

The Top 10 Reasons to Fix the FASB's Conceptual Framework

BY PAUL B.W. MILLER, CPA, AND
PAUL R. BAHNSON, CPA

The Financial Accounting Standards Board (FASB) produced most of its Conceptual Framework (CFW) more than 20 years ago in a project that began in the 1970s. It achieved notable positive results, yet it isn't without flaws.

These blemishes originate from several sources, including political pressures. But time has yielded a new environment that enables the FASB to fix the shortcomings.

In 2004, the Board announced it would reexamine the CFW, citing its incompleteness, a desire for convergence with the International Accounting Standards Board's (IASB) framework, and external encouragement to move toward principles-based standards instead of detailed rules. Two years later, the FASB published a Preliminary Views (PV) document with the ponderous title, *Conceptual Framework for Financial Reporting: Objective of Financial Reporting and Qualitative Characteristics of Decision-Useful Financial Reporting Information*. It recapped what the Boards had accomplished up to that point and solicited input.

TOP 10 REASONS

Here is our input: the top 10 reasons to fix the framework.

In offering these reasons, we may swim against conventional thought and leave some mumbling through clenched teeth about “ivory towers.” But even if you chafe at our willingness to challenge sacred ideas, we urge you to be thoughtful. This project provides a once-in-a-generation opportunity to recast a collective vision for financial reporting's future.

1. Social Objective

The existing framework doesn't fully acknowledge that accounting has a vital social role and that it's regulated to help ensure this role is fully served.

But any accounting theory is incomplete if it only describes what accountants should do without fully describing why doing so advances society's interests. The CFW's Statement of Financial Accounting Concepts No. 1 (SFAC 1), “Objectives of Financial Reporting by Business Enterprises,” opens with the objective that reported information should be useful for making financial decisions. That's certainly appropriate, but more should be said about why it's worth pursuing.

The new CFW should declare that regulated financial reporting's primary objective is to make the economy more productive by promoting more efficient capital markets through the process of creating more fully informed providers and users of capital. Because this greater productivity is in society's interest, its pursuit must trump any impediments to the free flow of information arising from self-interests of the three primary constituencies—statement users, auditors, and preparers—who traditionally interact with standards setters.

Establishing enhanced market efficiency as the guiding principle gives standards setters a more strategic perspective for defining and resolving issues. This platform

The Top 10 Reasons to Fix the Framework

1. Clarify the *social objective* of regulated financial reporting.
2. Explain the *content of useful information* in financial reporting.
3. Affirm that *assets and liabilities* are the primary elements.
4. Identify the *relevant attribute* that is to be measured and reported.
5. Clarify the meaning of *reliability* as a quality of useful information.
6. Amend the definition of *expense*.
7. Amend the definition of *liability*.
8. Clarify the meaning of *timeliness* as a quality of useful information.
9. Clarify the *costs and benefits* of financial reporting.
10. Clarify the significance of the reporting entity's *transactions* as a source of useful information.

would lend the Boards more strength for resisting political pressure from constituents who take a self-serving view that neglects financial reporting's impact on others and society as a whole.

The PV report slightly edits the original wording without adequately addressing financial accounting's important social role. It alludes to societal benefits by saying, “The economy and society as a whole are the ultimate beneficiaries of financial reporting that exhibits the qualitative characteristics to the maximum extent feasible.” While touching on our point, it's buried deep in the report instead of appearing up front among the objectives.

2. Content of Useful Information

After studying the CFW over the last 25 years, we conclude that its most gaping hole is its failure to fully resolve the issue of what decision-useful information should be about. This arose because both external political pressure and internal disagreement kept the FASB of the 1980s from deciding what measures make

financial statements useful.

The Board's one-step-at-a-time strategy postponed the crucial controversy over whether financial statements should be based on cost or market value. By the time SFAC 5, "Recognition and Measurement in Financial Statements of Business Enterprises," was released in 1984, Board members had given up. But because so much attention had been focused on the project, they couldn't just quit and hope no one would notice.

Instead of *prescribing* what needs to be done, SFAC 5 is a political compromise that merely *describes* existing practice as reporting a *mélange* of different kinds of numbers, some based on costs and others based on values.

To reassure constituents who feared any move toward market, the FASB also promised to crawl at a snail's pace in introducing change. We can safely say that promise has been fulfilled.

Although some standards require market values, others cling resolutely to cost or perpetuate the biased practice of marking assets to market only when they're below cost. The time has come to replace the pledge to move slowly with a more appropriate vision for serving the economy through more complete information.

