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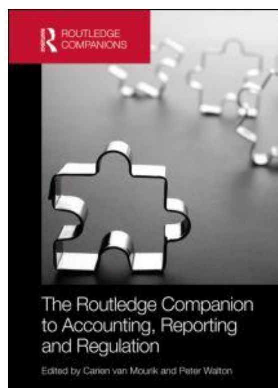


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# The Role of Conceptual Frameworks in Accounting Standard-Setting

*Carien van Mourik and Peter Walton*

## 1. Introduction and definition

In the world of IFRS, conceptual frameworks occupy a prominent role, and yet, outside of Anglophone countries, the use of conceptual frameworks in standard-setting is a relatively recent phenomenon inspired by the FASB and IASB Conceptual Frameworks. For example, the Accounting Standards Board of Japan's Conceptual Framework dates from 2006, and in Islamic accounting the Conceptual Framework of the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) is even more recent. Evidently therefore the use of an explicit conceptual framework is a choice rather than a necessity. In this chapter we will first define what we mean by a conceptual framework, then review the literature that considers the usefulness or otherwise of such a framework. After that we will review the evolution of the conceptual framework, the current IASB framework and finally the role that it plays in the world of IFRS.

Macve (1981, p. 9) wrote:

> The role of a 'conceptual framework' is to provide a structure for thinking about what is 'better' accounting and financial reporting. It is a theoretical endeavour with the practical aim of clarifying the objectives of financial reporting, and how alternative practices are likely to help achieve those objectives. Whether as a company director, a chief accountant, an auditor or an accounting standard-setter, one cannot make a rational choice of accounting procedures without some framework of principle.

Carsberg (1984: 25) defines a conceptual framework as:

> A conceptual framework comprises a set of basic principles that command general support and can be used to help with detailed decisions by increasing the likelihood of consistency and reducing the costs of analysis. In financial reporting, a conceptual framework is expected to help with decisions by standard-setters and others about how accounting measurements should be made, what information should be included in published reports, and how the information should be displayed.

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Carsberg points out that everyone who writes about the objectives of financial reporting, and considers income measurement and related issues, is in effect discussing a conceptual framework and authoritative analyses of financial reporting such as Paton and Littleton (1940) address the same subject area without calling it a conceptual framework.

The IASB's Conceptual Framework, originally entitled the *Framework for the Preparation and Presentation of Financial Statements*, but changed in 2010 to *Conceptual Framework for Financial Reporting*, which is again in the process of revision has its origins in problems with US standard-setting in the 1960s. The US standard-setting institutions were substantially changed with the creation in 1973 of the FASB as an independent standard-setter, and the FASB was mandated to develop a conceptual framework as part of its standard-setting process. Carsberg (1984, p. 27) notes that people thought that, if they could reach agreement on a conceptual framework, appropriate decisions would be clearer and people with vested interests would find greater difficulty in resisting them. The idea was that accounting–technical considerations would override political considerations in standard setting. For this purpose, the structure and substance of the conceptual framework would need to be coherent and theoretically sound, and its concepts internally consistent and applicable in practice. This chapter concerns the conceptual framework within this narrower focus of a tool for standard-setting, and eventually, preparation of financial reports.

## 1.1 The need for a conceptual framework in standard-setting

Standard-setting arrangements differ between countries and cultures, and have emerged and evolved at different times in different economies. The comparative international accounting literature (notably Nobes, 1984) shows that there are two separate streams of development in financial reporting in industrialized countries, an Anglo-Saxon stream and a Continental European stream. In the Anglo-Saxon group, standard-setting has typically evolved through arrangements where the private sector, and particularly the accounting profession, has been responsible for writing detailed rules, within an overarching statute law constraint. However, in the Continental European group, the tradition has been for the state to specify detailed accounting standards within a Commercial Code. Continental European countries have not evolved conceptual frameworks for standard-setting as such. While statute law may well set out the objectives of the law-makers, there is typically no appeal to accounting concepts as such.

Hoarau (1995) contrasts US standard-setting with the French model (one of two key models in the continental European group). He notes (p. 225): 'The composition and functioning of the standard-setting organisation is founded on multidisciplinary cooperation and the representation of the widest possible range of different users of accounting'. He adds that this forces the government to seek consensus and compromise between competing interests. He also points out that a governmental process of standard-setting 'is by its very nature discontinuous in terms of the government orders or other statutes which give accounting standards … the force of the law'. He emphasizes the link to corporate taxation as another important factor.

