Conceptual Framework Project Introduction

1. The Preface to each FASB Concepts Statement includes a description that is the same as, or similar to, the following taken from Concepts Statement 6:

   The conceptual framework is a coherent system of interrelated objectives and fundamentals that is expected to lead to consistent standards and that prescribes the nature, function, and limits of financial accounting and reporting. It is expected to serve the public interest by providing structure and direction to financial accounting and reporting to facilitate the provision of evenhanded financial and related information that helps promote the efficient allocation of scarce resources in the economy and society, including assisting capital and other markets to function efficiently.

   Establishment of objectives and identification of fundamental concepts will not directly solve financial accounting and reporting problems. Rather, objectives give direction, and concepts are tools for solving problems.

2. Furthermore, the Preface to the Concepts Statements indicate the following:

   The Board itself is likely to be the most direct beneficiary of the guidance provided by the Statements in this series. They will guide the Board in developing accounting and reporting standards by providing the Board with a common foundation and basic reasoning on which to consider merits of alternatives.

3. The FASB has issued eight Concepts Statements. Concepts Statement 6 superseded Concepts Statement 3 and incorporates in the elements definitions the nonbusiness objectives established in Concepts Statement 4. Concepts Statement 8 superseded Concepts Statements 1 and 2 and is the result of a joint effort with the IASB.

4. In announcing the joint project to improve their respective Conceptual Frameworks (Framework), the Boards said the project would:

   Focus on changes in the environment since the original frameworks were issued, as well as omissions in the original frameworks, in order to efficiently and effectively improve, complete, and converge the existing frameworks.
Give priority to addressing and deliberating those issues within each phase that are likely to yield benefits to the Boards in the short term, that is, cross-cutting issues that affect a number of their projects for new or revised standards.

5. The FASB has extensive experience in applying its Framework to a number of very difficult accounting issues. That application has revealed that clarifications of, or modifications to, several aspects of the Framework are necessary for expeditious resolution of standard-setting issues. In addition, the existing Framework has accepted limitations or deficiencies in need of development.

6. The joint Framework project was organized in a manner consistent with the structure of each Board’s existing framework.

7. As a consequence, the project contemplated addressing the following fundamental areas:

   Objectives of Financial Reporting
   Qualitative Characteristics of Decision Useful Information
   Elements, Recognition and Derecognition, and Measurement
   Reporting Entity (not in existing framework)
   Presentation (not in existing framework)
   Disclosure (not in existing framework but an FASB project already in process)

8. There is no apparent reason that an FASB-only effort should be organized differently. The task, therefore, is more to prioritize the areas and issues to be addressed and identify those issues that are precedential. The objective in project design would be to determine what issues need to be first resolved or risk being an impediment to resolving other issues.

9. The accompanying paper analyzes issues in each area, identifies those that may well be precedential, and recognizes which issues are consequential in more than one area of the Framework.
10. This paper is not intended to propose solutions or even solution alternatives. This paper cites the July 2013 IASB Discussion Paper, *A Review of the Conceptual Framework for Financial Reporting*, which includes in some sections the IASB’s preliminary views on the Framework, and includes comments on some of those preliminary views.

11. This preliminary outline of issues and factors to be considered in activating the Conceptual Framework project is organized as follows:

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12. There is an inevitable redundancy in discussing the issues to be addressed in a conceptual framework because there is an unavoidable interrelationship between various conceptual notions, most obviously recognition and measurement. For example, one can’t recognize a gain or loss (both individual elements) without
addressing remeasurement of an asset or liability or derecognition of an asset or liability. The discussion in this paper attempts to minimize those redundancies by reference to the primary discussion of an issue that is of concern in more than one area.

13. “The conceptual framework helps to ask the right questions. Indeed, the FASB has emphasized that contribution as much as any. For example, the definitions of elements of financial statements not only make clear which are the right questions but also the order in which to ask them:

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?

14. To start at the bottom and work up the list will not work. That is what ad hoc accounting has tried to do over many years, resulting in assets and liabilities in balance sheets that cannot meet the definitions.” [Storey & Storey, FASB Special Report, The Framework of Financial Accounting Concepts and Standards, page 87]

15. Acceptance of this analysis is based on the notion that assets and (to a lesser extent) liabilities have conceptual primacy, and income and its components do not. As discussed in the elements section of this paper this has been a misunderstood aspect of the conceptual framework. It is not a balance sheet as opposed to an income statement view. It does represent the conclusion that items that fail definitions of assets and liabilities should not be recognized as such and comprehensive income
results from changes in assets and liabilities excluding changes that result from investments by and distribution to owners.

16. If Board members do not accept these conclusions work on improving and clarifying aspects of the Framework is unlikely to be successful. However, work on improving the present Framework by skeptical Board members may well enhance their appreciation for how and why the Board itself is the most direct beneficiary of the Framework.
Objective of Financial Reporting

1. Concepts Statement (hereafter SFAC) 1 was recently superseded (2010) by SFAC 8, which includes the Objective of General Purpose Financial Reporting. The title of SFAC 1 was changed in two ways. SFAC 1 made clear it applied to business enterprises because SFAC 4 addresses the objective of financial reporting by nonbusiness enterprises. SFAC 8 is a converged Concepts Statement, and the IASB has not resolved the applicability of its Framework to nonbusiness entities. Given that the FASB is clear on the applicability of SFAC 4, it was inconsequential to remove the words *business enterprise* from the SFAC 1 title. The Boards also concluded that it was appropriate to make clear in the title that the objectives of reporting apply to general purpose financial reporting and not information prepared for other purposes. SFAC 8 concludes:

   OB2. The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity. Those decisions involve buying, selling, or holding equity and debt instruments and providing or settling loans and other forms of credit.

   OB3. Decisions by existing and potential investors about buying, selling, or holding equity and debt instruments depend on the returns that they expect from an investment in those instruments; for example, dividends, principal and interest payments, or market price increases. Similarly, decisions by existing and potential lenders and other creditors about providing or settling loans and other forms of credit depend on the principal and interest payments or other returns that they expect. Investors’, lenders’, and other creditors’ expectations about returns depend on their assessment of the amount, timing, and uncertainty of (the prospects for) future net cash inflows to the entity. Consequently, existing and potential investors, lenders, and other creditors need information to help them assess the prospects for future net cash inflows to an entity.

2. Those conclusions have stood a long test of time and seem widely accepted though in some parts of the world there are selected issues of concern that will be discussed. In the process of developing SFAC 8, significant explanatory material in SFAC 1 was eliminated because of the IASB’s strong preference for brevity. Now an independent project affords the opportunity to consider whether some of the eliminated material
should be reinstated. SFAC 8 introduced a Basis for Conclusions to Concepts Statements, so any reinstated material would presumably be added to the basis and not modify any conclusions.

3. The IASB has indicated in its Discussion Paper that it does not intend to fundamentally reconsider the objective of financial reporting or qualitative characteristics of useful financial information.

Although the IASB does not intend to fundamentally reconsider the content of these chapters, the IASB will make changes if work on the rest of the Conceptual Framework highlights areas that need clarifying or amending. . . .

Some have expressed concerns about the IASB’s decision not to reconsider fundamentally Chapters 1 and 3 of the existing Conceptual Framework. In particular, they have expressed concerns about the following aspects of these chapters:

(a) the treatment of ‘stewardship’ in Chapter 1 (see paragraphs 9.5–9.9);
(b) the decision to replace the fundamental characteristic of ‘reliability’ with that of faithful representation (see paragraphs 9.10–9.14); and
(c) the decision to remove any reference to the concept of ‘prudence’ from the Conceptual Framework (see paragraphs 9.15–9.22).

4. It is not clear whether concerns expressed about stewardship might result in reconsideration of the objective of financial reporting. Similarly, it is not clear whether concern over prudence reflect a concern about objectives or about the qualitative characteristics of information. What is clear is that reconsideration of stewardship and prudence would be both contentious and time consuming. Whether either affects measurement or recognition is difficult to predict, as there is no agreed definition of either term.

5. The IASB Discussion Paper also suggests that notions of accounting based on an entity’s business model is a matter of concern, while admittedly undefined business model considerations are supported as the IASB’s preliminary view.
9.23 This Discussion Paper does not define the business model concept. However, the IASB’s preliminary view is that financial statements can be made more relevant if the IASB considers, when it develops or revises particular Standards, how an entity conducts its business activities.

6. Business model, based accounting, has significant implications for comparability as discussed in the section of this paper devoted to Qualitative Characteristics of Decision Useful Financial Information.

7. Whether “business model” accounting is either a component of the objective of financial reporting or a qualitative characteristic of decision useful information may well need to be resolved. The notion now has affected measurement and presentation, and it is not clear whether it should affect recognition. In standards-level decisions, business model has affected derecognition conclusions.
Qualitative Characteristics of Useful Financial Information

1. SFAC 8 replaced SFAC 2, just as it did SFAC 1. The revisions to SFAC 2 were not particularly controversial. However, some continue to be concerned that “reliability” was subsumed by “representational faithfulness” in SFAC 8. That concern seems to be based on a belief that reliability means precision or verifiability. That, of course, was not the intended meaning of the term as explained in SFAC 8.

