

AMERICAN ACCOUNTING ASSOCIATION

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Via Email

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Re: Conceptual Framework Project

Unsolicited Comment Related to Conceptual Frameworks for Accounting and Financial Reporting

The American Accounting Association's Financial Accounting Standards Committee is pleased to submit the following document to IASB and FASB in conjunction with their projects on conceptual framework issues. The purpose of the document is to stimulate discussion and consideration of the purposes of conceptual frameworks and their contents.

Please contact Stephen Penman, (<u>shp38@columbia.edu</u> or 212-854-9151) or Thomas Stober (<u>stober.1@nd.edu</u> or 574-631-714), who co-chaired the drafting group for this effort, for clarifications or discussion.

Sincerely,

Robert H. Colson

Robert H Colon

Chair, AAA Financial Accounting Standards Committee 2008 - 2009

This comment was developed by American Accounting Association Financial Accounting Standards Committee and does not represent an official position of the American Accounting Association.

Alternative Conceptual Frameworks for Financial Reporting

American Accounting Association

Financial Accounting Standards Committee

Committee Chair's Introduction: In 2006, 2007, and 2008, the AAA Executive Committee asked the Financial Accounting Standards Committee to expand the scope of its activities and adopt a proactive stance on accounting standards and related policy matters. In response to these charges, the 2007 – 2008 Committee formed monitoring and drafting groups to take primary responsibility for following issues and drafting positions on them. The Committee adopted criteria for endorsement of a drafting group's output that primarily considered its intellectual stimulation, research or intellectual grounding, and contribution to the overall consideration of the issue. The Committee has worked productively during the past two years under this arrangement and has produced eight documents, each taking a proactive stance. The members have my personal thanks and gratitude for their efforts and collegiality.

In 2008 the Executive Committee, as a part of its thought leadership initiative to draw attention to the diversity of academic thinking on matters of policy, asked the Committee to develop alternative approaches to conceptual frameworks for financial reporting standards. The Committee agreed to accept this assignment and determined that it periodically would produce examples of conceptual frameworks for consideration by interested parties, and would host a listening session on conceptual issues at the AAA annual meeting as long as such sessions made sense. The listening sessions began at the 2008 annual meeting and there is one scheduled for the 2009 meeting. The paper that follows, a product of the 2008 - 2009 Committee, is the first effort in response to the charge. Subsequent Committees may produce additional such efforts in the future.

The framework presented in this paper was drafted by James Ohlson and Stephen Penman. Other members of the drafting group were Karim Jamal, Stephen Moehrle, Thomas Stober, and Shyam Sunder. Stephen Penman and Thomas Stober co-chaired the drafting group. The remaining Committee members (Robert Bloomfield, Ted Christensen, Robert Colson – Chair, Gary Previts – Executive Committee Liaison, and Ross Watts) participated through active reviews and discussions with the drafting group . Eight members of the Committee have endorsed the paper as consistent with the endorsement criteria while three have chosen not to endorse it for reasons they discuss in Appendix III.

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A Framework for Financial Reporting Standards: Issues and a Suggested Model.

Introduction

Standard setters and most academics maintain that accounting standards ought to rest on a set of guiding principles stated explicitly in a "conceptual framework." The FASB and IASB are currently involved in a project to refine conceptual framework documents developed earlier. At this point, it is not clear what their final product will look like; its defining characteristics as well as the substantive content can only be surmised. This paper addresses the issues that FASB and IASB face, including the question of what a conceptual framework should be all about. First, we suggest characteristics that a conceptual framework ought to exhibit. Most of these suggestions are based on our critique of the existing framework and the FASB-IASB work in progress.

Second, we present a model framework that meets our criteria. We emphasize up front that this framework is quite explicit. It goes to the heart of what a framework document should do: it places specific restrictions on what constitutes admissible accounting standards.

II. Issues with the Existing Conceptual Framework

The current conceptual framework in the United States, laid down in Concept Statements 1 through 7 (CON 1-7), has been with us for over 25 years. These documents have been quite limited in their influence. Though the FASB occasionally refers to CON 1-7, from what we can tell even individuals familiar with standard setting process cannot readily cite examples of when these documents have been consequential in setting standards. The new FASB and IASB project implicitly recognizes that CON 1-7 has not withstood the test of time.

The framework in CON 1-7 addresses far too many disparate issues and, as a consequence, fails to distill into a coherent whole. It does not define the boundaries within which standard

setters should operate, and defining boundaries is, of course, is central. How, then, should the boundaries be drawn? Should a framework lay down definitions of accounting concepts, such as assets and liabilities, that bind standard setters? Should it say something about the admissible set of measurement attributes? What about the recognition and de-recognition of assets? Should a framework be a statement of the purposes to be served in providing users with financial data, like "the prediction of the amount and timing of future cash flows?" Should a framework consider qualitative characteristics like "reliability" and "relevance?" Should the document be specific enough to guide the resolution of such accounting issues as the proper way of accounting for transactions with future benefits but without formal property rights? These kinds of questions can be raised *ad infinitum*. They highlight that individuals working on a foundational framework project will be well served by having narrowed the scope of what needs to be accomplished before they begin.

