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Technical Director, Financial Accounting Standards Board

File Reference No. 2020-500

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*

The California Society of CPA's ("CalCPA") Accounting Principles and Assurance Services Committee (the "Committee") is the senior technical committee of CalCPA. CalCPA has approximately 42,600 members. The Committee consists of 54 members, of whom 45 percent are from local or regional firms, 32 percent are from large multi-office CPA firms, 12 percent are sole practitioners in public practice, 6 percent are in academia and 5 percent are in international firms. Members of the Committee are with CPA firms serving a large number of public and nonpublic business entities, as well as many non-business entities such as not-for-profits, pension plans and governmental organizations.

<u>Committee's Views on the Proposed Statement</u>

While the Committee supports the efforts to update the Conceptual Framework for Financial Reporting (Framework) to be most helpful for use in standard setting, we do not believe the proposal will accomplish this objective. As discussed in more detail below in our answers to the specific questions, we recommend the Board illustrate the impact of the contemplated changes through examples and undertake expanded outreach with preparers to share further details. This is particularly important because while the Framework itself is not authoritative, accountants habitually use aspects of it to conclude on accounting for certain types of transactions where there is no directly applicable authoritative guidance.

We believe illustrative examples, expanded outreach and re-exposure are particularly important as related to

- the proposed change in the definition of a liability to include certain share-settled obligations, as the Board has stated its intent to use the revised definition for future standard-setting activities as related to the financial instruments; and
- any significant conceptual changes to when costs would be capitalized as intangible assets.

We believe it is important for the accounting community in general to understand how the revised definitions may impact future standard-setting activities in these complex area with challenging and sometimes conceptually inconsistent guidance, and be able to provide meaningful input.

FASB concept statements are unlikely to draw significant attention from the users of the financial statements, and it is often difficult to draw the line from concepts to accounting for specific transactions. . We believe there is a substantial risk that redefined concepts will lead to accounting results that are not anticipated by preparers and users, resulting in substantial consternation and pushback when the standards developed on the basis of these concepts are exposed for public comment. In this regard, we encourage the FASB to perform outreach and determine how the financial statements can best meet the needs of the users specifically with respect to financial instruments that can be settled in shares, and for costs incurred to develop or acquire intangible assets.

We disagree with the Board's decision to discontinue its efforts to work jointly with the IASB on their frameworks. We strongly believe that it would be wise, wherever possible, to harmonize the frameworks. To that end, differences with the IASB in the fundamental issues addressed in Chapter 4 of Concepts Statement 8 will not be helpful in a continuing effort to harmonize US GAAP and IFRS.

The following are our responses to the Questions in the proposal.

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.

We do support the proposed removal of the term "probable" from the definition of assets and liabilities, for the reasons noted in paragraphs BC4.10. While we do not anticipate this will result in systemic changes in what is recognized as assets, and though we cannot cite any specific examples, we expect there likely have been circumstances where companies could not recognize an asset for a specific expenditure because they were unable to conclude the resulting benefits met the threshold of "probable" (in its meaning of "likely"). It is not clear how the proposed Statement would impact such transactions. We are concerned that eliminating the term probable leaves a void about the level of certainty that must exist about future realizability of value to recognize an asset.

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?

It is not clear to us how the revised definition will help resolve issues of identifying intangible assets. Paragraph E35 states that knowing "whether a right to a future economic benefit exists at a particular date" is the "practical problem" in assessing whether intangible assets arise from expenditures such as research and development, advertising, training, start-up activities, and pre-operating activities. Yet the proposed Statement does not attempt to address how to solve this practical problem.

We do note significant conceptual and practical inconsistencies in today's accounting principles and prevailing practices as to when various internal or external costs are eligible to be capitalized as intangible assets, which undermines the usefulness of the financial statement information. This situation has developed over many decades as a reflection of prevailing thoughts around practicalities, measurement challenges, recoverability uncertainties, etc. We encourage the Board to address this challenge on a conceptual basis with the objective of aligning financial statements with the needs of the users, balanced with the practicalities of accumulating and processing the relevant information by the preparers. However, to the extent the Board is contemplating significant conceptual changes to the current accounting principles, we recommend highlighting such considerations through illustrative examples, including examples of measuring future value of expenditures resulting in intangible assets, performing a broader outreach, and exposing any practical considerations for public comments.

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.

We find the removal of the word "control" from the definition to be confusing. While we appreciate the Board's assertion in paragraphs BC4.16 and BC4.17 that including the word "control" in the definition was causing confusion, we expect on balance, even more confusion will arise if the word is removed. For instance, in deliberating the proposed Statement this topic was always the center of the Committee's discussion. We agree that the concept of control is embedded in the "right to an economic benefit"; however, this is not obvious, and makes application of the definition more challenging. Preparers who do not possess a PhD in accounting should be capable of reading, understanding and applying the definitions of elements of the financial statements. Accordingly, we recommend that the Board keep the Concepts transparent and easy to apply, and in particular, retain the word "control" in the definition of an asset.

