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The FASB's Conceptual Framework for Financial Reporting: A Critical Analysis

American Accounting Association's Financial Accounting Standards Committee
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INTRODUCTION

On July 6, 2006, the Financial Accounting Standards Board (FASB) published its "preliminary view" of the conceptual framework (FASB 2006). As the subtitle declares, it is (should or will be) the "objective of financial reporting and qualitative characteristics of decision-useful financial reporting information." This document, developed jointly with the International Accounting Standards Board (IASB), is "a step preceding the development of an Exposure Draft of the initial parts of an improved Conceptual Framework for Financial Reporting." If adopted, it will serve to move accounting increasingly toward an approach that emphasizes the balance sheet rather than the income statement, emphasizes investment in corporate equities, and de-emphasizes the stewardship role of accounting. Although at present preparers of financial statements are not required to consider the FASB's Concept Statements as authoritative, the FASB (2006, vi) states that "the GAAP hierarchy is under reconsideration," implying that the Conceptual Framework will be included in the hierarchy.

This project was undertaken because the Board believes that their standards must be based on "consistent principles." The FASB (2006) explains:

> To be consistent, principles must be rooted in fundamental concepts rather than being a collection of conventions. For the body of standards taken as a whole to result in coherent financial reporting, the fundamental concepts need to constitute a framework that is sound, comprehensive, and internally consistent.

Thus, the FASB expects that, when completed, a single document that is accepted by both the FASB and the IASB will replace the FASB's series of Conceptual Statements and the IASB's Framework. It should be clear, therefore, that this preliminary view should be examined thoroughly and critically. Indeed, the FASB has requested comments on the Preliminary Statement (as it does for all its statements).

The Financial Accounting Standard Committee (FASC) of the American Accounting Association (AAA) is charged with commenting on the FASB's publications, preferably when they are preliminary and advanced as exposure drafts. We do not and cannot speak for the AAA as an organization or for individual members. We do hope, though, to stimulate

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a spirited and informed discussion among AAA members and others regarding this important milestone in the development of accounting. From our analysis of individual paragraphs of the Preliminary Conceptual Framework, we have concluded that it is a fundamentally flawed approach and should not be adopted in its present form.

We have four basic objections to the Preliminary Conceptual Framework:

1. We believe it is too focused on an investment role of accounting and neglects the more important stewardship role.
2. We suggest that it relies on fair values (such as "mark-to-model" and present-value-determined numbers) that are rarely trustworthy because they are not grounded on actual relevant market transactions. We believe that accounting reports that provide such "soft" numbers will be harmful to the relevance and usefulness of accounting numbers generally.
3. We agree with the FASB's desire for neutral accounting numbers. However, given management's upward bias in reporting, we feel that conservative standards are required to produce neutral accounting numbers.
4. We suggest that the FASB's standards should not be based only on a conceptual framework. Concepts such as "relevance" are too broad to be useful for determining a specific standard. A more rigorous field-performance-testing model is needed before conducting real-world experiments with new accounting standards. We recommend allowing companies more flexibility in their reporting choices to allow market forces a greater role in setting accounting standards.

We drew these conclusions after reviewing and analyzing paragraph-by-paragraph the Preliminary Conceptual Framework. Rather than commenting here on each paragraph (which would result in a paper about twice as long as the FASB's 55-page document), we limit our discussion to the basic concepts. We now present the Preliminary Conceptual Framework (CF) key concept, followed by our comments (COM). We identify references to CF paragraphs with the abbreviations used by the FASB, where: S is the "Summary" (15 paragraphs); OB is the "Objectives" (Chapter 1, 28 paragraphs); BC1 and BC2 are the "Basis for Conclusions" (Chapter 1 Appendix A, 43 paragraphs and Chapter 2 Appendix A, 72 paragraphs); and QC is "Qualitative Characteristics of Decision-Useful Financial Reporting Information" (Chapter 2, 59 paragraphs).

OVERVIEW

The CF's key concept is presented in OB3:

> [F]inancial reporting should provide information to help present and potential investors and creditors and others to assess the amounts, timing, and uncertainty of the entity's future cash inflows and outflows (the entity's future cash flows). That information is essential in assessing an entity's ability to generate net cash inflows and thus to provide returns to investors and creditors.