Replacement of the term reliability

BC3.20 Concepts Statement 2 and the Framework (1980) used the term reliability to describe what is now called faithful representation.

BC3.21 Concepts Statement 2 listed representational faithfulness, verifiability, and neutrality as aspects of reliability and discussed completeness as part of representational faithfulness.

BC3.22 The Framework (1989) said:

Information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully that which it either purports to represent or could reasonably be expected to represent.

2. The Framework (1989) also discussed substance over form, neutrality, prudence, and completeness as aspects of faithful representation.

BC3.23 Unfortunately, neither framework conveyed the meaning of reliability clearly. The comments of respondents to numerous proposed standards indicated a lack of a common understanding of the term reliability. Some focused on verifiability or free from material error to the virtual exclusion of faithful representation. Others focused more on faithful representation, perhaps combined with neutrality. Some apparently think that reliability refers primarily to precision.

BC3.24 Because attempts to explain what reliability was intended to mean in this context have proven unsuccessful, the Board sought a different term that would more clearly convey the intended meaning. The term faithful representation, the faithful depiction in financial reports of economic phenomena, was the result of that search. That term
encompasses the main characteristics that the previous framework included as aspects of reliability.

3. As previously noted in the objective section of this paper, the IASB has identified the elimination of the term reliability as a concern raised by some.

4. The IASB has also identified the elimination of references to prudence (perhaps meaning conservatism) as an area of concern raised by some. This notion was not included in SFAC 8, and the basis explains the reasons why as follows:

Prudence (conservatism) and neutrality

BC3.27 Chapter 3 does not include prudence or conservatism as an aspect of faithful representation because including either would be inconsistent with neutrality. Some respondents to the Discussion Paper and Exposure Draft disagreed with that view. They said that the framework should include conservatism, prudence, or both. They said that bias should not always be assumed to be undesirable, especially in circumstances when bias, in their view, produces information that is more relevant to some users.

BC3.28 Deliberately reflecting conservative estimates of assets, liabilities, income, or equity sometimes has been considered desirable to counteract the effects of some management estimates that have been perceived as excessively optimistic. However, even with the prohibitions against deliberate misstatement that appear in the existing frameworks, an admonition to be prudent is likely to lead to a bias. Understating assets, or overstating liabilities in one period frequently leads to overstating financial performance in later periods—a result that cannot be described as prudent or neutral.

5. It is not at all clear whether prudence is intended to be an objective of financial reporting or a qualitative characteristic of useful financial information. Furthermore, is prudence intended to represent an attitude to be applied in making required estimates and judgments or something to be included in accounting standards by a standard setter? If the former, the attitude would be an instruction for preparers when dealing with uncertainty, but probably not a concept. If the latter, and Concept Statements primarily guide the Board in establishing standards, it is unclear how prudence as a concept would be useful in developing standards.
6. SFAC 8 in the basis for conclusions makes the following comment about comparability, an enhancing characteristic of useful information:

BC3.33 Relevant and faithfully represented information is most useful if it can be readily compared with similar information reported by other entities and by the same entity in other periods. One of the most important reasons that financial reporting standards are needed is to increase the comparability of reported financial information. However, even if it is not readily comparable, relevant and faithfully represented information is still useful. Comparable information, however, is not useful if it is not relevant and may mislead if it is not faithfully represented. Therefore, **comparability** is considered an enhancing qualitative characteristic instead of a fundamental qualitative characteristic.

7. SFAC 8 does not define comparability in an operational way, and it is not clear there is agreement on what is meant by comparability. If two entities own identical securities, is comparability achieved by presenting and measuring the securities the same way or is what the entity intends to do with those securities, as determined by its business model relevant to concluding what is comparable?

8. Business model notions are identified by the IASB as a concern. Whether portraying an entity’s business model should be an objective of reporting or should be a fundamental or enhancing characteristic of useful information seems to be open to debate. If a business model notion is to be applied, should it lead to differences in concept for recognition, derecognition, measurement, presentation, disclosures or potentially all of these?

9. Timeliness of information has been identified in SFAC 8 as an enhancing characteristic of useful information. Some have asserted that if information is to be timely, measurement of items recognized must be at a current value. Others believe that timeliness refers only to the enhanced value of reporting near the balance sheet date with no implications for measurement attribute selection. Either notion seems supportable in SFAC 8. Clarification of what was meant would seem to be desirable. If timeliness is thought to require a current measurement this issue would probably not be effectively resolved until concepts of measurement are completed.
10. The SFAC definition of materiality is clear but does not use the same words to define it as were used by the Supreme Court of the United States. The meaning seems the same and if that is the intent, that should be made clear.

11. As was noted earlier, when SFAC 8 replaced SFAC 1, the Boards deleted significant explanatory, clarifying discussion. Similarly, in SFAC 2, the Boards significantly reduced explanatory information. That information needs to again be carefully reviewed to determine if any of the information should be added to SFAC 8’s basis for conclusions.
Conceptual Framework: Reporting Entity

1. Developing a concept of the reporting entity for financial reporting was identified as a phase in the joint FASB-IASB Framework project. An Exposure Draft, *The Reporting Entity*, was issued in March 2010, which was intended to be finalized as Chapter 2 in SFAC 8 (Chapter 1, “Objective of General Purpose Financial Reporting,” and Chapter 3, “Qualitative Characteristics of Useful Financial Information”).

2. That Exposure Draft was not finalized but can be used as a starting point in developing a needed concept of the reporting entity.

3. The Exposure Draft described, or perhaps some think defined, a reporting entity as follows:

   **Description**

   RE2. A reporting entity is a circumscribed area of economic activities whose financial information has the potential to be useful to existing and potential equity investors, lenders, and other creditors who cannot directly obtain the information they need in making decisions about providing resources to the entity and in assessing whether management and the governing board of that entity have made efficient and effective use of the resources provided.

   RE3. A reporting entity has three features:

   a. Economic activities of an entity are being conducted, have been conducted, or will be conducted
   b. Those economic activities can be objectively distinguished from those of other entities and from the economic environment in which the entity exists
   c. Financial information about the economic activities of that entity has the potential to be useful in making decisions about providing resources to the entity and in assessing whether the management and the governing board have made efficient and effective use of the resources provided.

   These features are necessary but not always sufficient to identify a reporting entity.
4. Many of the issues raised in comments on the Exposure Draft may not be appropriate for a Concepts Statement and would need to be resolved at the standards level. Comments exhibit a frustration that the exact boundaries of a reporting entity were not resolved in concept. That frustration is understandable because at the same time the Boards were working on a reporting entity concept, the Boards were working on the Memorandum of Understanding (MOU) project on consolidations.

5. The notion of a circumscribed area of economic activities is certainly understandable. However in application drawing a line around the activities that should be eligible for general purpose financial statements has been problematic.

6. The most obvious issue in defining a reporting entity is to resolve the basis for determining when consolidated financial statements should be prepared to depict the result of having created a parent-subsidiary relationship. That relationship has been described in the accounting standards as based on control. Control was defined in the Exposure Draft as follows:

   RE7. An entity controls another entity when it has the power to direct the activities of that other entity to generate benefits for (or limit losses to) itself.

7. Consolidated financial statements are presumed to be necessary based on the following reasoning:

   RE8. If one entity controls another entity, the cash flows and other benefits flowing from the controlling entity to its equity investors, lenders, and other creditors often depend significantly on the cash flows and other benefits obtained from the entities it controls, which in turn depend on those entities’ activities and the controlling entity’s direction of those activities. Accordingly, if an entity that controls one or more entities prepares financial reports, it should present consolidated financial statements. Consolidated financial statements are most likely to provide useful information to the greatest number of users.
8. The Reporting Entity Exposure Draft distinguished joint control from control.

RE9. Two or more entities may share the power to direct the activities of another entity to generate benefits for (or limit losses to) themselves. In this case, none of the entities that share the power to direct the activities of this other entity individually controls this other entity. Accordingly, none of these entities would present information about itself and this other entity on a consolidated basis.

9. This conclusion would seem to preclude the practice of proportional consolidation for jointly controlled entities. That issue may potentially be contentious internationally and with the IASB.

10. Application of a control notion and an analysis of the various definitions of control would seem to be in need of resolution if control is to be the basis of consolidation at the concept level. Control as a basis for consolidation is complicated not only because of the various definitions but also because control is essential in the present definition of an asset. The meaning of control in the asset definition and whether it is operational is discussed in the asset element section of this paper.