The conceptual framework which is the subject of this chapter is typically something that is associated more with Anglo-Saxon standard-setting, operating in a private sector context. It is not associated with countries whose system is more law and taxation based, which could be said to operate on a basis of achieving pragmatic, consensual solutions to individual problems without regard to any concept other than appropriate regulation of the economy. Another possibly significant factor is that the Anglo-Saxon standard-setting world until relatively recently saw accounting standard-setting as simply a technical issue. It was only in the late 1970s and

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1980s that the literature started to acknowledge that standards had economic consequences. The potential social and financial consequences of standard-setting were not considered previously and its function of making political choices was not seen (see Chapter 17).

Pacter (1983: 76) points out that the American Institute of Certified Public Accountants (AICPA) had as early as 1958 called for the evolution of concepts that would 'provide a meaningful foundation for the development of principles and the development of rules or other guides for the application of principles in specific situations'. Carsberg (1984: 27) identifies a number of reasons for using a conceptual framework in standard-setting. He wrote: 'The first purpose in embarking on the conceptual framework project is to facilitate decisions on controversial issues'. He added that it also avoided wasted efforts in that standard-setters did not need to go over the same ground on each project, and it helped to generate consistency in standards. He also thought that 'an agreed conceptual framework should enable practitioners to make decisions on more issues themselves and avoid the need for so many detailed standards'.

This last point is a significant difference between the FASB and the IASB. The US framework is intended only for use by standard-setters to guide their decision-making. It does not figure in their authoritative literature – it is not part of the US Accounting Standards Codification. However, under IFRS, the conceptual framework is intended to be a tool for preparers and auditors as well. IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* specifically provides that where there is no IFRS that addresses a particular transaction, or which can be analogized to, the preparer should look to the conceptual framework. As Gélard (2010) underlines, the IASB framework is intended to be a working tool that helps preparers and auditors flesh out principles-based standards.

Burlaud and Colasse (2011: 28) suggest that there is another aspect to the conceptual framework: 'the use of a conceptual framework by a standard-setter contributes to building it a reputation for competence and gives it substantial legitimacy'. There is also a body of work in the literature on professions that suggests that the more 'technical' the cognitive base of a professional group is perceived to be, the higher is the professional standing of that group. One could argue that a possible factor in explaining why Anglo-Saxon private sector standard-setters have conceptual frameworks, and Continental European standard-setters do not, is that the latter are able to enact their standards through national law, while the former cannot, and must appeal to other forms of authority.

### *1.2 Criticism of the use of a conceptual framework*

Burlaud and Colasse (2011: 27) are critical of a number of aspects of the IASB's use of the conceptual framework. They also point out that the statement of objectives of financial reporting is 'highly political in character since it amounts to making a choice as to the governance of the company'. The French academics comment 'it may therefore seem surprising that such a declaration should emanate from a group of technical experts with no political legitimacy'.

They note that the IASB framework privileges the investor, and that it assumes that as the investor runs the most risks, information that meets their needs will meet the needs of others. Burlaud and Colasse (ibid.: 32) comment that this analysis is questionable and ask whether employees do not run higher risks, and whether the needs of all users are necessarily homogeneous. They add that 'investors do not constitute a homogeneous category and vary in their interests, the level of risk they run, their access to information and, in the end, their accounting information needs'.

Van Mourik (2010) notes that IFRS are used in a wide variety of institutional environments worldwide and suggests that providing information useful for investors provides too narrow a focus. She reviews seven assumptions that underlie the IASB conceptual framework and concludes that it

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focuses entirely on the economic functions of financial reporting and neglects its claim to satisfy a public interest because:

- it does not provide evidence of stewardship, even though the discharge of managers by shareholders is a formal part of the annual meeting in many countries;
- it does not provide accountability to the general public regarding public and private costs and benefits;
- it does not provide information about added value and how this has been distributed over its stakeholders; and
- it does not discuss protection and reconciliation of conflicting economic interests of all stakeholders.

She summarizes that financial accounting and reporting fulfil both economic and social functions, but the latter are ignored by the IASB.

A criticism of the way in which the US framework was constructed is that it favours an approach of measuring resources and claims on them as the starting point of recognition and measurement. The implicit assumption was that performance and income ought to be measured as the change in net assets from one period to the next (except for those changes resulting from transactions with the shareholders). In other words, the FASB implicitly adopted a balance sheet approach to the determination of income. This is a not uncontroversial assumption, but is addressed somewhat ambiguously in the original FASB framework.

Indeed, ambiguity could be said to be another weakness of conceptual frameworks in general. The underlying idea of the framework is to have high-level principles which are made operational in accounting standards. The principles are meant to give consistency to the standards, but the higher the level of abstraction from the operational, the more ambiguous the framework is likely to become, and the more difficult to operationalize.

