In Chapter 6, we examined a number of committee reports and documents emanating from the American Institute of Certified Public Accountants (AICPA), Accounting Principles Board (APB), and the American Accounting Association (AAA). The chronology of these documents is extremely important. The first one (ASOBAT, *A Statement of Basic Accounting Theory*) appeared shortly after ARSs 1 and 3 (the Moonitz and Sprouse and Moonitz postulates and principles studies) and the last one (SATTA, *Statement of Accounting Theory and Theory Acceptance*) appeared just prior to publication of the first part of the conceptual framework. Since all of the Chapter 6
documents became available just prior to the FASB’s conceptual framework project, they played an important role in its development.

There are two important points to keep in mind as we examine the contents of the conceptual framework. First, the project can be viewed as an evolutionary document with important parts drawing heavily on the works just discussed. Second, while much criticism can (and will) be directed toward the conceptual framework, the document can be improved so that it may yet provide a sound underpinning for future accounting standards.

The conceptual framework consists of eight different statements. Statement No. 7 came out in 2000, 15 years after Statement No. 6, then Statement No. 8 was not published until a decade later. Each of these eight parts is referred to as a statement of financial accounting concepts (SFAC), and our discussion of these parts proceeds chronologically. The eight SFACs and the year of publication by the FASB are:

**Statements of Financial Accounting Concepts:**

- No. 1. OBJECTIVES OF FINANCIAL REPORTING BY BUSINESS ENTERPRISES (SFAC No. 1) 1978
- No. 2. QUALITATIVE CHARACTERISTICS OF ACCOUNTING INFORMATION (SFAC No. 2) 1980
- No. 3. ELEMENTS OF FINANCIAL STATEMENTS OF BUSINESS ENTERPRISES (SFAC No. 3) 1980
- No. 4. OBJECTIVES OF FINANCIAL REPORTING BY NONBUSINESS ORGANIZATIONS (SFAC No. 4) 1980
- No. 5. RECOGNITION AND MEASUREMENT IN FINANCIAL STATEMENTS OF BUSINESS ENTERPRISES (SFAC No. 5) 1984
- No. 6. ELEMENTS OF FINANCIAL STATEMENTS; a replacement of FASB Concepts Statement N. 3, also incorporating an amendment of FASB Concepts Statement No. 2 (SFAC N. 6) 1985
- No. 7. USING CASH FLOW INFORMATION AND PRESENT VALUE IN ACCOUNTING MEASUREMENTS (SFAC No. 7) 2000
- No. 8. CONCEPTUAL FRAMEWORK FOR FINANCIAL REPORTING, a replacement of SFAC No. 1 and No. 2 2010

In this chapter, we provide a chronological overview of the SFACs and discuss some of the potential problem areas. These include problems between two of the objectives and the question of whether representational
faithfulness or economic consequences (Chapter 4) should dominate in the standard-setting process. We close by examining some philosophical orientations to a conceptual framework and mention empirical research pertaining to the conceptual framework. Before proceeding to the details of the conceptual framework, we start by mentioning the discussion memorandum that preceded all of the above statements.¹

**The FASB’s Conceptual Framework**

The conceptual framework is supposed to embody “a coherent system of interrelated objectives and fundamentals that can lead to consistent standards and that prescribes the nature, function, and limits of financial accounting and financial statements.”² The conceptual framework is an attempt to provide a metatheoretical structure for financial accounting. The project now includes eight statements of financial accounting concepts, initiated by an important discussion memorandum.

**Discussion Memorandum**

A discussion memorandum is, of course, not the end product of the FASB’s deliberations. However, the initial discussion memorandum for the conceptual framework was a massive study, perhaps the most extensive ever published by the FASB. In addition, it was widely disseminated and publicized. The discussion memorandum was accompanied by another document pertaining to tentative conclusions of the Trueblood Report on objectives.³ This latter report accepted the Trueblood Report’s user orientation and emphasis on cash flows but added little more of substance to the report.

The discussion memorandum brought up two new basic issues: (1) new views of financial accounting and orientations to the financial statements (discussed in Chapter 11), and (2) an outline of the various approaches to capital maintenance. In both cases, in order to elicit responses from the profession, the memorandum attempted to show the various alternatives and possibilities open for adoption. In addition, it presented various definitions for such basic terms as assets, liabilities, revenues, expenses, gains, and losses—along with a discussion of qualitative characteristics of financial statements.

The most important new issue presented in the document is capital maintenance. Chapter 2 notes that this concept is concerned with how earnings are measured in terms of maintaining intact the firm’s capital (assets minus liabilities) existing at the beginning of the period. This is an important
problem that should be given a very prominent place in the normative objectives of a metatheoretical structure. It was not considered extensively, if at all, in any of the other documents discussed in Chapter 6.

**Statements of Financial Accounting Concepts**

The SFACs constitute the finished portion of the conceptual framework project. These statements are analogous to APB Statement 4 in one respect: Like that document, these statements do not establish generally accepted accounting principles (GAAP) and are not intended to invoke Rule 203 of the Rules of Conduct of the AICPA (which prohibits departures from GAAP). This weakness may be disappointing, but it nonetheless provides some important benefits. First of all, the possibility of a crisis arising from a failure to comply with the statements is avoided. Second, the process of arriving at a workable and utilitarian metatheoretical-type structure must be acknowledged as a slow, evolutionary process.

**Statement No. 1**

SFAC No. 1\(^4\) is concerned with the objectives of business financial reporting. Its overall purpose is to provide information that is useful for making business and economic decisions (para. 9). The statement is a direct descendant of the Trueblood Report and is generally a boiled-down version of that report, with some necessary value judgments as well as some redundant statements scattered throughout. SFAC No. 1 reiterates the user orientation of the documents reviewed in Chapter 6.

Although it acknowledges the heterogeneity of external user groups, it states that a common core characteristic of all outside users is their interest in the prediction of the amounts, timing, and uncertainties of future cash flows. Hence, SFAC No. 1 maintains that financial statements must be general purpose in nature rather than geared toward specific needs of a particular user group, although investors, creditors, and their advisers are singled out among external users.\(^5\)

While it is difficult to tell what changes might have occurred, if any, a broader user focus embracing customers, employees, and the general public might have given the Board a broader outlook. The report also takes the position that it is assumed that users of financial statements are knowledgeable about financial information and reporting, an apparent departure from the Trueblood Report’s statement assuming “limited ability” of users. (We already noted the potential qualification of the literal meaning of that phrase in Chapter 6.) As in the Trueblood Report, users are assumed to have limited authority.
The FASB’s Conceptual Framework

The statement also notes the importance of stewardship in terms of assessing how well management has discharged its duties and obligations to owners and other interested groups. The notion of stewardship goes beyond the narrow interpretation of proper custodianship of the firm’s resources and moves toward accountability, a preferable term.

Several important value judgments are made throughout the report:

- Information is not costless to provide, so benefits of usage should exceed costs of production.
- Accounting reports are by no means the only source of information about enterprises.
- Accrual accounting is extremely useful in assessing and predicting earning power and cash flows of an enterprise.
- The information provided should be helpful, but users make their own predictions and assessments.

Finally, the document does not specify what statements should be used, much less what their format should be. It does mention, however, that financial reporting should provide information relative to the firm’s economic resources, obligations, and owners’ equity (para. 41). Also discussed is how firm performance is provided by measurements of earnings and its components (para. 43) as well as how cash is acquired and disbursed (para. 49). Hence, SFAC No. 1 is an extremely cautious invocation of the Trueblood Committee objectives and it maintains a high level of generality.

Statement No. 2 (subsequently replaced by SFAC No. 8)

SFAC No. 2 deals with qualitative characteristics of accounting information. The term qualitative characteristics is used in APB Statement 4, but the concepts discussed here proceed directly from ASOBAT. Exhibit 7.1, which comes from SFAC No. 2, best illustrates the document.

Decision makers stand at the apex of the diagram, a position indicative of the orientation of the financial accounting function to serve the decision needs of users. With regard to users, SFAC No. 1 previously established that financial statements should be aimed at a common core of similar information needs. Users are also presumed to be knowledgeable about financial statements and information; hence, understandability is recognized in Exhibit 7.1 as a “user-specific quality.” However, even if users are assumed to be knowledgeable, information itself can have different degrees of comprehensibility. The quality of understandability is a characteristic influenced by
both users and preparers of accounting information. Listed above understandability is the pervasive constraint that benefits of financial information must exceed its costs. The importance of this idea is shown by its place on the diagram. The specific qualitative characteristics of accounting that SFAC No. 2 enumerates come under the general heading of “decision usefulness,” which simply continues the emphasis on decision makers and their needs. Before discussing the two principal qualities of relevance and reliability, the pervasive constraint of requiring benefits to be greater than costs needs to be further discussed.

