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**SPECIAL REPORT**

## **The Framework of Financial Accounting Concepts and Standards**

**Reed K. Storey, Ph.D., CPA  
Sylvia Storey, MBA**



**Financial Accounting Standards Board**  
of the Financial Accounting Foundation

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## PREFACE

This book focuses on the conceptual framework developed by the Financial Accounting Standards Board to provide a foundation for financial accounting and reporting standards in the United States. Standards-setting bodies in several other countries, as well as the International Accounting Standards Committee, have developed substantially similar frameworks, often having been influenced by the American experience. The FASB's conceptual framework, its development, and its antecedents should be of interest to those who are concerned, both in the United States and internationally, with using, providing, or auditing financial statements and other financial reporting information.

Accountants in the United States have pioneered what is known as financial accounting standards setting. Beginning almost seventy years ago, academic and practicing accountants, in efforts to improve financial disclosure by publicly held corporations, began to emphasize the idea that financial accounting possessed "principles" that were widely recognized and accepted within the profession. Although most accountants interested in the search for accounting principles have essentially agreed that such principles do indeed exist, a complicating factor in the ensuing attempt to formally identify them has been the persistence of two competing views of accounting principles: one maintaining that accounting principles are based on what is generally done in practice and the other holding that a foundation of fundamental premises ("concepts") necessarily underlies and determines sound practice. The latter view has been the source of significant advances in accounting theory during those seventy years and for more than twenty years has affected financial accounting standards and practice through the FASB's conceptual framework; accounting practice, however, has continued to be dominated by the former view.

Key steps in the development of financial accounting standards setting included:

- Promotion by the American Institute of [Certified Public] Accountants and the New York Stock Exchange of financial statements based on "accepted principles of accounting"
- Authorization of a part-time committee to speak for the Institute on accounting principles by issuing authoritative pronouncements intended to provide the "substantial authoritative support" for accounting procedures required by the Securities and Exchange Commission
- Replacement of the committee with a part-time principles board charged with determining appropriate practice and narrowing areas of difference and inconsistency in accounting practice in response to an ever-increasing number and variety of generally accepted accounting principles
- Designation of a standards board, full time and independent of the Institute, as the body authorized to promulgate generally accepted accounting principles
- Adoption in six Concepts Statements of a conceptual framework for financial accounting and reporting.

That conceptual framework is the focus of this book, but the other steps also are significant parts of its subject matter. To understand what the conceptual framework is and why it developed as it did entails understanding the environment in which the principles and standards of financial accounting and reporting developed, the forces that shaped them, and how the concepts, principles, and standards relate to each other. That knowledge also helps explain the circumstance that while the idea of a conceptual framework generally has been favorably received, the standards that have resulted from its application often have met with significant resistance.

The book originally was written as the first chapter of *The Accountants' Handbook*, seventh edition, edited by D. R. Carmichael, Steven B. Lilien, and Martin Mellman and published in 1990 by John Wiley & Sons, Inc. The chapter was revised for the eighth edition, published in 1996. Although there are revisions throughout, major changes are concentrated under a few headings:

- “The Accounting Research Bulletins” (pages 18-30) has been enlarged by adding two topics: “Challenges to the Committee’s Authority” and “Influence of the Securities and Exchange Commission.”
- “Assets (and Liabilities)—the Fundamental Element(s) of Financial Statements” (pages 72-85), “Comprehensive Income of Business Enterprises” (pages 135-140), and “Comprehensive Income and Earnings” (pages 150-155) have been substantially rewritten, reorganized, or both.
- “Verifiability” (pages 106-111) has been expanded significantly.

Except for a smaller page size and use of footnotes instead of the parenthetical references in *The Accountants' Handbook*, the book is generally the same as the chapter in the eighth edition of the *Handbook*. The only part of the text that was reorganized and rewritten between the eighth edition and the book is “Revenues, Expenses, Gains, and Losses” (pages 136-140).

Many members of the Board and staff of the Financial Accounting Standards Board contributed significantly to this work. David Mosso, James J. Leisenring, and Timothy S. Lucas read the original manuscript in 1990, and Messrs. Mosso and Leisenring later reread sections with major revisions. Mary A. Huydic edited the manuscript and helped guide it through production and printing. Ana M. Dolan did the layout, composing text and graphics with an automated publishing system. Other members of the publications production and word processing staff who made significant contributions include Glen M. Kudlicki, Joseph M. Damico, Henrietta T. Hollauer, Donna J. Lorenti, Susan T. Miller, Dawn A. Williams, and Christine A. Wilson.

Mr. Storey was a senior technical advisor at the Financial Accounting Standards Board when this book was written. Expressions of individual views by members of the Financial Accounting Standards Board and its staff are encouraged. The views expressed here are those of the authors. Official positions of the FASB on accounting matters are determined only after extensive due process and deliberation.

New Canaan, Connecticut  
December 1997

Reed K. Storey  
Sylvia Storey





## SPECIAL REPORT

### The Framework of Financial Accounting Concepts and Standards

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## FINANCIAL ACCOUNTING AND REPORTING

The principal role of financial accounting and reporting is to serve the public interest by providing information that is useful in making business and economic decisions. That information facilitates the efficient functioning of capital and other markets, thereby promoting the efficient and equitable allocation of scarce resources in the economy. To undertake and fulfill that role, financial accounting in the twentieth century has evolved from a profession relying almost exclusively on the experience and practice of a handful of illustrious practitioners into one replete with a set of financial accounting standards and an underlying conceptual foundation.

An underlying structure of accounting concepts was deemed necessary to provide to the institutions entrusted with setting accounting principles or standards the requisite tools for resolving accounting problems. Financial accounting now has a foundation of fundamental concepts and objectives in the Financial Accounting Standards Board's "Conceptual Framework for Financial Accounting and Reporting," which is intended to provide a basis for developing the financial accounting standards that are promulgated to guide accounting practice.

The FASB's conceptual framework and its antecedents constitute the major subject matter of this book. Some significant terms, organizations, and authoritative pronouncements need to be identified or briefly introduced. They already may be familiar to most readers or will become so in due course.

### THE FASB AND GENERAL PURPOSE EXTERNAL FINANCIAL ACCOUNTING AND REPORTING

*Financial accounting and reporting* is the familiar name of the branch of accounting whose precise but somewhat imposing full proper name is *general purpose external financial accounting and reporting*. It is the branch of accounting concerned with general purpose financial statements of business enterprises and not-for-profit organizations. General purpose financial statements are possible because several groups, such as investors, creditors, and other resource providers, have common interests and common information needs. General purpose financial reporting provides information to users who are outside a business enterprise or not-for-profit organization and lack the power to require the entity to supply the accounting information they need for decision making; therefore, they must rely on information provided to them by the entity's management. Other groups, such as taxing authorities and rate regulators, have specialized information needs but also the authority to require entities to provide the information they specify.

General purpose external financial reporting is the sphere of authority of the *Financial Accounting Standards Board*, the private-sector organization that since 1973 has established *generally accepted accounting principles* in the United States. General pur-

## *The Framework of Financial Accounting Concepts and Standards*

pose external financial accounting and reporting provides information that is based on generally accepted accounting principles and is audited by independent certified public accountants. Generally accepted accounting principles result and have resulted primarily from the authoritative pronouncements of the FASB and its predecessors.