The current FASB-IASB Discussion Paper on their conceptual framework does not adequately address (if at all) the question of where standard setting and the supporting staff work is supposed to head. Such directions are needed so that work on a conceptual framework is guided by an understanding as to what constitutes end-product success. That question ought to be settled, as a matter of highest priority, before the various task forces produce reams of documents dealing with the full spectrum of what constitutes "good" financial accounting and reporting.

Because people come to accounting issues from many directions, they will naturally argue about what a conceptual framework should address and resolve. Controversy surrounds many issues, and defining the boundary between "good" and "bad" accounting particularly plays at the edge. In the spirit of furthering debate as the process moves forward, we focus on two issues and

present our views on both as explicitly as we can. First, in the next section we spell out of some useful (and not-so-useful) characteristics that a conceptual framework should (or should not) exhibit. Second, in section IV, we present our model framework in the form of five explicit principles that bear these characteristics and, most importantly, discriminate on "good" versus "bad" accounting. Our prescriptions contrast with the CON 1 – 7 documents and with what we have seen in the on-going FASB-IASB project. We hope that our implied critique allows those engaged in that project to evaluate whether they are on track to make a constructive impact on financial reporting practice.

III. Characteristics of a Useful Framework

Our discussion of the characteristics is based on what we think of as a common-sense approach. It reflects our interpretation of the history of standard setting and what can be learned from it. We do not claim any expertise in this matter, but hope that we can further the debate by simply stating a number of points that we feel have not been appreciated as they should. To be clear upfront, we provide no schematic empirical evidence to back up our claims, let alone pretend that they follow from explicit premises and tight reasoning.

Here are the points that have informed our own attempt at explicating a framework document:

A framework document best avoids general statements that are impossible to disagree
with. In particular, sweeping claims about the nature of virtuous accounting can be cast
aside. So our framework does not start with "motherhood" objectives, like "accounting
standards should maximize the relevance and usefulness of financial reports" and

"accounting standards should ensure that the reporting of firms' economic realities is fair and objective," because no one would ever disagree. Nor do more specific goals – like "accounting information should aid users to forecast the magnitude and timing of future cash flows" – provide clear enough directions for determining what accounting should actually look like. Reasonable as that claim may seem, it, too, is not worth hanging on to. Such statements embellish narratives by vaguely implying that the production of financial statements is of economic significance. But they also maintain a pretense that actual standards will follow from carefully selected criteria when really they have no significant consequences. (Does the objective of providing information about future cash flows suggest that users will benefit by having an income statement? Though a "yes" answer would seem to be fair enough, anyone who tries to firm up the logic behind this claim certainly has his or her work cut out.) While these statements are relatively harmless in isolation, collectively they distract from what really needs to be done: provide specific principles that have bite by restricting the future accounting standards that regulators can promulgate.1

• By having a framework of guiding principles that impose broad restrictions, the standard setting process will be simpler and more coherent because crucial accounting issues have

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¹ The FASB and IASB Discussion Paper with preliminary views of the conceptual framework refers to "relevance" and "faithful representation" as two primary, desirable characteristics of accounting information. Taken at face value as stand alone requirements, we do not believe anyone would disagree and claim that these characteristics should occasionally be violated by standard setters. The real issue becomes: What are their implications as a practical matter? We have difficulty coming up with any consequences. Not even broad notions such as "accrual accounting provides useful information" seem to follow from "relevance." One can even argue that almost any information is relevant unless it violates the characteristic, "faithful representation." Of course, such discussions will serve no useful purpose, the root cause being that "relevance" is far too sweeping. Elaborations would seem to be needed to make the characteristics consequential. As to "faithful representation," in an attempt to elaborate one could state something like "it rules out treating R&D as having no carrying value when, in fact, there are related property rights that objectively have market values." We suspect that this is not what the authors of the Discussion Paper have in mind, but we cannot be sure. To avoid any such confusion, it helps if a conceptual framework spells out the practical implications of higher level concepts sooner rather than later.

been settled up front. On the other side of the coin, a framework must be careful in the delicate matter of setting boundaries to what falls within the domain of standard setters. While a framework cannot be vacuous by reliance on language without consequence, it cannot be so restrictive that it places standard setters in too tight a box when it comes to the specifics. For example, "warranties outstanding must be approximated by their fair market values," and "inventories can be valued at the lower of cost and market only when the market is liquid and active" embed issues best left to standard setters to deal with in context.

