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A Common Framework for Accounting Standards

As the FASB and the IASB converge U.S. GAAP and IFRS at the standard level, they are also achieving convergence at the conceptual level.

In September 2010, the U.S. Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) completed the first phase of a project that will influence global standards setting for many years to come. Specifically, the Boards converged key portions of their *conceptual frameworks*. This month's column will explain what the Boards have done and the significance of their accomplishment.

What's a Conceptual Framework?

A conceptual framework for a set of accounting standards is an explicit declaration of the fundamental concepts on which the set of standards is based. The concepts addressed by conceptual frameworks tend to be general in nature, broad in scope, and stable over time. For example, a conceptual framework typically will identify the kinds of financial statements that reporting entities should prepare (balance sheet, income statement, etc.) and define the basic elements of those financial statements (assets, liabilities, income, expenses, etc.).

Having a conceptual framework eliminates the need for a standards setter, such as the FASB or the IASB, to reestablish core concepts each time it develops or updates a standard. Additionally, by consistently referring to a stable conceptual framework, a standards setter is more likely to promulgate standards that are consistent with each other as well as with significant assumptions and constraints.

The conceptual framework of U.S. Generally Accepted Accounting Principles (GAAP) is documented in a series of *Statements of Financial Accounting Concepts* (SFACs) issued by the FASB. The IASB has documented the conceptual framework of International Financial Reporting Standards (IFRS) in its *Framework for the Preparation and Presentation of Financial Statements*. Though similar in some respects, the two frameworks have always been separate and distinct from each other—until recently. As part of their efforts to converge the specific standards that comprise U.S. GAAP and IFRS, the Boards have begun to converge their conceptual frameworks as well.

The FASB-IASB Conceptual Framework Project

In October 2004, the FASB and the IASB added a joint conceptual framework project to their agendas. The objective of the project is "to develop an improved common conceptual framework that provides a sound foundation for developing future accounting standards." In other words, the Boards have been working together to replace their separate frameworks with a single framework on which both future U.S. GAAP and future IFRS will be based. Each Board is committed to making the single framework better than either one's existing framework.

The joint conceptual framework project consists of eight phases, designated "A" through "H":

A. Objective and qualitative characteristics
B. Elements and recognition
C. Measurement
D. Reporting entity
E. Presentation and disclosure, including financial reporting boundaries
F. Framework purpose and status in GAAP hierarchy
G. Applicability to the not-for-profit sector
H. Remaining issues

In July 2006, the FASB and the IASB issued a Preliminary Views (PV) document for Phase A that described the Boards' tentative thoughts on the overall objective of financial reporting and on the necessary and desirable qualitative characteristics of reported financial information. After further deliberations, the Boards issued an Exposure Draft (ED) for Phase A in May 2008 that proposed the first two chapters of a common conceptual framework. Final versions of those two chapters were subsequently issued by the Boards on September 28, 2010.

The FASB issued the two chapters together as SFAC No. 8, "Conceptual Framework for Financial Reporting—Chapter 1, *The Objective of General Purpose Financial Reporting*, and Chapter 3, *Qualitative Characteristics of Useful Financial Information* (a replacement of FASB Concepts Statements No. 1 and No. 2)." (SFAC No. 1 was "Objectives of Financial Reporting by Business Enterprises," and SFAC No. 2 was "Qualitative Characteristics of Accounting Information.") The Board had previously issued only seven SFACs in its 37-year history—none of them in the past 10 years. The infrequency of SFAC issuance reflects the high degree of stability in the FASB's conceptual framework over time. But change happens, and the less frequently it happens, the more significant it is when it does happen.

For its part, the IASB incorporated the two chapters into a revised version of its framework that it published as *The Conceptual Framework for Financial Reporting 2010*. Previously, the IASB hadn't made a substantive revision to its framework since 2001. Again, that fact that conceptual frameworks don't change frequently makes the recent changes by the FASB and the IASB all the more notable.

The Objective of General Purpose Financial Reporting

Chapter 1 of the Boards' common conceptual framework focuses on the overall objective of financial reporting. As stated in SFAC No. 8, "The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity." This is broadly consistent with the FASB's prior objective as stated in SFAC No. 1: "Financial reporting should provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit, and similar decisions." The newly defined objective is also similar to the IASB's prior objective of "provid[ing] information about the financial position, performance, and changes in financial position of an entity that is useful to a wide range of users in making economic decisions."

The aspect of the new converged objective that differs most from each Board's previous objective is the emphasis on "general purpose" financial reporting. Both Boards currently view their standards-setting efforts as directed at the needs of financial-statement users who aren't in a position to obtain specific information tailored to each user's individual needs.

Qualitative Characteristics of Useful Financial Information

The FASB and the IASB decided that the second chapter they issued recently will actually be Chapter 3 of their common conceptual framework. The Boards have reserved Chapter 2 for the output of Phase D (the reporting entity phase) of the conceptual framework project.

Most of us think of the information in financial statements as being primarily quantitative in nature. But the FASB and the IASB have long recognized that there are certain qualitative characteristics of financial information that affect its usefulness—specifically, how useful it is for making the kinds of economic decisions that users of financial statements make. Accordingly, the Boards have identified such qualitative characteristics in Chapter 3.

The Boards have deemed *relevance* and *faithful representation* to be the fundamental qualitative characteristics of useful financial information. This reflects the Boards' belief that financial information must exhibit those characteristics in order to be useful for making decisions.

Additionally, the Boards have identified *comparability*, *verifiability*, *timeliness*, and *understandability* as qualitative characteristics that enhance the usefulness of financial information. Such characteristics complement the fundamental characteristics and enhance decision-usefulness when they are present. In short, they are "nice to have" characteristics rather than "must have" ones. (As a matter of personal opinion, I

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find it somewhat disturbing that the Boards don't consider understandability to be "fundamental.")

In addition to fundamental and enhancing qualitative characteristics, the Boards have also identified a pervasive constraint: *cost.* They clearly recognize that if the costs of applying a particular accounting standard would exceed the benefits of doing so, then it makes no sense to impose such a standard on reporting entities.

The fundamental characteristics, enhancing characteristics, and pervasive constraint that the Boards have mutually identified represent a blending of concepts that were, for the most part, already present in their prior conceptual frameworks. The earlier frameworks of U.S. GAAP and IFRS, however, differed from each other with regard to relative priorities among the characteristics and the wording used to describe them.

What Now?

Because the conceptual framework of U.S. GAAP isn't itself authoritative, the recent revisions to it don't change authoritative U.S. GAAP as documented in the FASB *Accounting Standards Codification*™. The revisions do change authoritative IFRS, however, because the conceptual framework of IFRS is considered authoritative.

Chapter 2 of the common conceptual framework is due to be released by the end of 2010. As noted previously, it will address the concept of the reporting entity (Phase D). The Boards are also currently working on Phases B (Elements and Recognition) and C (Measurement).

Although the conceptual framework project is currently being conducted in parallel with numerous standard-level projects, its successful completion will be essential to the ultimate success of all of the Boards' convergence efforts. As I say in the *Convergence Guidebook for Corporate Financial Reporting* (Wiley), "If different standard setters disagree on the basic concepts of financial reporting, then it is unlikely that those standard setters will ever agree on specific standards." Now that the FASB and the IASB have agreed on some portions of a common conceptual framework, we see that the Boards are indeed capable of converging their standards at the conceptual level and are intent on achieving even more conceptual convergence in the years ahead. **SF**

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