The FASB's standards pronouncements—Statements of Financial Accounting Standards (often abbreviated FASB Statement, SFAS, or FAS) and FASB Interpretations (often abbreviated FIN)—are recognized as authoritative by both the *Securities and Exchange Commission* and the *American Institute of Certified Public Accountants*.

The FASB succeeded the *Accounting Principles Board*, whose authoritative pronouncements were the APB Opinions. In 1959 the APB had succeeded the *Committee on Accounting Procedure*, whose authoritative pronouncements were the *Accounting Research Bulletins* (often abbreviated ARB), some of which were designated as *Accounting Terminology Bulletins* (often abbreviated ATB).

With respect to the long name “general purpose external financial reporting,” this book does what the standards-setting bodies also have done: for convenience, it uses the short-cut term “financial reporting.”

## **MANAGEMENT ACCOUNTING AND TAX ACCOUNTING**

Financial accounting and reporting is only part of the broad field of accounting. Other significant kinds of accounting include management accounting and tax accounting.

Management accounting is internal accounting designed to meet the information needs of managers. Although the same accounting system usually accumulates, processes, and disseminates both management and financial accounting information, managers' responsibilities for making decisions and planning and controlling operations at various administrative levels of a business enterprise or not-for-profit organization require more detailed information than is considered necessary or appropriate for external financial reporting. Management accounting includes information that is normally not provided outside an organization and is usually tailored to meet specific management information needs.

Tax accounting is concerned with providing appropriate information needed by individuals, corporations, and others for preparing the various returns and reports required to comply with tax laws and regulations, especially the Internal Revenue Code. It is significant in the administration of domestic tax laws, which are to a large extent self-assessing. Tax accounting is based generally on the same procedures that apply to financial reporting. There are some significant differences, however, and taxing authorities have the statutory power to prescribe the specific information they want taxpayers to submit as a basis for assessing the amount of income tax owed and do not need to rely on information provided to other groups.

## WHY WE HAVE A CONCEPTUAL FRAMEWORK

“Accounting principles” has proven to be an extraordinarily elusive term. To the nonaccountant (as well as to many accountants) it connotes things basic and fundamental, of a sort which can be expressed in few words, relatively timeless in nature, and in no way dependent upon changing fashions in business or the evolving needs of the investment community.

The Wheat Report

**Principle.** A general law or rule adopted or professed as a guide to action; a settled ground or basis of conduct or practice.

Accounting Research Bulletin No. 7

A recurring theme in financial accounting in the United States in the twentieth century has been the call for a comprehensive, authoritative statement of basic accounting *principles*. It has reflected a widespread perception that something more fundamental than rules or descriptions of methods or procedures was needed to form a basis for, explain, or govern financial accounting and reporting practice. A number of organizations, committees, and individuals in the profession have developed or attempted to develop their own variations of what they have diversely called *principles, standards, conventions, rules, postulates, or concepts*. Those efforts met with varying degrees of success, but by the 1970s none of the codifications or statements had come to be accepted or relied on in practice as the definitive statement of accounting’s basic principles.

The pursuit of a statement of accounting principles has reflected two distinct schools of thought: that accounting principles are generalized or drawn from practice without reference to a systematic theoretical foundation or that accounting principles are based on a few fundamental premises that together with the principles provide a framework for solving specific problems encountered in practice. Early efforts to codify or develop accounting principles were dominated by the belief that principles are essentially a “distillation of experience,” a description generally attributed to George O. May, one of the most influential accountants of his time, who used it in the title of a book, *Financial Accounting: A Distillation of Experience* (1943). However, as accounting has matured and its role in society has increased, momentum in developing accounting principles has shifted to those accountants who have come to understand what has been learned in many other fields: that reliance on experience alone leads only so far because environments and problems change; that until knowledge gained through experience is given purpose, direction, and internal consistency by a conceptual foundation, fundamentals will be endlessly reargued and practice blown in various directions by the winds of changing perceptions and proliferating accounting methods; and that only by studying and understanding the foundations of practices can the path of progress be discovered and the hope of improving practice be realized.

## *The Framework of Financial Accounting Concepts and Standards*

The conceptual framework project of the Financial Accounting Standards Board represents the most comprehensive effort thus far to establish a structure of objectives and fundamentals to underlie financial accounting and reporting practice. To understand what it is, how it came about, and why it took the form and included the concepts that it did requires some knowledge of its antecedents, which extend back more than sixty years.

### **SPECIAL COMMITTEE ON CO-OPERATION WITH STOCK EXCHANGES**

The origin of the use of *principle* in financial accounting and reporting can be traced to a special committee of the American Institute of Accountants (American Institute of Certified Public Accountants since 1957). The Special Committee on Co-operation with Stock Exchanges, chaired by George O. May, gave the word special significance in the attest function of accountants. That significance is still evident in audit reports signed by members of the Institute and most other CPAs attesting that the financial statements of their clients present fairly, or do not present fairly, the client's financial position, results of operations, and cash flows "in conformity with generally accepted accounting principles." The committee laid the foundation that has been the basis of both subsequent progress in identifying or developing and enunciating accounting principles and many of the problems that have accompanied the resulting principles.

In 1930 the Institute undertook a cooperative effort with the New York Stock Exchange aimed at improving financial disclosure by publicly held enterprises. It was widely believed that inferior accounting and reporting practices had contributed to the stock market decline and depression that began in 1929. The Exchange was concerned that its listed companies were using too many different accounting and reporting methods to reflect similar transactions and that some of those methods were questionable. The Institute wanted to make financial statements more informative and authoritative, to clarify the authority and responsibility of auditors, and to educate the public about the conventional nature of accounting and the limitations of accounting reports.

The Exchange's Committee on Stock List and the Institute's Special Committee on Co-operation with Stock Exchanges exchanged correspondence between 1932 and 1934. The special committee's report, comprising a series of letters that passed between the two committees, was issued to Institute members in 1934 under the title, *Audits of Corporate Accounts* (reprinted in 1963). The key part was a letter dated September 22, 1932, from the Institute committee.

#### **"Accepted Principles of Accounting"**

The special committee recommended that an authoritative statement of the broad accounting principles on which "there is a fairly general agreement" be formulated in consultation with a small group of qualified persons, including accountants, lawyers, and corporate officials. Within that framework of "accepted principles of accounting," each



## *Why We Have a Conceptual Framework*

company would be free to choose the methods and procedures most appropriate for its financial statements, subject to requirements to disclose the methods it was using and to apply them consistently. Audit certificates (reports) for listed companies would state that their financial statements were prepared in accordance with “accepted principles of accounting.” The special committee anticipated that its program would improve financial reporting because disclosure would create pressure from public opinion to eliminate less-desirable practices.

The special committee did not define “principles of accounting,” but it illustrated what it had in mind. It gave two explicit examples of accepted broad principles of accounting:

It is a generally accepted principle that plant value should be charged against gross profits over the useful life of the plant. . . .