• Coming to terms with admissible and non-admissible accounting is difficult enough, so it is important to avoid issues that raise more questions than they resolve: they will compound the complexity by introducing what will be loose ends. In this regard, we note that framework documents typically strive to provide free-standing working definitions of accounting terms that are supposed to help with the resolution of issues. In our view, we fail to see how it helps to dwell on the "proper" definitions of (say) assets and liabilities. Doing so typically reduces to what one might call thesaurus research, which, in fact, will not pin things down. Nor is there any point in discussing accounting theory concepts such as what constitutes the set of conceivable measurement attributes or conceivable

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² Definitions of assets and liabilities are tricky insofar that they can have unanticipated consequences. Consider, for example, the FASB-IASB definition of a liability: "A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits." Any reasonable reading of this definition ought to imply that Preferred Stock shows up as a liability in the balance sheet. That it does not should not surprise since one is presumably not supposed to take the definition too seriously (as a free standing imperative). In a similar fashion, the FASB-IASB definition of an asset (which we do not restate here) ought to imply that internally developed brand names are no less an asset than a fabricating facility constructed by the firm itself. (The FASB-IASB definition does not distinguish between tangible and intangible assets, and hence an inadvertent consequence.)

recognition principles when the implications remain open-ended. And it goes almost without saying that trying to derive the "right" accounting precepts from some set of acceptable primitive assumptions is futile (and possibly worse). A framework document should be appreciated for the sole reason that it restricts standards as a *practical* matter, not for its philosophical or epistemological underpinnings or its examinations of alternative, hypothetical restrictions.

It may seem harmless to include such things as "objectives" and "qualitative characteristics" in a conceptual framework. Such ingredients might serve a constructive role in signaling to constituents that their needs will be of overriding importance in the standard setters minds. And dealing with definitions of assets and liabilities (for example) can signal that standard setters will base their promulgations on thoughtful accounting precepts. Maybe so. However, the negative aspect is that some individuals may believe that "objectives" etc. do have implications when in fact they do not. If one believes that such is the case, then it seems much better to spell out explicitly what practical restrictions follow from "objectives" etc. Thus the document would move closer to the realities of (sometimes hard) accounting choices. For example, suppose a characteristic, "relevance" say, points in the direction of, say, Fair Value Accounting, then why not spell it out *explicitly* in the framework document? Not to do so, while at some much later point in time argue that such is in fact the case, could look like a deliberate attempt to withhold information that constituents naturally care about. To avoid the indictment of not being transparent, a brute challenge would then stare the writers of the conceptual framework right in the face: Can one actually derive practical accounting implications from "objectives" etc.? If yes, what are they and how do they follow? To restate our point of view, we think on the whole the answers to these questions are in the negative.

The section that follows provides our sense of what an actual framework should be. It consists of five principles, all of which are grounded in the accounting literature; we claim no originality whatsoever. Lack of novelty would seem to be desirable if the goal is a framework that has some chance of being broadly comprehended and achieving political success. An appendix briefly discusses the reasoning behind the principles.

IV. The Framework

The framework states accounting principles that rule in, and rule out, potential accounting standards that deal with the myriad measurement, recognition and classification issues standard setters can encounter. After stating the principles, we discuss how each of the financial reports – the Income Statement, the Balance Sheet, the Statement of Owners' Equity, and the Statement of Cash Flows – depend on the stated principles.

Our development of the principles and related discussion does not consider in any substantive way how they differ from U.S. GAAP or IFRS. To the extent our proposed principles are reasonably clear, we believe the knowledgeable reader will encounter few problems in making such assessments. We do not think our principles could be labeled as "radical" or unrealistic as a matter of accounting practice. To the contrary, looking at the history of accounting thought, readers will recognize that much of what we offer has been proposed over the years by many others who have had their feet firmly planted on the ground. That said, we are not naive as to the complexities of accounting standards and concepts, nor about what is likely to be acceptable to various parties. One can presumably make all sorts of arguments that our proposed principles are unconvincing when one looks for conceptual support, not to speak of "political" support. To deal

with such matters is way beyond the scope of this paper, and the reader has to recognize that our principles provide a critique of GAAP and IFRS which is wholly implicit.

The Principles

A. Recognition and measurement rest on interpreting transactions. The word "transactions" refers to actual, verifiable events in which the firm is involved, in particular those involving changes in property rights and obligations. The qualifier, "arms-length" is understood so that accounting cuts across self-dealing.

The principle underscores that changes in assets and liabilities depend fundamentally on what transpired during the current period. It is implied that recognition and measurement depends substantially on past and current events rather than on what the firm plans to do, or could choose to do. Hence, items like Inventories, PPE, Prepaid Expenses, Accrued Expenses, and Deferred Taxes refer to current and past events as opposed to subjective assessments of expected future dollar amounts. Current and past events include prudent assessments of a firm's experience with certain transactions (such as the accounting for bad debts, warranties, and depreciation). The principle is consistent with the notion of historical cost accounting as generally understood, including the requirement that normal operating business expenditures incurred pass through the income statements via either product or period matching.

The principle severely confines the use of various fair market valuations as a measurement attribute. Because fair value approaches violate the current/past transactions perspective, they should be viewed as circumscribed in the development of measurement and recognition standards. If fair market valuation is applied, the market in question must be liquid and reliable. Subjective assumptions about risks, transactions costs, and the performance of counterparties are fundamentally inconsistent with acceptable accounting standards; these approaches tend to

degenerate into easy-to-manipulate versions of mark-to-market accounting. More generally, the possibility of using mark-to-market accounting for assets and liabilities that are normally not valued that way should require extensive justification.