Benefits Greater Than Costs

The pervasive constraint that benefits are greater than costs stems from information economics. Although it is a very necessary component of a conceptual framework, it is perhaps the most difficult part of the conceptual framework to apply in practice. It is virtually impossible to get a solid, quantifiable handle on the various costs and benefits. Moreover, there is an important question in terms of how far the net should be cast over the numerous costs of information that are considered or included.

The benefits of accounting information are represented primarily by the utility of the information for the various user groups—centering on investors and creditors—in the decision-making process. Thus, the benefits pertain to how useful the accounting information is relative to predictive and accountability objectives.

The direct costs of information pertain to gathering, preparing, and disseminating information. A good example was provided by SFAS No. 33, Financial Reporting and Changing Prices, which required certain additional disclosures in the form of general price-level adjusted information and current value (replacement cost) information. To produce this information, firms generally have to obtain consumer price indexes and appropriate specific price indexes, if direct measurements cannot be made. Numerous calculations are required along the lines illustrated in Appendix 1-A. The state of current information technology makes the cost of information production relatively low but not necessarily trivial. For example, pension and other postretirement calculations can be extremely complex and, therefore, costly to perform.

There are two indirect costs of information that immediately come to mind. Published information may contribute to a competitive disadvantage. SFAS No. 131 on segmental reporting, for example, required disclosures pertaining to the profitability of product lines, territories, and major customers for many firms. This information can obviously be quite useful for
Exhibit 7.1 A Hierarchy of Accounting Qualities

Users of Accounting Information

Pervasive Constraint

Benefits > Costs

Decision Makers and Their Characteristics
(for example, understanding or prior knowledge)

User-Specific Qualities

Primary Decision-Specific Qualities

Ingredients of Primary Qualities

Secondary and Interactive Qualities

Threshold for Recognition

Materiality

SOURCE: FASB Concepts Statement No. 2, Qualitative Characteristics of Accounting Information, page 15. FASB material is copyrighted by the Financial Accounting Foundation, 401 Merritt 7, Norwalk, CT 06856, USA, and is reproduced with permission.
competitors, although the traffic is likely to flow in both directions on this issue. A more graphic example of this problem pertains to SFAS No. 5 on loss contingencies. If an enterprise is having legal problems with a customer and a loss is both “probable” and the amount of the loss can be “reasonably estimated,” then the firm is required to make the appropriate entries. However, booking the loss in this fashion is a virtual admission of guilt that could, in effect, be a self-fulfilling prophecy.

Another indirect cost pertains to the understandability of information that is listed as a separate qualitative characteristic. Most evidence indicates that the additional disclosures required by SFAS No. 33 were not well understood by users. Since the information was relatively costly to produce, the pervasive constraint was not met because the benefits were negated owing to the lack of understandability. Another problem that arises here concerns information overload: the ability of individuals and the market to absorb and use information. Notice that the pervasive constraint goes beyond the firm itself when understandability is factored into the pervasive constraint equation.

The benefits and the costs of information, both direct and indirect, involve economic consequences, which are discussed in Chapter 4. Many other economic consequences of accounting information arise that are extremely difficult to evaluate. Some are quite legitimate and desirable. For example, the intention of SFAS No. 106, *Employers’ Accounting for Post-retirement Benefits Other Than Pensions*, is to book postretirement health care costs of employees as they accrue rather than handling these costs on a cash basis, as was done prior to the standard. We can certainly make a good case that this is useful information for predictive or accountability purposes for all user groups. However, a valuation problem arises: Should we value the expense and liability at currently existing costs or attempt to estimate what the costs will be when they are actually incurred (discounting to present value is appropriate in both cases)? If we use future costs, which are most likely considerably higher than present costs, several consequences are possible:

1. Management bonuses might be adversely affected if they are based on reported income.

2. The evaluation of management’s accountability might be downgraded owing to lower reported income.

3. Dividends to shareholders might be adversely affected due to lower income negatively impacting on debt-equity ratios.

4. Bondholders could be better protected as a result of (1) and (3).
5. Because of (1), (2), and (3), postretirement benefits might be reduced, which, in turn, adversely affect employees.

As can be seen from these relatively simple examples, the economic consequence issues arising from the pervasive constraint can cause huge problems for standard setters. The discussion of the pervasive constraint in paragraphs 133 to 144 of SFAC No. 2 provides little help in resolving this issue. An attempt has been made to concentrate on the representational faithfulness characteristic rather than economic consequences, but this has been a very qualified success at best.

Relevance

Relevance is a quality carried forward from ASOBAT and is rather awkwardly expressed in SFAC No. 2 as being “capable of making a difference in a decision by helping users to form predictions about the outcomes of past, present, and future events or to confirm or correct expectations.” Relevance has two main aspects—predictive value and feedback value—and one minor one—timeliness.

Predictive Value. Predictive value, as in previous documents, refers to usefulness of inputs for predictions, such as cash flows or earning power, rather than being an actual prediction itself.

Feedback Value. Feedback value concerns “confirming or correcting their [decision makers] earlier expectations.” It thus refers to assessing where the firm presently stands and overlaps with how well management has carried out its functions. When viewed broadly, feedback value is closely related to accountability. Information providing this quality must also influence or affect predictive value. Hence, there appears to be a dual meaning to the term feedback value that is somewhat confusing. This confusion does not, however, negate the linkage between feedback value and predictive value, which is expanded on very shortly.

Timeliness. Timeliness is really a constraint on both of the other aspects of relevance. To be relevant, information must be timely, which means that it must be “available to decision makers before it loses its capacity to influence decisions.” There is a conflict between timeliness and the other aspects of relevance because information can be more complete and accurate if the time constraint is relaxed. Hence, a trade-off is often present between timeliness and other components of relevance.
Possible Inconsistency Between Predictive Value and Feedback Value. Predictive value and feedback value, which are qualitative characteristics, derive from the objectives of providing information useful for predicting cash flows and accountability. In going from the Trueblood Report to SFAC No. 1 and then to SFAC No. 2, slightly more detail and specificity were added in each succeeding document. Throughout these three documents, the importance of decision making by outside users is stressed.\(^9\) Obviously, predictive ability is very closely related to decision making. However, SFAC No. 2 notes that stewardship (feedback) is also involved with decision making:

The (stewardship) measurement confirms expectations or shows how far actual achievements diverged from them. The confirmation or divergence becomes the basis for a decision—which often is a decision to leave things alone. To say that stewardship reporting is an aspect of accounting’s decision-making role is simply to say that its purpose is to guide actions that may need to be taken in relation to the steward on . . . the action that is being monitored.\(^10\)

Hence, feedback value really involves two user objectives: (1) assessing how well management has done, which is stated as confirming or disconfirming expectations relative to its accountability, and (2) decision making. Predictive value may utilize, to some extent, how well management has performed during the current period.\(^11\) However, conflicts between predictive value and feedback value can arise.

One example of this type of conflict is in defined benefit pension accounting.\(^12\) SFAS No. 87 made a sharp departure from its predecessor, APB Opinion No. 8. Periodic pension cost measurement is determined by multiplying factors based on service of covered employees earned to date (years of service) and annual salary. The latter is the point of contention. Most pension plans base the annual salary on either the employee’s final salary just prior to retirement or on an average of annual salaries over the employee’s last few years of service prior to retirement.

In APB Opinion No. 8, pension cost was based on currently existing salaries. SFAS No. 87, however, changed the cost factor to an estimate of final salary or final average salary, whichever was in force in the firm’s pension contract, and which was used to determine actual pension payments.\(^13\) Future salaries are, of course, dependent on future events such as general and specific inflation, employee advancement, and improved quality of employee services (with or without promotion). Future management, not current management, determines the actual decision relative to promotion.
and amount of future salaries. Present management is thus being asked to determine a present expense by estimating future salaries, a factor that is clearly beyond current management’s control. Furthermore, employee advancement and improved quality of employee services are totally executory in nature: Neither party, employees or employer, has performed its part of the contract by either performing the required future services or paying for them.\textsuperscript{14}

The FASB justified its choice of the future salary orientation of the pension cost measurement in SFAS No. 87 on the grounds that prediction of future cash flows is the paramount objective of financial reporting.\textsuperscript{15} However, from the standpoint of accountability, the future salary orientation simply does not work. How can present management estimate—and be held accountable for—expenses that are based on future costs, which current management (a) does not actually determine, and (b) cannot therefrom receive the benefits? In addition to the accountability problem, there are also verifiability problems relative to estimating future salaries as well as a very obvious agency theory problem, particularly if management bonuses are based on current income.