Again, the most commonly accepted method of stating inventories is at cost or market, whichever is lower. . . .<sup>1</sup>

It also listed five principles that it presumed would be included in the contemplated statement of “broad principles of accounting which have won fairly general acceptance”:

1. Unrealized profit should not be credited to income account of the corporation either directly or indirectly, through the medium of charging against such unrealized profits amounts which would ordinarily fall to be charged against income account. Profit is deemed to be realized when a sale in the ordinary course of business is effected, unless the circumstances are such that the collection of the sale price is not reasonably assured. An exception to the general rule may be made [for industries in which trade custom is to take inventories at net selling prices, which may exceed cost].
2. Capital surplus [other paid-in capital], however created, should not be used to relieve the income account of the current or future years of charges which would otherwise fall to be made thereagainst. This rule might be subject to the exception that [permits use of quasi-reorganization].
3. Earned surplus [retained earnings] of a subsidiary company created prior to acquisition does not form a part of the consolidated earned

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<sup>1</sup>*Audits of Corporate Accounts: Correspondence between the Special Committee on Co-operation with Stock Exchanges of the American Institute of Accountants and the Committee on Stock List of the New York Stock Exchange, 1932-1934* (New York: American Institute of Accountants, 1934), page 7. [Reprinted (New York: American Institute of Certified Public Accountants, 1963), and in Stephen A. Zeff, *Forging Accounting Principles in Five Countries: A History and An Analysis of Trends* (Champaign, Illinois: Stipes Publishing Company, 1972), pages 237-247.]

## *The Framework of Financial Accounting Concepts and Standards*

surplus of the parent company and subsidiaries; nor can any dividend declared out of such surplus properly be credited to the income account of the parent company.

4. While it is perhaps in some circumstances permissible to show stock of a corporation held in its own treasury as an asset, if adequately disclosed, the dividends on stock so held should not be treated as a credit to the income account of the company.
5. Notes or accounts receivable due from officers, employees, or affiliated companies must be shown separately and not included under a general heading such as Notes Receivable or Accounts Receivable.<sup>2</sup>

The Institute submitted the committee's five principles for acceptance by its members in 1934, and they are now in ARB No. 43, *Restatement and Revision of Accounting Research Bulletins* (issued 1953), Chapter 1A, "Rules Adopted by Membership" (paragraphs 1-5).

The special committee's use of the word principle set the stage not only for the Institute's efforts to identify "accepted principles of accounting" but also for future confusion and controversy over what accountants mean when they use the word principle.

### **But Were They "Principles"?**

The special committee's examples of broad principles of accounting were much less fundamental, timeless, and comprehensive than what most people perceive to be principles. They had little or nothing in them that made them more basic or less concrete than conventions or rules. Moreover, the special committee itself referred to them as rules in describing exceptions to them, the Institute characterized them as rules in submitting them for approval by its members, and the chairman of the special committee later conceded that they were nothing more than rules:

When the committee . . . undertook to lay down some of the basic principles of modern accounting, it found itself unable to suggest more than half a dozen which could be regarded as generally acceptable, and even those were rules rather than principles, and were, moreover, admittedly subject to exception.<sup>3</sup>

Not surprisingly, the special committee's use of principles was soon challenged. In a contest sponsored by the Institute for its fiftieth anniversary celebration in 1937, Gilbert R.

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<sup>2</sup>*Audits of Corporate Accounts*, page 14. Lengthy exceptions in items 1 and 2 are summarized rather than quoted in full.

<sup>3</sup>George O. May, "Improvement in Financial Accounts," *The Journal of Accountancy*, May 1937, page 335.

## *Why We Have a Conceptual Framework*

Byrne's essay entitled "To What Extent Can the Practice of Accounting Be Reduced to Rules and Standards?" won first prize for the best answer to the question posed in the title. He complained about accountants' propensity to downgrade principle by equating it with terms such as rule, convention, and procedure.

[R]ecent discussions have used the term "accounting principles" to cover a conglomeration of accounting practices, procedures, conventions, etc.; many, if not most, so-called "principles" may merely have to do with methods of presenting items on financial statements or technique of auditing, rather than matters of fundamental accounting principle.<sup>4</sup>

Stephen Gilman made the same point in his careful analysis of terms in five chapters of his book, *Accounting Concepts of Profit*.

With sublime disregard of lexicography, accountants speak of "principles," "tenets," "doctrines," "rules," and "conventions" as if they were synonymous.<sup>5</sup>

Gilman also quoted an excerpt from the *Century Dictionary* that he thought pertinent "because of the confusion noted in some accounting writings [about] the distinction between 'principle' and 'rule'":

There are no two words in the English language used so confusedly one for the other as the words *rule* and *principle*. You can make a *rule*; you cannot make a *principle*; you can lay down a *rule*; you cannot, properly speaking, lay down a *principle*. It is laid down for you. You can establish a *rule*; you cannot, properly speaking, establish a *principle*. You can only declare it. *Rules* are within your power, *principles* are not. A *principle* lies back of both *rules* and *precepts*; it is a general truth, needing interpretation and application to particular cases.<sup>6</sup>

Byrne, Gilman, and others pointed out that the form of accountant's report recommended by the special committee made accountants look foolish by requiring them to express opinions based on the existence of principles they actually could not specify. In

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<sup>4</sup>Gilbert R. Byrne, "To What Extent Can the Practice of Accounting Be Reduced to Rules and Standards?" *The Journal of Accountancy*, November 1937, page 366. [Reprinted in Maurice Moonitz and A. C. Littleton, eds., *Significant Accounting Essays* (Englewood Cliffs, New Jersey: Prentice-Hall, Inc., 1965), pages 103-115.]

<sup>5</sup>Stephen Gilman, *Accounting Concepts of Profit* (New York: The Ronald Press Company, 1939), page 169.

<sup>6</sup>Gilman, *Accounting Concepts of Profit*, page 188.

## *The Framework of Financial Accounting Concepts and Standards*

that form of report, an accountant expressed the opinion that a client's financial statements "fairly present, *in accordance with accepted principles of accounting consistently maintained by the company during the year under review*, its position . . . and the results of its operations. . . ." According to Byrne, that opinion presumed that accepted principles of accounting actually existed and accountants in general knew and agreed on what they were. In fact, "While there have been several attempts to enumerate [those principles], to date there has been no statement upon which there has been general agreement."<sup>7</sup>

That diagnosis was confirmed by Gilman as well as by Howard C. Greer:

. . . the entire body of precedent [the "accepted principles of accounting"] has been taken for granted.

It is as though each accountant felt that while he himself had never taken the time nor the trouble to make an actual list of accounting principles, he was comfortably certain that someone else had done so. . . .

[T]he accountants are in the unenviable position of having committed themselves in their certificates [reports] as to the existence of generally accepted accounting principles while between themselves they are quarreling as to whether there are any accounting principles and if there are how many of them should be recognized and accepted.<sup>8</sup>

There is something incongruous about the outpouring of thousands of accountants' certificates [reports] which refer to accepted accounting principles, and a situation in which no one can discover or state what those accepted accounting principles are. The layman cannot understand.<sup>9</sup>

Byrne argued that lack of agreement on what constituted accepted accounting principles resulted "in large part because there is no clear distinction, in the minds of many, between that body of fundamental truths underlying the philosophy of accounts which are properly thought of as *principles*, and the larger body of accounting rules, practices and conventions which derive from principles, but which of themselves are not principles."<sup>10</sup> His prescription for accountants was to use principle in its most commonly understood sense of being more fundamental and enduring than rules and conventions.

