The FASB’s conceptual framework is built on a logical progression of ideas. Thus, understanding the framework may best be accomplished by examining that progression.

Objectives and Concepts
The framework consists of two main components: (1) the objectives of financial reporting and (2) the concepts that result and follow logically from those objectives.

The objectives flow from the more general to the specific. The objectives begin with a broad focus on information that is useful in investment and credit decisions.

That focus then narrows to investors’ and creditors’ primary interests in the prospect of receiving cash from their investments in or loans to reporting entities and the relation of those prospects to those of the entities.

Finally, the objectives focus on information about an entity’s economic resources, the claims to those resources, and the changes in them (including measures of the entity’s performance). That information is useful to investors and creditors in assessing the entity’s cash flow prospects.

The objectives, therefore, focus on matters of wealth. Investors and creditors seek to maximize their wealth (within the parameter of the risks that they are willing to bear). Likewise, business entities also seek to maximize their wealth. It follows, then, that information about the wealth of those entities and the changes in it is relevant to investors and creditors that are seeking to maximize their wealth by investing in or lending to those entities.

Fundamental Building Blocks
The building blocks are what the conceptual framework describes as the “elements” of financial statements (assets, liabilities, revenues, expenses, and so forth), which are defined in FASB Concepts Statement No. 6, Elements of Financial Statements. Because the objectives focus on an entity’s economic resources, the claims to those resources, and the changes in them, it follows that the definitions of assets, liabilities, and other elements necessarily are central concepts in the framework.
The Board's Decision
The decision that the Board made in deciding between the two views has been described as follows:

The Board’s early experiences had convinced it that definitions of assets and liabilities that depended on definitions of income and its components did not work. . . . those kinds of definitions proved to be of little help to the Board in deciding whether results of research and development expenditures qualified as assets or whether reserves for self insurance qualified as liabilities because they permit almost any debit balance to be an asset and almost any credit balance to be a liability.

In addition, the Board had attempted to test whether revenues and expenses could be defined without first defining assets and liabilities. It asked respondents to the [Conceptual Framework] Discussion Memorandum to submit for its consideration precise definitions of revenues and expenses that were wholly or partially independent of economic resources and obligations (assets and liabilities) and capable of general application in a conceptual framework. . . . That no one was able to do that without having to resort to subjective guides, such as proper matching and nondistortion of income, was a significant factor in the Board’s ultimate rejection of the revenue and expense view.1

Furthermore,

. . . the Board found that definitions [based on the revenue and expense view] that made assets and liabilities essentially fall out of the process of matching revenues and expenses provided no anchor. They excluded almost nothing from income because they excluded almost nothing from assets and liabilities. The definitions were primarily conventional, not conceptual, and had made periodic income measurement largely a matter of individual judgment and personal opinion. . . . That is, the Board found the revenue and expense view to be part of the problem rather than part of the solution.

In contrast, the Board’s definitions of assets and liabilities limited what can be included in all of the other elements. The Board’s choice of the asset and liability view limited the population of assets and liabilities to the underlying economic resources and obligations of an enterprise. The resulting definitions impose limits or restraints not only on what can be included in assets and liabilities but also on what can be included in income. The only items that can meet the definitions of income and its components—revenues, expenses, gains, and losses—are those that increase or decrease the wealth of an enterprise.2

Affirmation by Others
The FASB’s adoption of the asset and liability view as the basis for its framework has been affirmed by others. Standard setters around the world that have developed conceptual frameworks—those in Australia, Canada, New Zealand, the United Kingdom, and the IASB—all have based their frameworks on the asset and liability view.

And, just last year, in a study that it submitted to Congress,3 the SEC staff explicitly supported the asset and liability view and rejected the revenue and expense view as the basis for the conceptual framework and accounting standards. The staff stated:

We believe that the revenue/expense view is inappropriate for use in standard setting. . . . In establishing an accounting standard, the standard setter is attempting to define and establish the accounting principles for the underlying substance of the class of transactions under consideration. . . . from an economic perspective, income represents a flow of, or change in, wealth during a period. Without first having an understanding of the wealth at the beginning of the period, it is not possible to determine the change in wealth during the period. The accounting equivalent to identifying “wealth” is identifying the assets and liabilities related to the class of transactions. This identification of wealth acts as a conceptual anchor to determining revenues and expenses that result from the flow of wealth during the period. Historical experience suggests that without this conceptual anchor the revenue/expense approach can become ad hoc and incoherent.

Although some continue to believe that the asset and liability view emphasizes the balance sheet and deemphasizes the income statement, that is not the case. Instead, the issue is how income is manifested. As the SEC staff noted, income represents a change in wealth during a period. Thus, without an increase in wealth (as evidenced by an increase in assets or a decrease in liabilities), there is no income.