In summary, pension accounting provides an example in which measurements that can be useful for predictions of cash flows are definitely suboptimal relative to accountability purposes. If pension cost measurements are based on currently existing salaries (as they are in APB Opinion No. 8 and SFAS No. 35), the measurement is useful for both accountability and predictive purposes (although not as useful for prediction of cash flows as the SFAS No. 87 requirements).\textsuperscript{16} The example of defined benefit pension accounting is a very good one for illustrating the importance of objectives of financial reporting and the potential conflicts that can be present.\textsuperscript{17} However, we believe that most conflicts between predictive value and feedback value can be reasonably, if not optimally, solved.

\textit{Reliability}

Reliability is composed of three parts: verifiability, representational faithfulness, and neutrality.

\textbf{Verifiability}. Verifiability in SFAC No. 2 refers, as in previous documents, to the degree of consensus among measurers. It is thus concerned with measurement theory. Unlike aspects of relevance, there is a quantifiable element to verifiability. However, it is unquestionably difficult to measure,
so SFAC No. 2 stops short of specifying how high the degree of verifiability should be.

**Representational Faithfulness.** Representational faithfulness, likewise, pertains to measurement theory. It refers to the idea that the measurement itself should correspond with the phenomenon it is attempting to measure. A simple example from baseball helps clarify the concept. If one wants to determine who the “fastest pitcher” is, a radar gun, which provides highly accurate measurements, can calculate the speed of the pitch in miles-per-hour, which is representationally faithful. An indirect measurement such as average number of strikeouts per inning is not necessarily representationally faithful because speed alone is not the only component of the strikeout matrix; an effective slow-ball pitcher may have a high strikeout-per-inning ratio.

In accounting, valuation of all fixed assets can be calculated by employing straight-line depreciation for 20 years with no salvage value. This calculation achieves an extremely high degree of verifiability. However, if this characteristic is supposed to be indicative of the proportion of historical cost that still has economic utility, the resulting values would, in most cases, not be representative of the attribute of unamortized cost. Individually determined depreciation schedules might represent a better calculation of the attribute of unamortized cost as previously defined. Similarly, if replacement costs are selected as the property to be measured, actual market values, if available, accomplish representational faithfulness, whereas the amount the firm could sell the asset for does not.

It is clear that there can easily be a conflict between verifiability and representational faithfulness, and the need to make a trade-off between these two characteristics of reliability may well arise. Sterling appears to minimize the possibility of a trade-off between representational faithfulness and verifiability. Relevant phenomena pertaining to a decision are faithfully represented; an unfaithful representation of a relevant characteristic is not useful for decision-making purposes. Nevertheless, we are still left with the problem of dealing with relevant characteristics (of assets or liabilities) that cannot be easily measured. Whether criteria can ever be developed to guide implementation of the many potential trade-offs is a very speculative question.

**Neutrality.** Neutrality refers to the belief that the policy-setting process is primarily concerned with relevance and reliability rather than the effect a standard or rule has on a specific user group or the enterprise itself. In other words, neutrality is concerned with financial statements “telling it
like it is” rather than the way a particular interest group, such as management or stockholders, might like it to be. Neutrality is the only qualitative characteristic that pertains wholly to the attitude of Board members as opposed to being more directly concerned with specific aspects of the information itself. The purpose of neutrality, as seen by Wyatt and Brown, is a conscious attempt to ward off interference by groups having an important interest in financial statements and the accounting standards underlying them.¹⁹ As we soon see, the role of neutrality generates a great deal of controversy.

**Representational Faithfulness Versus Economic Consequences**

One of the central issues regarding the conceptual framework is whether representational faithfulness or economic consequences should underlie the promulgation of accounting standards. Representational faithfulness is part of the conceptual framework, whereas economic consequences is not. Several articles examined this important issue.

**Sole Emphasis on Representational Faithfulness.** Ruland clearly favors exclusive emphasis on representational faithfulness as an obligation of the FASB in drafting standards.²⁰ He sees representational faithfulness as sufficient justification for accounting standards. If economic consequences is the criterion for standard setting, outcomes of accounting policy making have to be carefully determined but could by no means be certain.²¹

**The Complementary Roles of Representational Faithfulness and Economic Consequences.** Ingram and Rayburn take a dualistic position relative to the roles of representational faithfulness and economic consequences in the standard-setting process.²² Unfortunately, difficulties are inherent in achieving representational faithfulness. For example, the definition of assets in SFAC No. 6 is not complete enough to enable us to determine a unique amount for the cost of an oil producer’s petroleum field holdings. Under the full cost approach, a country or even a continent is considered a cost center. The components of the definition in SFAC No. 6 are, thus, necessary, but not sufficient, to fully define assets.²³ Even moving to current valuation does not eliminate the problem of levels of aggregation in achieving representational faithfulness (an oil well as opposed to an oil field with many wells or even wider aggregational units, such as countries or continents). Hence, in Ingram and Rayburn’s view, faithfulness of representation is often a matter of employing measurement rules (or calculation rules, as Sterling would have it) rather than “mapping reality”—that is,
determining a “true” figure from the representational faithfulness standpoint. Because it cannot employ an easily ascertainable means to objective truth, the standard-setting process necessarily entails a consideration of economic consequences: how users, preparers, and other parties are affected by prospective accounting standards. Ingram and Rayburn conclude that representational faithfulness and economic consequences are not either/or alternatives in the standard-setting process; rather, they are complementary to each other.24

The Preeminence of the Economic Consequences View. Daley and Tranter’s position relative to faithful representations and economic consequences is at the opposite pole from Ruland’s.25 They see economic consequences embodied in the conceptual framework—like the camel gaining access to the tent by slipping its nose under the flap—despite the FASB’s attempt to give representational faithfulness primacy in setting accounting standards. The underlying reason for Daley and Tranter’s conclusion is that the FASB cannot be neutral in assessing the relevance and reliability of accounting information given the pervasive constraint of the benefits/costs trade-off.

Daley and Tranter view the benefits/costs trade-off as covering a broad gamut of economic consequence issues. For example, they state that:

This process of weighing costs and benefits on differing sectors of our society is not neutral. It cannot be. In the case of marketable equities securities the decision was clearly that the interests of the insurance industry outweighed the general benefits to financial statement users [italics added] of moving to flow-through accounting, even though this method has much support in the conceptual framework.26

However, Ruland interprets the benefits/costs trade-off as a materiality threshold for assessing the usefulness of an accounting standard: Benefits to users should be greater than the costs of preparation.27 Moreover, the discussion of the pervasive constraint of benefits/costs in SFAC No. 2 focuses mainly on such issues as the fact that the preparer initially bears the cost of collecting, processing, and disseminating information to users and makes only limited mention of distributional effects on different user groups (for example, the benefit of off-balance-sheet financing for investors as opposed to creditors).28

In one sense, Daley and Tranter are certainly correct. The benefits/costs trade-off unquestionably involves economic consequences involving the
costs of preparing information relative to the benefits to users. Clearly, this aspect of standard setting by its very nature is an inherent part of the process and should thus be viewed as a special type of economic consequence. In other words, standard setters directly affect the cost of information preparation as a result of the standards that they generate. Beyond this point, however, the role neutrality plays is appropriate because it focuses concern on relevance and reliability (given the benefits/costs constraint, with costs being restricted to cost of preparation) rather than on other types of economic consequences. While the role assigned to neutrality is conceptually appropriate, attaining representational faithfulness has proved to be an extremely difficult task for the FASB.

Daley and Tranter do not believe that neutrality can be a component of reliability because the pervasive constraint (benefits of standards exceeding their cost) to reliability necessarily entails economic consequences. We believe that rather than being inconsistent, the problem is one of maintaining a difficult balancing act. The FASB’s primary objective is providing useful information for external users subject to the benefits/costs constraint. Information can both be useful for decision making and also involve economic consequences. Neutrality means a primary concern with decision usefulness rather than distributive effects.