11. Three issues not satisfactorily resolved in concept need to be addressed. One is when, if ever, parent company financial statements should be considered general purpose. One can argue consolidation is a matter of presentation. A parent and its subsidiaries are always “included” in parent company financial statements because, obviously, the investment that gives rise to control is included in the parent entity statements. The consolidation process just explodes that investment account to display the elements of the financial statements of the investee. Given the conclusion in paragraph RE8 quoted above, the acceptance of parent company statements as general purpose would seem to be an exception or contradiction to that conclusion and, if done, it should be allowed at the standard level not in concept. The Boards have recently taken that approach with investment company financial statements. Investment companies are not required to consolidate all controlled subsidiaries, and their presentation is essentially that of parent company financial statements.
12. A second conceptual issue is what presentation is appropriate when two or more entities are under common control though no parent-subsidiary relationship exists. The entities may comprise a “circumscribed area of economic activity” and seem to therefore meet the description of a reporting entity. To extend a control notion beyond circumstances when a parent-subsidiary relationship exists is consistent with the reporting entity description, but when to allow or require that presentation would also have to be resolved at the standards level.

13. A third issue is when, if ever, a portion of an entity could present general purpose financial statements. A subsidiary of a parent is certainly a legal entity, and the economic activity of that entity can be easily circumscribed in legal terms. A more difficult decision involves whether some portion of a single legal entity or some identified economic activity within consolidated financial statements should be reported as general purpose financial statements. The Reporting Entity Exposure Draft did not resolve issues concerning portions of an entity. However, it is clear that areas of economic activity can be circumscribed and consequently meet the description of a reporting entity. Some have suggested that to qualify as a reporting entity the portion of an entity should represent a business as that is defined in the standards-level guidance.

14. The definitions of control and the conclusion that consolidated financial statements should be prepared when control exists are with some exceptions (investment companies) relatively noncontroversial. However when the entity under consideration for consolidation is a variable interest entity, controversy begins. It is presumed that criteria for consolidation of a variable interest entity is a standards-level issue and not a conceptual conclusion. At the standards level, the FASB has required consolidation of a special-purpose entity (SPE) that is under common control and also when there is a parent-subsidiary relationship. This is the result of attributing a primary beneficiary relationship to an entity because ownership of the SPE is a related party to the reporting entity.
15. The IASB has indicated that it intends to build on, in its current deliberations, the Reporting Entity Exposure Draft. Reaching a converged concept may be achievable if the FASB follows a similar approach.
Conceptual Framework: Elements—General

1. SFAC 6 defines 10 elements in general purpose financial statements. These elements are:

   - Assets
   - Liabilities
   - Equity
   - Revenues
   - Expenses
   - Gains
   - Losses
   - Comprehensive Income
   - Investments by Owners
   - Distributions to Owners

2. Assets and (to a lesser extent) liabilities have conceptual primacy, over income and its components. Revenues, expenses, gains, and losses are dependent on changes in assets and liabilities. At present, the definition of a liability is dependent on the obligation to deliver an asset—hence the primacy of assets and secondarily liabilities. The basis for this is described by former Board Member Oscar Gellein.

   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, resources, 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. [Oscar S. Gellein, “Primacy: Assets or Income?” in Research in Accounting Regulation, vol. 6 edited by Gary John Previts (Greenwich, Connecticut: JAI Press), 1992, page 198]

3. The IASB Framework at present contains definitions of assets, liabilities, equity, income, and expense. Income includes revenues and gains, and expense includes both expenses and loss. There is no element for comprehensive income or investments by or distributions to owners.
4. Curiously the IASB Discussion Paper contradicts the existing IASB framework and states the elements are:

2.5 The elements are:

(a) in the statement of financial position assets, liabilities and equity (see paragraphs 2.6-2.36 for the discussion on assets and liabilities and Section 5 for the discussion on equity);
(b) in the statement(s) of profit or loss and OCI income and expense (see paragraphs 2.37-2.50);
(c) in the statement of changes in equity: contributions of equity, distributions of equity and transfers between classes of equity (see paragraph 2.52 and Section 5); and
(d) in the statement of cash flows: cash inflows and cash outflows (see paragraph 2.52).

5. Later in the Discussion Paper the paragraph quoted above is contradicted by the following:

2.52 The existing Conceptual Framework does not define separate elements for the statement of cash flows and for the statement of changes in equity. It may be helpful for the Conceptual Framework to define elements for each primary financial statement. The elements not discussed so far in this Section would be:

(a) statement of cash flows, whether prepared using the indirect method or the direct method:
   (i) cash receipts; and
   (ii) cash payments.
(b) statement of change in equity:
   (i) contributions to equity:
   (ii) distributions of equity; and
   (iii) transfers between classes of equity.

The Discussion Paper does not propose definitions for these elements. The IASB does not foresee great difficulties in developing definitions of these elements for inclusion in an Exposure Draft of the revised Conceptual Framework.

6. There is certainly a possibility that other element definitions could be considered and judged to be desirable. The leading candidates for consideration as elements have been seen to be:
1. Net income (or net earnings or perhaps net operating income or earnings)
2. Retained earnings (to distinguish equity not created by investments by owners).

7. Given the overwhelming importance attached to the subtotal net income (or net earnings) in the statement of comprehensive income, the fact that it is not an element is difficult to explain. The difference between revenue and expenses would seem to be a candidate for a net income definition, but most would consider that more a definition of “operating earnings.” Net earnings at present is an “extremely important” caption arrived at by default. It is all items recognized in comprehensive income except items designated for “other comprehensive income.”

8. Comprehensive income is defined in SFAC 6.

70. Comprehensive income is the change in equity of a business enterprise during a period from transactions and other events and circumstances from nonowner sources. It includes all changes in equity during a period except those resulting from investments by owners and distributions to owners.

9. However, as noted elsewhere in this paper, there is no operational distinction between liabilities and equity either in concept or at the standards level of the literature. Absent a precise agreement on liabilities, any definition of comprehensive income that rests on the change in net assets is not very effective. There is also no definition of an owner other than to describe an owner as a claimant on the residual assets of the entity.

10. Given there are no criteria for determining items to be presented in other comprehensive income, as discussed in the presentation section of this paper, any development of net income (earnings) as an element would not be practicable. Attempts to define net income (earnings) would predictably result in a debate as to the consequence of difference in an entity’s “business model.”
11. At a minimum, clarification is necessary to determine whether retained earnings should represent the undistributed accumulation of comprehensive income or comprehensive income excluding “other” comprehensive income. If distributable earnings, or equity created other than from investments by owners, is a desired attribute of a caption called retained earnings, then these issues need resolution. Certainly something that was never earnings (or comprehensive income) is not credible if reported as retained earnings.

12. Cash flow statement items also could be reasonable candidates for elements. Whether cash receipts and cash payments as suggested by the IASB would be more useful than cash flow from operating, investing, and financing would probably be debated. Cash receipts and cash payments do not seem to be elements as they represent movements in the cash asset account.

13. What is clear from considering additional items or elements is we have no clear criteria for concluding what is an element. SFAC 6 (paragraph 5) states that elements are:

5. Elements of financial statements are the building blocks with which financial statements are constructed—the classes of items that financial statements comprise. Elements refers to broad classes, such as assets, liabilities, revenues, and expenses. Particular economic things and events, such as cash on hand or selling merchandise, that may meet the definitions of elements are not elements as the term is used in this Statement. Rather, they are called items or other descriptive names.
Conceptual Framework: Elements—Assets

1. Assets are the element with conceptual primacy in the sense of being fundamental to all other element definitions. SFAC 6 defines assets and the fundamental characteristics of assets.

Assets

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

Probable is used with its usual general meaning, rather than in a specific accounting or technical sense, and refers to that which can reasonably be expected or believed on the basis of available evidence or logic but is neither certain nor proved. Its inclusion in the definition is intended to acknowledge that business and other economic activities occur in an environment characterized by uncertainty in which few outcomes are certain. [References omitted.]

Characteristics of Assets

26. An asset has three essential characteristics: (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, and (c) the transaction or other event giving rise to the entity’s right to or control of the benefit has already occurred.

2. The Boards took significant effort in their joint conceptual framework project to refine, clarify, and improve the asset definition with no particular objective of modifying the meaning or changing the population of items that would meet the definition. Words and phrases that were thought to be problematic are discussed below.

Probable: The footnote is widely misunderstood, and the position of the word suggests some inbound cash or other asset must have some (unspecified) likelihood of occurrence for an asset to exist.

Future Economic Benefit: Assets are present rights and have a present benefit. That right may well have an uncertain outcome, which could be
zero. Contingent assets are not assets. There is no present right if conditions in the future must be met for it to exist. The phrase causes some to focus on the future flow that is the result of having an asset rather than on the present right to the potential flow. Present rights may, however, have very uncertain outcomes.

Control: The word may or may not mean the same thing, in the context of the asset definition, that it means in any variation in definition of the word used to depict control of an entity. In the asset definition control is said to mean control others’ access to the right or benefits.

Past transactions or events: If one has a present right and benefit, of course it had to be obtained from some past transaction or event. The phrase is thought to be redundant. The phrase does make clear that assets are not rights or benefits created by future events.

3. The characteristics and other discussions in the Framework make clear that an asset is a present right that is a benefit and has the capacity to benefit the future. More emphasis needs to be placed on the present right and less on the future, which tends to cause emphasis on the flow that is the result of the asset. If the emphasis is on the present, there is much less need for the phrase “past transaction or events,” as it is clear it is a present right to any benefits that may or may not occur.