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<sup>7</sup>Byrne, "To What Extent Can the Practice of Accounting Be Reduced to Rules and Standards?" page 368.

<sup>8</sup>Gilman, *Accounting Concepts of Profit*, pages 169 and 171.

<sup>9</sup>Howard C. Greer, "What Are Accepted Principles of Accounting?" *The Accounting Review*, March 1938, page 25.

<sup>10</sup>Byrne, "To What Extent Can the Practice of Accounting Be Reduced to Rules and Standards?" page 368.

## *Why We Have a Conceptual Framework*

If accounting, as an organized body of knowledge, has validity, it must rest upon a body of principles, in the sense defined in Webster's New International Dictionary:

“A fundamental truth; a comprehensive law or doctrine, from which others are derived, or on which others are founded; a general truth; an elementary proposition or fundamental assumption; a maxim; an axiom; a postulate.” . . .

Accounting principles, then, are the fundamental concepts on which accounting, as an organized body of knowledge, rests. . . . [T]hey are the foundation upon which the superstructure of accounting rules, practices and conventions is built.<sup>11</sup>

Gilman, in contrast, could find no principles that fit Byrne's definition. He concluded that most, if not all, of the propositions that had been put forth as principles of accounting should be relabeled “as doctrines, conventions, rules, or mere statements of opinion.”<sup>12</sup> He called on accountants to admit that there were no accounting principles in the fundamental sense and to waste no more time and effort on attempts to identify and state them.

### **May's Attempts to Rectify “Considerable Misunderstanding”**

In several articles and a book, George O. May responded to those and other criticisms of “accounting principles” and explained what the special committee, as well as several other Institute committees of which he was chairman, had done and why. He detected, in the criticisms and elsewhere, what he described as “considerable misunderstanding” of both the nature of financial accounting and the committees' work on accounting principles and thought it necessary to get the matter back on the right track.

Although he acknowledged that “in the correspondence the [special] Committee had used the words ‘rules,’ ‘methods,’ ‘conventions,’ and ‘principles’ interchangeably,”<sup>13</sup> May considered questions such as whether the propositions should be called rules or principles not to be matters “of any real importance.” As Byrne had pointed out, if there were any principles that fit his definition, “they must be few in number and extremely

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<sup>11</sup>Byrne, “To What Extent Can the Practice of Accounting Be Reduced to Rules and Standards?” pages 368 and 372.

<sup>12</sup>Gilman, *Accounting Concepts of Profit*, page 257.

<sup>13</sup>George O. May, *Financial Accounting: A Distillation of Experience* (New York: The Macmillan Company, 1943), page 42.

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general in character (such as ‘consistency’ and ‘conservatism’).”<sup>14</sup> Thus, they would afford less precise guidance than the more concrete principles illustrated by the special committee. Those who scolded the special committee for misusing principles had apparently forgotten that “accounting rules and principles are founded not on abstract theories or logic, but on utility.”<sup>15</sup>

May urged the profession and others to focus efforts to improve financial accounting, as had the special committee, on the questions “of real importance”—the consequences of the necessarily conventional nature of accounting and the limitations of accounting reports. He explained the philosophy underlying the recommendation of the special committee and summarized that philosophy in the introductory pages of his book:

In 1926, . . . I decided to relinquish my administrative duties and devote a large part of my time to consideration of the broader aspects of accounting. As a result of that study I became convinced that a sound accounting structure could not be built until misconceptions had been cleared away, and the nature of the accounting process and the limitations on the significance of the financial statements which it produced were more frankly recognized.

It became clear to me that general acceptance of the fact that accounting was utilitarian and based on conventions (some of which were necessarily of doubtful correspondence with fact) was an indispensable preliminary to real progress. . . .

Many accountants were reluctant to admit that accounting was based on nothing of a higher order of sanctity than conventions. However, it is apparent that this is necessarily true of accounting as it is, for instance, of business law. In these fields there are no principles, in the fundamental sense of that word, on which we can build; and the distinctions between laws, rules, standards, and conventions lie not in their nature but in the kind of sanctions by which they are enforced. Accounting procedures have in the main been the result of common agreement between accountants. . . .<sup>16</sup>

He also reiterated and amplified a number of points the special committee had emphasized in *Audits of Corporate Accounts* concerning what the investing public already knew or should understand about financial accounting and reporting, such as, that because the value of a business depended mainly on its earning capacity, the income statement was

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<sup>14</sup>George O. May, “Principles of Accounting,” *The Journal of Accountancy*, December 1937, page 424. [The article was a comment on Byrne’s essay.]

<sup>15</sup>George O. May, “Terminology of the Balance Sheet,” *The Journal of Accountancy*, January 1942, page 35.

<sup>16</sup>May, *Financial Accounting*, pages 2 and 3.

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more important than the balance sheet and should indicate to the fullest extent possible the earning capacity of the business during the period on which it reported; that because the balance sheet of a large modern corporation was to a large extent historical and conventional, largely comprising the residual amounts of expenditures or receipts after first determining a proper charge or credit to the income account for the year, it did not, and should not be expected to, represent an attempt to show the present values of the assets and liabilities of the corporation; and that because financial accounting and reporting was necessarily conventional, some variety in accounting methods was inevitable.

### **The Special Committee's Definition of Principle**

May not only identified the definition of principle the special committee had used but also explained why it had chosen that particular meaning. In his comment on Byrne's essay, he recalled the committee's discussion and searching of dictionaries before choosing the "perhaps rather magniloquent word 'principle' . . . in preference to the humbler 'rule.'" The definition of principle in the *Oxford English Dictionary* that came closest to defining the sense in which the special committee used the word was the seventh definition:

A general law or rule adopted or professed as a guide to action; a settled ground or basis of conduct or practice.

The time and effort spent in searching dictionaries was fruitful—the committee found exactly the definition for which it was looking:

[The] . . . sense of the word "principle" above quoted seemed . . . to fit the case perfectly. Examination of the report as a whole will make clear what the committee contemplated; namely, that *each corporation should have a code of "laws or rules, adopted or professed, as a guide to action,"* and that the accountants should report, first, whether this code conformed to accepted usages, and secondly, whether it had been consistently maintained and applied.<sup>17</sup>

Thus, the special committee opted for the lofty "principle" rather than the more precise "rule" or "convention" because the definition that best fit the committee's needs was a definition of principle, albeit an obscure one, not a definition of rule or convention. Moreover, rule and convention carried unfortunate baggage:

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<sup>17</sup>May, "Principles of Accounting," pages 423 and 424, emphasis added.

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[The] word “rules” implied the existence of a ruling body which did not exist; the word “convention” was regarded as not appropriate for popular use and in the opinion of some would not convey an adequate impression of the authority of the precepts by which the accounts were judged.<sup>18</sup>

Whereas principle conveyed desirable implications:

It used to be not uncommon for the accountant who had been unable to persuade his client to adopt the accounting treatment that he favored, to urge as a last resort that it was called for by “accounting principles.” Often he would have had difficulty in defining the “principle” and saying how, why, and when it became one. But the method was effective, especially in dealing with those (of whom there were many) who regarded accounting as an esoteric but well established body of learning and chose to bow to its authority rather than display their ignorance of its rules. Obviously, the word “principle” was an essential part of the technique; “convention” would have been quite ineffective.<sup>19</sup>

Rules were elevated into principles because the committee thought it necessary to use a word with the force or power of “principle” to prevent the auditor’s authority from being lost on the client.