In reality, the FASB is concerned with economic consequences beyond the benefits/costs constraint, witness its commission of several economic consequences studies. Furthermore, the FASB is not immune to influence from the political process resulting from economic consequences. From a theoretical perspective, taking cognizance of economic consequences by means of research studies is valuable provided it is understood that relevance and reliability are the primary characteristics with which standard setters should be concerned.

Conservatism

Conservatism is not shown in Exhibit 7.1, but, curiously enough, it is discussed in SFAC No. 2, where it is called a convention. SFAC No. 2 is not in favor of deliberate understatements or overstatements of assets or income. Deliberate understatement conflicts with representational faithfulness, neutrality, and both of the main aspects of relevance. Conservatism is associated with the need for “prudent reporting” which ensures readers are informed about uncertainties and risks. Thus, conservatism really appears to pertain to disclosure, an extremely important concept that is not discussed in SFAC No. 2. Conservatism is extensively discussed in Chapter 5.
Comparability and Consistency

These qualities are defined essentially the same way that they are defined in Chapter 5. We view these characteristics as being output oriented. Hence, comparability and consistency should be the result of a viable conceptual framework rather than part of the theoretical structure itself. More is said about comparability in Chapter 9.

Materiality

Materiality is also discussed in much the same fashion as in Chapter 5. The question that must be raised relative to materiality is whether an item is large enough to influence users’ decisions. Materiality is recognized as being a quantitative characteristic, and some progress is being made in that area as is discussed in Chapter 5. Materiality is also a relative concept rather than an absolute one, an aspect that most research in this area has stressed.

Statement No. 3

SFAC No. 3 defines ten (10) elements of financial statements. It is obviously a resolution of the definitions presented in the discussion memorandum for the conceptual framework project. Since these definitions were amended in SFAC No. 6, they are presented in the discussion of that document.

Several observations are worth making, particularly about what SFAC No. 3 does not include. First of all, it barely mentions the three views of financial accounting (revenue-expense, asset-liability, and non-articulated) as put forth in the discussion memorandum. It also does not specify the type of capital maintenance concept to employ. Likewise, it does not address matters of recognition (realization) and measurement as well as “display” in financial statements. Thus, the definitions in the statement seem to be a “first screen” in determining the content of financial statements. It is clear that much work remained to be done in prescribing the properties of these various elements, not to mention their arrangement in financial statements.

SFAC No. 3 also reveals a reversal of terminology. Throughout the discussion memorandum and SFAC No. 1, the word earnings supplanted the more commonly used income. However, in SFAC No. 2, earnings disappeared and income was used in paragraphs 90 and 94. Finally, SFAC No. 3 made the reversal official by designating income as the term to indicate the comprehensive or total change in net assets occurring during the period as a result of operations. Earnings was reserved as a possible component of income, to be specified at a later date (see the discussion of SFAC No. 5).
Statement No. 4

SFAC No. 4 is concerned with objectives of nonbusiness financial reporting. Nonbusiness organizations are characterized by

1. receipts of significant amounts of resources from providers who do not expect to receive either repayment or economic benefits proportionate to resources provided;

2. operating purposes that are primarily other than to provide goods or services at a profit . . . ;

3. absence of defined ownership interests that can be sold, transferred, or redeemed, or that convey entitlement to a share of residual distribution of resources in the event of liquidation of the organization.33

SFAC No. 4 also notes that nonbusiness organizations do not have a single indicator of the entity’s performance comparable to income measurement in the profit sector.34 Since the emphasis in this text is on the profit sector, SFAC No. 4 is outside the scope of this manuscript.

Statement No. 5

The long-awaited SFAC No. 5 finally appeared in December 1984, exactly four years after SFAC No. 4. Since this statement was to deal with the difficult issues of recognition and measurement, it was clear that it would be the linchpin for the success or failure of the entire project. The statement let the cat out of the bag immediately in Paragraph 2, which made it quite clear that there would be no extensive attempt to come to grips with the issues of recognition and measurement:

The recognition criteria and guidance in this Statement are generally consistent with current practice and do not imply radical change. Nor do they foreclose the possibility of future change in practice. The Board intends future change to occur in the gradual, evolutionary way that has characterized past change.35

The statement’s reliance on the evolutionary process made David Solomons angry; he termed it a “cop-out.”36 He was also disappointed with the Board’s failure to deal with executory contracts in terms of either their possible inclusion within the body of the statement, their disclosure in footnotes, or their total omission.37
Scope of the Statement

SFAC No. 5 makes clear that the concepts discussed apply strictly to financial statements and not other means of disclosure. Indeed, it is almost vehement on the subject:

Disclosure by other means is not recognition. Disclosure of information about the items in financial statements and their measures that may be provided by notes or parenthetically on the face of financial statements, by supplementary information, or by other means of financial reporting is not a substitute for recognition in financial statements for items that meet recognition criteria. ³⁸

Although it doesn’t say so explicitly, SFAC No. 5 appears to deny one of the main tenets of the efficient-markets hypothesis (Chapter 8)—that disclosure outside of the body of the financial statements is as effective as disclosure within the statements themselves. However, there are numerous criticisms of the efficient-markets hypothesis, which may well justify the FASB’s opinion. The various formats for presenting financial information are illustrated in SFAC No. 5 (Exhibit 7.2).

Earnings and Comprehensive Income

One of the principal concerns of SFAC No. 5 was the format and presentation of changes in owners’ equity that do not arise from transactions with owners. This has been referred to as the matter of “display.” Earnings replace net income and differ from the latter by excluding the cumulative effect on prior years of a change in accounting principle, such as a switch from straight-line depreciation to sum-of-the-years’-digits, for example. Earnings thus are a better indicator of current operating performance than net income. A hypothetical comparison between the two is shown in Exhibit 7.3.

Accompanying the statement of earnings is a statement of comprehensive income. The latter is now conceived as a statement that covers all changes in owners’ equity during the period except for transactions with owners. The previously mentioned cumulative effect of a change in accounting principle would appear here. Also appearing here would be such items as the income effect of losses or gains (to the extent recognized) of marketable securities that are not classified as current assets as well as foreign currency translation adjustments. Finally, the only two items that are now classified as prior period adjustments (Chapter 12) enter into a comprehensive income statement. A quick comparison of earnings and comprehensive income is shown in Exhibit 7.4.

The recasting of performance into earnings and comprehensive income in SFAC No. 5 arose as a result of the inability to come to grips with the
Exhibit 7.2  Delineation of Formats for Presenting Financial Information

All Information Useful for Investment, Credit, and Similar Decisions
(Concepts Statement 1, paragraph 22; partly quoted in Note 6)

Financial Reporting
(Concepts Statement 1, paragraphs 5–8)

Area Directly Affected by Existing FASB Standards

Basic Financial Statements
(in AICPA Auditing Standards Literature)

Scope of Recognition and Measurement
Concepts Statements

Financial Statements
- Statement of Financial Position
- Statements of Earnings and Comprehensive Income
- Statement of Cash Flows
- Statement of Investments by and Distributions to Owners

Notes to Financial Statements
(& parenthetical disclosures)
Examples:
- Accounting Policies
- Contingencies
- Inventory Methods
- Number of Shares of Stock Outstanding
- Alternative Measures (market values of items carried at historical cost)

Supplementary Information
Examples:
- Changing Prices Disclosure (FASB Statement 33 as amended)
- Oil and Gas Reserves Information (FASB Statement 69)

Other Means of Financial Reporting
Examples:
- Management Discussion and Analysis
- Letters to Stockholders

Other Information
Examples:
- Discussion of Competition and Order Backlog in SEC Form 10-K (under SEC Reg. S-K)
- Analysts’ Reports
- Economic Statistics
- News Articles about Company

SOURCE: FASB Concepts Statement No. 5, Recognition and Measurement in Financial Statements of Business Enterprises, pages 5, 13, and 16. FASB material is copyrighted by the Financial Accounting Foundation, 401 Merritt 7, Norwalk, CT 06856, USA, and is reproduced with permission.
measurement problem. Using earnings was, more or less, an attempt to maintain the status quo of income, and the possibility was open in the future to include unrealized holding gains in comprehensive income.\textsuperscript{39} More is said about comprehensive income in Chapter 12.

\textit{Recognition Criteria}

Recognition criteria refers to when an asset, liability, expense, revenue, gain, or loss is recorded in the accounts. The fundamental recognition criteria from earlier parts of the conceptual framework 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.