To our astonishment, we realized several years ago that SFAC 1 actually does prescribe the content of useful financial information—but with such subtlety that it was overlooked during the latter stages of the CFW project by the Board and the staff (including both of us).

SFAC 1 describes a subobjective for financial reporting, asserting that useful information should assist users in assessing the amount, timing, and uncertainty of the reporting entity's future cash flows. We endorse that, not as an interesting side comment, but as *the essential guiding concept*; abiding by it would cause everything in the statements to help users anticipate how much cash is likely to come from the entity, how likely it is to flow, and when it will happen.

The PV document increases this idea's prominence, but not as much as we suggest.

Why do we think market-based numbers are preferable? We find it unarguable that the time dimension for decision making is the future; if so, the best platform for making those decisions is the present, not the past. The Boards should affirm this point from the old CFW that has been so patiently awaiting its day in the sun.

3. Assets and Liabilities

The CFW broke new ground in a big way when SFAC 6, "Elements of Financial Statements—a replacement of FASB Concepts Statement No. 3 (incorporating an amendment of FASB Concepts Statement No. 2)," embraced the *asset-liability* theory that puts an entity's assets and liabilities in the lead position among the financial statement elements. That is, they're defined first, with the definitions of income elements then expressed in terms of changes in assets and liabilities.

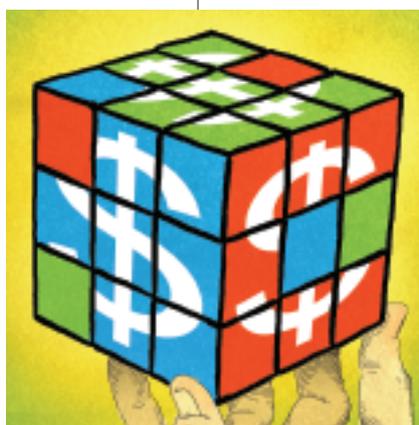
The FASB adopted this priority to link reported income directly to real events involving real things. It's quite different from traditional *matching*, which puts revenues in the prime position, followed by expenses, and then relegates assets and liabilities to being residual debit and credit balances on the balance sheet.

For example, under the asset-liability theory, depreciation is observed and measured as a real change in real assets. In contrast, matching leads accountants to merely assume that depreciation will occur and then calculate the expense using predictions. The resulting book value for the asset is merely an artifact of this allocation

process and has no authentic capacity for helping users assess the amount, timing, and uncertainty of future cash flows.

Despite endorsing the asset-liability theory, the FASB has not always abided by this priority in setting standards. For example, it has never reconsidered depreciation; it also issued pension and options standards that amortize off-balance-sheet debits into earnings with predetermined patterns, with the goal of matching allocated costs against revenues.

Some pieces of the asset-liability theory have been implemented, as in accounting for marketable investments at market value. But Statement of Financial Accounting Standards (SFAS) No. 115, "Accounting for Certain Investments in Debt and Equity Securities," provides a matching-like shelter against earnings volatility by reporting unrealized gains and losses on the balance sheet instead of the income statement. SFAS No. 158 on defined benefit pension plans ("Employers Accounting for Defined Benefit Pension and Other Postretirement Plans—an amendment of FASB Statements No. 87, 88, 106, and 132(R)") employs the same dodge by temporarily parking real gains and loss-



es in stockholders' equity instead of including them as part of annual reported income.

Therefore, we urge the FASB and IASB to affirm the superior usefulness of statements based on observed real economic things and events, not hypothetical ones. The result: progress in the direction of more complete and reliable information.

4. Relevant Attribute

The CFW project ground to a lumbering halt in the 1980s because the FASB was worn down by the controversial issue of whether financial reporting should be based on cost or market values.

Three Board members favored the *status quo*, three advocated market values as the direction for change, and the chair hoped to somehow produce a unanimous statement. The outcome was SFAC 5, which basically catalogs the variety of measures applied in GAAP without saying whether any of them is conceptually preferable to the others.

Practice has been largely frozen since then without a clear purpose. Although some market values have been introduced, they haven't been fully implemented. Many key components of GAAP are compromises reached in the 1930s, '40s, and '50s. It's long past time to reopen the discussion.

We encourage the Boards to reframe the issue and then actually resolve it. The relevant attribute of assets and liabilities is described, albeit obliquely, in SFAC 1 and the PV in the context of the objectives. If users are to receive useful information that helps assess the amount, timing, and uncertainty of the entity's cash flows, then it follows that the relevant attribute of assets and liabilities is simply their *ability to affect the amount, timing, and uncertainty of the entity's future cash flows*.

