



Financial Accounting Standards Board

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Why Does the FASB Have a Conceptual Framework?

By John M. (Neel) Foster, FASB Member, and L. Todd Johnson, Senior Project Manager



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Although some of the FASB's constituents—especially those that interact with the Board on a regular basis—are quite familiar with the FASB's conceptual framework, many others either are not aware of it or are only vaguely aware of it. To them, what the framework is and why it is needed are not clear. To provide a better understanding about the nature and role of the framework, this article focuses on certain questions

that are commonly asked about it. Those questions include:

- What is the conceptual framework?
- How does the framework affect practice?
- Why is a framework needed and who benefits from it?
- What motivated the FASB to develop its framework?
- Have others developed such frameworks?
- What does the future hold for the framework?

What is the Conceptual Framework?

The conceptual framework is a body of interrelated objectives and fundamentals. The objectives identify the goals and purposes of financial reporting and the fundamentals are the underlying concepts that help achieve those objectives. Those concepts provide guidance in selecting the transactions, events and circumstances to be accounted for, how they should be recognized and measured and how they should be summarized and reported.

To date, the FASB has issued seven Concepts Statements¹ covering the following subjects:

- Objectives of financial reporting by business enterprises and nonprofit organizations
- Qualitative characteristics of useful accounting information
- Elements of financial statements (that is, the definitions of assets, liabilities, revenues and so forth)

- Criteria for recognizing and measuring those elements
- Use of cash flow and present value information in accounting measurements.

The first of those Concepts Statements was issued in 1978 and the most recent in 2000. No additional ones are currently planned although the Board has proposed a limited amendment to revise the definition of a liability and is exploring the possibility of a broader reconsideration of liabilities and their recognition.

How Does the Framework Affect Practice?

Concepts Statements do not affect practice directly. They do not require changes in generally accepted accounting principles,



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amend, modify or interpret existing accounting or disclosure standards or require changes in accounting procedures or require disclosure of practices that might be in conflict with the concepts. Concepts Statements are not intended to invoke application of Rules 203 or 204 of the AICPA's Rules of Conduct of the Code of Professional Ethics. The framework affects practice only by means of its influence in the development of new accounting standards.

Why Is a Framework Needed and Who Benefits from It?

The FASB is the most direct beneficiary of the framework. The framework provides the Board with both a foundation for setting standards and concepts to use as tools for resolving accounting and reporting questions. The FASB staff is guided by pertinent concepts that might provide guidance in developing its analysis of issues for consideration by the Board, as well as in making its

¹One (Concepts Statement No. 6, *Elements of Financial Statements*) is a replacement of an earlier one (Concepts Statement 3, *Elements of Financial Statements of Business Enterprises*) to include nonprofit organizations in addition to business enterprises.

recommendations to the Board. Similarly, those concepts are the basis for the FASB's discussions of those issues and for making its decisions about a specific standard. In fact, a discussion of the concepts that were utilized in developing a standard is included in the basis for conclusions of each standard.

The framework provides a basic reasoning on which to consider the merits of alternatives. Although it does not provide all the answers, the framework narrows the range of alternatives to be considered by eliminating some that are inconsistent with it. It thereby contributes to greater efficiency in the standard-setting process by avoiding the necessity of having to redebate fundamental issues such as "what is an asset?" time and time again.

In addition, the framework contributes to greater efficiency in communications, both internal and external. By providing a common terminology and frame of reference, it greatly facilitates the Board's debates about specific technical issues. It also greatly facilitates communications between the Board and its constituents, particularly communications between the FASB and its constituents who offer comments and suggestions about the Board's proposals. A framework should also reduce political pressures in making accounting judgments.

The framework is used to guide the development of accounting standards that are intended to facilitate the provision of evenhanded, or neutral, financial and related information. Neutral information enables users of that information to make informed investment and credit decisions. Consequently, neutral information serves the public interest by helping to promote the efficient allocation of scarce resources in the economy and society. The framework helps the capital markets and other markets to function more efficiently in the same way.

The use of an agreed-upon framework reduces the influence of personal biases on standard-setting decisions. Without the guidance provided by an agreed-upon conceptual framework, standard setting would be quite different, as it necessarily would have to be based on the personal frameworks of individual members of the Board. As Charles Horngren, former APB member, former FASAC member and former FAF trustee, once noted, "As our professional careers unfold, each of us develops a technical conceptual framework. Some individual frameworks are sharply defined and firmly held; others are vague and weakly held; still others are vague and firmly held."² He added that:

At one time or another, most of us have felt the discomfort of listening to somebody attempting to buttress a preconceived conclusion by building a convoluted chain of shaky reasoning. Indeed, perhaps on occasion we have voiced such thinking ourselves. . . .

My experience as a member of the APB taught me many lessons. A major one was that most of us have a natural tendency and an incredible talent for processing new facts in such a way that our prior conclusions remain intact. [footnote omitted]

In an environment in which standard setting is based on the personal conceptual frameworks of individual standard setters, agreement on specific standard-setting issues will only occur when a sufficient number of those personal frameworks intersect. However, even those agreements may prove to be transitory because, as the membership of the body changes over time, the mix of individual conceptual frameworks will change as well. As a result, that standard-setting body may reach significantly different conclusions about similar—or even identical—issues than it did earlier, resulting in standards not being consistent with one another and past decisions not being indicative of future ones. Standard setting therefore becomes more or less ad hoc. Moreover, without a framework, rational debate cannot occur because positions about the appropriate accounting treatment for a given transaction can neither be defended nor refuted—the appropriate treatment is simply "in the eye of the beholder." That was the case with the AICPA's Committee on Accounting Procedure which preceded the Accounting Principles Board (APB) and, it largely was true of the APB as well.