### **The Best Laid Schemes . . .**

The special committee’s program focused on what individual listed companies and their auditors would do. Each corporation would choose from “accepted principles of accounting” its own code of “laws or rules, adopted or professed, as a guide to action” and within that framework would be free to choose the methods and procedures most appropriate for its financial statements but would disclose the methods it was using and would apply them consistently. An auditor’s report would include an opinion on whether or not each corporation’s code consisted of accepted principles of accounting and was applied consistently. The Stock Exchange would enforce the program by requiring each listed corporation to comply in order to keep its listing.

The Institute was to sponsor or lead an effort in which accountants, lawyers, corporate officials, and other “qualified persons” would formulate a statement of “accepted principles of accounting” to guide listed companies and auditors, but it was not to get into the business of specifying those principles. The special committee had explicitly considered and rejected “the selection by competent authority out of the body of acceptable

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<sup>18</sup>May, *Financial Accounting*, page 42.

<sup>19</sup>May, *Financial Accounting*, page 37.



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methods in vogue today [the] detailed sets of rules which would become binding on all corporations of a given class.” The special committee also had avoided using “rule” because the word implied a rule-setting body that did not exist, and it had no intention of imposing on anyone what it considered to be an unnecessary and impossible burden. “Within quite wide limits, it is relatively unimportant to the investor what precise rules or conventions are adopted by a corporation in reporting its earnings if he knows what method is being followed and is assured that it is followed consistently from year to year.”<sup>20</sup> Moreover, the committee felt that no single body could adequately assess and allow for the varying characteristics of individual corporations, and the choice of which detailed methods best fit a corporation’s circumstances thus was best left to each corporation and its auditors. Because financial accounting was essentially conventional and required estimates and allocations of costs and revenues to periods, the utility of the resulting financial statements inevitably depended significantly on the competence, judgment, and integrity of corporate management and independent auditors. Although there had been a few instances of breach of trust or abuse of investors, the committee had confidence in the trustworthiness of the great majority of those responsible for financial accounting and reporting.

In the end, the special committee’s recommendations were never fully implemented. Nonaccountants were not invited to participate in developing a statement of accepted accounting principles. In fact, although the Institute submitted the special committee’s five principles for acceptance by its members, it attempted no formulation of a statement of broad principles, even by accountants. Nor did the Exchange require its listed companies to disclose their accounting methods.

### **The Special Committee’s Heritage**

The only recommendation to survive was that each company should be permitted to choose its own accounting methods within a framework of “accepted principles of accounting.” The committee’s definition of “principle” also survived, and “accepted principles of accounting” became “generally accepted.”

The special committee’s definition of principle—“A general law or rule adopted or professed as a guide to action; a settled ground or basis of conduct or practice”—was incorporated verbatim in Accounting Research Bulletin No. 7, *Report of the Committee on Terminology* (George O. May, chairman), in 1940, but it was attributed to the *New English Dictionary* rather than to the *Oxford English Dictionary*. When Accounting Research Bulletins 1-42 were restated and revised in 1953, the same definition of principle, by then attributed only to “Dictionaries,” was carried over to Accounting Terminology Bulletin No. 1, *Review and Résumé*.

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<sup>20</sup>*Audits of Corporate Accounts*, pages 8 and 9.

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“Generally” was added to the special committee’s “accepted principles of accounting” in *Examination of Financial Statements by Independent Public Accountants*, published by the Institute in 1936 as a revision of an auditing publication, *Verification of Financial Statements* (1929). According to its chairman, Samuel J. Broad, the revision committee inserted “generally” to answer questions such as “. . . accepted by whom? business? professional accountants? the SEC? I heard of one accountant who claimed that if a principle was accepted by him and a few others it was ‘accepted.’”<sup>21</sup>

In retrospect, the legacy of institutionalizing that definition of *principle* has been that the terms *principle*, *rule*, *convention*, *procedure*, and *method* have been used interchangeably, and imprecise and inconsistent usage has hampered the development and acceptance of subsequent efforts to establish accounting principles. Moreover, within the context of so broad a definition of principle, the combination of the latitude given management in choosing accounting methods, the failure to incorporate into financial accounting and reporting the discipline that would have been imposed by the profession’s adopting a few, broad, accepted accounting principles, and the failure to enforce the requirement that companies disclose their accounting methods gave refuge to the continuing use of many different methods and procedures, all justified as “generally accepted principles of accounting,” and encouraged the proliferation of even more “generally accepted” accounting methods.

Finally, despite the reluctance of the Institute to become involved in setting principles or rules, it eventually assumed that responsibility after the U.S. Securities and Exchange Commission was created.

### **Securities Acts and the SEC—“Substantial Authoritative Support”**

The Securities Exchange Act of 1934 established the Securities and Exchange Commission and gave it authority to prescribe accounting and auditing practices to be used by companies in the financial reports required of them under that Act and the Securities Act of 1933. The SEC, like the Stock Exchange before it, became increasingly concerned about the variety of accounting practices approved by auditors. Carman G. Blough, first Chief Accountant of the SEC, told a round-table session at the Institute’s fiftieth anniversary celebration in 1937 that unless the profession took steps to develop a set of accounting principles and reduce the areas of difference in accounting practice, “the determination of accounting principles and methods used in reports to the Commission would devolve on the Commission itself. The message to the profession was clear and unambiguous.”<sup>22</sup>

In April 1938, the Chief Accountant issued Accounting Series Release No. 4, *Administrative Policy on Financial Statements*, requiring registrants to use only accounting prin-

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<sup>21</sup>Zeff, *Forging Accounting Principles in Five Countries*, page 129.

<sup>22</sup>Zeff, *Forging Accounting Principles in Five Countries*, page 134.

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ciples having “substantial authoritative support.” That made official and reinforced Blough’s earlier message: if the profession wanted to retain the ability to determine accounting principles and methods, the Institute would have to issue statements of principles that could be deemed to have “substantial authoritative support.” Through ASR 4, the Commission reserved the right to say what had “substantial authoritative support” but also opened the way to give that recognition to recommendations on principles issued by the Institute.

### **COMMITTEE ON ACCOUNTING PROCEDURE—1938-1959**

The Institute expanded significantly its Committee on Accounting Procedure (not principles) and gave it responsibility for accounting principles and authority to speak on them for the Institute—to issue pronouncements on accounting principles without the need for approval of the Institute’s membership or governing Council. The committee was intended to be the principal source of the “substantial authoritative support” for accounting principles sought by the SEC.

The president of the Institute was the nominal chairman of the Committee on Accounting Procedure. Its vice chairman and guiding spirit was George O. May.