Macve (1981) was commissioned by the UK Accounting Standards Committee to 'review current literature and opinion in the UK, US and elsewhere with a view to forming preliminary conclusions as to the possibilities of developing an agreed conceptual framework for setting accounting standards and the nature of such a framework' (ibid.: 3). This study remains one of the most authoritative critiques of the idea of using a conceptual framework. More recent critiques include Christensen (2010), which was commented and elaborated upon by Macve (2010).

Macve (1981: 11) notes that there are inherent limitations to what financial statements can show. 'There is no unambiguous or correct definition of "income" and "value" on which to base measures of profit and net assets.' He points to an 'absence of comprehensiveness' because it is not possible to reflect all the attributes concerning an entity's value and changes in its value. There will be a need to make allocations and estimates of the future which require subjective judgements (irrespective of the performance measurement and income concept adopted).

He says that there is general agreement that financial statements should be useful, but there is uncertainty about how accounting information is used and why. He suggests there is a variety of needs – 'different users will have different needs for accounting information depending on the situations and decisions they face, their level of understanding, and the alternative sources of information available to them' (ibid.: 11). In addition:

> the different individuals and groups involved with financial reporting … often have conflicting economic interests, and any decisions about accounting practices (which will affect

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> them all) have to be made after weighing up the consequences for these different parties and what their respective rights are (ibid.).

He comments that these problems make financial reporting and the establishment of a conceptual framework a political as well as a technical matter. Macve concludes:

> Accounting theory cannot give complete, precise answers to accounting problems. The history of the development of accounting suggests that it serves many purposes reasonably well, rather than any one purpose very well. It therefore seems unlikely that searching for an agreed conceptual framework of theory in abstraction from individual problems of disclosure and measurement will be successful (ibid.: 13–14).

## 2. The IASB conceptual framework

Leaving aside the argument that any discussion of the objectives of financial reporting is in effect a conceptual framework discussion, the history of the development of elaborated conceptual frameworks in standard-setting starts in the US.

### *2.1 The US framework*

Zeff (forthcoming) reviews the evolution of the idea that the objective of financial reporting is to provide decision-useful information to investors. He notes that George O. May (senior partner in Price Waterhouse) gave advice to the New York Stock Exchange in 1932 that referred to both stewardship (the traditional orientation) and decision-making as objectives. He analyses a great deal of literature in the succeeding years which show a range of views on the objectives of financial reporting and the users of statements. He says:

> the earliest exponent of the decision-usefulness approach to accounting theory and standard setting was George Staubus, an accounting professor at the University of California, Berkeley. He first developed the approach in his doctoral thesis, 'An Accounting Concept of Revenue', completed in 1954 at the University of Chicago (ibid.).

He expanded on this in subsequent publications. Zeff adds: 'The first sign of institutional acceptance of the decision-usefulness objective was in *A Statement of Basic Accounting Theory* (*ASOBAT*) issued by a nine-member American Accounting Association (AAA) committee in 1966' (ibid.).

Pacter (1983) wrote that the Accounting Principles Board (APB), formed in 1959, had been urged to work on concepts as well as specific standards. Zeff notes that in 1970 the APB did indeed issue its non-mandatory Statement no 4 *Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises* which said that the basic purpose of financial accounting and financial statements was to provide quantitative financial information about a business enterprise that was useful to statement users, particularly owners and creditors, in making economic decisions.

However, the APB was relatively short-lived. As Meek (2003: 68) notes:

> The APB was criticised almost from its beginning. One of its objectives was to establish broad accounting principles, but too many of its decisions were ad hoc in nature and … focused on specific problems. The APB had trouble producing opinions that were consistent internally and across one another.

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As a consequence the AICPA in 1971 set up two committees to review standard-setting. The Wheat Committee reviewed the standard-setting institution and its recommendations resulted in the creation of the FASB in 1973. The second committee, chaired by Robert Trueblood, was to consider the objectives of financial statements (Pacter, 1983) and its report (the 'Trueblood Report': AICPA, 1973) was published in 1973. Pacter reports:

> The members and staff of the FASB were mindful that its predecessor was criticised for not having made adequate progress toward developing a normative set of objectives and concepts for corporate financial reporting. And so, among the seven projects on the FASB's initial technical agenda was one that encompassed the objectives of financial reporting … work on the FASB's objectives project began with a consideration of the Trueblood study group's report (Pacter, 1983: 78).

The FASB issued a series of Statements of Financial Accounting Concepts, starting with SFAC 1 *Objectives of Financial Reporting by Business Enterprises* in 1978. It issued SFAC 2 *Qualitative Characteristics of Accounting Information* and SFAC 3 *The Elements of Financial Statements of Business Enterprises* (replaced in 1985 by SFAC 6) in 1980. SFAC 5 *Recognition and Measurement in Financial Statements of Business Enterprises* was issued in 1984 (SFAC 4 addressed the objectives of reporting by non-profit organisations).