4. The IASB Discussion Paper supports these observations and they were also agreed upon tentatively in the joint project.

5. In paragraph 2.10 of the 2013 Discussion Paper the IASB said that “the IASB believes that the definitions can be improved in two ways:

(a) confirming more explicitly that:
   (i) an asset is a resource (rather than the inflow of economic benefits that the resource may generate). . .
   (iii) an asset must be capable of generating inflows of economic benefits. These inflows need not be certain. The probability of
the inflows need not reach any minimum threshold before the underlying resource meets the definition of an asset.

6. The result of these observations is to emphasize that an asset is a present right to potential benefits and that any uncertainty about the ultimate benefits realized is a matter of measurement. The following proposed definitions attempt to accomplish this (page 7, 2013 Discussion Paper):

   (a) an asset is a present economic resource controlled by an entity as a result of past events.
   (c) an economic resource is a right, or other source of value, that is capable of producing economic benefits.

7. These definitions ignore some problems of concern in the past, such as retaining the word control, but do seem to point in a direction that is an improvement.

8. One troubling aspect of SFAC 6 is the phrase in the first characteristic of an asset—“a capacity, singly or in combination with other assets.” That phrase is cited as determinative in concluding goodwill is an asset which raises questions about whether anything that might be thought of in combination with an asset isn’t also an asset. This would be a fundamental unit of account issue.
Conceptual Framework: Elements—Liabilities

1. SFAC 6 defines liabilities and three characteristics of liabilities.

Liabilities

35. Liabilities are probable\textsuperscript{21} future sacrifices of economic benefits arising from present obligations\textsuperscript{22} of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.

\textsuperscript{21}Probable is used with its usual general meaning, rather than in a specific accounting or technical sense, and refers to that which can reasonably be expected or believed on the basis of available evidence or logic but is neither certain nor proved. Its inclusion in the definition is intended to acknowledge that business and other economic activities occur in an environment characterized by uncertainty in which few outcomes are certain. [References omitted.]

\textsuperscript{22}Obligations in the definition is broader than legal obligations. It is used with its usual general meaning to refer to duties imposed legally or socially; to that which one is bound to do by contract, promise, moral responsibility, and so forth. It includes equitable and constructive obligations as well as legal obligations. [References omitted.]

Characteristics of Liabilities

36. A liability has three essential characteristics: (a) it embodies a present duty or responsibility to one or more other entities that entails settlement by probable future 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, and (c) the transaction or other event obligating the entity has already happened.

2. In application by the FASB, it is clear the obligation, to be a liability, is to transfer an asset of the entity and not an asset to the transferee. This point is fundamental in resolving how to distinguish liabilities from equity.
3. The definition has clarification issues very similar to those discussed with respect to the asset definition.

Probable: The footnote is widely misunderstood, and the position of the word suggests that some out-bound cash flow or other asset sacrifice must have some (unspecified) likelihood of occurrence for a liability to exist.

Future Sacrifice of Economic Benefits: Liabilities are present obligations as the definition makes clear. The future sacrifice is the possible result of the present obligation. Contingent liabilities are not liabilities. There is no present obligation if conditions in the future must be met for it to exist. The outcome of the present obligation may be uncertain, and the result could be no sacrifice of any asset.

Obligations: This term has caused the most trouble. It is clear an obligation must be present, but other phases in the characteristics of a liability suggest “little or no discretion to avoid the future sacrifice.” Many circumstances offer the potential for little or no discretion to avoid a sacrifice but do not create a present (rather than a predictable future) obligation.

Past Transaction or Events: To have a present obligation some past transaction or event must have occurred, so the notion is redundant. The phrase does help clarify that a liability is not a future obligation caused by a future event.

4. Similar to its preliminary views with respect to assets, the IASB’s Discussion Paper suggests that the liability definition can be improved by:

(a) confirming more explicitly that:
   (ii) a liability is an obligation (rather than the outflow of economic benefits that the obligation may generate).
   (iv) a liability must be capable of generating outflows of economic benefits. Those outflows need not be certain. The probability need not reach any minimum threshold before the underlying obligation meets the definition of a liability. (paragraph 2.10)
5. The result of these observations is to emphasize that a liability is a present obligation and that uncertainty in the amount of benefits transferred would be a matter of measurement. The following proposed definition attempts to accomplish this (page 7, 2013 Discussion Paper).

   (b) a liability is a present obligation of the entity to transfer an economic resource as a result of past events
   (c) an economic resource is a right, or other source of value that is capable of producing economic benefits.

6. Given that an asset is an economic resource, it is not clear whether a liability is an obligation to transfer an asset of the entity or to transfer an asset to the transferee. It does seem clear that the intention of the IASB’s Preliminary Views is that to be a liability the obligation must be to transfer an asset of the (transferor) entity.

7. Liabilities have posed difficult application issues. The Boards had great difficulty in the following circumstances:

   a) Distinguishing liabilities from business risks
   b) Explaining the notion of standready obligations. The term itself may have caused much of the problem, but the issue is very fundamental. Writing a guarantee creates a present obligation even if an outflow as a result of the guarantee is remote. The uncertainty of the payment affects measurement of the guarantee, not the existence of an obligation to honor the guarantee if called upon to do so.
   c) Analyzing some arrangements that seem to create an “economic compulsion” to take some action. Like the “little or no discretion” phrase, this notion, to many, contradicts the requirement for a present obligation.
   d) Contingent liabilities: Liabilities that are referred to as contingent frequently are not liabilities. As with assets, if the liability is contingent, it is not a liability because the existence depends on a
future event. Most items thought of as “contingent liabilities” are really liabilities with uncertain outcomes.

e) Obligations that are conditional or potentially modified by actions of the obligor.

f) Constructive or equitable obligations are identified and explained in SFAC 6 of the present Framework. The explanation is not helpful and in fact seems almost an apology because the Board recognized how difficult the concept of constructive obligation would be to apply.

40. . . . , although most liabilities stem from legally enforceable obligations, some liabilities rest on equitable or constructive obligations, including some that arise in exchange transactions. Liabilities stemming from equitable or constructive obligations are commonly paid in the same way as legally binding contracts, but they lack the legal sanction that characterizes most liabilities and may be binding primarily because of social or moral sanctions or custom. An equitable obligation stems from ethical or moral constraints rather than from rules of common or statute law, that is, from a duty to another entity to do that which an ordinary conscience and sense of justice would deem fair, just, and right—to do what one ought to do rather than what one is legally required to do. For example, a business enterprise may have an equitable obligation to complete and deliver a product to a customer that has no other source of supply even though its failure to deliver would legally require only return of the customer’s deposit. A constructive obligation is created, inferred, or construed with another entity or imposed by government. For example, an entity may create a constructive obligation to employees for vacation pay or year-end bonuses by paying them every year even though it is not contractually bound to do so and has not announced a policy to do so. The line between equitable or constructive obligations and obligations that are enforceable in courts of law is not always clear, and the line between equitable or constructive obligations and no obligations may often be even more troublesome because to determine whether an entity is actually bound by an obligation to a third party in the absence of legal enforceability is often extremely difficult. Thus, the concepts of equitable and constructive obligations must be applied with great care. To interpret equitable and constructive obligations too narrowly will tend to exclude significant actual obligations of an entity, while to interpret them too broadly will effectively nullify the definition by including items that lack an essential characteristic of liabilities.
8. It is often suggested that constructive obligations result when an entity’s action causes others to rely on the entity to undertake or continue some action. Failure to do so may create remedies for the relying party under notions of promissory estoppel. It is difficult to distinguish actions that could lead to such remedies for potential counterparties from legal obligations. Furthermore, if constructive obligations are created by mind-set, or understandings of counterparties, it is difficult to know how that can be made operational.

9. Like its preliminary views on assets, the IASB’s 2013 preliminary views on liabilities are a natural starting point to improve and clarify the liability definition. The 2013 IASB Discussion Paper also has extensive discussions concerning guidance on liability issues similar to the questions raised earlier.
1. In present Frameworks of the FASB and IASB, equity is not separately defined. SFAC 6 states that equity or net assets is the residual interest in the assets of an entity that remains after deducting its liabilities. Equity recognized is thus dependent on the assets recognized and, certainly more problematic, the liabilities recognized. Equity is also consequently dependent on whatever definition is adopted for liabilities as discussed in the previous section of this paper.

2. Distinguishing liabilities from equity has been a difficult standard-setting issue. An entity may have an obligation requiring it to deliver an asset of the entity or obligating it to deliver an equity instrument of the entity. The liability definition consequently resolves how to determine equity by resolving the question of what must an entity be obligated to do in order for the obligation to meet the definition of a liability.