Comparison to Prior Definitions
Because the framework of the FASB’s predecessor, the Accounting Principles Board (APB) of the American Institute of CPAs, also included definitions of assets and liabilities, it is instructive to compare those definitions with the ones in the FASB’s framework.

The APB defined assets and liabilities in APB Statement 4, Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises, as follows:

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

Liabilities—economic obligations of an enterprise that are recognized and measured in conformity with generally accepted accounting principles. Liabilities also include certain deferred credits that are not obligations but that are recognized and measured in conformity with generally accepted accounting principles. [Paragraph 132; footnote references omitted.]
Those definitions are consistent with the approach taken in APB Statement 4, that is, by inferring principles from existing practice. In doing so, however, the APB produced definitions that are circular in nature. In effect, the APB’s definition of assets states that an asset is anything with a debit balance once the books are closed. Defining assets (liabilities) as anything that GAAP treats as assets (liabilities) confuses the accounting representations on the balance sheet with the economic phenomena that are to be represented. Such circular definitions do not provide guidance in making standard-setting decisions about which items qualify to be represented on balance sheets as assets and liabilities because they do not rule out anything.

In contrast, the FASB defines assets and liabilities in terms of the items to be represented (that is, economic phenomena) rather than the representations of those items on balance sheets. Concepts Statement 6 defines them as follows:

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

**Liabilities are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.** [Paragraphs 25 and 35; footnote references omitted.]

Each of those definitions identifies three essential characteristics needed for an item to qualify for representation in the balance sheet as an asset or liability. The three essential characteristics of an asset are:

a. It embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows.

b. A particular entity can obtain the benefit and control others’ access to it.

c. The transaction or other event giving rise to the entity’s right to or control of the benefit has already occurred.

Any item that possesses all three of those characteristics meets the definition of an asset; if it fails to possess any one of those characteristics, it does not meet that definition.

The three essential characteristics of a liability are:

a. It embodies a present duty or responsibility to one or more other entities that entails settlement by probable transfer or use of assets at a specified or determinable date, on occurrence of a specified event, or on demand.

b. The duty or responsibility obligates a particular entity, leaving it little or no discretion to avoid the future sacrifice.

c. The transaction or other event obligating the entity has already happened.

Any item that possesses all three of those characteristics meets the definition of a liability; if it fails to possess any one of those characteristics, it does not meet that definition.

All of the other definitions flow from those basic definitions. For example, equity is defined as the residual interest in an entity’s assets that remains after deducting its liabilities. Similarly, changes in equity—investments by owners, distributions to owners, revenues, expenses, gains, losses, and comprehensive income—are all defined in terms of changes in assets and liabilities (that is, as inflows, outflows, or other increases or decreases in assets or liabilities). Thus, the definitions of assets and liabilities are the most fundamental because all of the other definitions flow from them.

### A Needed Discipline

That conceptual hierarchy provides the necessary discipline that APB Statement 4 lacked. It helps the Board identify the items that qualify for inclusion in financial statements as well as the ones that do not qualify. For example, deferred charges and deferred credits (that result from conventional practices such as “matching” revenues and expenses) that do not possess the characteristics of assets and liabilities do not meet the definitions and do not qualify for admission to the financial statements.

Thus, assets and (to a lesser extent) liabilities have conceptual primacy, while income and its components—revenues, expenses, gains, and losses—do not. Former FASB Board member (and former APB member) Oscar Gellein, expressed it succinctly:

> Every conceptual structure builds on a concept that has primacy. That is simply another way of saying some element must be given meaning before meaning can be attached to others. I contend that assets have that primacy. I have not been able to define income without using a term like asset, resource, source of benefits, and so on. In short, meaning can be given to assets without first defining income, but the reverse is not true. That is what I mean by conceptual primacy of assets. No one has ever been successful in giving meaning to income without first giving meaning to assets.\(^4\)
With that hierarchy, the conceptual framework provides guidance on the right questions to ask in standard setting and the order in which they should be asked. Reed Storey, a principal architect of the framework, described those questions as follows:

*What is the asset?*
*What is the liability?*
*Did an asset or liability or its value change?*
*Increase or decrease?*
*By how much?*
*Did the change result from:*
  *An investment by owners?*
  *A distribution to owners?*
  *Comprehensive income?*
*Was the source of comprehensive income what we call:*
  *Revenue?*
  *Expense?*
  *Gain?*
  *Loss?*

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2. Storey and Storey, p. 80.
5. Storey and Storey, p. 87.