In sum, the transactions principle aligns with the traditional accounting adage that "accounting should be based on facts, not conjectures."

B. Operating activities separate from financial activities. This requirement means that operating and financial activities are not only mutually exclusive, but also exhaustive. Operating activities reflect transactions that logically connect to the generation of sales-revenues in current, future or past periods. Financial activities, on the other hand, link borrowing and lending activities (possibly with no explicit interest rate) to the expenditures connected with operating activities.

As a practical matter one can think of all non-financial activities as operating, when the term "operating" pertains to (net) capital expenditures (investments) as well as current operations.

Balance sheet financial activities consist of cash and (liquid) marketable debt securities (long and short term), outstanding loans, bonds payables and other similar securities. Promulgated standards accordingly must resolve whether a recognized asset or liability and income and expense are financial or not. In this regard, difficult cases will arise for compensation options and leases. Such cases must be addressed by standard setters rather than resolved in the framework. Other issues that arise may be contextual due to the nature of the business, such as the classification of accounts receivable and accounts payable.

This principle also bears on the measurement attribute. A necessary condition for the use of market valuation is its classification as a financial activity. Thus, as a point of principle, the carrying values of operating assets and liabilities exclude (fair) market valuation approaches (and some financial items may not use market valuation as a measurement attribute). Exceptions to a

transactions perspective on operating activities should be invoked by standard setters only if it can be shown that (i) the transactions history cannot meaningfully guide the measurement of the the asset or liability and (ii) an (approximate) fair market valuation approach will rectify otherwise obvious problems associated with income measurement.

C. The centrality of operating earnings measurement. This principle recognizes the income statement as the center piece in financial reporting. Consequently, under most circumstances, the other three statements serve a useful role primarily because they enrich interpretations of the income statement. Thus consecutive balance sheets, beside reporting the net financing position, serve the crucial role of providing input to earnings measurement, with assets and liabilities the product of the accrual process for measuring earnings. Similarly, the statement of cash flows provides the input for an assessment of how those accruals contribute to the earnings.

Within the income statement, the key item is income before financial items, that is, operating income net of associated taxes. With operating income as primary, the principle recognizes that, to understand a business operation and the direction it is heading, a reader initially focuses on (i) the top-line number, current sales and its expected future growth, and (ii) the current operating profit margin and how it might change in the future. Accordingly, balance sheets and the cash flow statement, in their supporting role, must contribute to an understanding of these central features of any business model.

A focus on operating income means that accounting standards are most effective if they take a position that current operating earnings provides the natural starting point for forecasting future operating earnings. Assured of this focus, forecasters should, to a reasonable extent, expect that the current operating profit margin will remain unchanged if business conditions remain essentially the same. Thus accounting standards strive to achieve a measurement of "permanent"

(operating) earnings."

From a standard setting perspective, this earnings concept has several implications. First, the balance sheet accounts that relate to operating activities can take on the role of smoothing (operating) earnings via explicit rules that pertain to deferred expense and deferred revenue accounts. This approach to earnings measurement enhances the predictability of earnings. (Non-recurring items, if present, must be shown explicitly in the income statement.) For example, gains and losses due to PPE transactions should generally be deferred via group depreciation methods; this accounting will then smooth the measurement of earnings. Second, accounting standards should generally discourage any attempt to convert non-recurring expenses in the current period into improved future profit margins. Standards should strongly discourage the use of essentially discretionary write-offs. Third, standards should recognize that, in the short term at least, the carrying values of assets and liabilities might well deviate from what many may view as fair market values. Fourth, it is perfectly acceptable that some assets and liabilities do not in any substantive sense relate to property rights or contractual obligations. Standards can thus allow for purchased "Goodwill" and "Deferred Tax Liabilities," for example.

D. Balance sheet conservatism. Standards should work from the principle that tangible operating assets cannot exceed reasonably assessed fair values. Any exception should require an explicit standard that justifies the deviation from the principle. To handle intangible assets, standards should also recognize that there must be rules in place to prevent the total of operating assets, net of operating liabilities, to exceed a fair value assessment of the business in its entirety. This conservatism principle ensures that the return on net operating assets cannot exceed the cost of capital for numerous years.

Consistent with Principle C, if the fair market value assessment is less than carrying value then

the resulting adjustment should not generally be implemented with a discrete, one-time write-down. Rather, the adjustment should take the form of an acceleration of expensing over many periods. Thus overvalued PPE should generally imply a modified depreciation schedule rather than a write-off charge. Overvalued inventory should not generally be reduced with a discrete charge unless it is essentially worthless. Conservatism applied in this fashion should prevent firms from converting a business with low margins to high ones in subsequent periods via use of one-time charges that reduce carrying values of operating assets. Discontinuity in the business model itself should be a necessary condition for one-time charges; adverse conditions or poor outcomes do not suffice per se. Conservatism thereby embeds the traditional maxim that unfavorable events or circumstances, as opposed to favorable ones, generally modifies the accounting rules. But here we underscore additionally that this should generally be implemented without one-time charges.