3. The present IASB and FASB Frameworks requires an asset of an entity to be delivered to satisfy an obligation for the obligation to be classified as a liability. The IASB’s preliminary view is that this notion should be perpetuated. The consequence of the present requirement has created a vexatious issue that at one time, the FASB tried to resolve in connection with SFAS 150. The result of that proposed resolution was never finalized. The basic issue is that, with the present definition, if an entity has the right to settle an obligation by delivery of its own share of stock (rather than an asset of the entity), then that obligation would by definition be equity. Many found the possibility of accounts payable classified as equity to be inappropriate. The nature of the item transferred to settle an obligation at present determines the classification of the obligation. Resolving this issue is dependent on modifying the definition of a liability by concluding that all obligations irrespective of settlement alternatives are liabilities or somehow determining what form of settlement of an

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1The Basis for Conclusion of SFAS 150 indicates the FASB planned to amend SFAC 6 but that has not been done.
obligation to deliver the entity’s equity instrument should be liabilities. The latter approach has been demonstrably unsuccessful.

4. If to meet the definition of a liability the obligation must be to deliver an asset of the entity it is not clear why obligations to deliver a variable number of shares are often considered liabilities. In these instances shares of stock are what is to be delivered to settle an obligation and whether a fixed number or variable number both seem to fail the liability definition.

5. Equity instruments that would not seem to present classification issues (common stock) have also been problematic. If shares are mandatorily redeemable they have not been classified as equity. Also, shares puttable by the holder raise uncertainty as to classification particularly when required to be put in circumstances certain to occur. Of particular concern are contracts to issue shares (options written or forward contracts) when an insufficient number of shares are available for issuance. If the issuer must enter the market to acquire shares to meet issuance commitments many feel the inevitable outflow of assets to acquire shares suggest a liability should be recognized.

6. Finally forward contracts to buy or sell equity instruments of an entity are often presented gross and not net as is traditional for other forward contracts. It would also be helpful to resolve the classification of instruments such as a stock option issued in exchange for goods or services. Whether those contracts, to potentially receive equity instruments, represent a liability or an equity instrument has been contentious.

7. Some have suggested that only common stock (or the equivalent) and retained earnings should be considered equity. That is also problematic in that contracts that provide no obligation to do anything, such as a perpetual preferred stock with no obligations to pay dividends, would be recognized as liabilities. That also has been viewed by many as conceptually unacceptable.
8. That equity should be the residual that results from deducting liabilities from assets, as the IASB suggested in its Discussion Paper, seems appropriate. A definition of equity other than as a residual makes it virtually certain some instrument would seem to meet neither the liability nor the equity definition.

9. A related and equally contentious issue is whether gains and losses on settlement or redemption of equity instruments should be recognized in comprehensive income or directly in equity. Also contentious is the presentation of certain contracts as negative equity that create assets which is discussed in the presentation section of this paper.

10. Resolving the question of how to distinguish equity from liabilities will have consequences for the application of the elements Investments by and Distributions to Owners. Presumably equity instruments represent claims held by owners. As a result if, for example, preferred stock dividends were paid and preferred stocks were determined to be a liability, any dividends paid on these shares would be classified as an expense, not a distribution to owners.
Conceptual Framework: Elements—Revenue/Gains

1. Revenues are defined in SFAC 6.

78. Revenues are 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.

2. Revenues depend on increases in assets or decreases in liabilities. Revenues are distinguished from gains by defining the gain element as follows:

82. Gains are increases in equity (net assets) from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity except those that result from revenues or investments by owners.

3. Identifying what is peripheral or incidental is problematic (also discussed with respect to expenses/losses in the expense element section of this paper). In both instances, there are presentation issues including, in particular, the inclination to display gains and losses net rather than gross.

4. A more fundamental problem with respect to revenues and gains is that SFAC 5 provides special recognition criteria for those elements. The consequences of those special criteria is that assets can be received for an asset transferred or service provided but the transferor (seller) may not be allowed to credit revenue because one of the special revenue recognition criteria is not met. The result will be to credit a liability, by default, yet the definition of a liability also is not met. This conflict appears in the standards-level literature in several instances. The special criteria are described and articulated as follows:

83. Further guidance for recognition of revenues and gains is intended to provide an acceptable level of assurance of the existence and amounts of revenues and gains before they are recognized. Revenue and gains of an enterprise during a period are generally measured by the exchange values of the assets (goods or services) or liabilities involved, and recognition
involves consideration of two factors, (a) being realized or realizable and (b) being earned, with sometimes one and sometimes the other being the more important consideration.

a. **Realized or realizable.** Revenues and gains generally are not recognized until realized or realizable.\(^50\) Revenues and gains are realized when products (goods or services), merchandise, or other assets are exchanged for cash or claims to cash. Revenues and gains are realizable when related assets received or held are readily convertible to known amounts of cash or claims to cash. Readily convertible assets have (i) interchangeable (fungible) units and (ii) quoted prices available in an active market that can rapidly absorb the quantity held by the entity without significantly affecting the price.

b. **Earned.** Revenues are not recognized until earned. An entity’s revenue-earnings activities involve delivering or producing goods, rendering services, or other activities that constitute its ongoing major or central operations,\(^51\) and revenues are considered to have been earned when the entity has substantially accomplished what it must do to be entitled to the benefits represented by the revenues. Gains commonly result from transactions and other events that involve no “earning process,” and for recognizing gains, being earned is generally less significant than being realized or realizable.

5. The two criteria represent a description of practice as opposed to a concept. In most circumstances until revenues are “earned,” assets received from a customer also result in a performance liability. Much confusion has also been created by the use of terms such as deferred revenue when, in fact, a performance liability exists. As a minimum the conceptual framework project must first justify why any special criteria exist. If required, the criteria must be clear and result in answers that do not present conceptual conflicts.
Conceptual Framework: Elements—Expenses/Losses

1. Expenses are defined in SFAC 6 as follows:

80. Expenses are outflows or other using up of assets or incurrence of liabilities (or a combination of both) from delivering or producing goods, rendering services, or carrying out other activities that constitute the entity’s ongoing major or central operations.

2. The definition specifies that expenses are dependent on decreases in assets or increases in liabilities. A practical issue is to identify decreases in assets given the multi-attribute measurement system used for assets. Many expenses are the result of allocation of a portion of the cost of an asset to a particular period.

149. However, many assets yield their benefits to an enterprise over several periods, for example, prepaid insurance, buildings, and various kinds of equipment. Expenses resulting from their use are normally allocated to the periods of their estimated useful lives (the periods over which they are expected to provide benefits) by a “systematic and rational” allocation procedure, for example, by recognizing depreciation or other amortization. Although the purpose of expense allocation is the same as that of other expense recognition—to reflect the using up of assets as a result of transactions or other events or circumstances affecting an enterprise—allocation is applied if causal relations are generally, but not specifically, identified. For example, wear and tear from use is known to be a major cause of the expense called depreciation, but the amount of depreciation caused by wear and tear in a period normally cannot be measured. Those expenses are not related directly to either specific revenues or particular periods. Usually no traceable relationship exists, and they are recognized by allocating costs to periods in which assets are expected to be used and are related only indirectly to the revenues that are recognized in the same period.

3. Expense recognition becomes capturing some systematic diminution in cost or value of an asset. Presumably, if an asset ceased to exist, expense or loss would always be recognized.

4. A second issue, is the difficulty in distinguishing an expense from a loss. Losses are defined in SFAC 6 as:
83. Losses are decreases in equity (net assets) from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity except those that result from expenses or distributions to owners.

5. What is incidental or peripheral is naturally problematic, and attempts to clarify their meaning will inevitably lead to a discussion of the importance of accounting for the business model as incidental or peripheral will be entity specific.

6. As discussed with respect to revenue and gains, SFAC 6 acknowledges the difficulty in distinguishing gains and losses from revenues and expenses.

84. Gains and losses result from entities’ peripheral or incidental transactions and from other events and circumstances stemming from the environment that may be largely beyond the control of individual entities and their managements. Thus, gains and losses are not all alike. There are several kinds, even in a single entity, and they may be described or classified in a variety of ways that are not necessarily mutually exclusive.

7. As discussed in the revenue section of this paper, gains and losses are often presented net rather than gross with no identifiable concept providing a basis for that practice.

8. With respect to revenues/gains and expenses/losses it is instructive, though hardly definitive, to note the following paragraph in SFAC 6. Reading the concepts related to gains and losses leads one to conclude that the discussion is intended to be a description of present practice and not a description of a concept.

Revenues, Expenses, Gains, and Losses

87. Revenues and gains are similar, and expenses and losses are similar, but some differences are significant in conveying information about an enterprise’s performance. Revenues and expenses result from an entity’s ongoing major or central operations and activities—that is, from activities such as producing or delivering goods, rendering services, lending, insuring, investing, and financing. In contrast, gains and losses result from incidental or peripheral transactions of an enterprise with other entities and from other events and circumstances affecting it. Some gains and losses may be considered “operating” gains and losses and may be closely related to revenues and expenses. Revenues and expenses are
commonly displayed as gross inflows or outflows of net assets, while gains and losses are usually displayed as net inflows or outflows.