In applying recognition criteria to revenue and gain situations, recognition requires that the asset received has been realized or is realizable and that the revenue should be earned, as discussed in Chapter 5. Likewise, recognition criteria for expenses and losses arise as the asset is used up or when no further benefits are expected (para. 85). Recognition methods for expenses include matching with revenues, write-off during the period when cash is expended, or liabilities incurred for very short-lived expense items, or other systematic and rational procedures (para. 86).

Although resorting to previous statements logically closed the circle, SFAC No. 5 needed to do much more work on recognition criteria than its two-page coverage. To take one example, the definitions of elements from SFAC No. 3 and SFAC No. 6 are clearly superior to previous definitions.

They are necessary in and of themselves, but not sufficient. Solomons notes that the definition of a liability is difficult to apply to pensions:

Quite apart from the measurement problems resulting from uncertainties, what is an employer’s present obligation to the participants in a pension plan? Is it the (discounted) amount of all future payments to all eligible employees, past and present? Or is it the amount that would be payable if the plan is discontinued at the balance sheet date? Or is it the amount of benefits vested at the balance sheet date? Or is it only the amounts currently due and payable to those who have already retired at the balance sheet date?\textsuperscript{40}
Similar examples of the incompleteness of definitions are the liability definition as applied to deferred taxes and the asset definition for oil and gas exploration costs regarding the level of aggregation (full costing or successful efforts) in accounting. Suffice it to say that much greater detail is necessary to successfully implement recognition criteria. Tying recognition criteria to SFAC Nos. 2 and 3 barely began the job.
Measurement Attributes

The five measurement attributes extensively covered in the discussion memorandum of 1976 were dusted off and brought forward in SFAC No. 5:

1. Historical cost
2. Current cost (replacement cost)
3. Current market value (exit value)
4. Net realizable value (selling cost less any costs to complete or dispose)
5. Present (discounted) value of future cash flows

However, as previously noted, the statement backed away from considering possible criteria for change, which suggests a continued use of present measurement attributes and reliance on an evolutionary approach.

SFAC No. 5 is considered a distinct letdown, if not an outright failure. Sterling made an extremely trenchant point relative to it: By dealing with recognition before measurement, the FASB put the cart before the horse. The issue of when to recognize an element cannot be discussed until we know the measurement characteristics that are to be recognized.\(^41\)

This is the shortcoming of SFAC No. 5.

In addition, Miller’s analysis of the conceptual framework project and, in particular, SFAC No. 5 is also of great interest.\(^42\) Miller was a faculty fellow at the FASB in 1982–1983 where he was involved with the conceptual framework project. He believed that the first three SFACs would lead to “radical changes” in accounting practice and, therefore, SFAC No. 5 acted as a “counterreformation” to real progress. The linchpin of what Miller calls the “reformation” is the user orientation of SFAC No. 1 as opposed to the CAP’s and APB’s emphasis on the needs of auditors. In addition, the move toward the asset–liability viewpoint in the first three documents, as reflected in the definition of assets and liabilities, was a shift toward current valuation and away from matching. The counterreformation, led by the preparer constituency (in particular, members of Financial Executives International) and supported by three members of the FASB, appeared when SFAC No. 5 was being drafted.\(^43\) SFAC No. 5, particularly paragraph 2’s statements to the effect that change should occur in a gradual and evolutionary manner, effectively stymied reform, at least for the time being.

Statement No. 6

SFAC No. 6 is a replacement (not a revision) of SFAC No. 3. However, its definitions are virtually identical to those in SFAC No. 3 except that they are
extended to nonbusiness organizations. Likewise, the qualitative characteristics of accounting information of SFAC No. 2 are extended to nonbusiness organizations. Clearly, then, SFAC No. 6 added nothing further to the conceptual framework from the perspective of business enterprises.

Perhaps, however, there was a hidden agenda behind the apparent conclusion of the conceptual framework with a virtual repetition of an earlier segment of the framework. Terminating with SFAC No. 5 meant that the project ended on a low—if not a sour—note. Possibly for this reason the project was concluded by reprising SFAC No. 3 (with the previously mentioned extensions to nonbusiness organizations). In any event, the definitions of the 10 elements of financial statements presented in SFAC No. 6 (with very slight modification from SFAC No. 3) are as follows:

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

2. Liabilities are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.

3. Equity or net assets is the residual interest in the assets of an entity that remains after deducting its liabilities. In a business enterprise, the equity is the ownership interest. In a not-for-profit organization, which has no ownership interest in the same sense as a business enterprise, net assets is divided into three classes based on the presence or absence of donor-imposed restrictions—permanently restricted, temporarily restricted, and unrestricted net assets.

4. Investments by owners are increases in equity of a particular business enterprise resulting from transfers to it from other entities of something valuable to obtain or increase ownership interests (or equity) in it. Owners most commonly receive assets as investments, but that which is received may also include services or satisfaction or conversion of liabilities of the enterprise.

5. Distributions to owners are decreases in equity of a particular business enterprise resulting from transferring assets, rendering services, or incurring liabilities by the enterprise to owners. Distributions to owners decrease ownership interest (or equity) in an enterprise.

6. 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.

7. 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.

8. Expenses are outflows or other depletions of assets or incurrences 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.

9. 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.

10. 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.\(^{45}\)

SOURCE: FASB Concepts Statement No. 6, *Elements of Financial Statements*, pages ix and x. FASB material is copyrighted by the Financial Accounting Foundation, 401 Merritt 7, Norwalk, CT 06856, USA, and is reproduced with permission.

These definitions are a marked improvement over their immediate predecessor, the circular and redundant definitions of APB Statement 4.\(^{46}\) Dopuch and Sunder have criticized these definitions on the grounds that the various criteria for each of the categories are necessary but not sufficient to determine whether a general type of accounting event falls into a particular definitional category.\(^{47}\) For example, deferred tax credits could be interpreted as liabilities from the individual asset perspective because repayment of benefits generally does occur; but when deferred tax credits are viewed from the aggregate perspective, repayment is far less likely. However, Brown, Collins, and Thornton point out that it would be impossible to completely specify all characteristics of elements such as assets and liabilities.\(^{48}\) They also point out that when enumerating definitions or prescribing standards, it is impossible to be absolutely complete or sufficient. The more complete and sufficient definitions and standards are, the lengthier and cumbersome they become. However, the lack of completeness must be supplemented by the professional judgment capabilities of the accountant and auditor.\(^{49}\)
Samuelson criticized the conceptual framework definition of assets. He believes that the FASB definition, which emphasizes future economic benefits (future cash inflows), is grounded in future revenues and costs. Consequently, he believes that the matching concept—matching costs against revenues—is the primary focus of this definition. Matching is a historical cost notion. Therefore, we do not agree with Samuelson’s interpretation that the FASB’s asset definition is matching oriented.

Samuelson believes that the asset definition should concentrate on property rights that are concerned with wealth, which provides a solid balance sheet orientation. One of the key points about the property rights approach lies in exchangeability of the asset. Samuelson’s viewpoint results in certain deferred charges being expensed immediately even though their incurrence may bring about future economic benefits. Some costs that fall into this category include training costs, relocation costs, plant rearrangement costs, and prior service costs when pension plans are either adopted or amended.

Another contentious point of these definitions concerns how broadly the term “past transactions” can be interpreted under the asset and liability definitions. As previously mentioned in the discussion of SFAC No. 2, in pension accounting (SFAS No. 87) and other postretirement benefits (SFAS No. 106) future costs are combined with service to date in determining these costs. The problem involves a conflict among objectives, but the meaning and interpretation of “past transactions” still requires resolution. In summary, these definitions are an improvement over their predecessors, but further refinement may yet take place.

Finally, SFAC No. 6 (paras. 150–151 and 169) mentions a small and limited number of transactions involving owners’ equity that are nonreciprocal in nature. These include receipts of cash by the firm with (presumably) no strings attached or with no presumed necessity to transfer assets in the future. Nonreciprocity is extremely rare and should not be used as a basis for transaction avoidance.

Statement No. 7

Two important points should be immediately made about SFAC No. 7. First, in light of the importance of the Trueblood Committee Report with its emphasis on the importance of cash flows, it is surprising that it took this long (15 years after SFAC No. 6) for this statement to appear, although work began on the project in 1988. Second, this statement concerns specific measurement issues rather than broader conceptual-type issues; hence it can be viewed as a subset of SFAC No. 5. SFAC No. 7 applies to situations in which
present market-determined amounts such as cash received or paid and current cost or market value are not available at the point of recognition. Instead estimated future cash flows are used for asset or liability measurement.