The FASB is not the only beneficiary of the framework. The credibility of financial reporting is enhanced when objectives and concepts are used to provide direction and structure to financial accounting and reporting. The framework helps by leading to the development of standards that are not only internally consistent but also consistent with each other. As a result, both preparers and users of financial statements benefit from financial statements that are based on a body of standards that is more internally consistent and less ad hoc.

The framework further helps users of financial reporting information to better understand that information and its limitations. It also provides a frame of reference for understanding the resulting standards. That frame of reference is useful to preparers who apply those standards and to auditors who examine the resulting reports, as well as to students who study accounting and the faculty who teach it.

What Motivated the FASB to Develop Its Framework?

In a sense, the motivation for the FASB to develop its framework grew out of observations about the difficulties that its predecessor, the APB, had experienced.

From its inception, the APB was urged to develop a conceptual basis for its decisions. The AICPA special committee whose 1958 report resulted in the creation of the APB had urged the APB to work on both concepts and standards on the grounds that such

²Charles T. Horngren, "Uses and Limitations of a Conceptual Framework," *Journal of Accountancy*, April 1981, p. 90.

concepts would provide a meaningful foundation for standards. In response, the APB commissioned two research studies on the “postulates” and “broad principles” of accounting. However, after reviewing the studies, the APB concluded that the recommendations contained therein were “too radically different” from existing generally accepted accounting principles for acceptance at that time.

As a result of problems that emerged from the Opinions that the APB subsequently issued (that were not based on conceptual guidance), the AICPA appointed another special committee in 1964 to re-examine the program for establishing accounting principles. Among its major recommendations were that the APB develop a conceptual framework to guide its decision making. The APB responded by publishing APB Statement 4, *Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises*, in 1970. However, the APB itself acknowledged that APB Statement 4 was “primarily descriptive, not prescriptive,” focusing on what financial accounting was at the time rather than what it ought to be. Because Statement 4 was backward looking, it did not provide robust guidance to the APB in setting standards.

Soon afterward, due to the criticism the APB was receiving, the AICPA appointed two study groups—one chaired by Francis M. Wheat and the other chaired by Robert M. Trueblood—to consider the establishment of accounting principles and the objectives of financial statements. The recommendations of those groups laid the foundation for the FASB and for its conceptual framework project.

When the FASB first began operations in 1973, among the projects on its initial agenda was one that encompassed the objectives of financial reporting. That project focused on the findings of the Trueblood Study Group, as published in *Objectives of Financial Statements* (the Trueblood Report).³ The Trueblood Report focused on what might be thought of as “first principles,” namely, the objectives of financial statements. The FASB built upon that work and, by establishing early on what the objectives of financial reporting should be, it laid a sound foundation on which to develop the subsequent concepts that constitute the conceptual framework.

Have Other Standard Setters Developed Conceptual Frameworks?

Following the FASB’s lead, standard setters in a number of other jurisdictions have also developed their own frameworks. Canada and the International Accounting Standards Committee (IASC), now the International Accounting Standards Board (IASB) were the first to do so, followed by Australia, New Zealand and, most recently (in 1999), the United Kingdom. Their frameworks, like that of the FASB, are based on the fundamental objective that

financial reporting should provide information that is useful to investors and creditors in making investment and credit decisions. Not surprisingly, the conceptual frameworks that were developed are generally similar but not necessarily identical to the FASB’s framework.

What Does the Future Hold for the Framework?

As noted earlier, the Board has proposed a limited revision of the liabilities definition and is exploring a broader reconsideration of liabilities and their recognition. The need for that reconsideration was highlighted by certain issues that arose in several recent agenda projects involving liabilities. That broader reconsideration could also encompass interrelated issues involving revenue recognition, particularly in light of the growing concerns associated with such matters.

Additionally, the advent of the new IASB may also lead to further development of the framework. As part of its effort to achieve greater convergence of accounting standards internationally, the IASB is considering whether differences in the existing conceptual framework of the IASB and those of national standard setters—such as the FASB—may be impediments to convergence. If so, there may be need to reconsider those frameworks or at least certain aspects of them.

Moreover, none of the frameworks—neither the FASB’s nor those of the IASB and others—are really “complete.” For example, matters of financial statement presentation and display were not addressed as planned in the FASB’s framework, nor were matters of reporting outside of the main body of financial statements. Furthermore, certain aspects of the framework that were addressed, such as recognition and measurement, remain somewhat incomplete.

Finally, the FASB’s framework was, for the most part, developed two decades ago. Since then, business and financial activities have changed considerably and have become increasingly complex. As a result, many of the standard-setting issues of today are different and more complex than those that were contemplated when the framework originally was developed. For that reason, some updating of the framework may be both desirable and necessary to enable it to better cope with the issues of today and tomorrow.

The views expressed in this article are those of the authors. Official positions of the FASB are determined only after extensive due process and deliberations.

³The other study, *Establishing Financial Accounting Standards*, (the Wheat Report) focused on how accounting principles should be established. In doing so, it reviewed the operations of the FASB’s predecessor, the Accounting Principles Board, and proposed the establishment of an independent standard-setting body, which led to the formation of the FASB.

Understanding the Issues

The FASB welcomes feedback on *Understanding the Issues*.

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