### *2.2 The IASC's 1989 framework*

Cairns (2001: 3) says that the decision-usefulness concept was included in the IASC's first standard: IAS 1 *Disclosure of accounting policies* issued in 1974. There was some call for the IASC to follow the US and work on a conceptual framework, but Cairns says:

> The IASC believed, however, that its constituency was far more likely to criticise it for gaps in its standards rather than its failure to develop a conceptual framework. Therefore, it was not until the early 1980s that the first seeds of the framework were sown (ibid.: 4).

The IASC started work in 1982 on a limited project to examine some aspects of the objectives of financial statements. It produced separate documents dealing with different aspects but in 1986 decided to work on a full conceptual framework. Cairns writes:

> In its new project the IASC was able to draw on the published concepts statements of the FASB and work in progress of the standard setting bodies in Australia and Canada. The FASB's concepts statements had been used in all the building block projects [pursued by the IASC] and were familiar to all members of the steering committee. Australia was contemporaneously developing its statements of accounting concepts while Canada was also developing its financial statement concepts (ibid.: 7).

The IASC also examined the concepts underlying financial reporting in Japan, continental Europe, and a range of developing and newly industrialized countries. While none of these countries had published a conceptual framework in a similar form to that of the FASB or that proposed by Canada, Australia and the IASC, there were clearly concepts or principles underpinning their accounting requirements

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The final document was issued in 1989. Cairns reports (ibid.: 8) that the IASC considered whether stewardship or accountability should be an objective, but concluded that users were not interested in these for their own sake but wanted information to make decisions about management performance. The IASC also considered whether to make any reference to the true and fair view (a UK concept extended to the EU by the Fourth Company law Directive; see Chapter 17), but decided against it. A number of countries said they did not know what it meant, and it had not been used elsewhere by the IASC.

Although the 1989 IASC Conceptual Framework[1] certainly appears to give priority to the information needs of investors as providers of risk capital, Cairns (2001: 8) says that the 1989 IASC framework did not focus on investor needs, as some assert. He points out that the IASC framework identifies a number of users, without giving precedence to any, but does suggest that information that satisfies the needs of providers of risk capital will meet many of the needs of other users. He adds that, like the US framework, the IASC framework bases the recognition of assets, liabilities and income round the definitions of asset and liability, but contests that this implies a balance sheet orientation:

> Rather, the IASC believed (and still believes) that it is impossible to define income and expenses without including in those definitions the definitions of assets and liabilities – none of the critics of the IASC's approach or the similar approach adopted by some national standard-setting bodies have proposed operational definitions of income and expenses which are independent of the definitions of assets and liabilities (Cairns, 2001: 9).

## *2.3 Convergence with the FASB*

In 2004 the IASB agreed to start a joint project with the FASB to update and converge their conceptual frameworks. The argument was that if their objective was to converge their standards, it was appropriate that there should be a common conceptual framework which underpinned the standards. In 2010 the boards issued final versions of the objectives of financial reporting (Chapter 1) and the qualitative characteristics (Chapter 3), and the project was suspended while they concentrated on finalizing their financial crisis-related projects.

The IASC framework talked about financial statements and not financial reporting, which is a wider concept, but the IASB agreed to move to the US use of 'financial reporting'. However, some IASB members (notably Sir David Tweedie and Professor Geoff Whittington, who gave an alternative view in the exposure draft) wanted stewardship to be part of the objectives. A similar view was held by Benston *et al.* (2007: 231–2) in their critique of the FASB's (2006) Preliminary View of the objective of financial reporting and the qualitative characteristics in the conceptual framework. Nevertheless, the FASB was firmly against this, asking what information would be provided under a stewardship approach that was not provided under a decision-useful for investors approach. The 2010 objectives are expressed as follows:

> [OB2] 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. Those decisions involve buying, selling, or holding equity and debt instruments and providing or settling loans and other forms of credit (IASB, 2010a).

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However, paragraph OB4 does add:

> To assess an entity's prospects for future net cash inflows, existing and potential investors, lenders, and other creditors need information about the resources of the entity, claims against the entity, and how efficiently and effectively the entity's management and governing board have discharged their responsibilities to use the entity's resources (ibid.).

When the project staff worked on the qualitative characteristics of financial reporting, it was decided that the original formulation did not give any clue as to how the main characteristics interacted. They tried to design a flowchart that would take the standard-setter (or other user) through a series of steps which in effect prioritized the different characteristics. In the end they abandoned this and moved to a formulation where they have fundamental characteristics (that financial reporting must satisfy) and 'enhancing' characteristics which would lead one to choose between alternatives.