In SFAC No. 7, the Board recognized that present valuation methods were inconsistently applied in various standards. To take two examples, in APB Opinion No. 16 on business combinations, assets that are acquired by incurring liabilities are to be booked at present value without specifying how to determine the rate, whereas in the case of leases, the lessee uses its own incremental borrowing rate unless the lessor’s implicit interest rate can be determined and it is lower than the lessee’s incremental rate. SFAC No. 7 applies only to initial recognition and not subsequent revaluations, which it terms “fresh-start measurements.” To understand that term, know that the SFAC is divided into two parts: asset measurement and liability measurement.

**Present Value Asset Measurement**

The most important point about asset measurement is that present value measurements are intended to simulate fair value rather than the particular present value of the asset to the firm itself. For example, the asset might have a higher value to the firm because it holds special manufacturing processes or other preferences that increase the value of the asset to the particular enterprise. Thus any value accruing to the particular firm because the simulated fair value is less than the present value of the asset to the firm is to be realized in the form of cost savings during usage rather than in higher initial valuation. Hence if the firm does not know the specific market value of a particular asset, it strives for that discount rate, which leads as closely as possible to estimated fair value. Discount rates should also include risk and uncertainty, which reflects the assessment by the market of the asset’s value. It is important to note that the FASB’s preference for fair value rather than specific firm valuation emphasizes the severability of the asset.

One specific measurement technique should be mentioned. If a particular asset has several possible cash flows within specific years, the expected cash flows should be determined (the probability weighted average of the possible individual cash flows) rather than using the single most likely cash flow (the mode).

**Present Value Liability Measurement**

The key point about liability measurement is that the discount rate must be tied to the credit standing of the firm. The carrying value of the original liability is tied to the firm’s credit standing. Notice that this means that if the
firm’s credit standing deteriorates, the valuation of the liability decreases (because a poorer credit standing means that the applicable discount rate rises). Hence any firm acquiring the liability from the original creditor pays less to acquire the liability owing to the debtor’s worsening credit standing.

Asset and liability measurements under SFAC No. 7 are not inconsistent. An asset can be viewed and therefore valued separately from the firm owning it, but a liability cannot be separately viewed. In other words, a liability must ultimately be resolved by the debtor. An asset’s value to others is separate from its current owner.

Subsequent Revaluations

Although SFAC No. 7 does not address “fresh-start” measurements occurring after initial acquisition, it does state preferences. If estimated cash flows of an asset or liability change, the original discount rate is applied to the revised cash flows.\(^55\) The FASB refers to this method as the “catch-up approach.”

Statement No. 8

In September 2010, the FASB issued Concepts Statement No. 8, Conceptual Framework for Financial Reporting, replacing, some 30 years after their adoption, SFACs No. 1 and No. 2. In 2004, this joint project by the FASB and IASB began as an addition to their original Norwalk Agreement. It completed phase one (1) of the eight (8) phase plan to converge their respective conceptual frameworks. The FASB/IASB’s initial issuance of a discussion paper in 2006 and an exposure draft two years later were significant steps in the pursuit of a single, common conceptual framework.

The resultant objective of general purpose financial reporting, *Chapter 1 of the Conceptual Framework for 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.”\(^56\) This emphasis on financial reporting is consistent with SFAC No. 1’s wording, but broader than the IASB’s earlier focus on financial statements alone. SFAC No. 1 sees potential investors and creditors, as its primary user group; SFAC No. 8 considers this group to be resource providers, not the primary user group.\(^57\) Historically, the divide between businesses and their owners widened. FASB’s conclusion is that entity theory better represents this increasing separation rather than the owner focused proprietary theory.

SFAC No. 8, Chapter 3: Qualitative Characteristics of Useful Financial Information, results from FASB’s collaborative work with the IASB and their
respective qualitative characteristics (see Exhibit 7.1). The end result is a shuffling/reorganizing/renaming of characteristics from the original 30 year-old graphical depiction.

Comparing Exhibits 7.1 and 7.5, cost continues to be a pervasive constraint in the new hierarchy. However, materiality is now established as “an entity-specific aspect of relevance,” not a practical, quantifiable threshold applicable to all entities or to all qualitative characteristics.

Relevance continues to be one of the two fundamental qualitative characteristics of useful information; however, “faithful representation” replaces “reliability” as the second. Relevance influences user decisions, this is a subtle shift from SFAC No 2’s emphasis on making a difference in decisions. Predictive and confirmatory values determine relevance. Confirmatory value is essentially feedback that confirms or refutes prior judgments related to the information. Again, relevant information is constrained by entity-specific materiality and costs.

Information that is faithfully represented is complete, neutral, and free from error. When reporting financial information, the FASB recommends a 3-step process: (1) identification of the economic phenomenon, (2) determination of the most relevant information and that it can be faithfully represented, and (3) determination of the information’s availability and that it can be faithfully represented. Note that in SFAC No 2’s hierarchy, verifiability was closely associated with representational faithfulness, but is now one of four “enhancing qualitative characteristics.”

The new framework groups comparability, verifiability, timeliness, and understandability as enhancing qualitative characteristics. This result simplifies the framework while improving the usefulness of information that is relevant and faithfully represented. The boards considered other concepts (e.g., true and fair view, transparency, quality) for inclusion in the framework, but determined they were not qualitative characteristics.59

The Conceptual Framework as a Codificational Document

We have outlined the conceptual framework, now it is instructive to consider what type of document it is. The postulates and principles approach of ARSs 1 and 3 is called an example of foundational standard setting because it attempts to provide a logical foundation for deductively deriving “correct,” or at least appropriate, accounting standards.60 On the other hand, the conceptual framework is compared to a constitution in the sense that alternatives to it can be viewed as either within the law or outside of the law.61 The constitutional approach clearly does not provide a logical structure as strong as the foundational approach. The conceptual
framework, however, is not a legally binding instrument, nor does it contain arbitrary elements similar to those found in a constitution (such as the number of senators from each state). In Solomons’s view, a conceptual framework does not have room for arbitrariness, and so his enthusiasm for the constitutional metaphor diminished.

We saw in Chapter 4 that standard setting by an organization such as the FASB was justified on codificational grounds. Codification is a justification of the standard-setting process itself rather than of the individual standards that result from that process. The codificational approach is seen as rational and as one requiring presumably good reasons for the choice of accounting standards, although these may not necessarily be the “best” possible standards. Also, it should be understood that codification refers to the process and not to the individual members (of the FASB) who are responsible for

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carrying out that process. It should also be remembered that choosing standards by a rational process implies that standards can be changed and improved.

Within the codificational view of standard setting, a conceptual framework makes good sense because it can support and promote the rational nature of that process. Gaa sees the conceptual framework as embodying aspects of both a constitution and a theory. The constitutional view of Gaa differs from Solomons’s more legalistic and empowering view. For Gaa, the distributional view also involves the question of who benefits from the financial information. As we have seen, SFAC No. 1 resolved the user-heterogeneity problem through the objective of providing information that is useful to present and potential investors and creditors and other external users who have a reasonable understanding of business and economic activities.

The conceptual framework also, in Gaa’s view, has theoretical aspects because it does provide criteria for choice when evaluating accounting alternatives. These include factors such as relevance, reliability, and the benefits/costs constraint discussed in SFAC No. 2, as well as the definitions provided in SFAC No. 6. These criteria for choice can help or guide the FASB, but they cannot guarantee the best outcome despite the constitutional guideline for information that is useful for actual and prospective investors, creditors, and other outside users. According to the codificational view, not only can standards be improved on, but the conceptual framework itself is also subject to correction and refinement.

The FASB Accounting Standards Codification™ is the single source of U.S. GAAP for nongovernmental entities. At this point, the Conceptual Framework for Financial Reporting is not included in the codification and is, therefore, a nonauthorative source for determining GAAP. However, as the FASB-IASB project progresses toward converged frameworks, we expect movement of the conceptual framework into the FASB Accounting Standards Codification™.

The Jurisprudential View

Somewhat similar to the codificational view is the jurisprudential view of the FASB advocated by Archer. The jurisprudential view is concerned with the process of legitimization and acceptance of the conceptual framework as opposed to the actual “theory” embodied in the document. Archer raises some very trenchant points relative to how the conceptual framework was developed. He questions whether a solid theoretical document can be developed on the one hand while the other hand resorts to an arrangement utilizing consensus among the various affected groups (preparers, users,
and auditors) by means of a system of discussion memoranda and exposure
drafts. Archer also criticizes the FASB from the standpoint of confusing
means and ends in the development of the conceptual framework with a
strong desire to maintain the status quo. Certainly SFAC No. 5’s adherence
to historical costing can be seen as an attempt to preserve the old order.
Archer attempts, as part of his jurisprudential approach, to use benefits/
costs analysis for assessing the social desirability of the various alternatives.
This approach, of course, is fraught with its own difficulties.