E. Owners' equity accounting rests on a proprietorship perspective. This principle requires that owners' equity pertains to the residual interest, typically the common shareholders' equity. The principle implies that only liabilities and common shareholders equity can be presented on the credit side of the balance sheet; there can be no "mezzanine" category. As a consequence, claims like preferred stock, warrants and other contingent claims, minority interests must be included as part of the liabilities.

The income statement must be consistent with a residual interest perspective. Preferred dividends, gains and losses due to the extinguishing of contingent claims, and changes in minority interest, cannot bypass comprehensive income and be treated as direct charges or credits to owners' equity. Thus the change in common shareholders' equity must equal the comprehensive income adjusted for common cash dividends and other capital transactions with

common shareholders. And barring exceptional circumstances, all transactions with common shareholders must be valued at market value.

The principle does not prejudice the use of Other Comprehensive Income as a special category. This category might well include realized and unrealized gains and losses related to preferred stock and equity-linked contingent securities that are financial in nature.

The Financial Statements

This section develops the implications of the five principles we have outlined for the financial statements. As stated, these implications broadly restrict the accounting, yet at the same time leave ample room for the judgments and the rules that spell out the accounting for specific assets and liabilities.

The Balance Sheet

Due to the second principle, the balance sheet should partition, in an exhaustive and mutually exclusive fashion, all assets and liabilities as either financial or operating. With respect to the financial items, it should also be clear whether the valuation is based on mark-to-market measurement or not. As to the valuation and measurement of operating assets and liabilities, their carrying values should generally rest on traditional accrual accounting, consistent with what is understood by the term historical cost accounting. This approach implies that operating assets and liabilities can deviate materially from their fair values. Such a possibility reflects that (consecutive) balance sheets serve as a means to an end, namely the preparation of an income statement. As has been the case through the history of accounting regulation, recognition and the details of measurement fall squarely within the standard setters' domain.

The Income Statement

Because operating activities differ from financial activities, the income statement should distinguish operating income (associated with operating items in the balance sheet) from income and expense associated with financial items. Operating income in turn rests on the interpretation of transactions and the matching of expenses with the period or with products and services for which revenues have been recognized.

The centrality of the income statement requires that earnings provide a useful starting point for the forecasting of future earnings; net operating earnings should, to the extent feasible, be permanent. Accordingly, both operating and financial earnings should be split into non-recurring and recurring components. Thus the net income splits into four parts. In this framework operating income on a recurring basis serves as the primary performance metric. Accounting principles accordingly benefit from disallowing discretionary balance sheet conservatism, which builds in non-recurring expensing. To the extent practically feasible, standards should allocate firms operating expenditures over periods in a consistent fashion without arbitrary lumps.

Owners' Equity Statement

Consistent with the proprietorship principle, this statement tracks the firm's residual interest, the common shareholders' equity. Two elements should fully account for the change in common shareholders' equity, namely, (i) the period's value creation as determined by comprehensive earnings, minus (ii) the net distribution of value to the common shareholders as determined by common (cash) dividends and stock repurchases net of all common shareholders' capital contributions. With respect to the second element, to maintain homogeneity across transactions, all distributions and contributions should be recorded at fair market values. If a transaction in

shares embeds a gain or loss relative to fair market valuation, the gain or loss must be included in comprehensive earnings.

Cash Flow Statement

One can argue that the cash flow statement supplies information that is not governed by accounting precepts in the five principles: Why should ideas about, say, the relevance of operating earnings or the proprietorship principle constrain the way one generates the most useful cash flow information? Might this statement be orientated more to creditors concerned with liquidity rather than shareholders? These questions are good ones, especially in light of the history of standards related to cash flows. Standard setters have always recognized that the big picture of cash flows raises its own uniquely intricate problems (such as the concept of "cash" and the distinction between so-called operating flows and investing flows) which have little, if anything, to do with such things as measurement attributes of assets and liabilities or whether the preferred stock is treated as equity or debt.

That said, one can ask what a cash flow statement would look like if it were to honor our principles. The principles imply that the cash flow statement must embed the idea of proprietorship (with its focus on a residual interest as the "bottom line"), operating vs. financial activities (which embeds the idea of accrual accounting for operating income measurement vs. accounting for cash flows to claimants), and the centrality of income measurement (so that the cash flow statement, like the balance sheet, is presented in support of the income statement).

The cash flow statement, accordingly, should be formatted like an income statement: it has a top line related to sales. There is no particular demand that the deductions in the cash flow

statement and the income statement have a one-to-correspondence (useful though it may be, it can be too complicated to accomplish), but the cash flow statement should nevertheless have the texture of an income statement that now is independent of accrual measurement. Thus the cash flow statement reports the income statement on a cash basis, rather than an accrual basis. The concept of "cash" rests on the financing activities so that the statement of cash flows can be reconciled through the change in financial assets and financial liabilities in consecutive balance sheets. The concept of cash is thus broad rather than narrow in the sense that "cash" can include not only equivalents such as short-term investments but also bonds payable and other financial liabilities.