A contentious issue in this area is the use of the word 'reliability' in the old US framework. This said that the primary characteristics should be relevance and reliability, but then defined reliability as meaning a faithful representation of what the number purported to represent. However, many constituents have taken reliability to mean verifiability, i.e. that a reliable number is one that can be independently checked and verified. Board members argued that, given the essentially subjective nature of estimates used in financial reporting, they did not want to constrain estimates to those that could be verified. They have tried to make this issue clear by using the term 'representational faithfulness' as a fundamental characteristic instead of reliability, and identifying verifiability as an enhancing characteristic.

Between 2004 and 2010 the project staff did extensive work on the elements of financial reporting, measurement and the reporting entity. In reviewing the elements, the intention was not to change the recognition approach but to consider whether the wording should be refined in any way. However, staff found it very difficult to get beyond the existing definition of an asset without changing the underlying notion, and the financial crisis put pressure on staff time so this aspect was shelved, but not before the boards had debated alternative formulations. The existing definition talks about an asset being probable future cash flows. The boards raised the issue that sometimes the value of an asset was that the entity had rights to prevent other people accessing the asset. Such an asset (e.g. an unused trademark) would not generate cash flows directly, but would enhance the flows to other assets. They also discussed whether what was being recognized was the actual asset or the *right* to the asset.

The old frameworks define a liability as the opposite of an asset, and equity as the difference between the two. The boards debated, without coming to any conclusion, whether it was possible to have a definition of a liability that was independent of the definition of an asset, and whether the same might be possible for equity.

The existing IASC/IASB framework says very little about measurement, which was also a problematic issue for the FASB's old framework. The boards decided that they wanted to address the subject thoroughly. The staff of the Canadian Accounting Standards Board produced a discussion paper, but this seemed to advocate fair value for everything and was not taken up by the FASB and IASB. FASB staff then had a number of attempts to draft a measurement chapter, all of which fell foul of the board members. One particular analysis that emerged was that in measuring assets one should distinguish between those that generated cash flows directly (e.g. an investment property or a financial instrument) and those that generated cash flows indirectly,

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needing a combination with other assets and labour inputs (e.g. a manufacturing facility, retail premises, etc.).

The boards also did some work on the reporting entity. They issued a Discussion Paper (IASB, 2008) which asked thirteen questions covering four topics:

- whether or not the reporting entity concept should be limited to legal entities, and whether or not the entity should be described rather than precisely defined;
- consideration of three approaches to determining the composition of a group reporting entity: the controlling entity model (ibid.: Pars. 64–79), the common control model (ibid.: Pars. 80–95) and the risks and rewards model (ibid. Pars. 96–105) which the IASB preferred;
- whether to follow the parent company approach to consolidated financial statements (proportionate consolidation reflecting the proprietors' perspective where non-controlling interests are shown as liabilities) or the entity approach (full consolidation method reflecting the reporting entity's perspective where no distinction is drawn between controlling and non-controlling interests). This third topic also included the question of whether parent company financial statements should be precluded or not; and
- the fourth issue concerned issues related to definitions of control.

The IASB's subsequent Exposure Draft ED/2010/2, for which comments were to be received by 16 July 2010, described the reporting entity as:

> a circumscribed area of economic activities whose financial information has the potential to be useful to existing and potential equity investors, lenders and other creditors who cannot directly obtain the information they need in making decisions about providing resources to the entity and in assessing whether the management and the governing board of that entity have made efficient and effective use of the resources provided. The reporting entity concept is intended to further this objective (IASB, ED/2010/2: RE2).

In a letter dated 15 July 2010, the European Financial Reporting Advisory Group (EFRAG) responded to the Exposure Draft:

> We consider that the perspective from which the financial statements are presented is critical and should be discussed in the conceptual framework. Clarifying the 'perspective' is important in assessing how to resolve accounting policy issues and is central to considering how to satisfy the objective of financial reporting. Accordingly, we think it is necessary to carry out an in-depth analysis of the implications of adopting either (the proprietary or the entity) perspective and to ensure they are properly debated.

However, all of these phases of the project were suspended in light of the need to focus resources on the financial crisis. At the time of writing (2012) the IASB has made the tentative decision to abandon the joint conceptual framework project in favour of finalizing its own framework improvements independently of the FASB. At an IASB meeting, ironically being held at the FASB's board room in Connecticut during a week of joint meetings, the staff proposed that, following an extensive review of the IASB's future agenda, which had involved many constituents, finalizing the framework should be the next priority once the financial

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crisis projects were completed. The suggestion was that the IASB would do its own work on the elements of financial reporting, measurement, presentation and disclosure. The presentation part would go beyond the existing framework and would also involve defining the role of Other Comprehensive Income. The disclosure part would be completely new, but would aim to develop some disclosure framework and would extend to interim statements. The work on the reporting entity (Chapter 2) would be finalized.