Archer, as opposed to Dopuch and Sunder, is not unalterably opposed
to a conceptual framework. Dopuch and Sunder, as well as Hines, basically
see a conceptual framework as a self-justifying type of document that serves
as a source for deflecting the attacks of interested parties. Archer, in fact,
favors the use of a conceptual framework but hoped that it would be more
systematic and philosophic (jurisprudential) in its drafting. Archer also
appears to subscribe to the position of Ingram and Rayburn, discussed pre-
viously, that a conceptual framework cannot ignore the consideration of
taking into account economic consequences.

Michael Power, another constructive critic of the conceptual framework,
sees the document as one capable of providing help to standard setters but
not providing final and conclusive answers (this is also true of Archer): “A
conceptual framework is not an ultimate foundation in any classical sense
but a point of reference in the network of accounting standards and prac-
tices that serves to ‘organize’ thinking about them.”

Power uses a combination of essentially deductive and inductive reason-
ning to determine accounting standards with a conceptual framework playing
a partial—but not total—role in the determination of accounting standards.
The deductive aspect of Power’s approach is a conceptual frame-
work, but it is used in conjunction with “accepted accounting practice,”
which is the inductive aspect of the standard-setting process.

Both Archer and Power provide useful critiques for the construction of
a conceptual framework. However, we have a conceptual framework, and
the issue is how it can be improved so that it performs a more useful role in
the standard-setting process. Not surprisingly, perhaps, an evolutionary—
but hopefully not glacial—approach is possible. The evolutionary approach
is certainly not inconsistent with both Archer and Power, and it embodies
the codificational approach discussed by Gaa. In particular, the evolutionary
approach to the conceptual framework possesses both deductive and induc-
tive aspects similar to Power’s suggestions. For example, it is possible to
update SFAC No. 5 by vigorously advocating current costs where verifiability
is not a major problem, such as with “mark-to-market,” which is already
occurring with many debt and equity securities, as discussed in SFAS No. 115
(see Chapter 11). This is an example of the deductive approach going forward from the conceptual framework to individual accounting standards.

The inductive approach works backward from standards to the conceptual framework. A possible example discussed earlier in the chapter is the case of pensions in SFAS No. 87. That analysis suggested a strong emphasis on prediction of future cash flows, which conflicted with the accountability objective. Therefore, where conflicts arise, concentrating on accountability might give accounting standards more flexibility since accountability-oriented numbers are useful for decision making. Certainly, the pension analysis helps us to understand the conflict between the predictive and accountability objectives. At any rate, we believe that the FASB and International Accounting Standards Board (IASB) convergence project involving conceptual frameworks might take into account these considerations (the IASB conceptual framework is discussed in Chapter 10).

**Empirical Research on the Conceptual Framework**

There has been a limited amount of empirical work done on the conceptual framework. In an experiment involving 28 former members of the FASB and APB who attempted to use the qualitative characteristics of SFAC No. 2, only verifiability and costs (as in benefits outweighing costs) were found to be operational in terms of having some degree of common meaning to the standard setters. Although these results are not encouraging, the researchers noted that the understanding of the concepts prior to the publication of SFAC No. 2 could have been considerably lower. In addition, subjects answered questions independently and not in the “give-and-take” atmosphere of the actual standard-setting process.

Hudack and McAllister conducted a content analysis examination of the first 117 SFASs. They found that the Board emphasized, more or less evenly, both relevance and reliability from SFAC No. 2. However, in standards emphasizing disclosure (footnotes or separate schedules) rather than recognition (numbers appearing in the body of the statements), a stronger emphasis was placed on relevance rather than reliability.

Another study of SFAC No. 2 was concerned with the importance of the qualitative characteristics to three groups: preparers, auditors, and users. The sample selected was 600 CPAs in Pennsylvania who were identified based on the majority of their work experience as preparers, auditors, or users (55% of respondents were identified as auditors with the remainder splitting evenly between the other two categories). Users and preparers gave more weight to relevance than did auditors. Results were not significantly different among the three groups within the reliability category,
although auditors gave more importance to neutrality than did the other two groups. Reliability was more important for auditors than was relevance. Materiality, as a pervasive constraint, ranked approximately even with relevance and reliability within each of the three groups.

Assessing the Conceptual Framework

Many opinions have been expressed about the conceptual framework, the consensus negative. Certainly there are some fine things in the SFACs, including the qualitative characteristics (SFAC No. 2 and 8), the definitions of the elements (SFAC No. 6), and the refining of present value measurements (SFAC No. 7). It is somewhat difficult to take this project seriously, despite all the time, money, and effort spent on it, when in the preface to each of the standards the Board declares that SFACs do not “(a) require a change in existing generally accepted accounting principles; (b) amend, modify, or interpret statements of Financial Accounting Standards; or (c) justify either changing existing generally accepted accounting and reporting practices. . . .” Certainly one might hope that deferred tax assets and liabilities (SFAS No. 109) are discounted, but this disclaimer tells us not to hold our breath. On the other hand, one might hope that the FASB is merely cutting itself some slack and that good changes eventually occur.

However, one promising sign relative to the possible use of the conceptual framework is arising in the area of leases (see Chapter 17). Another positive note began with SFAS No. 141, wherein summaries of each major standard have a short section titled, “How the Conclusion in the Statement Relates to the Conceptual Framework.”

Opinion is virtually unanimous that SFAC No. 5 on recognition and measurement is the low point of the conceptual framework. However, in areas such as marketable securities (SFAS No. 115), derivatives (SFAS No. 133), and impaired assets (SFAS No. 121), the FASB has instituted some aspects of fair (current) value.

Summary

The eight SFACs that comprise the conceptual framework were completed between 1978 and 2010. The document is an evolutionary one because the objectives were rooted in the Trueblood Report and the qualitative characteristics that stemmed from ASOBAT via APB Statement 4. The definitions of SFAC No. 6, while not perfect, are a distinct improvement over the circular and illogical definitions of APB Statement 4.
document is SFAC No. 5, which then reaffirmed historical cost as the basic measurement system.

Perhaps the key document in the series is SFAC No. 8, the replacement of SFAC No. 2. The principal qualitative characteristics are now relevance and faithful representation. The pervasive constraint that benefits should exceed their costs is an economic consideration affecting FASB’s neutrality when setting standards. As many of its critics have certainly noted, the conceptual framework is far from a perfect document. The possibility of drafting a document that all parties resoundingly approve of occurs as often as the likelihood of attaining a just and lasting peace in the Middle East. Fortunately, that is not the issue. When viewed from the evolutionary standpoint, the document is definitely capable of improvement. This evolutionary enhancement is consistent with the codificational viewpoint of the conceptual framework. Despite all of the past criticisms of the conceptual framework, it still has a very important role to play in helping financial accounting standards attain more consistency and comparability in financial reporting.

QUESTIONS

1. Of what importance are definitions of such basic terms as assets, liabilities, revenues, and expenses in a conceptual framework or metatheory?

2. What is the relationship between the economic consequences of accounting standards and the quality of neutrality presented in SFAC No. 8?

3. Why must objectives be at the topmost level of a conceptual framework of accounting?

4. How does the freedom from bias mentioned in ASOBAT compare to the quality of neutrality mentioned in SFAC No. 8?

5. How do earnings, as discussed in SFAC No. 5, differ from net income?

6. What is comprehensive income?

7. Is neutrality consistent with the primary orientation of SFAC No. 8 toward the external user and the pervasive constraint (benefits outweighing costs) of the same statement?

8. SFAC No. 6 is largely a repetition of SFAC No. 3. Discuss two possible reasons why this repetition occurred.

9. Very carefully explain why conflicts can exist between prediction of cash flows and accountability. How can these conflicts be resolved?
10. How does feedback value relate to predictive ability and accountability?

11. Is there a similarity between the codificational approach (Gaa) to standard setting and the jurisprudential approach?

12. Verifiability is part of reliability in SFAC No. 2, but is now an enhancing qualitative characteristic in SFAC No. 8. What effect does this reclassification have on the importance of verifiability in the framework?

13. Conservatism is discussed in paragraphs 91 to 97 of SFAC No. 2. Why is its role in SFAC No. 2 rather ambiguous? Why is conservatism absent from SFAC No. 8?