Similar to the income statement, the statement of cash flows should provide a sub-total showing operating earnings on a cash basis, that is, comprehensive earnings on a cash basis before financial items (net of taxes). In effect, this approach to the cash flow statement means that change in operating assets (net of change in operating liabilities) corresponds to the period's total net accrual.

To implement this "direct method" cash flow statement, the standards that relate to principle B will be of overriding importance. It captures the idea that the cash concept, and the flows, cannot be divorced from the idea that a firm's financing activities can be conceived as being identified by a pool of "cash and their approximate positive or negative equivalents."

This approach can readily handle the demand to distinguish cash outflows due to current activities as opposed to those that have long term benefits, e.g., capital expenditures and R&D. This can be done via supporting schedules or in a columnar layout that explains the differences

between the income statement and the cash flow statement.

Appendix I

Arguments Supporting the Five Principles

A. Transactions-based accounting.

This principle has had a long history of apparent utility. It reflects that accounting needs to be reliable, objective, and based on observable and verifiable events. While it also means that anticipated events (such as an apparent future demand for a product) do not show up in the accounts immediately — the accounting is less timely — the alternative of accounting for events based on relatively subjective interpretation causes more problems – potential manipulations of accounts in particular – than it is worth. Accounting should not rest on a principle under which reasonable and honest individuals can disagree materially on what asset and liability values on the balance sheet ought to be. Sticking to such a principle makes it so much harder to "manage" earnings." The advantage is obvious: analysts, while recognizing that the financial statements can only paint an incomplete picture of the firm's performance, are assured that the accounts have some integrity (assuming they have been properly audited). Of course there is ample room for more "subjective" and "forward-looking" data, but this information belongs in the footnotes. With this "below-the-line" designation, analysts will recognize that much caution is required about such information, for even reasonable people can disagree. In sum, this reasoning makes the case that the focus in accounting statements should be on interpreting transactions and their

explicit characteristics rather than adding all sorts of subjective elements, even when the latter are potentially relevant to analysts.

The principle effectively rejects fair market valuation concepts, unless the asset or liability satisfies a narrow condition of being traded in liquid markets with depth. In turn, this means that the carrying values of assets and liabilities do not purport to tie to fair values, even in an approximate sense. But, as proponents of (modified) historical cost accounting tend to note, this drawback is mitigated by the fact that the "missing" values in the balance sheet partially cancel each other in the measurement of earnings.

Even a narrow transactions based accounting cannot avoid some anticipation of the future, as the accounting for "product warranties" and PPE accounting clearly illustrate. But the related accruals tend to rely on historical experience or broadly valid rules which, to considerable extent, eschew "subjective" input. Nevertheless, it is apparent that standard setters will always have their work cut out as to how one "best" factors in future-oriented information in the standards. As they engage in such activity, the principle thus espouses that (i) standards that allow for manipulation tend to cause problems and (ii) the accounting is not intended to capture (approximate) fair market values for assets and liabilities central to a firm's value creating process.

B. Operating vs. financial activities.

Contemporary finance theory, and related financial statement analysis, depends on splitting a firm's activities into financial and non-financial (operating) activities. This analysis scheme occurs for a very good reason: operating activities identify the (ex ante) value creating activities, with the concept of a top line in the income statement, namely revenues from customers.

Financial activities, on the other hand, are so-called zero NPV activities (at least as a first cut), which provide a necessary condition for the application of mark-to-market accounting. Thus

the invocation of the operating vs. financing principle should help equity analysts and other users of financial statements when they assess a firm's performance. Much time-consuming work will be eliminated by making the financial statements consistent with needs.

The "measurement attribute "conclusion that fair market valuation is not appropriate for operating activities combines this perspective with the transaction principle: operating activities are the value-adding activity but value should not be added in the accounts without a transaction (when value is added at market). Correspondingly, the application of fair market values to non-value-adding financing activities is justified because one cannot add value to a fair market price.

An apparent difficulty with the classification scheme arises when firms engage in transactions where the classification a matter of, more or less, subjective opinion. The financial industry is a case in point; there the dichotomy is indeed blurred to the extreme. For industrial companies, investments in non-liquid equity shares and non-strategic real estate investments beg the question. Do these situations invalidate the usefulness of the proposed principle? We think not, once the basic idea behind it is understood: some transactions are not part of the strategic value-creating process and, if there is doubt that the transaction falls into this category, then the activity can be classified as operating. Thus the users of the financial statements will be well served because the accounting recognizes that firms engage in strategic activities, and the consequences of those need to be understood separately from the (financing) activities that broadly support the value-adding activities: the fact that the line may not always be clear-cut does not invalidate the principle.

