples.

It is not clear what the impact of some of the proposed changes will be without specific examples to illustrate their practical application. For example, removing the term "probable" from the definition could result in more items meeting the definition. We question whether the Board expects that, or if probability would be considered in measurement, in which case an asset that is not probable of yielding an economic benefit may have no value or an immaterial value.

In addition, some of the proposed language describing the "right to an economic benefit" requires clarification or edit.

- One of the most difficult assessments in the Framework is *when* an asset meets the definition—*when* there is a present right to an economic benefit. The ED does not provide much additional clarification to aid in that assessment. In fact, removing the notion of control from the definition may make the assessment harder as it may suggest that a contract is required, which would be a significant change in application. The same is true for the difficulty of the assessment as to when an item meets the definition of a liability, and it is not clear whether assets and liabilities should be evaluated the same way.
- Paragraph E33 indicates that in addition to cash, an economic benefit may result from "being exchanged for cash or other goods or services, ***by being used to produce goods or services***, or by being used to settle liabilities or pay distributions to owners [emphasis added]." Limiting the economic benefit to items used to "produce" goods or services seems to limit some items that previously met the definition of an asset, such as prepaid assets, to those that directly relate to cost of sales. Other items that are more general and administrative may not fit that part of the definition, nor would some property, plant and equipment if it does not relate to the cost of sales.
- Paragraph E19 indicates "that economic benefit eventually results in potential net cash inflows." We believe the wording would benefit from clarification. We suggest instead: "In a business entity, that economic benefit has the potential to result in net cash inflows to the entity."

The Framework could be improved by including additional concepts in two areas: unit of account and executory contracts.

- Unit of account: At the standards level, there have been different decisions regarding unit of account determinations (e.g., bifurcate embedded derivatives but not embedded conversion options). When evaluating whether an item meets the definition of an element, it would be beneficial to know at what level to consider the definition. We suggest the Board include a concept on unit of account in this or another Framework chapter.
- Executory contracts: It would be helpful for the Board to clarify whether executory contracts meet the definition of asset or liability.

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Question 2: In particular, respondents are asked to focus on internally generated intangible assets. Is the definition of an asset in this proposed chapter helpful in resolving issues of identifying intangible assets?

As noted in our response to Question 1, removing the word "probable" from the definition may make more items meet the definition of an asset, including certain intangible items. It is unclear whether this is the Board's intention.

In addition, certain of the proposed language requires clarification to be helpful. Paragraph E35 describes circumstances in which expenditures in anticipation of future benefit may or may not be considered assets. The wording seems to rule out recording those costs as assets but says the benefits may qualify without giving any guidance on how that might be determined. It would be more helpful to provide guidance as to how to make the determination.

Question 3: The Board's definition of an asset in this proposed chapter does not include the term control. However, this proposed chapter explains why and how control is interrelated to the definition of an asset. Is this discussion sufficient or is the term control necessary to include in the definition of an asset? If the term control is necessary to include, please explain how its inclusion would change the population of items that would meet the definition of an asset in this proposed chapter.

It would be helpful to clarify whether the Board expects different outcomes under the existing and proposed definitions. While control is no longer an essential characteristic, Paragraph E17 states: "The combination of these two characteristics allows an entity to obtain the economic benefit and ***control*** others' access to the benefit [emphasis added]." The Basis for Conclusions does not answer the question because it explains the benefit of removing the term from the definition, but also asserts how important the concept of control is to application of the definition. If the Board does not expect a change in application, we believe the concept of control should remain in the definition, especially since many recent standards are largely based on control (e.g., ASC 606 and ASC 842). We agree with Ms. Botosan's dissent on this point.

> Ms. Botosan … believes that control is sufficiently important that it should be elevated from the explanatory paragraphs to the definition itself. She believes that explicit inclusion of control in the definition helps establish the link between an economic resource and a particular entity, which is necessary for an item to be considered an asset of the entity. Ms. Botosan believes that including control in the definition would mitigate potential misapplication of the definition to economic resources to which an entity has a right but no ability to control.

Question 4: The Board decided that an obligation to transfer either assets or, in certain limited circumstances, an entity's own shares would meet the definition of a liability. Is the discussion in this proposed chapter of the limited circumstances in which the entity's own shares would meet the definition of a liability sufficiently clear?