## *2.4 The 2010 conceptual framework*

The IASB decided in 2010 that the two parts of the framework that had been revised, the objectives and the qualitative characteristics, should be published and be bolted on to the 1989 framework, with the latter amended as necessary to reflect the update. So currently the official IASB Conceptual Framework is a hybrid of the 2010 update and the 1989 original. The significant aspects of the 1989 framework that have not been revised are the elements of the financial statements, their recognition and measurement, and the concepts of capital and capital maintenance. The other work the IASB plans to do will go well beyond what is in the 1989 version, while, based on the previous debates, the asset definition is not likely to be changed significantly.

Chapter 1 addresses the objectives of general purpose financial reporting which, as discussed above, is to provide 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. The sentence in the 1989 IASC Conceptual Framework referring to the information needs of the providers of risk capital has been removed from the 2010 IASB Conceptual Framework. However, in spite of the ambiguity of the terms used in the IASB Conceptual Framework, the IFRS Foundation's Report on the Trustees' Strategy Review (IFRS Foundation 2011: 11) leaves no doubt that the IASB is committed first and foremost to protecting the interests and information needs of investors in capital markets.

The chapter goes on to detail that investors' decisions depend on their expectations of future returns, which in turn depend on 'their assessment of the amount, timing and uncertainty of (the prospects for) future net cash inflows to the entity' (OB3). There is a subtlety here, not always understood by students of the earlier framework, that the financial statements relate to the *entity*'s cash flows, but the investor is looking to estimate future cash flows to the *investor*, which will be dividends, interest and capital gains, so the decision-making is a two step process.

The conceptual framework places stress on the notion of *general purpose* financial reporting, which it says is aimed at those who do not have the power to require the entity to provide information directly. Consequently management is considered to be outside the scope. The chapter also notes that financial reports cannot give all the information needed to make decisions, and that different users will have different and possibly conflicting needs.

Financial reports should give information about the entity's resources and the claims against them but should also give information about transactions and other events that change the entity's resources and claims against it. 'Both types of information provide useful input for decisions about providing resources to an entity' (OB12).

The 1989 framework did not define the reporting entity, but Chapter 2 of the new conceptual framework is intended to provide an operational definition of a group reporting entity and has been left blank. The revised qualitative characteristics of financial reporting are Chapter 3 of the new conceptual framework. Reflecting the move from 'financial statements' to 'financial

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reporting', the new chapter notes that the qualitative characteristics apply to any information supplied to investors, including forward-looking information. There is a cost constraint that pervades all financial reporting (QC3) – the cost of providing the information must not exceed the expected benefits (QC35).

As discussed above, the chapter identifies fundamental characteristics and enhancing characteristics. The fundamental characteristics are relevance, materiality and representational faithfulness. Relevance is defined as the information being capable of making a difference to decisions, which occurs if information has predictive or confirmatory qualities, or both. Some people would argue that the most useful information is sometimes forward looking, or informative about the market value of the net assets of the firm.

The document describes representational faithfulness as follows:

> Financial reports represent economic phenomena in words and numbers. To be useful, financial information must not only represent relevant phenomena, but it must also faithfully represent the phenomena that it purports to represent. To be a perfectly faithful representation, a depiction would have three characteristics. It would be *complete*, *neutral* and *free from error*. Of course, perfection is seldom, if ever, achievable. The Board's objective is to maximise those qualities to the extent possible [italics in original] (QC12).

The enhancing characteristics are comparability, verifiability, timeliness and understandability. These are largely self-explanatory. The chapter says that financial reports are intended for people who have a reasonable knowledge of business and economic activities and who review and analyse the information diligently. It notes that sometimes phenomena are inherently complex and cannot be made easy to understand. This section is silent on the degree of accounting knowledge as such that a user might be expected to have, but does say a user may on occasion have to call for expert advice. The subject is slightly controversial because critics say that IFRS are too complex and produce information that is not understandable, but it is not clear what level of knowledge should be required.

The qualitative characteristics section also discusses materiality. This is a threshold quality in as far as reports should include all material information and no immaterial information. The definition is linked to that of relevance:

> Information is material if omitting it or misstating it could influence decisions that users make on the basis of financial information about a specific reporting entity. In other words, materiality is an entity-specific aspect of relevance based on the nature or magnitude, or both, of the items to which the information relates in the context of an individual entity's financial report (QC11).