For the same reason, we do not support the removal of the words "past transactions or events" from the definitions of assets and liabilities.

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?

We support adding an obligation to transfer a variable number of shares to settle an obligation of a determinable or defined amount to the definition of a liability. However, it is not clear to us how this narrow set of circumstances would reconcile with (or impact in the future) the accounting standards that regulate whether equity-indexed instruments (options, warrants, forwards, etc.) are classified as liabilities or as equity.

In Paragraph BC4.28, the Board highlights the past "ad hoc standard-setting decisions, which… has resulted in a complex accounting model for financial instruments that have characteristics of both liabilities and equity". It also states that "the Board recognizes that resolving the distinction between liabilities and equity at the standards level begins with a conceptually sound definition of a liability in the Conceptual Framework that the Board can apply in standard setting".

We agree with these statements and objectives. However, we do not understand how the proposed Statement accomplishes these objectives. In addition, the Board stated its intent to reflect the revised definition of a liability in future standard setting related to accounting for financial instruments. Since this may impact many entities in ways difficult to foretell, we recommend the Board provide a number of examples illustrating the application of the new concepts, perform outreach with preparers and practitioners, and expose such examples and illustrations for public comments.

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 not clear to us how the proposed removal of the term "probable" from the definition of a liability would impact recognition of liabilities. We appreciate the reasons for the proposed removal in paragraphs BC4.10. However, we note that there are significant inconsistencies in the existing accounting standards as to whether the threshold of "probable" is required for recognition of liabilities. Certain obligations are recognized as liabilities only if they are probable. Other obligations are recognized at fair value, initially and potentially subsequently. For these obligations, settlement may not necessarily be probable at any point in time.

It is also not clear whether obligations under executory contracts would meet the definition of a liability. Current standards require recognition of such liabilities in specific circumstances, e.g. lease liabilities and certain noncancelable contract liabilities under Topic 606. Paragraph E46 states that a contractual obligation requiring an entity to pay more than fair value for an asset to be acquired may create a liability. However, it is not clear based on the proposed definition why a noncancelable contractual obligation to pay cash in an amount *equal to* the fair value of an asset to be acquired would not meet the proposed definition of a liability. The obligation would still be "present", i.e. existing at the reporting date, because it is noncancelable; and it will require the entity to transfer assets (e.g. pay cash). Thus, the rationale in paragraph E46 that the liability represents "what the entity might have to pay to undo the unfavorable contract" may equally apply to fair-value obligations as well. Many customer-vendor contracts cannot be terminated at will by the customer, as they may have substantial value to the vendor even before performance has started.

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?

We found the discussion of business risks, constructive obligations and stand-ready obligations to be helpful in understanding and applying 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.

We find that many preparers and practitioners refer to the concept statement's definition of revenue, gains, expenses and losses when assessing presentation of various inflows and outflows in their statement of comprehensive income. As such, we believe distinguishing between those is a matter of elements of the financial statements.

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?

We do not support removal of the term "ongoing major or central operations" from the definition of revenue. We believe it continues to be useful for many preparers and practitioners in assessing the appropriate presentation in the financial statements since there is often no direct guidance on presentation matters in the accounting standards. We recommend retaining the existing distinctions between revenues and gain, and between expenses and losses.

Regarding two of the typical gain and loss items included in paragraph E89:

- It is not clear what is meant by "exchange transactions" as the term is used in this paragraph. In our experience, and consistent with how the term is used in paragraph A4.2, an exchange transaction typically results in both revenue and expenses (or assets) for the entity, as the exchange represents a transaction between two entities in which each both receives and sacrifices value, i.e. encompassing a sale or purchase of goods or services.

- It is not clear what is meant by "adjustments to estimates of reported assets and liabilities". For example, an entity may have recorded an estimated contingent liability related to environmental cleanup. The amount is subsequently adjusted as additional information becomes known. We are uncertain whether paragraph E89 implies that the adjustment should be recorded as a loss, as opposed to reported in the same manner as the original estimate.

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?

We support the Board's conclusions on this matter.

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 recommend to remove the references to "matching" from paragraphs A4.5 and A4.9.

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We thank you for the opportunity to comment on these matters. We would be glad to discuss our opinions with you further should you have any questions or require additional information.

Sincerely,

Nancy Rix

Nancy A. Rix, Chair
Accounting Principles and Assurance Services Committee
California Society of Certified Public Accountants