This attribute, which we call AAATUC, is the intrinsic economic capacity of an asset or liability to shape the flow of benefits in and out of the firm. AAATUC is neither cost nor market but something more abstract; however, it isn't so theoretical that it can't be understood or implemented.

5. Reliability Revisited

The thinking behind SFAC 2, "Qualitative Characteristics of Accounting Information," is mostly on point in defining and describing the qualities of useful information, including reliability, but it came up short in three ways.

First, while the PV prioritizes relevance above reliability, the original CFW did not. Reliability is essential, but putting it second clarifies that it does no good to report

reliable yet irrelevant information. Reliability can be improved, but nothing can be done to make irrelevant information useful, regardless of how reliable it might be.

Second, the FASB and its constituents often seem to act as if verifiability is enough to make information reliable. At its core, verification is nothing more than double-checking a recorded amount to see whether it was transcribed or calculated correctly. Auditors often verify the recorded cost of an asset by comparing that amount to the purchase invoice or cancelled check. They also verify any amounts that management asserts to be the market values of assets and liabilities, including marketable securities, impaired productive assets, and the assets and liabilities of acquired companies.

Although verifiability is necessary for reliability, it isn't sufficient. According to SFAC 2 (and common sense), reliable information also must be an adequately *faithful representation* of the real amount of the relevant attribute. (Another word that could be used is *congruence*.) Even if we know someone paid \$10,468,550 for land 10 years ago, that amount doesn't represent the land's present ability to generate cash flow as faithfully as its current value of \$25 million.

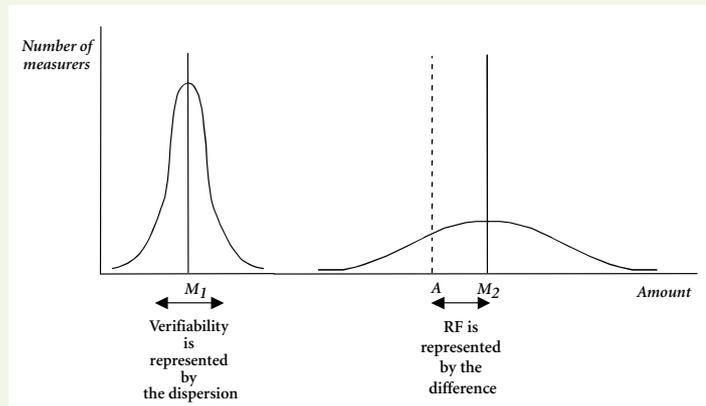
Reliability also demands *neutrality*, which is the absence of bias. Perhaps surprisingly, earnest pursuit of neutrality would end the conservative practice of writing assets down when their value is below cost without writing them up when they've appreciated above cost. In fact, traditional conservatism is *not* neutral and produces unreliable financial statements. There is nothing virtuous about reporting only part of the whole truth to create a desired message.

Third, the CFW erroneously asserts that relevance and reliability can be traded off against each other. This just isn't true because giving up even a sliver of relevance as the goal inevitably produces useless information. We aren't saying there are no tradeoffs. But rather than giving up relevance to gain reliability, the trade is between verifiability and representational faithfulness. Although neither can be totally sacrificed, faithfulness dominates. More reliability exists in knowing the relevant attribute's approximate amount rather than a verifiable measure of an irrelevant attribute. (See "Trading Off Representational Faithfulness and Verifiability.")

This analysis led us to conclude that AAATUC is most reliably described by current market values. Historical amounts and their derivatives (such as book values) aren't reliable because they don't faithfully represent the ability of an asset or liability to impact the entity's future

Trading Off Representational Faithfulness and Verifiability

To apply the language of the original Conceptual Framework, representational faithfulness (RF) exists when a measure can be depended on to be sufficiently close to the real amount of the measured attribute. Verifiability exists when different measurers agree that the measure is known with enough precision to be presented. In statistical terms, RF is present when there is only a small difference between the observed measure and the real amount of the relevant attribute. Verifiability is present when observations produced by the measurers are tightly distributed.



The diagram represents a large number of measurers' attempts to assign a magnitude to two attributes, such as an asset's original cost and market value. The narrow curve on the left has high verifiability because the consensus among the measurers produces little dispersion on either side of the mean M_1 . The flatter curve on the right has less verifiability because the results are more dispersed. If the relevant attribute's real magnitude is A , the right-hand curve is a more faithful representation because its mean M_2 is closer to the target amount. (In other words, M_2 is more congruent with the real amount A .)