The ability to transfer equity and meet the definition of a liability is a sizable change in concept to today's Framework definition of a liability that requires the transfer of an asset. However, the definition and supporting information seem to give different indications about whether delivering either a fixed or variable number of shares would qualify.

The definition in Paragraph E38 indicates that one of the two characteristics of a liability is that "the obligation requires an entity to transfer or otherwise provide economic benefits to others." The supporting guidance in Paragraph E57 subsequently clarifies that "an obligation also can be fulfilled, satisfied, or settled in a number of other ways, including by…converting the obligation to equity, or, in certain circumstances, transferring shares of the entity." Paragraph E58 further states that a "transfer of shares sufficient in number to satisfy an obligation of determinable or defined amount is a transfer of an economic benefit. If arrangements permit or require settlement of obligations by issuance of a variable number of the entity's own shares, those shares are essentially being used in lieu of assets to settle an obligation and therefore meet the definition of a liability."

As written, Paragraphs E57 and E58 suggest that an obligation that is required to be or may be settled by issuing a variable number of shares with a fixed monetary amount meets the definition of a liability. While satisfaction of an "obligation of determinable or defined amount is a transfer of an economic benefit," it is unclear whether satisfaction of an obligation that is impacted by other factors, such as share price or some other factor unrelated to shares, would also constitute a transfer of an economic benefit. If so, it would mean that any instrument that transfers equity could, in concept, be a liability. We question whether that is the Board's intent.

While this proposal may be helpful in not constraining deliberations in liability versus equity projects, it may lead to more questions than answers as it does not appear to be based on a concept. The concept may more likely be based on the difference in standing between equity and liability holders and the impact of indexation, which is not addressed in the ED.

We observe that one of the reasons to distinguish a liability from equity is to differentiate whether changes in value are presented in the income statement or in equity. This is another reason to consider the presentation chapter in conjunction with this one.

Question 5: Other than as described in Question 4, to allow certain share-settled instruments to be liabilities, the Board expects the liabilities that met the definition of a liability in Concepts Statement 6 will continue to qualify as liabilities under the definition of a liability in this proposed chapter. Do you agree that the definition of a liability in this proposed chapter is consistent with the Board's assertion? If not, please provide examples.

It is unclear whether there will be a change in what meets the proposed definition. Removing the term "probable" from the definition could make more items meet the definition. However, as noted in our response to Question 1, we question whether the Board expects that probability would be considered in measurement.

Question 6: In practice, the more challenging applications of the definition of a liability in Concepts Statement 6 were related to business risks, constructive obligations, and stand-ready obligations. Is the discussion of those three areas in this proposed chapter adequate to understand and apply the definition of a liability?

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The discussion of business risks, constructive obligations and stand-ready obligations is generally helpful in understanding and applying the definition of a liability. However, further clarification in certain areas is warranted.

In describing liabilities, Paragraph E49 states, in part: "an entity must be bound, either legally ***or in some other way***, to perform or act in a certain way…" [emphasis added]. The reference to "some other way" raises questions about whether being economically bound—the concept of economic compulsion—would create a liability. For example, consider preferred stock that does not legally bind the issuer to redeem the instrument, but includes an issuer-held option to redeem. The issuer could be economically compelled to exercise its redemption option if at some point not redeeming would result in a compulsory dividend that is exorbitant. We question whether economic compulsion such as this binds an entity and creates a liability. In standard setting, the Board has decided that certain liabilities arise from economic compulsion, such as when lease renewal is assumed. However, the discussion in the ED is not clear. We recommend the Board clarify this point.

In addition, similar to our response to Question 1, we observe that one of the most difficult assessments in the Framework is when a liability meets the definition—*when* there is a present obligation to transfer an economic benefit. The ED does not provide clarification to aid in that assessment or to determine whether assets and liabilities should be evaluated the same way. The ED suggests that a contract is necessary to meet the definition of an asset but is not necessary to meet the definition of a liability.

Question 7: The Board suggested that integration with presentation principles would be helpful in distinguishing between the components of comprehensive income. To facilitate this distinction, paragraph E92 of this proposed chapter references presentation principles. Is distinguishing revenues from gains and expenses from losses essential as a matter of elements, or should those distinctions be exclusively a matter for presentation concepts? Please explain.