88. The definitions and discussion of revenues, expenses, gains, and losses in this Statement give broad guidance but do not distinguish precisely between revenues and gains or between expenses and losses. Distinctions between revenues and gains and between expenses and losses in a particular entity depend to a significant extent on the nature of the entity, its operations, and its other activities. Items that are revenues for one kind of entity may be gains for another, and items that are expenses for one kind of entity may be losses for another. For example, investments in securities that may be sources of revenues and expenses for insurance or investment companies may be sources of gains and losses in manufacturing or merchandising companies. Technological changes may be sources of gains or losses for most kinds of enterprises but may be characteristic of the operations of high-technology or research-oriented enterprises. Events such as commodity price changes and foreign exchange rate changes that occur while assets are being used or produced or liabilities are owed may directly or indirectly affect the amounts of revenues or expenses for most enterprises, but they are sources of revenues or expenses only for enterprises for which trading in foreign exchange or commodities is a major or central activity.

89. Since a primary purpose of distinguishing gains and losses from revenues and expenses is to make displays of information about an enterprise’s sources of comprehensive income as useful as possible, fine distinctions between revenues and gains and between expenses and losses are principally matters of display or reporting (paragraphs 64, 219–220, and 228).

9. The IASB Discussion Paper concludes the following with respect to distinguishing revenue from gains or expenses from losses.

2.46 If differentiating gains from revenue and losses from expenses is useful then, arguably, gains, revenue, losses and expenses should each be defined as separate elements. However, in order to do this it would be necessary to define more clearly the differences between these four items. Among other things, this would require the IASB to define ordinary activities. The IASB believes that the process of deciding whether to distinguish these four items would be best carried out in a project to review Standards on financial statement presentation and not in a project to revise the Conceptual Framework. Consequently, the IASB intends to leave the discussion of gains, revenue, expenses and losses largely unchanged.
10. It would appear the IASB has concluded these distinctions are a matter of presentation and that presentation is a standards-level issue and not conceptual.
Conceptual Framework: Recognition

1. There was no substantive discussion of recognition or the need for any recognition criteria when work on the joint Framework was in process. Element definitions were thought to be more important to the joint project deliberation, and recognition discussions were deferred. SFAC 5 defines recognition as follows:

   6. Recognition is the process of formally recording or incorporating an item into the financial statements of an entity as an asset, liability, revenue, expense, or the like. Recognition includes depiction of an item in both words and numbers, with the amount included in the totals of the financial statements. For an asset or liability, recognition involves recording not only acquisition or incurrence of the item but also later changes in it, including changes that result in removal from the financial statements. [Footnote omitted.]

2. SFAC 5 specifies four fundamental recognition criteria are required:

   63. An item and information about it should meet four fundamental recognition criteria to be recognized and should be recognized when the criteria are met, subject to a cost-benefit constraint and a materiality threshold. Those criteria are:

      Definitions—The item meets the definition of an element of financial statements.

      Measurability—It has a relevant attribute measurable with sufficient reliability.

      Relevance—The information about it is capable of making a difference in user decisions.

      Reliability—The information is representationally faithful, verifiable, and neutral.

All four criteria are subject to a pervasive cost-benefit constraint: the expected benefits from recognizing a particular item should justify perceived costs of providing and using the information. Recognition is also subject to a materiality threshold: an item and information about it need not be recognized in a set of financial statements if the item is not large enough to be material and the aggregate of individually immaterial items is not large enough to be material to those financial statements.
3. The criteria and their explanatory guidance are potentially problematic. The need to meet the definition of an element for recognition, seems unassailable. Criterion 2 to be measured with “sufficient reliability”, raises two questions. Is reliability, in this context, as now explained in SFAC 8 an element of representational faithfulness or is it intended to mean verifiable or a level of precision? If the latter, it is why the term was subsumed in representational faithfulness in SFAC 8. It is also unclear what is intended by the modifier “sufficient.”

4. Relevance also seems unassailable and the materiality constraint seems consistent with the SFAC 8 conclusion that is a matter of relevance.

Materiality

QC11. Information is material if omitting it or misstating it could influence decisions that users make on the basis of the financial information of a specific reporting entity. In other words, materiality is an entity-specific aspect of relevance based on the nature or magnitude or both of the items to which the information relates in the context of an individual entity’s financial report. Consequently, the Board cannot specify a uniform quantitative threshold for materiality or predetermine what could be material in a particular situation.

5. However, while materiality itself is agreed to be a component of relevance the explanatory language with respect to materiality seems potentially problematic. At the concept level the notion that individually immaterial items can, if aggregated, become material seems clear but is not consistent with the basis for conclusions or the application of recent standards-level decisions. The SFAC 2 conclusion that materiality is not a standard-setting issue but a standards application issue does not seem to be helpful in resolving this issue.

6. The last criterion (reliability) is curious in that the word there seems to be used as intended in SFAC 2 and as clarified in SFAC 8. However, as previously asked does the word when used with respect to measurability mean the same? Either the word means different things or the two criteria would be redundant. SFAC 5 paragraph 65
states that “measurability must be considered together with both relevance and reliability.”

7. SFAC 5 also contains special recognition criteria for revenue and gains. As discussed in more detail in the section of this paper that considers the revenue and gains elements this separate guidance is problematic and produces answers that create fundamental conflicts with element definitions. The most difficult area may well be to resolve whether, in fact, “special” revenue recognition criteria are necessary and perhaps that should be a standards level issue.

8. The IASB Discussion Paper does not help in conceptually resolving recognition issues. The IASB’s preliminary view is as follows:

The 2013 IASB’s preliminary view on recognition is that an entity should recognise all its assets and liabilities, unless the IASB decides when developing or revising a particular Standard that an entity need not, or should not, recognise an asset or a liability because:

(a) recognising the asset (or the liability) would provide users of financial statements with information that is not relevant or is not sufficiently relevant to justify the cost; or
(b) no measure of the asset (or the liability) would result in a faithful representation of both the asset (or the liability) and the changes in the asset (or the liability), even if all necessary descriptions and explanations are disclosed.

9. It is not clear without further guidance on when recognition of an asset or liability would ever not be relevant, unless the amount is immaterial. In addition, notions of “sufficient” relevance do not seem to be operational. Certainly, there may be some asset or liability that can’t be measured in a representationally faithful way but even that conclusion may be debated. The underlying issue may be element uncertainty (existence) and not measurement uncertainty, and that should be explored.

10. The IASB view appears to apply only to assets and liabilities. Recognition also needs to address gain and loss recognition and the (b) criterion may imply no gain or loss would be recognized if a representationally faithful measure is not achievable.
11. Option contracts and forward contracts present potential recognition issues. An option held is an asset and is usually accounted for as such. The underlying to which the option holder has a right is not recognized until (if) the option is exercised. Written options are liabilities. The result of having written an option can be beneficial, and the option writer hopes the option will be exercised by the holder. In these circumstances, distinguishing an offer to sell from an enforceable option can be problematic. Can a written option ever be an asset? Similarly, an option held is an asset. However, options held may result in asset sacrifices (think of renewal options held by the lessee) that many seem to believe should be liabilities. Whether a contract creating an asset (right) can be thought of as a liability or a contract creating a liability (obligation) can be thought of as an asset is fundamental to certain current accounting issues.

12. Forward contracts typically do not result in recognition of the underlying subject to the contract until the forward contract is exercised. Whether forward contracts create assets and liabilities to be separately recognized is considered in the presentation section of this paper.

13. The fundamental recognition concept issue is whether any criteria are needed other than the recognized item meeting the definition of an element. Those that find that threatening are perhaps concerned with remeasurement and resulting income statement effects. The desire for any recognition criteria, other than to meet an element definition, may be a concern for income statements effects and that must be resolved.

14. Concerns are at times expressed about element uncertainty, meaning uncertainty about existence of an element. Those concerns usually are about assets or liabilities. Whether the concerns are really about uncertainty as to whether an ambiguous definition of the element is met or uncertainty as to whether a right or obligation is even present is often not clear. The circumstances as to when an entity would not
know whether it had an asset would seem rare. It is easier to see uncertainty with respect to a liability with litigation being an obvious example.

15. Existence uncertainty might be an aspect of recognition criteria. For example, should an entity meet some probability threshold as to whether a known right or known obligation is that of the reporting entity? Also, should that threshold differ depending on whether the uncertainty relates to an asset or gain or an expense or loss.

16. Existence of an element can also be a question of whether a gain or loss exists. In a circumstance when an entity has recognized an asset or a liability, whether the value did or did not change determines whether a gain or loss has occurred. Measurement uncertainty or inability in these cases may make gain or loss recognition problematic.

17. Concerns about asset and liability recognition are sometimes expressed as a desire to present risks and rewards. Risks and rewards are not assets or liabilities. They are the result or outcome of having assets and liabilities. Accounts receivable represent a right to collect cash. There is risk the cash will not be collected. If you wrote a guarantee for a portfolio of receivables, as a guarantor you are subject to the credit risk in the receivables. To record the receivables to present the credit risk is not credible because the guarantor has no right to any cash collection from the receivables. This argument about risk and rewards is typically confusion about potential flows that may or may not be the result of present rights or obligations. Risk and rewards seem to refer to the ex ante assessment of the potential outcomes that may occur from having an asset or liability and thus maybe indicative of having an asset or liability but the risk or reward is not the asset or liability. Clarification of the asset and liability definitions should help explain this distinction. However, recognition and derecognition discussion in the Framework would help define some of these issues.
Conceptual Framework: Derecognition

1. Derecognition is not addressed in the FASB’s Framework. The closest the Framework comes to the subject is in the last sentence of paragraph 6 of SFAC 5.