In contrast, M_1 lacks faithfulness because it's too far from A to be considered congruent. The tradeoff in selecting between the left and right amounts is that the more verifiable mean M_1 isn't sufficiently close to the real magnitude to be considered faithful, while the more faithful mean M_2 is less verifiable. The resolution in any given situation depends on the facts, yet it does no good to report a highly verifiable measure of something financial statement users don't need to know. It's often said that "It's better to be approximately right than precisely wrong." We concur, and we believe that the CFW would be strengthened by making these points perfectly clear.

cash flows as of the statement date.

For reasons best understood by the Boards, the PV document proposes that "representational faithfulness" move into the place of "reliability" in the FASB's original Conceptual Framework. This would be innocuous, except that they failed to use a new word to describe the need for congruence between the reported and real magnitudes. This vacuum, if left unfilled, will make it harder for the new CFW to overcome the frequent misunderstanding that verifiability is sufficient to create reliability. Nothing could be further from the truth.

6. Expenses Redefined

The FASB's struggle over expensing employee stock options was prolonged in part because the CFW's definition of expense doesn't clearly include equity-based payments.

The existing definition says an expense involves a decrease in assets and/or an increase in liabilities, but the FASB didn't anticipate situations in which companies might pay for goods or services by issuing equity instruments. The definition can be easily modified to add share-

based payments. We'd simply strike one word and add the italicized words to the original definition from SFAC 6:

"Expenses are outflows or other using up of assets or incurrences of liabilities *or issuances of equity-based financial instruments* (or combinations of *both these events*) from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations."

Would this have prevented the Options War that broke out when the FASB first proposed reporting an expense for options granted to employees? Probably not, but it would've given the Board more resources for resisting opponents who used the definition's omission of equity to buttress their arguments that options don't create expenses.

7. Liabilities Redefined

Another CFW shortcoming is its definition of liabilities, which didn't anticipate the growing popularity of using equity-based derivative instruments to create obligations.

This definition could be revised to include all call

options because they obligate a company to deliver shares at a discount. It should also include all other arrangements that similarly obligate the company to deliver fixed or variable numbers of its own shares at predetermined prices or in response to pre-established conditions.

Reporting these instruments as equity erroneously ignores the crucial fact that they don't yet endow their holders with fundamental ownership rights to dividends and voting power. They'd be most usefully reported as liabilities until ownership rights are bestowed on their holders, which, in the case of call options, doesn't happen until they are exercised.

We think useful information is suppressed when these instruments are reported as if they create equity or, what's worse, are left off the statements entirely. Under today's GAAP, these instruments linger stealthily in the issuer's equity section or off the balance sheet; with this change, they could be presented above the mezzanine as full-blown debts at their current market value, regardless of their volatility. We propose the following (our modifications are italicized):

"Liabilities are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services *or deliver equity-based financial instruments* to other entities in the future as a result of past transactions or events."

The definition would include among liabilities all obligations to deliver equity or derivative instruments where the underlying is the reporting entity's own securities. Although their value may not be known with certainty, the company is obligated to make an economic sacrifice in the future because of what happened in the past.

8. Timeliness Expanded

The CFW's definition of relevance includes timeliness, or the promptness with which information is presented to financial statement users. (The PV defines timeliness as "making information available to decision makers before it loses its capacity to influence decisions.")

While it's unarguable that more frequent reporting contributes to timeliness, that point is incomplete because it doesn't explicitly consider the timeliness of the information *content*.

Ponder whether it does any good to report out-of-date information. Would a newspaper have usefulness if it arrived promptly each morning yet listed last year's stock prices? Although it would provide accurate and verifiable facts, they would have no capacity to affect rational decisions.

We question the timeliness of financial reports that,

even though filed before all deadlines, contain outdated information. If the content of useful financial statements should help users assess the amount, timing, and uncertainty of future cash flows, then it follows that information in those statements can be relevant (and useful) only if it provides timely insight. There's no timeliness in reporting the same old facts about past cash outflows.

9. Costs and Benefits

The FASB and IASB would do everyone a good turn by abandoning the timeworn notion that only statement preparers incur reporting costs and that only users reap the benefits. *This chestnut isn't true and never has been.*

The costs of reporting aren't borne by preparers but by their entities' owners, who are also among the reports' primary users. Furthermore, managers benefit greatly from better public information that enables capital markets to establish more efficient security prices that reflect real risks.

There are no reasonable grounds for believing that markets respond to today's inferior public information by bidding prices higher and accepting returns that are too low for their risk. In fact, the only rational response to incomplete and untrustworthy financial reports is *lower* security prices and *higher* capital costs.