It is not clear how an inflow that falls within the definition of an element, such as revenue, might not be presented as such. In practice, when GAAP does not specify presentation in the income statement as revenue versus other income, practice references the Concepts Statement definition of revenue. Examples in which presentation is not specified include collaboration income (ASC 808), interest income, license royalties/income, government grants, and foreign currency gains and losses. If the Board does not intend the definition of revenue to be used to determine whether amounts should be presented as revenue (when not otherwise specified in GAAP), that should be explicitly stated.

Question 8: As described in Question 7, this proposed chapter seeks to distinguish between revenues, expenses, gains, and losses. Do the definitions of and other explanatory language related to revenues, expenses, gains, and losses make the distinction between these elements sufficiently clear?

Removing the term "ongoing major or central operations" from the definition of revenue may be hard to operationalize. This is one of the most common areas in which preparers use the Framework in lieu of specific guidance. We believe there will be many questions as to how to apply the proposed definition and whether it is intended to change practice. The language suggests that what might meet the definition of revenue could expand, stay the same, or be limited.

Paragraph BC4.37 explains that the Board decided to remove the term because it is "not clear whether...it is intended to refer to all revenues and expenses or only those that relate to revenues and expenses from other activities." The same concerns that led to the Board's decision in the ED would apply to the current definition of revenue as codified in ASC 606[1], and as such, we question whether the Board has considered these effects.

Expanding what meets the definition of revenue
The proposed definition could be interpreted as expanding the scope of inflows that are considered to be revenue. Paragraph E88 indicates that revenue includes "inflows from other activities" such as interest, rent, royalties, fees, and charitable contributions without applying the current filter of whether it is part of ongoing major or central operations.

No change to what meets the definition of revenue
In some instances, it appears that the concept of what is ongoing major or central to the operation remains. Paragraph E90 states that the distinction between revenues and gains for "exchange transactions" depends on "the nature of the entity and the activity with which an item is associated" and gives an example of a machine displayed as inventory versus used in a productive capacity. This is similar to a "central operations" concept, but it is not clear how this links to the proposed definition that excludes that concept.

Limiting what meets the definition of revenue
The addition of Paragraph E89 that seeks to clarify when to record a gain or loss raises several questions. Gains and other income are typically viewed as similar concepts, and both are addressed in ASC 610. If the list in ASC 610 is the only guidance on gains, it may result in a narrower definition that effectively expands what is included in revenue versus other income or gain.

Other comments and questions include:

- Is the list in Paragraph E89 complete or are there other transactions that could result in a gain or loss (e.g., a financial institution that sells a building)? Explanation of the concept would be more helpful than a list as there will be other transactions that are hard to classify as revenue or gains.
- We believe exchange transactions would generally result in revenue. It may be helpful to provide examples of exchange transactions that may result in a gain.
- If the list is retained, we suggest splitting nonreciprocal transactions and extraordinary transactions into separate bullets as they are quite different.

[1] 606-10-20 Glossary: Revenue - 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.

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We also question some of the guidance included on comprehensive income. Paragraph E81 mentions financial capital versus physical capital. There is limited information on these complex concepts, and we suggest it be expanded so the distinction is clear, or instead remove it.

Question 9: The Board has concluded that, other than when exceptions are specifically noted in this proposed chapter, the elements described in this proposed chapter would apply to not-for-profit organizations. Do you agree with this conclusion?

The FRC does not have any not-for-profit preparers so our comments are from the perspective of business entities.

Question 10: This proposed chapter was developed on the basis of Concepts Statement 6, though several paragraphs have been removed or adapted. Are any of the paragraphs from Concepts Statement 6 that have been removed in drafting this proposed chapter necessary to keep? If so, why?

We have no comments on this question.

Question 11: "Appendix A: Accrual Accounting and Related Concepts," includes discussion of several concepts that are used in this proposed chapter and in other chapters of the Conceptual Framework. Is this material helpful in a chapter discussing the elements of financial statements?

We believe this material pertains to recognition and should not be included in the elements chapter. However, we have the following observations on it should the Board decide to include it or publish it as a separate chapter.

- Paragraphs A4.5-A4.10 and other parts of Appendix A include reference to the matching principle, which could be confusing. Paragraph A4.9, for example, notes that proper application of the asset and liability definitions should normally achieve matching. However, Footnote 20 indicates that the term "matching" should not be used. We suggest that the Board make it clear that the old income statement notion of matching is not conceptually acceptable.
- Paragraph A4.6 uses lower of cost or market marketable securities as an example of accrual accounting, which is outdated guidance.