The following paragraphs apply this concept to specified conditions. We organize our discussion of these conditions in the following order: users of financial reports, primary use of financial statements—stewardship and investment decisions, cash flow as the objective of financial reporting, limitations of external financial reporting, relevance and trustworthiness, auditing and trustworthy numbers, conservatism bias, balance-sheet versus income-statement approach, and the function of the FASB/IASB.

FASB's PRELIMINARY CONCEPTUAL FRAMEWORK

Users of Financial Reports

CF: (OB11) "Thus, the primary users of general purpose financial reports are present and potential investors and creditors (and their advisors)." Other users are mentioned, but they are secondary.

(OB10): "... financial reports reflect the perspective of the entity rather than only the perspective of the entity's owners ..."

(BC1.14): "The Board concluded that the objective of general purpose external financial reporting should be the same for all entities that issue such reports."

COM: The primary users should be the owners of enterprises.

1. They prepare the financial records and statements and engage the auditors.
2. To the extent that the owners do not satisfy other users (which include customers and employees as well as creditors and potential investors), the owners bear the cost as those users will include the cost to them of knowledge and uncertainty about the enterprise in their dealings with it (the cost of moral hazard). Hence, the owners have strong incentive to provide financial reports that will serve the needs of other users. (An extensive study of this perspective and what follows is available in Benston et al. [2006, Chapters 2 and 3].)
3. Only 17,000 of approximately 4.9 million enterprises have publicly traded stock and report to the SEC. The AICPA's Rule 203 requires independent certified public accountants to adhere to GAAP when they attest to financial statements. The millions of nonpublicly traded enterprises, though, should not have to bear the cost of preparing and having audited statements that do not meet or exceed their needs. GAAP, therefore, should either apply separately to corporations with publicly traded stock or should be the minimum that is useful to all companies (see AICPA [2005] for an analysis and survey that supports this conclusion).
4. The CF should be sensitive to whether the reporting entity is publicly or privately held. Standards are not about numbers, but about the information conveyed by those numbers. Standards should be set to achieve the desired production and allocation of information

Primary Use of Financial Statements—Stewardship and Investment Decisions

CF: The primary use of information in financial reports is for investment decisions (equity and debt); stewardship is mentioned, but almost in passing.

COM: While stewardship is often claimed to be well served by a focus on investment decisions (or valuation), the claim is logically false. Information useful for stewardship purposes may or may not be useful for valuation purposes and *vice versa*. This has been documented in the academic literature during the last three decades.

COM: Stewardship is not only important, but also it is more important for most enterprises than investment.

1. For all enterprises, the primary benefit from accounting is control and reporting to the owners on the use and disposition of resources entrusted to the managers. Periodic reporting provides information on inflows and outflows of resources, stated in monetary terms, as evidenced by market transactions and allocations to output and time periods according to pre-specified rules. The reports provide useful (but not complete) information on how the managers of the enterprise have conducted their stewardship. The reports concurrently serve to motivate managers to operate

the enterprise in the interest of the owners, since what the managers have done is measured and reported.

2. An enterprise's accounting system also provides managers with information about how their subordinates have conducted their assigned responsibilities. As with the managers, the accounting and reporting system serves to motivate subordinates to do their jobs as directed and expected.
3. The financial reports generated by and reflecting the accounting system are audited, both externally for the owners and internally for the managers and the owners, to assure those users and others to whom the reports are given that the reports are trustworthy and that the numbers are as they purport to be.
4. To the extent that the reported numbers are trustworthy, financial reports provide useful information for investment decisions, both internally by the managers and externally by owners, creditors, and potential investors.
5. The CF (S7) emphasizes relevance: "*Relevant* information is capable of making a difference in the decisions of users by helping them evaluate the effects of past, present, or future transactions or other events on future cash flows *(predictive value)* or to confirm or correct their previous evaluations *(confirmatory value)*." (emphasis in all quotes in the original) This definition reveals the strong bias toward investment decisions and neglect of decisions related to stewardship. Almost disregarded is information about how managers have used and possibly misused other enterprise assets, as well as cash, and examination and reports of the effects of conflicts of interest between their interests and the interests of owners of the enterprise.