#### **No Comprehensive Statement of Principles by Institute**

The course the committee would follow for the next twenty years was set at its initial meeting in January 1939. Carman G. Blough, who had left the Commission and become a partner of Arthur Andersen & Co. and who was a member of the committee, recounted in a paper at a symposium at the University of California at Berkeley in 1967 how the committee chose its course:

At first it was thought that a comprehensive statement of accounting principles should be developed which would serve as a guide to the solution of the practical problems of day to day practice. . . .

After extended discussion it was agreed that the preparation of such a statement might take as long as five years. In view of the need to begin to reduce the areas of differences in accounting procedures before the SEC lost patience and began to make its own rules on such matters, it was concluded that the committee could not possibly wait for the development of such a broad statement of principles.<sup>23</sup>

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<sup>23</sup>Carman G. Blough, “Development of Accounting Principles in the United States,” *Berkeley Symposium on the Foundations of Financial Accounting* (Berkeley: Schools of Business Administration, University of California, 1967), pages 7 and 8.

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The committee thus decided that the need to deal with particular problems was too pressing to permit it to spend time and effort on a comprehensive statement of principles.

### **Statements of Accounting Principles by Others**

Although the Institute attempted no formulation of a statement of broad accounting principles, two other organizations did. Both statements were written by professors and each was an early representative of one of the two schools of thought about the nature and derivation of accounting principles.

#### *AAA's Theoretical Basis for Accounting Rules and Procedures*

“A Tentative Statement of Accounting Principles Underlying Corporate Financial Statements,” by the Executive Committee of the American Accounting Association in 1936, was based on the assumption “that a corporation’s periodic financial statements should be continuously in accord with a single coordinated body of accounting theory.”<sup>24</sup> The phrase “Accounting Principles Underlying Corporate Financial Statements” emphasized that improvement in accounting practice could best be achieved by strengthening the theoretical framework that supported practice. The “Tentative Statement” was almost completely ignored by the Institute, and its effect on accounting practice at the time was minimal. However, two of its principles (one a corollary of the other) and a monograph by W. A. Paton and A. C. Littleton based on it proved to have long-lasting influence and are described shortly.

#### *Sanders, Hatfield, and Moore's Codification of Accounting Practices*

In contrast to the AAA’s attempt to derive a coordinated body of accounting theory, *A Statement of Accounting Principles*, by Thomas Henry Sanders, Henry Rand Hatfield, and Underhill Moore, two professors of accounting and a professor of law, respectively, was a compilation through interviews, discussions, and surveys of “the current practices of accountants” and reflected no systematic theoretical foundation. It was prepared under sponsorship of the Haskins & Sells Foundation and was published in 1938 by the Institute, which distributed it to all Institute members as “a highly valuable contribution to the discussion of accounting principles.”

The report was excoriated for its virtually exclusive reliance on experience and current practice as the basis for principles, its reluctance to criticize even the most dubious practices, and its implication that accountants had no greater duty than to ratify whatever

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<sup>24</sup>Page 188 of the “Tentative Statement,” which was published in *The Accounting Review*, June 1936, pages 187-191. [Reprinted in *Accounting and Reporting Standards for Corporate Financial Statements and Preceding Statements and Supplements* (Iowa City, Iowa: American Accounting Association, 1957), pages 60-64.]

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management wanted to do with its accounting as long as what it did was legal and properly disclosed. Many, perhaps most, of the characteristics criticized were inherent in what the authors were asked to do—formulate a code of accounting principles based on practice and the weight of opinion and authority. Even so, the report tended to strike a dubious balance between auditors' independence and duty to exercise professional judgment on the one hand and their deference to management on the other.

It was, nevertheless, "the first relatively complete statement of accounting principles and the only complete statement reflecting the school of thought that accounting principles are found in what accountants do. . . ." It was a successful attempt to codify the methods and procedures that accountants used in everyday practice and "was in fact a 'distillation of practice.'"<sup>25</sup> Moreover, since the Committee on Accounting Procedure adopted and pursued the same view of principles and incorporated existing practice and the weight of opinion and authority in its pronouncements, *A Statement of Accounting Principles* probably was a good approximation of what the committee would have produced had it attempted to codify existing "accepted principles of accounting."

### *Sets of Principles by Individuals*

Three less ambitious efforts in 1937 and 1938—eight principles in Gilbert R. Byrne's prize-winning essay,<sup>26</sup> nine accounting principles and conventions in D. L. Trouant's book, *Financial Audits*,<sup>27</sup> and six accounting principles in A. C. Littleton's "Tests for Principles"<sup>28</sup>—provided examples, rather than complete statements, of principles. Each described what principles meant and gave some propositions to illustrate the nature of principles or to show how propositions could be judged to be accepted principles. The resulting principles were substantially similar to those of the special committee. For example, all three authors included the conventions that revenue usually should be realized (recognized) at the time of sale and that cost of plant should be depreciated over its useful life. An interesting exception was Trouant's first principle—"Everything having a value has a claimant"—and the accompanying explanation: "In this axiom lies the basis of double-entry bookkeeping and from it arises the equivalence of the balance-sheet totals for assets and liabilities."<sup>29</sup> That proposition not only was more fundamental than most principles of the time but also was distinctive in referring to the world in which accounting takes place rather than to the accounting process.

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<sup>25</sup>Reed K. Storey, *The Search for Accounting Principles* (New York: American Institute of Certified Public Accountants, 1964), page 31. [Reprinted (Houston, Texas: Scholars Book Company, 1977).]

<sup>26</sup>Byrne, "To What Extent Can the Practice of Accounting Be Reduced to Rules and Standards?" page 372.

<sup>27</sup>D. L. Trouant, *Financial Audits* (New York: American Institute Publishing Co., Inc., 1937), pages 5-7.

<sup>28</sup>A. C. Littleton, "Tests for Principles," *The Accounting Review*, March 1938, pages 16-24.

<sup>29</sup>Trouant, *Financial Audits*, page 5.

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### **Principles from Resolving Specific Problems**

None of those five efforts to state principles of accounting seems to have had much effect on practice, although Sanders, Hatfield, and Moore's *A Statement of Accounting Principles* may indirectly have affected the decision of the Committee on Accounting Procedure to tackle specific accounting problems first: "[A]nyone who read it could not fail to be impressed with the wide variety of procedures that were being followed in accounting for similar transactions and in that way undoubtedly it helped to point up the need for doing something to standardize practices."<sup>30</sup>

In any event, the Committee on Accounting Procedure decided that to formulate a statement of broad accounting principles would take too long and elected instead to use a problem-by-problem approach in which the committee would recommend one or more alternative procedures as preferable to other alternatives for resolving a particular financial accounting or reporting problem. The decision to resolve pressing and controversial matters that way was described by members of the committee as "a decision to put out the brush fires before they created a conflagration."<sup>31</sup>

### **The Accounting Research Bulletins**

The committee's means of extinguishing the threatening fires were the Accounting Research Bulletins. From September 1939 through August 1959 it issued 51 ARBs on a variety of subjects. Among the most important or most controversial (or both) were No. 2, *Unamortized Discount and Redemption Premium on Bonds Refunded* (1939); No. 23, *Accounting for Income Taxes* (1944); No. 24, *Accounting for Intangible Assets* (1944); No. 29, *Inventory Pricing* (1947); No. 32, *Income and Earned Surplus [Retained Earnings]* (1947); No. 33, *Depreciation and High Costs* (1947); No. 37, *Accounting for Compensation in the Form of Stock Options* (1948); No. 40 and No. 48, *Business Combinations* (1950 and 1957); No. 47, *Accounting for Costs of Pension Plans* (1956); and No. 51, *Consolidated Financial Statements* (1959).