   6. Recognition is the process of formally recording or incorporating an item into the financial statements of an entity as an asset, liability, revenue, expense, or the like. Recognition includes depiction of an item in both words and numbers, with the amount included in the totals of the financial statements. For an asset or liability, recognition involves recording not only acquisition or incurrence of the item but also later changes in it, including changes that result in a removal from the financial statements.

2. The issue of derecognition has long been a long and difficult issue at the standards level. All the following have addressed derecognition in some manner:

   - SFAS 76  Extinguishment of Debt
   - SFAS 77  Reporting by Transferors for Transfers of Receivables with Recourse
   - SFAS 125 Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities
   - SFAS 140  (Same as 125)
   - SFAS 166 Accounting for Transfers of Financial Assets

3. Other standards-level derecognition efforts have involved sales of real estate, sale and leaseback transitions, repurchase activities, as several issues involving revenue recognition. While all the issues ultimately address the removal from the balance sheet of an asset, or extinguishing a liability, the motivation for the standards-level activity has often been the prohibition of gain, loss, or revenue recognition.

4. To illustrate the frustration of the issue, both the assenters and the dissenters to SFAS 76 and 77 justified their respective positions in terms of the Framework. Special recognition criteria in SFAC 5 for revenue and gains are a significant further complication as previously noted in the recognition discussion and the discussion of the element definitions of revenue and gains.
5. What is fundamental to the problem is actually very simple to discuss—if recognition requires meeting the definition of an element, derecognition must (should) occur when an element fails the definition or a conflict of concept will always exist. If an item that once met the definition of the element but no longer does continues to be recognized, an element now failing the definition will continue to be recognized. There would seem to be no conceptual basis for this result and would seem to violate faithful representation.

6. Option and forward contracts present special derecognition issues. When one holds an option, or is party to a forward contract, to acquire an underlying item the item is not recognized until the option is exercised. (See the discussion of forward and option contracts in the recognition section of this paper.) However, if an item is sold and an option or forward to reacquire the item is held by the seller, the item is typically judged not to have been sold and thus not derecognized. As a result, the underlying subject to an option or forward is thought to be retained, if once held, but not thought to be obtained if not previously held.

7. The FASB and IASB’s standards-level history of debating derecognition has often polarized around notions said to be based on control or alternatively notions of risks and rewards. As discussed in the section of this paper concerning definitions of assets and liabilities, these discussions are not helpful. Risks and rewards are the result of having assets and liabilities but are not assets and liabilities. These discussions have usually been around continuing involvement in an asset or liability and result in conclusions based on path dependency or “stickiness.” The 2013 IASB Discussion Paper is not very helpful:

The existing Conceptual Framework does not address derecognition. The IASB’s preliminary view is that an entity should derecognise an asset or a liability when it no longer meets the recognition criteria. However, for cases in which an entity retains a component of an asset or a liability, the IASB should determine, when developing or revising particular Standards how the entity would best portray the changes that resulted from the transaction. Possible approaches include:
(a) enhanced disclosure;
(b) presenting any rights or obligations retained on a line item that is different from the line item used for the original rights or obligations, to highlight the greater concentration of risk; or
(c) continuing to recognise the original asset or liability and treating the proceeds received or paid for the transfer as a loan received or granted.

8. The (c) alternative results in recognizing an item that fails to meet the definition of an asset or liability and brings about the conceptual contradiction that a well-developed framework would avoid.
Conceptual Framework: Measurement

1. As indicated in the recognition discussion, “a recognized item is depicted in both words and numbers.” The number selected to depict the item in numbers is thought of as measurement. The FASB concluded in SFAC 5 that:

   66. Items currently reported in financial statements are measured by different attributes, depending on the nature of the item and the relevance and reliability of the attribute measured. The Board expects the use of different attributes to continue.

2. The Board then describes five different measurement attributes that are said to be used in present practice. It is debatable that all five can accurately be called an attribute of measurement because it is unclear what is the qualifying characteristic of a “measurement attribute” as opposed to a calculation or selection of a number. SFAC 5 describes, “Present (or discounted) value of future cash flows,” as an attribute. However absent a basis for selecting a discount rate this only represents a calculation methodology with no discernible measurement objective. Furthermore, SFAC 5 indicates that having concluded multiple attributes will continue, it “discusses how the Board may select the appropriate attribute in particular cases.” The Concepts Statement does not even attempt to accomplish that objective. It does describe what attributes have been applied in certain circumstances. It gives no indication of whether that application is desirable or undesirable.

3. Many will conclude that a Concepts Statement on measurement will be a failure if it does not conclude that a single attribute is appropriate. Others believe that a multiple-attribute system is not only desirable but essential. As a practical matter, it seems unlikely the Board would select a single attribute even if it was convinced that was the appropriate conclusion. Assuming that a multiple measurement attribute model is to continue, then determining what criteria should be used to select among alternative attributes is essential to a concept on measurement.
4. That approach represents the IASB’s preliminary view.

The IASB’s preliminary views on measurement are that:

(a) the objective of measurement is to contribute to the faithful representation of relevant information about:

(i) the resources of the entity, claims against the entity and changes in resources and claims; and

(ii) how efficiently and effectively the entity’s management and governing board have discharged their responsibilities to use the entity’s resources.

(b) a single measurement basis for all assets and liabilities may not provide the most relevant information for users of financial statements.

(c) when selecting which measurement to use for a particular item, the IASB should consider what information that measurement will produce in both the statement of financial position and the statement(s) of profit or loss and OCI.

(d) the relevance of a particular measurement will depend on how investors, creditors and other lenders are likely to assess how an asset or a liability of that type will contribute to future cash flows. Consequently, the selection of a measurement:

(i) for a particular asset should depend on how that asset contributes to future cash flows; and

(ii) for a particular liability should depend on how the entity will settle or fulfill that liability.

(e) the number of different measurements used should be the smallest number necessary to provide relevant information. Unnecessary measurement changes should be avoided and necessary measurement changes should be explained.

(f) the benefits of a particular measurement to users of financial statements need to be sufficient to justify the cost.

5. Factor (d) suggests an intent-based (business model based) selection and purports to know ex ante how an asset will in fact contribute to further cash flows.
6. The 2013 IASB approach seems logical if multiple attributes are to be maintained. However, the breadth of the problem in trying to narrow the alternatives is significant. The IASB discusses “cost based measurements, current market prices, including fair value; and other cash-flow based measurements.” Given there are perhaps dozens of “cost based” measurements, several current market-price-related measures and many different cash-flow-based measurements (at a minimum the measure is different depending on which interest rate is selected to discount the cash flows), the task of narrowing alternatives is formidable.

7. With respect to cash-flow-based measurements, SFAC 7 should be instructive. However, SFAC 7’s use of expected values of cash flows is primarily as a tool to meet a fair value measurement objective, based on estimated cash flows, and not helpful in selecting a measurement objective.

8. Given the many different applications of the different measurements now used in practice, narrowing alternatives may not be possible at the concepts level. A more reasonable goal may be to try and distinguish measurement objectives and relate these objectives to the objective of financial reporting and qualitative characteristics of decision useful information.

9. At the standards level, fair value has been defined (SFAS 157) as an exit price. That definition seems very similar to current market value in SFAC 5. Minimizing potential confusion in terms, value as differentiated from price, for example, may be a useful exercise.

10. Measurement of liabilities has presented various divisive issues. At a minimum, clarifying that a change in the price of credit, for a given level of credit quality, is a real phenomenon that can be unrelated to entity-specific factors such as the entity’s credit quality would be helpful.
11. The IASB measurement chapter discussed the objective of alternative measures, which should be the appropriate focus. The danger in looking at objectives of measurement is that many will want to describe the measurement objective to be to depict “the business model.” That, of course, will be controversial and raise comparability and other concerns, which have been discussed elsewhere in this paper.
Conceptual Framework: Unit of Account

1. *Unit of account* is a phrase used to describe several different things. Fundamentally it applies to recognition and measurement as well as presentation. The FASB Accounting Standards Codification defines unit of account as “that which is being measured by reference to the level at which an asset or liability is aggregated (or disaggregated).” The IASB glossary defines the same term as “the level at which an asset or a liability is aggregated or disaggregated in an IFRS for recognition purposes.” One Board suggests that unit of account is a measurement issue; the other describes it as a matter of recognition. This may not be of significant consequence given that something must be measured to be recognized, but whether or not the difference is intended should be resolved. The IASB’s preliminary view in the Discussion Paper is as follows: the “unit of account will normally be decided when it develops or revises particular Standards and that, in selecting a unit of account, it should consider the qualitative characteristics of useful information.”