Cash Flow as the Objective of Financial Reporting

CF (OB5): "The objective for financial reporting could have been stated in terms of *cash, cash equivalents, or other resources that can be converted to cash* or the like. The role of cash as a medium of exchange and store of value, and therefore the ultimate interest of investors and creditors in cash, makes it unnecessary to use such an unwieldy term." (OB24): "Cash flow information provides a perspective on the entity's economic activities ... that is largely free from the measurement and related issues inherent in accrual accounting."

COM: Financial statements are likely to more useful to investors particularly if the more unwieldy term were used in formulating the objectives of financial reporting. Including close substitutes for cash reduces the effect of random and irrelevant changes and measurement errors and reduces the opportunities for opportunistic managers to distort the variable.

1. Cash is used for present value computations because the transaction costs of transfers from cash to and from other assets and liabilities are very small. Otherwise, it is just one of many assets.
2. Focusing on cash alone is relevant for decisions involved in the management of cash. But, except for concern about defalcations, this is of minor interest to owners and other external users of financial statements.
3. For most investment decisions, the transaction cost of transfers among cash and other assets and liabilities are so small as to be essentially irrelevant. These include assets that can and will be converted into cash (e.g., short-term marketable investments and accounts receivable net of an allowance for bad debts) or used instead of cash (e.g., prepaid expenses) and liabilities that will be paid within the relevant decision period.

4. Cash flows are not "largely free from measurement and related issues." Cash flows can be affected by random fluctuations in receipts and payments. Indeed, accrual accounting is designed to reduce these fluctuations. Opportunistic managers can easily increase cash inflows by such means as delaying purchases of interest-bearing, short-term securities and supplies, and payments on liabilities.
5. The totality of information provided by financial statements comes from the combination of cash basis and accrual basis measures. This complementarity is not explored in the CF.

Limitations of External Financial Reporting

CF (OB14): "Financial reporting is but one source of information needed by those who make investment, credit, and similar resource allocation decisions." But, the CF explains (S8): "To be useful in making investment, credit, and similar resource allocation decisions, information must be a *faithful representation* of the real world economic phenomena that it purports to represent ... To be a faithful representation of those economic phenomena, information must be *verifiable, neutral, and complete*." S11 explains: "*Completeness* means including in financial reporting all information that is necessary for faithful representation of the economic phenomena that the information purports to represent."

COM: Information required for many (perhaps most) investment and other decisions includes expectations about micro- and macro-economic changes, such as the supply and demand of alternative products and services, local and general economic activity, price level changes, and the effect of past, current, and expected political and social conditions on the enterprise's inputs and outputs. (This limitation is recognized by the CF in OB20: "financial reports are not designed to show the value of an entity. Estimating the value of an entity would require taking into account information in addition to that provided in financial reports, for example, general economic conditions and the industry in which the entity operates.") Thus, the first sentence is correct. But it is inconsistent with the other quoted requirements, as the information provided in financial reports cannot be complete.

1. If the balance sheet is supposed to report on the value of assets and liabilities held by an entity that is expected to continue (not be liquidated) for the benefit of investors and creditors, the "economic phenomena" should be value in use, the present value of expected net cash flows. This calculation requires estimates of future cash flows, including those that result from intra-firm externalities, and the discount rate that takes into account the risk preferences of claimants to the entity's assets.
2. Such data are rarely verifiable, as they necessarily depend on subjective judgments by managers. Nor are they likely to be neutral, since managers have their own agenda that rarely would exactly (or even largely) mirror those of all (or even most) investors and creditors. Furthermore, even if the data were trustworthy and provided reliable measures of the economic effect of future events, the amounts reported are likely to be out of date by the time the financial reports are made public. The stock prices of corporations with widely held publicly traded stock are likely to impound the information before it is presented in their financial statements. For all enterprises, the market prices or estimated values of many assets and liabilities as of the end of the accounting period are likely to have changed before they can be used for investment decisions. While the numbers often are useful for stewardship

decisions, such changes could make the numbers not only not useful, but misleading for investment decisions.