Materiality is a difficult issue for preparers, auditors and standard-setters. There is a growing feeling that financial reports are too lengthy because preparers are reluctant to exercise their judgment about the materiality of the information. Preparers argue that, if they apply materiality, they then have to justify the judgement to their auditors which involves extra work – it is simpler just not to exercise judgement. The IASB has a policy of not mentioning materiality in individual standards, even if the exercise of a materiality judgment may be particularly relevant.

The final key section of the framework is the definition of the elements. As mentioned, the definition of an asset is the cornerstone, and the definition of the liability is the opposite of

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the asset, with equity being a residual of the asset and liability measurement process. An asset is a resource controlled by the entity as a result of past events and from which future benefits are expected to flow to the entity. Its recognition is constrained by two further factors:

- it must be probable (more likely than not) that future economic benefits will flow to the entity; and
- the item must have a cost or value that can be measured with reliability (it is complete, neutral and free from error).

Although the definition of an asset seems simple, the combination of required factors – control, past event, probable inflows, reliable measurement of cost – provides a relatively strict test. Advertising cannot be treated as an asset, for example, because its effects cannot be controlled, client loyalty cannot be measured.

The definition of a liability is that it is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow of resources from the entity. The requirement for there to be a triggering past event is a key issue in prohibiting the creation of provisions that are excessively prudent in nature – you cannot, for example, provide for restructuring while it is just a board decision and no event has taken place.

This part of the conceptual framework also discusses income and expense. It raises the question of the difference between revenue and gains and between expenses and losses, suggesting that revenues and expenses arise from transactions in the ordinary course of business whereas gains (increases in economic benefits). For example, these could be the result of advantageous increases in the market price of assets and advantageous decreases in the market price of liabilities, when items are measured at fair value. Conversely, losses are the result of disadvantageous increases in the market price of liabilities and decreases in the market price of assets. Income is recognized when an increase in assets or a decrease in liabilities takes place, expenses are recognized when there is a decrease in future expected benefits or an increase in future expected cash outflows.

## 3. The uses of the conceptual framework

As discussed earlier in this chapter, there are two primary uses of this kind of conceptual framework. First, there is the use of the framework by standard-setters to guide them in setting standards, and, second, there is the use by preparers and auditors to guide them in the choice of specific accounting policies for use in the particular entity.

### *3.1 A guide for standard-setters*

The FASB Conceptual Framework has its origins in a desire to make US standards more consistent and provide a rationale for resisting pressure from constituents. It is clear that the standard-setter uses the framework in writing standards, and the preparer and auditor concern themselves only with the standards, and not the concepts supposedly underpinning it. The IASB, however, sees the framework as being both a guide for standard-setting and a tool for preparers and auditors. The IASB constitution specifies that the standard-setters must set standards that are based on the conceptual framework. A piece of content analysis of documents reporting the IASB's debates (Walton 2009) shows that references to the conceptual framework figure frequently in debate. The conceptual framework is also referred to often in the Basis for Conclusions to new

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standards (the Basis for Conclusions as its title suggests provides the board's rationale for the choices it has made).

In practice the way in which the board expects staff to analyse a topic is to ask if there is any change in the assets or liabilities of the entity, and, if the answer is affirmative, to carry out further analysis of the change to determine if there is income or expense. The effects of this approach can be seen in the new revenue recognition standard, IFRS 14, which starts from the point of a contract being signed and asks if there exist from that moment any assets or liabilities. The board concluded there was an asset in the right to receive the revenue from the contract and a liability to provide the good or service specified in the contract, which the board calls a performance obligation. The standard requires the asset and liability to be recognized at inception of the contract – which is a significant departure from the traditional approach of not recognizing executory contracts in the financial reports, unless they are deemed onerous (loss-making). Revenue is then released under the new standard as performance obligations are satisfied.

The conceptual framework says the financial reports should show the resources of the entity (the right to receive payment in this case) and claims against the entity (the obligation to deliver a good or service). When there is a change in either of these assets and liabilities, this flows through the income statement. The revenue recognition standard is a clear application of the conceptual framework to a central operation in accounting. However, the application is flawed – the asset and liability are not measured independently. The standard specifies that the liability is measured by taking the revenue amount specified in the contract and allocating it to the performance obligations.

In a wholesale application of the framework, the asset would be measured at contract price, and the performance obligation at whatever was the cost of satisfying the obligation (i.e. expected future outflows). The IASB and FASB (it was a joint project) did indeed discuss that for a very long time, but they came up with objections that measuring the performance obligation separately would normally release a profit (at least the part of the price that was supposed to cover selling costs) at the time of signing the contract. Of course the normal requirement is to release profit only on realization, and the standard-setters thought that a strict application of the framework would open the door to earnings manipulation. There was also the question of whether the performance obligation should be measured at an entity-specific value (more opportunities for manipulation) or fair value (but how do you measure that in this case, and what if the entity-specific cost is actually higher than the market?). Finally, how did you know that the difference between performance obligation and selling price was all profit? The standard-setters settled for specifying that the liability was measured at the selling price, so there would be no profit at inception. They were 'comfortable' with that situation – a qualitative characteristic not specified in the conceptual framework, but frequently mentioned by IASB members.