2. At a minimum, with respect to the unit of account, there would seem to be several issues that need resolution whether they are thought to be a matter of recognition, measurement or presentation. For example, is the unit of account issue intended to apply to all of the following circumstances:

   a) Only 1X or 1,000X or may several X and several Y be combined?
   b) Must all items combined be assets or liabilities or may assets and liabilities be combined?
   c) Must each and every item aggregated each meet the definition of either an asset or a liability?
   d) What would be the basis for disaggregating an asset or a liability?

3. Unit of account from an aggregation standpoint has been discussed by both Boards and their respective interpretive bodies. In these circumstances, the consideration has typically been about when individual transactions or contracts should be combined. That discussion has been referred to as concerning linkage. Among the criteria usually considered for when transactions or contracts might be linked are:
a) Transactions or contracts are with the same counterparties (or are structured through an intermediary).
b) The transactions are entered into in contemplation of one another.
c) Transactions are based on a business model or commercial purpose.
d) The transactions share at least one underlying.
e) Transactions are entered into contemporaneously.
f) Transactions that have been separated for no discernible purpose other than to change the accounting.

4. Whatever criteria are agreed to for combining/linkage, it is important that this issue be resolved. If criteria are agreed to, whether the correct concept should be required or merely an option would probably be a standards-level issue.

5. Standards-level discussions concerning disaggregation have frequently concerned separating a derivative from a cash instrument asset or liability. The process of separating (bifurcating) the derivative portion of a contract has generally been driven by a desire to measure the separate pieces of a single contract by different attributes.

6. Unit of account notions also have been used to describe separate recognition of assets and liabilities created by a single contract (or group of contracts). For example, a bank deposit liability can be thought of as a liability for the deposited amount and a separate asset for the customer relationship asset created by the deposit. Alternatively, it can be agreed that the bank deposit amount represents an attractive (perhaps zero) interest rate in the deposit and not a customer relationship. In that approach, the advantageous interest rate is a benefit that would be impounded in the liability measure. At the present time there is no conceptual basis for resolving such debates.

7. Combining, for example, 1,000 explicit contracts with individuals to pay a pension recognized as a single liability seems to have not been controversial. Clearly it is easier to estimate and therefore measure the consequences of 1,000 contracts than to estimate or measure an identical promise in a single contract and then multiply that amount by 1,000. The combination of unlike items such as distinct assets is more problematic.
8. Combining assets and liabilities is even more difficult and perhaps more consequential. Measurements of asset and liabilities would always be distinct unless the credit risk of the entity is ignored. Credit risk in an asset of an entity is not, of course, the credit risk in any liability of that entity except by accident.

9. Combining assets or liabilities that might be similar but not the same raises conceptual measurement issues. In measuring inventory, at LOCOM, for example, some individual items have a value greater than cost and, as prices change, some have less. The measure of the individual items or the measure of the inventory as a whole is a much different amount. These issues have long been resolved at the standards level with no apparent agreed upon conceptual basis.

10. Some standards-level issues have been said to have been resolved on the basis of recording the “contract as a whole.” This approach raises the question of whether contract provisions that would not meet the definitions of assets and liabilities can be measured together with assets and liabilities. Some believe that this is just a “netting” or presentation issue. While separate presentation of items that fail asset or liability definitions would not be permitted, a net amount of these items has been proposed as long as that net amount appears to meet the definition of an asset or a liability.

11. This net notion raises additional unit of account issues. Does writing an option (by definition a liability) ever meet the definition of an asset? Does holding an option (by definition an asset) ever give rise to an obligation that meets the definition of liability? These conclusions are supported in current standards-level projects and justified by unit of account or “whole contract” notions.
Conceptual Framework: Presentation

1. No consideration of any broad concepts of presentation has been attempted except in connection with the MOU project Financial Statement Presentation. It would seem that a detailed analysis of the results of the long debates in the Financial Statement Presentation project should be undertaken as soon as possible. Presentation may well include the most precedential issues. Intellectually, presentation is distinct from all other issues. Practically and politically, both inside and outside the Board, presentation issues often seem to be determinative in resolving recognition and measurement issues.

2. When presentation issues may impede resolution of other issues, it has been noted elsewhere in this paper. For example, is recognition of the element of either gain or loss influenced by where the element would be presented in a statement of comprehensive income? The first step in developing presentation concepts is to learn from the Board’s immediate past while recollections are sharp and staff experienced with the issue are still present.

3. There is a high likelihood of international and IASB concerns over any FASB presentation deliberations. The 2013 IASB Discussion Paper focuses on other comprehensive income and the need for recycling. The analysis in that Discussion Paper seems to lead to a justification and perpetration of the status quo which to many has not been acceptable.

The IASB’s preliminary views are that:

(a) the Conceptual Framework should require a profit or loss total or subtotal that also results, or could result, in some items of income or expense being recycled; and

(b) the use of OCI should be limited to items of income or expense resulting from changes in current measures of assets and liabilities (remeasurements). However, not all such remeasurement would be eligible for recognition in OCI. Section 8 discusses two approaches that could be used to define which remeasurements might be included in OCI.
4. Profit or loss is not defined (and, may therefore, be awkward as an element) but is the default category for items in comprehensive income that do not qualify for other comprehensive income (OCI). The emphasis is on what is (1) “other” and (2) whether items in OCI need be recycled. The alternative approaches discussed, seem to be based on a desire to be sure to include certain items than to develop a concept for distinct presentation and why, if distinct, the items should be recycled.

5. Even if broad presentation concepts can’t be developed, resolving these issues should be considered of substantive importance.

1) Should a single statement of comprehensive income be required?
2) Should net income be defined as an element and required as a subtotal in a statement of comprehensive income?
3) Is recycling ever appropriate or is it always appropriate?
4) Is the statement of comprehensive income a matter of applying notions of accounting for the business model?

6. Perhaps most fundamental is the need to define net income (net earnings, profit or loss). If items fail to meet criteria to be included in net income how their presentation by default in the statement of comprehensive income could be left to a standards-level decision. Whether net income is dependent on the “business model” of an entity is an inevitable debate. It does seem if net increase is so important it should be defined and the default position seems other comprehensive income. This is of course the opposite of present practices.

7. Presentation issues with respect to transactions involving an entity’s own equity instrument (however defined) raise presentation issues. Whether limited to presentation or related to other conceptual concerns, it is important to resolve:
1) Why options held to acquire an entity’s equity (an asset) are displayed as negative equity?

2) Why remeasurements of forward contracts to buy or issue equity instruments (if remeasured) are recognized in equity and not in comprehensive income?

8. Other presentation issues involve whether the presentation is net or gross. A gain or loss on sales of certain assets is presented net in comprehensive income. Discontinued operations including the ultimate disposition of the activity are presented net. All of these issues are related to the presentation of comprehensive income.

9. Balance sheet presentation issues also involve net on gross presentation. At the standards level, net presentation (offsetting) has been troublesome, with no apparent conceptual basis for resolution. In particular, forward contracts (executory contracts) are usually presented net. At inception they are typically thought to have zero value and as prices in the underlying item change, an asset or liability is recognized. The conceptual basis for the treatment needs to be resolved.

10. Johnson & Storey explore alternatives to the normal accounting for forward contracts that needs consideration.

Because each party obtained a right by incurring an obligation, the rights and obligations may be said to be equal to each other. That is, the sacrifice made to obtain the right was the incurrence of the obligation. However, simply because they are equal to each other does not lead to the conclusion that they are necessarily offsetting. For a contracting party to be able to offset a right against an obligation, either (a) both would have to be cancelable at his or her behest or (b) the other party would have to agree to mutual cancelation. Neither condition generally applies to sale-purchase contracts.

Case (a) is not possible because only the rights but not the obligations are cancelable. Case (b), while possible, is highly unlikely. No one would seek cancellation of a contract unless it were unfavorable. However, the same conditions that make it unfavorable to one party make it favorable to the party whose agreement must be obtained to cancel. Because a rational person would not be likely to give up something of value, it is unlikely
that one party would agree to cancel a favorable right so that the other party could be relieved of an unfavorable obligation.

Because the necessary conditions are not present, the rights and obligations in sale-purchase contracts, while equal, should not generally be regarded as offsetting. As a consequence, the rights and obligations should be recognized as assets and liabilities in the same manner as those arising in one-sided option-commitment contracts such as puts and calls. [FASB Research Report, Recognition in Financial Statements: Underlying Concepts and Practical Consequences, page 248]
Conceptual Framework: Disclosures

1. The FASB has an active disclosure framework project on the agenda. That project should be used to develop any Conceptual Framework document and that has been the intent. It seems premature to make comments about disclosure because the ongoing deliberations will result in identifying unresolved concept-level issues.

2. Comments from the IASB leadership suggest that the area may become problematic if convergence is to be an objective. The FASB objective of the disclosure framework project has been to improve disclosures to better meet the objectives of financial reporting. Of concern is the international inclination to view disclosure as a matter of “overload,” which may well conflict with improvement.