3. The CF should have *emphasized* that financial reports cannot provide all the information that might be required for investment and stewardship decisions. The essential issue is which type of information can provide the most useful input for, though not the answer to, those decisions.
4. It also should have emphasized the comparative advantage of financial statement information in relation to all sources of financial information. This becomes particularly telling when we consider the audit side of the enterprise.

Relevance and Trustworthiness

CF (QC43): "[R]elevance must be considered before the other qualitative characteristics because relevance determines which economic phenomena should be depicted in financial reports."

(CC 44): "[T]he next qualitative characteristic to be applied is *faithful representation* ... (Considering faithful representation after relevance does not mean that faithful representation is secondary to relevance. Rather, relevance is considered first because it would be illogical to consider how to faithfully represent a phenomenon that is not pertinent—information about it is not relevant—to the decisions of users of financial reports.)"

COM: The order of importance assigned by the FASB between trustworthiness (faithful representation) and relevance is both revealing and very important.

1. It is revealing because the CF does not recognize that all numbers presented in financial statements are relevant for some purposes that are important to enterprise owners, among other users, particularly for stewardship. Financial statements provide evidence that the resources entrusted to managers have been accounted for and a useful (though not definitive) indication of how those resources were used. For example, although the original amount expended for a building less depreciation is not its economic value (value in use) or market value (value in exchange), it does account for resources expended to purchase the building and an estimate of the amount of that cost assigned to accounting periods over the building's useful economic life (a crude and at least not easily manipulated measure of economic user cost).
2. The usefulness to financial statement users of the numbers presented in financial statements can and should be improved (as discussed below). However, if the result is numbers that the users cannot trust, if they have reason to fear that the numbers were manipulated to mislead them, then those numbers are not relevant. Untrustworthy numbers are inherently irrelevant, at best. Worse yet, users might believe untrustworthy numbers to be trustworthy.
3. Numbers that are not grounded in actual market transactions that can be audited for veracity usually are not trustworthy.
4. Historical cost and liability numbers can be made more relevant by converting them to current values when those amounts are trustworthy and are more meaningful than the historical numbers. For example, marketable securities can be restated at their ask prices, since by holding those securities the enterprise is, in effect, selling and repurchasing them. Purchased inventories that will be replaced (and, by the time the statements are published, often were replaced) can be restated at their

replacement costs. Differences between the initial purchase price and the current replacement costs would be reported as holding gains or losses.

5. Level 3 fair values rarely would qualify as trustworthy numbers, since these usually depend on estimates of net cash flows and discount rates that are readily subject to manipulation by opportunistic managers.

Auditing and Trustworthy Numbers

CF: No mention is made of auditing and, hence, the relationship between auditing and accounting standards is not considered.

COM: As noted earlier, the numbers presented in financial statements are relevant and useful to users only to the extent that the numbers are trustworthy. Independent public accountants have for centuries offered enterprise owners, creditors, and managers assurance that the numbers reported in financial statements are what they purport to be. Accounting standards affect the ability of independent public accountants to give this assurance. In this regard, transaction-based and grounded accounting is much preferred over fair values based on models, present values, and exit prices determined as the amounts hypothetical parties would pay for assets or be paid to assume liabilities.