The use of an asset and liability starting point to addressing any accounting question leads to an assumption that the IASB favours a balance sheet approach over an income statement approach to the determination of income. This is a very old and fundamental issue (for example see Chapters 2, 3 and 4 of this book), and is only really an issue if the measurement basis is something other than historical cost, such as where the measurement of assets, liabilities and, as a consequence, income is based on market price changes rather than realized transactions or events. If the standard-setter takes a balance sheet approach and uses a current value measurement, then there will be changes in the values of assets and liabilities each period that arise from market changes and not transactions and these will normally be recorded in income (or indeed Other Comprehensive Income). Some IASB members have asserted, as did the Secretary General of its predecessor (Cairns 2001: 9), that basing the income statement on changes in assets and liabilities

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is conceptually superior and therefore the only clear way of defining profit and loss. However, both the transactions approach and the balance sheet approach to the determination of income have advantages and disadvantages related to relevance, reliability, practical application, and auditability, and there is little *evidence* of the conceptual superiority of one concept over the other.

### *3.2 Its use by preparers and auditors*

The IASB Conceptual Framework includes a page on its purpose and status, this confirms that in addition to being used by the standard-setter, the framework is intended (unlike the FASB framework):

- to assist preparers of financial statements in applying IFRSs and in dealing with topics that have yet to form the subject of an IFRS;
- to assist auditors in forming an opinion on whether financial statements comply with IFRSs; and
- to assist users of financial statements in interpreting the information contained in financial statements prepared in compliance with IFRSs

This intention is given concrete force by IAS 8 *Accounting Policies, Changes in Estimates and Errors*. The IASB revised this standard in 2003, as part of their overhaul of the legacy standards they took over from the IASC. In that revision they included a hierarchy to guide preparers in their choice of accounting policies. The standard says that if an IFRS addresses a particular transaction, then it should be followed. However, if there is no IFRS on the subject, then the preparer should be guided in their choice of policy by the qualitative characteristics, and should look (a) to see whether an existing IFRS can be analogized to, if not (b) should devise an accounting policy based on the conceptual framework, and (c) may look at recent pronouncements by national standard-setters who use a similar framework.

A number of writers, including former IASB member Gilbert Gélard (2010), insist on the idea that the conceptual framework plays a significant role in helping preparers and auditors in adapting IFRS to specific transactions and circumstances. They argue that IFRS are necessarily more oriented towards principles than detailed rules because they are applied in many different legal, social and economic environments, and that the framework should be used by the entity to work out how to apply the standards to their transactions. We have not been able to find any research evidence on this subject, and we acknowledge that evaluating how people make decisions is a notoriously difficult issue to research.

## 4. Conclusion

This chapter has aimed to explore the origins of conceptual frameworks in accounting, the evolution of the IASB's framework and its use by standard-setters and constituents. The chapter notes that any discussion of the objectives and nature of financial reporting might be considered to be a conceptual framework discussion, but the specific issue of having a formalized conceptual framework as a tool in standard-setting emerged in the US and crystallized with the Trueblood Report (AICPA, 1973), followed from 1978 by a series of concepts statements issued by the FASB (Pacter, 1983). The objective of providing information that was useful for investors' decisions also emerged in the US (Zeff, forthcoming) and superseded traditional approaches such as considering the statements as monitoring stewardship or providing accountability.

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The US framework is organized in separate parts which address primarily the objectives, qualitative characteristics and elements of financial reporting. The IASC built the decision-usefulness objective into its first standard (1974) and issued a number of separate documents addressing different aspects but subsequently decided to issue a single framework document which emerged in 1989. This was amended over the period 2004–2010 in an effort to update and align with the FASB, although some work was abandoned under pressure to give priority to financial crisis projects. The IASB finalized its revised objectives and qualitative characteristics in 2010 and plans to work on updating and extending the rest of the 1989 framework.

The IASB does make frequent reference to the framework in its deliberations, and in particular analyses transactions from the perspective of changes in assets and liabilities. Critics say performance is based on income generation not asset valuation, but the standard-setter says you can only reliably measure income by looking at the changes in resources and claims against them. The IASB mandates the use of the framework by preparers to apply IFRS in particular situations or to develop accounting policies consistent with IFRS where no relevant IFRS exists.

## Note

1 As it subsequently appears in the IASB literature.

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