Each ARB described one or more accounting or reporting problems that had been brought to the committee's attention and identified accepted principles (conventions, rules, methods, or procedures) to account for the item(s) or otherwise to solve the problem(s) involved, sometimes describing one or more principles as preferable. Because each Bulletin dealt with a specific practice problem, or a set of related problems, the committee developed or approved accounting principles (to use the most common descriptions) case-by-case, ad hoc, or piecemeal.

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<sup>30</sup>Blough, "Development of Accounting Principles in the United States," page 7.

<sup>31</sup>Blough, "Development of Accounting Principles in the United States," page 8.

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### **Piecemeal Principles Based on Practice, Experience, and General Acceptance**

As a result of the way the committee operated and the bases on which it decided issues before it, the Accounting Research Bulletins became classic examples of George O. May's dictum that "the rules of accounting, even more than those of law, are the product of experience rather than of logic."<sup>32</sup> Despite having "research" in the name, the Accounting Research Bulletins, rather than being the product of research or theory, were much more the product of existing practice, the collective experience of the members of the Committee on Accounting Procedure, and the need to be generally accepted.

Since the committee had not attempted to codify a comprehensive statement of accounting principles, it had no body of theory against which to evaluate the conventions, rules, and procedures that it considered. Although individual ARBs sometimes reflected one or more theories apparently suggested or applied by individual members or agreed on by the committee, as a group they reflected no broad, internally consistent, underlying theory. On the contrary, they often were criticized for being inconsistent with each other. The committee used the word *consistency* to mean that a convention, rule, or procedure, once chosen, should continue to be used in subsequent financial statements, not to mean that a conclusion in one Bulletin did not contradict or conflict with conclusions in others.

The most influential unifying factor in the ARBs as a group was the philosophy that underlay *Audits of Corporate Accounts*, a group of propositions that May and the Special Committee on Co-operation with Stock Exchanges had described as pragmatic and realistic—not theoretical and logical. For example, the Bulletins clearly were based on the propositions that the income statement was far more important than the balance sheet; that financial accounting was primarily a process of allocating historical costs and revenues to periods rather than of valuing assets and liabilities; that the particular rules or conventions used were less significant than consistent use of whichever ones were chosen; and that some variety in accounting conventions and rules, especially in the methods and procedures for applying them to particular situations, was inevitable and desirable.

Most of the work of the Committee on Accounting Procedure, like that of most Institute committees, was done by its members and their partners or associates, and the ARBs reflected their experience. The experience of Carman G. Blough also left its mark on the Bulletins after he became the Institute's first full-time director of research in 1944. The Institute had established a small research department with a part-time director in 1939, which did some research for the committee but primarily performed the tasks of a technical staff, such as providing background and technical memoranda as bases for the Bulletins and drafting parts of proposed Bulletins. Committee members and their associates did even more of the committee's work as the research department also began to provide

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<sup>32</sup>May, *Financial Accounting*, page vii.

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staff assistance to the Committee on Auditing Procedure in 1942 and then increasingly became occupied with providing staff assistance to a growing number (44 at one time) of other technical committees of the Institute.

The accounting conventions, rules, and procedures considered by the Committee on Accounting Procedure and given its stamp of approval as principles in an ARB were already used in practice, not only because the committee had decided to look for principles in what accountants did but also because only principles that were already used were likely to qualify as “generally accepted.” General acceptance was conferred by use, not by vote of the committee. Each Bulletin, beginning with ARB 4 in December 1939, carried this note about its authority: “Except in cases in which formal adoption by the Institute membership has been asked and secured, the authority of the bulletins rests upon the general acceptability of opinions . . . reached.”

The committee was authorized by the Institute to issue statements on accounting principles, which the Institute expected the SEC to recognize as providing “substantial authoritative support,” but the committee had no authority to require compliance with the Bulletins. It could only add a warning to each Bulletin “that the burden of justifying departure from accepted procedures must be assumed by those who adopt other treatment.”

The committee’s reliance on general acceptability of principles developed or approved case-by-case, ad hoc, or piecemeal invited challenges to its authority whenever it tried either to introduce new accounting practices or to proscribe existing practices. Moreover, although the SEC also dealt with accounting principles case-by-case, ad hoc, or piecemeal, its power to say which accounting principles had substantial authoritative support—its own version of general acceptability—limited what the committee could do without the Commission’s concurrence.

### *Challenges to the Committee’s Authority*

The Committee on Accounting Procedure introduced interperiod income tax allocation in ARB No. 23, *Accounting for Income Taxes* (December 1944). The reason it gave for changing practice was that “income taxes are an expense that should be allocated, when necessary and practicable, to income and other accounts, as other expenses are allocated. What the income statement should reflect . . . is the [income tax] expense properly allocable to the income included in the income statement for the year” (page 186 [fourth page of ARB 23], carried over with some changes to ARB No. 43, *Restatement and Revision of Accounting Research Bulletins* (June 1953), Chapter 10B, “Income Taxes,” paragraph 4).

A committee of the New Jersey Society of Certified Public Accountants reviewed ARB 23 soon after its issue and questioned whether the new procedures it recommended were “accepted procedures” at the date of its issue. General acceptability, the committee contended, depended on the extent to which procedures were applied in practice, which



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only time would tell. The committee proposed that the Institute submit a new Bulletin to a formal vote a year after issue because approval of a Bulletin by more than 90 percent of its members would demonstrate its general acceptability and authority.<sup>33</sup>

The Institute ignored the proposal, but the New Jersey committee had in effect challenged the authority of the Committee on Accounting Procedure to change accounting practice, raising an issue that would not go away. The Institute's Executive Committee or its governing Council found it necessary to reaffirm the committee's authority a number of times in the following years,<sup>34</sup> and in the committee's final year its authority to change practice was challenged in court, again on a matter involving income tax allocation. Three public utilities, subsidiaries of American Electric Power, Inc., sought to enjoin the Committee on Accounting Procedure from issuing a letter dated April 15, 1959, interpreting a term in ARB No. 44 (revised), *Declining-balance Depreciation* (July 1958).

The object of the letter was to express the Committee's view that the "deferred credit" used in tax-allocation entries was a liability and not part of stockholders' equity. The three plaintiff corporations alleged that classification of the account as a liability would cause them "irreparable injury, loss and damage." They also claimed that the letter was being issued without the Committee's customary exposure, thus not allowing interested parties to comment. The Federal District Court ruled against the plaintiffs. An appeal to the Second Circuit Court of Appeals was lost, the Court saying *inter alia*, "We think the courts may not dictate or control the procedures by which a private organization expresses its honestly held views." *Certiorari* was denied by the U.S. Supreme Court, and the committee's letter was issued shortly thereafter [July 9, 1959].<sup>35</sup>

Neither the Institute's repeated reconfirmations of the committee's status nor its success in court corrected the weaknesses inherent in accounting principles whose authority rested on their general acceptability. The Institute did not finally face up to the problem until almost two decades later when the authority of the Accounting Principles Board was challenged on another income tax matter—accounting for the investment credit (pages 37-40).