1. Traditional historical-based accounting numbers are subject to manipulation. For example, maintenance on buildings and equipment and expenditures on advertising and business development can be delayed to reduce reported expenses. Assets that have increased in value over several periods can be sold in a particular period to increase the income reported in that period. If all assets and liabilities could be stated at their values in use at the end of an accounting period, then manipulation of that sort could be eliminated. However, restating assets and liabilities at trustworthy current numbers, where these are available, would have the same effect.
2. Under both traditional and fair-value accounting, some important numbers still could be manipulated. For example, a current ratio above 1.0 could be increased by paying down liabilities just before the end of an accounting period. Some expenses still could be delayed, since it is very difficult for an auditor to distinguish between delays designed to increase reported net income and delays that have a valid business purpose.
3. Under both traditional and fair value accounting, reported numbers can be falsified by opportunistic and dishonest managers (and owners for financial statements prepared for creditors). Fraudulent practices include misdating post-period sales to earlier period, using side-letters that allow purchasers to return goods, removing contingency clauses from contracts before they are processed by bookkeeping, and capitalizing expenditures that should have been recorded as expenses. However, discovering such frauds is an important and often feasible audit function.
4. But fair values that are derived from present values, models, and estimates of exit prices are easy for managers to manipulate and very difficult for auditors to verify. The managers are and should be presumed to be more knowledgeable than auditors in estimating future cash flows, appropriate discount rates, the appropriate models and the assumptions that drive them, and the potential purchasers of their assets and assumers of their liabilities. On what basis could auditors question assumptions and estimates that are not clearly unreasonable? Furthermore, how could an auditor determine that managers' estimates of fair values were deliberately wrong? For example, managers might (and probably would) forecast a range of

possible net cash flows, and use the expected (mean or median) value for their present value calculations. That the present value turns out to be even substantially different from the estimate could be because of properly forecast numbers that are within the distribution. Also, future events rarely are exactly what they were projected to be, and reasonable *ex ante* assumptions can turn out to be wrong for that reason rather than as a consequence of deliberate misstatement. And how can the auditor verify the price that a hypothetical purchaser might have paid for an enterprise's assets?

5. Thus, fair value accounting not based on actual and relevant market numbers is likely to result in misleading financial statements, debasement of the value of audits, and diminution of accountants' reputations for integrity and expertise.
6. More broadly, it is imperative that any such document acknowledge the audit function as part and parcel of the entire financial reporting scene and, by implication, the activities of the FASB and IASB.

Conservatism Bias

CF (QC28): Conservatism is rejected: "Neutrality is incompatible with conservatism, which implies a bias in financial reporting information ... Conservatism or otherwise biased financial reporting information is equally unacceptable."

COM: All measurements contain some bias, both inadvertent and advertent. Honest managers tend to be overly optimistic; if they were otherwise inclined, then they probably would not be successful managers. Some managers are not honest. They will to a much greater degree tend to choose or design measurements that overstate favorable events (e.g., sales) and understate unfavorable events (e.g., expenses). Furthermore, owners and investors, as well as the law, tend to be upset with and punish reporters who overstate but not those who understate net gains, despite the fact that both could lead to opportunity losses. Hence, it is both prudent and reasonable for accountants to apply a conservative bias, wherein revenue is not reported as such unless it is clear (certain or very highly probable) that it has been earned. However, expenses are reported currently (not deferred in the form of assets) unless it is clear that they will be at least offset by deferred or future revenue. Indeed, the net impact of a conservative bias is to encourage early disclosure of apparently "bad" news coupled with guarded disclosure of apparently "good" news. That is, we believe that conservative standards are essential to counteract managements' upward bias.

Balance-Sheet versus Income-Statement Approach

CF: Although the alternative approaches to financial reporting are not discussed directly, the emphasis appears to be on the balance-sheet approach. As expressed in BC1.30: "[I]n measuring performance, an entity first identifies and measures its economic resources and the claims to them in accordance with the applicable recognition and measurement guidance. The entity then calculates the net change in economic resources and claims other than changes resulting from transactions with owners as owners, as well as the net change in claims by owners."

COM: Because the balance-sheet approach requires revaluations that often are not trustworthy (e.g., present values), the traditional income-statement approach should be emphasized, with consideration given to its improvement based on the revaluation to current values when these can be determined objectively and reliably, such that they are trustworthy.