C. The centrality of the income statement and earnings measurement.

Cursory observation of the use of financial statements validates this point: it is earnings that is forecast, anticipated, and reported. It hardly requires discussion at all, but needs emphasis given

the apparent balance sheet (asset and liability measurement) approach in the FASB-IASB conceptual framework discussion documents. The balance sheet, with individual assets and liabilities reported and summed as if they were separable (and many (intangible) assets missing), cannot hope to provide an overall performance measure for assets and liabilities used jointly. But the income statement provides a summary number, earnings, from this joint use (including earnings from assets not on the balance sheet).

Less apparent, we further would argue that users of financial statements, particularly equity analysts, tend to analyze the income statement in search for some number that is useful as a starting point in forecasting next year's (or quarter's) net income. Hence, it makes sense that accounting standards evaluate transactions in a systematic fashion such that income will be "smoothed" over periods. If this means that some operating assets and liabilities do not correspond to their perceived "fair values," so be it. Our motivation therefore depends on the powerful idea that income statements can be extremely useful as long as the "errors" in the beginning and ending net asset values on the balance sheet substantially cancel each other. Current R&D accounting according to GAAP illustrates this point; the income statement will generally be not much affected by its capitalization. In fact, this idea is among the most important to justify the usefulness of traditional historical cost accounting.

D. Conservatism.

This principle may seem somewhat redundant. Nonetheless, it is not so if one allows standards to work such that (i) over-valuation is allowable unless it is material and (ii) the existence of over-valuation generally leads to an acceleration of expensing over many periods rather than a discrete write-down. Conservatism properties enhance earnings measurement because they exploit the (partial) cancelling of error concept. Thus, the principle indeed is desirable, but not if it

degenerates into mere "discretionary conservatism triggering an abundance of more or less hidden non-recurring ítems." GAAP accounting has always built in balance sheet conservatism, and it has rarely (if ever) been claimed to be inappropriate unless "overdone." One can argue that (ex ante) operational risk in outcomes and (balance sheet) conservatism are two side of the same coin.

E. Proprietorship perspective.

Elementary financial statement analysis in the context of equity valuation always underscores that the residual interest in the balance sheet and the income statement pertains to common shareholders. Hence, the principle should be adopted if one accepts that equity markets are the main users of financial reports. In terms of dollar trading, there is no question that contemporary equity markets now dominate bond markets. Moreover, it is far from clear whether, in fact, creditors prefer an entity perspective in financial reporting. We are not aware that such a case has ever been made. Indeed, clear identification of the property rights (claims) of common shareholders also delineates claims by others, including minority interests. Another advantage with the common equity perspective is that it simplifies the calculation of EPS insofar that there should be no need to adjust for contingent equity securities (warrants, compensation options, convertible bonds and put options in particular). If these securities are treated as liabilities and income or expenses, then neither the numerator nor the denominator requires adjustments for so-called potentially diluted effects. In sum, the proprietorship theory of accounting provides for a more coherent perspective than the entity theory.

Appendix II

American Accounting Association

2008 – 2009 Financial Accounting Standards Committee Members

Robert Bloomfield, Cornell University (not endorse)

Theodore E. Christensen, Brigham Young University (not endorse)

Robert H. Colson – Chair, Grant Thornton LLP (endorse)

Karim Jamal, University of Alberta (endorse)

Stephen Moehrle, University of Missouri at St. Louis (endorse)

James Ohlson, New York University (endorse)

Stephen Penman, Columbia University (endorse)

Gary Previts, Case Western Reserve University (endorse)

Thomas Stober, University of Notre Dame (endorse)

Shyam Sunder, Yale University (endorse)

Ross L. Watts, Massachusetts Institute of Technology (not endorse)

Appendix III

Communications from Committee Members Not Endorsing

Ross Watts communication:

The authors have responded to my concerns about the verifiability of the balance sheet items that would arise from concentrating on the income statement by dropping the discussion of those items. Those items would be at least as unverifiable as some fair valuations and would enable considerable misleading financial reporting. Given that, I request that it be noted that I dissent for that reason and for the lack of concern for the net asset role of the balance sheet (opportunity cost of continuing in business). In my opinion, the financial statements can, via dirty surplus, address both the income role envisaged in the paper (subject to verifiability constraints) and the opportunity cost role.

Ted Christensen's communication:

The authors have done a great job of expressing their views in the conceptual framework document. I provided some editorial suggestions to them on the first round and hoped that it would continue to progress. However, as it currently stands, I'm still uncomfortable with endorsing it (at least in its current form). After reading Rob Bloomfield's dissent, I'm much more in line with his views than those presented in the document. There are many aspects of the document that are quite thought provoking, but others that don't totally fit my way of thinking. I considered abstaining, but after reading Rob's dissent, I've decided to join him. Since he has authored the dissenting view, I'm happy to simply be listed as "joining" his dissenting opinion.