14. A study in disclosure standards by the FASB (discussed in this chapter) found a heavier emphasis placed on relevance rather than reliability (SFAC No. 2). Why do you think this is the case?

15. Samuelson uses a property rights definition of assets (discussed in this chapter). Do you think that SFAS No. 2, requiring immediate expensing of research and development costs, is an example of Samuelson’s property rights approach? Discuss.

16. Does changing the asset definition in the conceptual framework to one concerned with property rights have any other ramifications? Discuss.

17. Is capital maintenance oriented toward proprietary theory or entity theory?

18. Do you see any inconsistency in SFAC No. 1, which sees financial statements as general purpose but geared primarily toward investors and creditors?

19. Do you see any inconsistency between the present value of assets and liabilities in SFAC No. 7, since the latter is based on a firm-specific discount rate and the former does not use a firm-specific rate? Discuss.

20. Stewardship is absent from SFAC No. 8; why?

CASES, PROBLEMS, AND WRITING ASSIGNMENTS

1. Discuss as many of the potential trade-offs among the qualities mentioned in SFAC No. 8 as you can and give either a general or a concrete example of each one.

2. Analyze three accounting standards promulgated by the FASB and show how economic consequences (rather than representational faithfulness) influenced the shaping of the standard (your professor may suggest particular standards for this case).

3. One of the principal problems of SFAC No. 2 and 8 is whether, relative to drafting accounting standards, representational faithfulness should predominate
over economic consequences or the reverse. State the case as carefully as you can for each of the two possibilities.

4. **Part 1.** Tucker Company has an asset in the form of a cash flow that it expects to collect in three years. However, the amount of the cash flow is not certain. These are the probabilities underlying the cash flow.

<table>
<thead>
<tr>
<th>Amount</th>
<th>Probability</th>
</tr>
</thead>
<tbody>
<tr>
<td>$3,000</td>
<td>.30</td>
</tr>
<tr>
<td>4,000</td>
<td>.30</td>
</tr>
<tr>
<td>5,200</td>
<td>.40</td>
</tr>
</tbody>
</table>

The discount rate is 10%.

**Required:**

a. How should the asset be valued according to SFAC No. 7?

b. What other valuation is possible?

c. Which valuation do you prefer?

**Part 2.** Donahoe Company has a liability of $10,000, which is due in three years. The discount rate applicable to the liability is 10%. Assume that the firm’s credit standing is adversely affected by an untoward economic event. As a result, the discount rate applicable to the liability goes up to 12%.

**Required:**

a. How does the value of the liability change?

b. If the firm’s financial condition worsens, does it make sense for the value of the liabilities to decline? Explain.

5. In examining recognition and measurement, Sterling believes that measurement should precede recognition, whereas Archer believes that it is “logical” for recognition to precede measurement. What is your position?

**CRITICAL THINKING AND ANALYSIS**

1. Evaluate the benefits versus costs of an accounting conceptual framework.

2. In SFAC No. 8, the objectives of financial reporting clearly take an entity perspective rather than a proprietary one. If the FASB had taken the proprietary perspective, what effect, if any, does it have on the resultant conceptual framework?
NOTES

1. FASB (1976a).
2. FASB (1976b, p. 2).
3. See FASB (1976a) and FASB (1976c).
4. SFAC No. 8 replaces SFAC No. 1 and No. 2 in 2010.
5. FASB (1978, para. 30).
7. Ibid. (para. 51).
8. Ibid. (para. 56).
9. Ibid. (para. 30, for example).
10. Ibid. (para. 29).
11. FASB (1980a, para. 51) states that most information is useful for both predictive and accountability objectives.
12. See Wolk and Vaughan (1993) for further detail relative to the split between predictive and accountability objectives in pension accounting.
13. For a simple example of basing pension costs on current or future salaries, see Appendix 16-A in this text.
14. The role of future events in accounting is now being examined. See Beaver (1991) for a discussion of some of the problems. An important question is whether the future event orientation of SFAS No. 87 is consistent with the “past transactions or events” part of the liability definition in SFAC No. 6.
15. The primacy of predicting future cash flows is discussed in FASB (1978, paras. 25 and 30).
16. Ijiri (1975) sees accountability as the most important function of financial reporting and has even brought up the idea of a conceptual framework based on accountability (Ijiri, 1983).
17. Another area in which the split between predictive ability and accountability arises is in other postretirement benefits, the subject matter of SFAS No. 106. See Chapter 16.
18. Sterling (1985, pp. 30 and 31), but see page 29 on the inability to obtain absolute precision. Within the broad context of relevance versus reliability, the Financial Accounting Standards Advisory Council (FASAC) discussed this trade-off dispute concerning the general balance sheet movement toward fair values. FASAC members brought up the issue of the greater reliability of historical costs, particularly in light of auditing concerns. See FASAC (2004).
19. Wyatt (1990) and Brown (1990). At the time of these publications, Wyatt was a former Board member and Brown was a current member of the FASB.
23. For more coverage, see the critique of Dopuch and Sunder (1980, p. 7). The FASB attempted to limit diversity in asset values in SFAS No. 19, Financial Accounting and Reporting by Oil and Gas Producing Companies, by allowing only successful efforts, but it was forced to suspend SFAS No. 19 as a result of political pressure.

24. While Ingram and Rayburn (1989, p. 65) maintain the balanced view, they state that “good economic consequences . . . are difficult to achieve” while “representational faithfulness . . . is impossible to achieve.”


26. Ibid. (p. 19).


28. Paragraph 137 of SFAC No. 2 mentions factors under the costs of providing information such as loss of competitive advantages and dangers of litigation, which could support the broader Daley and Tranter view of economic consequences, but the main discussion concerns the narrower interpretation of what might be termed the direct costs of preparation. See FASB (1980a, pp. 54–58).


30. Ibid. (pp. 18–21).

31. Solomons (1991a and 1991b) and Tinker (1991) debated the issue of neutrality versus the accountant’s role in distributive issues (economic consequences). Bell (1993), like Solomons, is a strong proponent of the primacy of representational faithfulness over economic consequences. He believes that the qualitative characteristics of costs, benefits, and neutrality are concerned with allocative efficiency only (maximizing the utility stemming from the investment of scarce resources). However, because the FASB needed consensus among the various affected parties, allocative efficiency was broadened into a notion of distributional equity. Stated slightly differently, the FASB should be concerned with direct economic consequences only, but the need for consensus led to a concern with indirect economic consequences as well as direct ones.

32. FASB (1980b, footnote 1, page 1).

33. FASB (1980c, p. x).

34. Ibid. (p. xi).

35. FASB (1984, para. 2).


37. Ibid. (p. 116).

38. FASB (1985, para. 9).

39. Kirk (1989, p. 102). Newberry (2003, pp. 327–328) attacks the conceptual framework for inconsistencies in the measurement of income (called “earnings” in SFAC No. 5) by stating (a) if it is to be a measure of wealth enhancement to owners, exit valuations in asset values and depreciation is implied, and (b) if it is to be a measure of performance, replacement values of assets and depreciation should be employed.

43. Ibid. (p. 28).
44. Miller (1990, p. 29) views SFAC No. 6 in different terms. He sees it as upholding the progress made in SFAC Nos. 1–3 and thus a bulwark against the advocates of the counterreformation represented by SFAC No. 5. Perhaps SFAS No. 157 on fair value measurement upholds Miller’s opinion.
46. Schipper (2002, p. 6) noted an inconsistency between the definition of revenues in SFAC No. 6, which is grounded in changes in assets and liabilities, indicating the preeminence of the balance sheet, and the revenue recognition criteria in SFAC No. 5, based on “substantially accomplishing” the revenue task, which is based on income statement primacy.
47. Dopuch and Sunder (1980, pp. 3–5).
49. For an excellent discussion of professional judgment, see Mason (1993).
51. Somewhat similar criticisms are made by Schuetze (1993) and Chambers (1996), although the latter is primarily concerned with valuation issues.
52. FASB (2000, para. 15).
53. Ibid. (para. 32).
54. Ibid. (para. 67).
55. Ibid. (para. 97).
56. FASB (2010, OB2).
58. The term “confirmatory value” replaces the term “feedback” as used in SFAC No. 2.
59. See Kaminski and Carpenter (2011) for a more detailed recount of SFAC No. 8’s development.
64. Ibid. (p. 73).
65. Ibid. (p. 80).
66. Ibid. (pp. 104–107).
REFERENCES