The Boards' discussions must articulate the point that management policies intended to reduce preparation costs *diminish* information quality and thus lead to *higher* information-gathering and processing costs. The seemingly economical practice of reporting only the bare minimum is actually much more costly than just reporting what management already knows (or ought to know).

If users want to know assets' market values not disclosed by management, then all users must make decisions under uncertainty or elect to go through their own expensive estimation process. Adding to the total cost is the fact that the users' self-generated data has questionable reliability and limited capacity to reduce uncertainty. If so, they demand higher returns, which, in turn, increase the reporting company's cost of capital.

A decision to reduce accounting costs unavoidably causes *total* costs to go higher. Considered within the context that the highest objective of financial reporting is promoting economic productivity, it's clear that overall savings can be achieved by mandating additional disclosures of useful information. (In fact, we're confident that managers and owners can reap even greater savings by *voluntarily* disclosing useful information that isn't required.)

These points are controversial, but we encourage the Boards to expand their discussion to include *all* costs and

benefits, not just the simplistic idea that managers bear all costs and gain no benefits while users gain all benefits and bear no costs. In fact, both sides incur costs and gain benefits; once that relationship is clear, constructive progress is sure to follow.

To our great satisfaction, the PV document says, “The benefits of financial reporting information include better investment, credit, and similar resource allocation decisions, which in turn result in more efficient functioning of the capital markets and lower costs of capital for the economy as a whole.” The same is true for individual companies.

10. Role for Transactions

Traditionally, great respect has been paid in financial accounting to the entity’s own transactions as reliable sources of information about its assets and liabilities. We speculate that this tradition has roots in the tight relationship between financial reporting and internal control, specifically the fact that an accounting system is the first line of defense against improper transactions.

The company’s own transactions may be sparse, even impoverished, sources of useful information. Far more information resides in the multitudes of transactions executed by *other* entities.

Can it be wise to constantly look inward and backward at past one-time events that no longer reflect current conditions? For example, could investors who bought shares of Wal-Mart in the 1970s or Enron in late 2000 predict current cash flows from these investments using only their original costs? While their original transactions *were* evidence (although incomplete) of probable cash flow potential at the purchase dates, much more information content resides in recent transactions involving other entities. The same applies to all other assets and liabilities as well.

Suppose the goal is to infer the distribution of red and white marbles in an opaque jar by drawing a sample. How useful is a sample of only one marble? And how useless is it to infer the mix in today’s jar based on a past sample of one marble from a jar that existed weeks, months, or years ago? We find no rational justification for acting as if useful information is provided by continuing to report the results of an entity’s historical transactions.

We urge the Boards to break the constraining tie between a company’s financial statements and its unique experiences that may or may not be representative of economic truth, even at the time they happen.

Who can say an asset’s original purchase price really represented its market value at that date? It was only one

event in the population of similar transactions, and there’s no valid reason to believe it was executed exactly at that distribution’s mean. Instead, a sincere search for reliable financial representations leads to considering the much more useful facts inherent in the many transactions engaged in by others.

The consequence has to be more reliable and useful financial reporting.

SETTING A STEADY COURSE

An opportunity to reconsider the theoretical foundations of accounting comes along only once in a generation. At that glacial rate, it’s important that our generation asks all the big questions, including the all-important one: “What are we doing now that we could do better?” If we don’t, we’ll saddle those who come after us with the same ineffective paradigm handed down to us.

The current reexamination of the Conceptual Framework is a rare opportunity that must not be squandered by aiming low and tinkering with the small stuff while running from the big issues to avoid political controversy. Our generation needs to challenge even the most fundamental assumptions and, if they’re found wanting, replace them with something better.

Our goal is to point out directions for progress and reform. We have no interest in encouraging the FASB and IASB to produce an air-brushed Conceptual Framework that merely uses new language to justify the status quo. If that empty goal becomes the project’s objective, both Boards will have thrown away the opportunity of their members’ lifetimes to have a lasting impact for the good of society.

Will any of our suggestions be implemented? We certainly hope so. If they’re not, we hate to think that accounting and management professionals all over the world will stumble through another quarter century, meandering from one political standards-setting crisis to another without a compass that marks a steady course toward greater efficiency and productivity.

It would be a tragedy of epic proportions if this opportunity were to be lost for fear of rocking the boat. ■

Paul B.W. Miller, CPA, Ph.D., is a professor of accounting at the University of Colorado at Colorado Springs. You can reach him at (719) 262-3590 or pmiller@uccs.edu.

Paul R. Bahnson, CPA, Ph.D., is a professor of accounting at Boise State University. You can reach him at pbahnson@boisestate.edu.