Rob Bloomfield's communication:

I think it's great that the AAA has a committee that is rethinking foundational issues, and this paper has certainly forced me to think more carefully about the role of the conceptual framework. But in the end, I just feel that the document throws out the baby with the bathwater, and does not recognize the value of "platitudes to which everyone would agree" (as the preface puts it).

Thanks and congratulations to the authors for writing a thought-provoking document.

Dissent From

A Framework for Financial Reporting Standards: Issues and a Suggested Model Robert Bloomfield

I am honored to be part of a committee that strives to rethink the foundations of accounting standards, and I hope that this document will inspire some constructive debate on issues about

which many academic researchers (not just those on this committee) disagree with accounting standard setters. However, I find I must dissent because I believe that a conceptual framework must clearly define the objectives of financial reporting and the desirable qualities of financial reports. By eschewing a framework that does so, this committee has denied itself a powerful tool with which to defend the restrictions they seek to impose on standard setters and persuade those who do not already agree with their positions.

In Section III, the majority states that a conceptual framework should avoid general statements that are impossible to disagree with, and in particular should avoid statements of objectives and specific goals, because they 'maintain a pretense that actual standards will follow from carefully selected criteria when really they have no significant consequences' and because they 'distract from what really needs to be done: provide specific principles that have bite by restricting the future accounting standards that regulators can promulgate.

Statements describing objectives that command near-universal agreement can be powerful instruments for guiding policy. Perhaps the most famous examples are the opening words of the Declaration of Independence ("We hold these truths to be self-evident...") and the Preamble to the Constitution of the United States ("We the people of the United States, in order to form a more perfect union, establish justice, insure domestic tranquility, provide for the common defense, promote the general welfare, and secure the blessings of liberty to ourselves and our posterity, do ordain and establish this Constitution for the United States of America.") Appendix I unintentionally demonstrates the power of the existing Conceptual Framework to shape thought and frame persuasive arguments by referring to relevance, reliability, verifiability, timeliness and neutrality in its first paragraph.

I readily grant that practical considerations and political pressures often trump conceptual goals. However, the same can be said of the Constitution. In effect, the majority is arguing that the difficulties in interpreting the First Amendment are so severe that we should simply draft specific laws restricting the Government's ability to limit free speech. However, without mooring those laws to a clear description of their larger policy goals, how would one balance practical considerations, resist political pressure. Without being able to refer agreed-upon objectives, how would one persuade others to take a position they do not initially prefer?

The majority also errs by claiming that the purposes of financial reporting, as stated in the existing conceptual framework, command universal agreement. Many do agree with the existing framework's statement that financial reporting should be (as stated in the Framework's first paragraph) "to provide information that is useful to present and potential investors and creditors and others in making investment, credit, and similar resource allocation decisions." However, in the wake of the financial crisis, some policy-makers have argued that financial reporting should promote macroeconomic stability. Even before the crisis, some academics have argued implicitly that financial reporting should facilitate contracting between the firm and its counterparties. In my view, both of these objectives differ from those stated in the existing Conceptual Framework.

Recognizing disagreement about objectives is important because it raises two possible explanations for why the principles stated by the majority conflict with existing and proposed

standards. The majority may disagree with the standard-setters' views of the objectives of financial reporting, or may simply believe that existing standards fail to achieve those goals. The reasoning presented in this document is not precise enough to allow me to distinguish between these alternatives. Early in the document the majority relies on appeals to 'common sense.' Later, the committee justifies the principle that recognition and measurement rest on interpreting transactions is justified by "the traditional accounting adage that 'accounting should be based on facts, not conjectures." However, it is not clear why readers should agree with this statement. Without the common ground of clearly voiced objectives reasoning like this seems unlikely to result in a productive conversation among parties who disagree about specific principles or standards.

On the five specific principles proposed by the committee, I share many of the committee's sentiments, despite a number of quibbles that I will not air here. However, some of the principles seem to be based implicitly on one objective of financial reporting that I do not accept: that accounting standards should provide summary numbers (such as a measure of permanent operating earnings) that analysts and other financial statement users can employ with a minimum of adjustment. It is undeniable that the asset-liability view, which has been embraced by the FASB and IASB, and rejected by the majority, results in comprehensive income measures that include highly transitory and subjective components, as well as more persistent and objective components. Analysts will surely need to discriminate among these diverse components as they project future cash flows and other aspects of firm performance. However, users differ in the summary measures they find most helpful, and the more this summary measure differs from comprehensive income, the more easily preparers will be able to manipulate it through self-serving classifications and judgments.

The power to construct summary statistics (such as core operating income) is better placed in the hands of the financial statement users, not financial statement preparers. Thus, my own recommendation for a conceptual framework would specify that the objective of financial reporting is to assist the decision-making of the most sophisticated users who are willing and able to process all available information given the best widely-available technology and financial theory. Disaggregation of disclosure should be considered a key desirable quality of financial reports, and the privileged presentation of any income number other than total comprehensive income should be considered a key undesirable quality of financial reports. Calculating performance on a per-share basis, or adjusting it for items deemed more permanent or more tied to operations, should remain the prerogative of the user, not the preparer.