1. As noted earlier, the economic value of many assets cannot be determined except with procedures that result in untrustworthy numbers. Hence, the change in economic resources and claims, as described by the CF, will not provide owners and other investors with a useful measure of the change in the owners' wealth.
2. Alternatively, the income statement provides owners and investors with useful information about the performance and prospects of enterprises by concentrating on the net increase in equity holders' wealth as a result of the operations of the enterprise.
3. The income statement could be improved by revaluations of assets and liabilities to current (end-of-period) trustworthy numbers. Since trustworthy numbers are not available for many assets and liabilities, the revaluations will be incomplete. The matching convention, together with the conservative bias, provides an effective means of dealing with this situation. Increases in the value of assets or diminution of liabilities would be recorded as income to the extent that these increases are derived from trustworthy numbers. Expenses would be matched to the income. Moreover, income statement bypass is a conceptually unacceptable diversion.
4. Where the income related to an expense is deferred or is expected to occur in the future, the expense is deferred up to the amount of the income and reported in the balance sheet among the assets. However, CF (QC18) asserts: "Because such deferred charges and deferred credits do not exist in the real world outside financial reporting, they cannot be faithfully represented as the term is used in the framework." But, they are assets and liabilities. The "deferred charges" are present values of expected revenue, limited by the conservatism convention that constrains these amounts to be the amounts expended to achieve the revenue. "Deferred credits" are the present value of amounts that will be expended to meet obligations represented by, say, cash received in advance. Again in accordance with the conservatism convention, the gains from fulfilling the obligations are not reported as income until the obligations are met.

Function of FASB/IASB

CF (BC2.72): "Regardless of the difficulty, standard setters must take into account both the benefits and the costs of proposed financial reporting requirements."

(BC2.71): "The major problem in conducting rigorous cost-benefit analyses in financial reporting is the inability to quantify the benefits of a particular reporting requirement, or even to identify all of them. However, obtaining complete, objective quantitative information about the initial and ongoing costs of a requirement, or the failure to impose that requirement, would also be extremely difficult."

COM: This is fine on the surface, but the lament about unavailable concrete measures misses the point, that this is a regulatory enterprise. As such, the Board is charged with anticipating the effects of its regulations, and designing those regulations in light of these anticipations. This includes how firms will react, and how other information suppliers will react. It is not a question of how well transactions and economic values function as measures, but of how transactions will be affected as well as how they will be measured. To twist a phrase, it is a question of the Board itself exercising stewardship over the accounting information channel. For example, we suggest that the Board subject new standards to a trial run just as drug companies must conduct clinical trials before drugs are approved. We should not discover the side effects after damage is done in the marketplace. In addition, we suggest that the Board allow more than one rule to be used (this is how the Internet Engineering Task Force operates), or create a competition where a rule is evaluated based on some set of possible transactions, again in the interest of obtaining additional information concerning the long term effects of a proposed rule.

CF: (QC1): "The objective of financial reporting is to provide information that is useful ... Because the qualitative characteristics discussed in this chapter distinguish *more useful* information from *less useful* information, they are the qualities to be sought in making decisions about financial reporting" (emphasis in original).

COM: While commendable and reflective of a long line of thought (e.g., AAA's *ASOBAT*), this claim can be logically supported only under specialized circumstances. In broad general terms, it is false. The difficulty is the concept of "qualitative characteristics," regardless of their definition or number. From an economic perspective, we cannot represent an information choice problem in such broad-based terms; rather, we must get substantially closer to understanding who is using the information, what other information it is used in conjunction with, and so on. This fact has been reported and discussed in the literature for over 30 years (see Christiansen and Demski 2003).

CONCLUSION

Though a regulatory agency or board is likely to find it useful to have a conceptual framework that reflects its core values, the Conceptual Framework (CF) presently in place as well as what is suggested in the Preliminary View, with its emphasis on qualitative characteristics, is not an adequate foundation on which to base professional understanding, standards, or professional aspirations. Indeed, the FASB's preliminary Conceptual Framework is so highly abstract that it is unlikely to be directly useful in setting accounting standards. A more detailed, intermediate-level conceptual structure should be developed to guide accounting standard-setting.

Accounting standard-setting should be more than a conceptual exercise; it should also consider the incentives of both producers and users of accounting. Otherwise, the actual implementation of accounting standards is likely to be quite different from what the standard-setters expected to occur. Then the standard-setters will be locked into a cycle of revision and disappointment with the actual implementation of accounting standards.

Despite our reservations about the Conceptual Framework, we applaud the FASB's desire to seek views on its preliminary effort and hope to participate again as this important activity progresses.

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