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<sup>33</sup>"Comments on 'Accounting for Income Taxes,'" A Statement by the Committee on Accounting Principles and Practice of the New Jersey Society of Certified Public Accountants, *The Journal of Accountancy*, March 1945, pages 235-240.

<sup>34</sup>Zeff, *Forging Accounting Principles in Five Countries*, pages 160-167.

<sup>35</sup>Zeff, *Forging Accounting Principles in Five Countries*, page 166.

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### *Influence of the Securities and Exchange Commission*

Because accounting principles in the Accounting Research Bulletins would be acceptable in SEC filings only if the Commission deemed them to have “substantial authoritative support” (pages 14 and 15), two committees of the Institute carefully cultivated a working relationship with the Commission to try to ensure that the Bulletins met that condition. The Committee on Cooperation with the SEC met regularly with the SEC’s accounting staff and occasionally with the Commissioners. The Committee on Accounting Procedure and the director of research met with representatives of the SEC as needed and took great pains to keep the Chief Accountant informed about the committee’s work, not only sending him copies of drafts of proposed Bulletins but also seeking his comments and criticisms and, if possible, his concurrence. Efforts to secure his agreement usually were successful.<sup>36</sup>

Some differences of opinion between the Committee on Accounting Procedure and the Commission were inevitable, of course, but they were the exception rather than the rule. Most disagreements were settled amicably, as was the long-running disagreement over the current operating performance and all-inclusive or clean surplus theories of income that is described on pages 27 and 28. The committee and the Commission sometimes were able to work out a compromise solution. The committee often adopted the Commission’s view, at least once withdrawing a proposed Accounting Research Bulletin because of the Commission’s opposition and at other times apparently being discouraged from issuing Bulletins by the Commission. The Commission occasionally adopted the committee’s view or at least delayed issue of its own accounting releases pending issue of a Bulletin by the Institute.

The Commission affected accounting practice indirectly through its influence on the Accounting Research Bulletins. It also directly exercised its power to say whether or not a set of financial statements filed with it met the statutory requirements by means of rulings and orders, some published but most private.

The Commission published some formal rules, mostly on matters of disclosure rather than accounting principles. For example, the first regulations promulgated by the newly formed SEC required income statements to disclose sales and cost of goods sold, information that many managements had long considered to be confidential. Over six hundred companies, about a quarter of those required to file registration statements in mid-

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<sup>36</sup>Zeff, *Forging Accounting Principles in Five Countries*, pages 150 and 151; Blough, “Development of Accounting Principles in the United States,” pages 8 and 9.

Carman G. Blough, first Chief Accountant of the SEC (1935-1938), became a charter member of the Committee on Accounting Procedure and later became the first full-time director of research of the Institute (pages 14, 15, 19, and 20 of this book). Chief Accountants during the life (1938-1959) of the Committee on Accounting Procedure were William W. Wertz (1938-1947), Earle C. King (1947-1956), and Andrew Barr (1956-1972), whose term also included most of the life (1959-1973) of the committee’s successor, the Accounting Principles Board.

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1935, risked delisting of their securities by refusing to disclose publicly the required information. The Commission granted hearings to a significant number of them and also heard arguments of security analysts, investment bankers, and other users of financial statements that the information was necessary. The Commission then “notified all of the companies affected that the information was necessary for a fair presentation and that this need overcame any arguments that had been advanced against it.”<sup>37</sup>

The companies had little choice but to comply, and the effect of the rule was to put reporting of sales and cost of sales in the United States decades ahead of most of the rest of the world. The controversy surrounding initial application of the rule subsided, and reporting sales and cost of goods sold has been common practice for so long that few people now know of its once controversial nature or of the Commission’s part in promulgating it.

The Commission largely exercised its power behind the scenes through informal rulings and orders in “deficiency letters” on registrants’ financial statements. The recipient of a deficiency letter could decide either to amend the financial statements to comply with the SEC’s ruling or go to Washington to try to convince the staff, and anyone else at the Commission who would listen, of the merits of the accounting that the staff had challenged. If that informal conference process failed to produce agreement, a registrant could do little except comply or withdraw the registration and forego issuing the securities. The only appeal to the Commission of a staff ruling on an accounting issue was in the form of a hearing to determine whether a stop order should be issued to prevent the registration from becoming effective because it contained misrepresentations—in effect “a hearing to determine whether or not [the registrant was] about to commit a fraud. . . . [Since b]usinessmen who have any reputation do not put themselves in the position of putative swindlers merely to determine matters of accounting,”<sup>38</sup> those private administrative rulings effectively settled most accounting questions.

The SEC’s far-reaching rule that assets must never be accounted for at more than their cost was promulgated in that way. “[N]either the Securities and Exchange Commission nor the accounting profession issued rules or guidelines directly proscribing write-ups [of assets] or supplemental disclosures of current values. The change was brought about by the intervention of the SEC’s staff, who ‘discouraged’ both practices through informal administrative procedures.”<sup>39</sup> “[T]he SEC took a stand from the very beginning. . . . establish[ing] its position so early [that] we often overlook the fact that in [the basis for

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<sup>37</sup>Blough, “Development of Accounting Principles in the United States,” page 10.

<sup>38</sup>A. A. Berle, Jr., “Accounting and the Law,” *The Accounting Review*, March 1938, page 12. [Reprinted in *The Journal of Accountancy*, May 1938, page 372.]

<sup>39</sup>R. G. Walker, “The SEC’s Ban on Upward Asset Revaluations and the Disclosure of Current Values,” *Abacus*, March 1992, pages 3 and 4.

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accounting for assets] the Commission never gave the profession a chance to even consider the matter insofar as registrants are concerned.”<sup>40</sup>

In the sense that the Commission’s role has long been forgotten or unknown, experience with the cost rule was similar to that of the rule requiring disclosure of sales and cost of sales. But the similarity ended there. The cost rule involved accounting principle rather than disclosure. And, instead of subsiding as did resistance to the disclosure rule, controversy surrounding the cost rule intensified and in the years following the Second World War led to a major and long-lasting division within the Institute.

Because of widespread concern about the effects on financial statements of the high rate of inflation during the war and the greatly increased prices of replacing assets after the war, the Institute had created the Study Group on Business Income, financed jointly with the Rockefeller Foundation. Its report concluded that financial statements could be meaningful only if expressed in units of equal purchasing power. It advocated accounting that reflected the effects of changes in the general level of prices on the cost of assets already owned and the resulting costs and expenses from their use,<sup>41</sup> a change in accounting considered necessary by many Institute leaders and members.

While the Study Group was still at work, the Committee on Accounting Procedure, supported by many other Institute leaders and members and by the SEC, issued ARB No. 33, *Depreciation and High Costs* (December 1947), which rejected “price-level depreciation” and suggested instead that management annually appropriate net income or retained earnings in contemplation of replacing productive facilities at higher price levels. The Bulletin effectively blocked use of depreciation in excess of that based on cost in measuring net income that had been contemplated or adopted by a few large companies but also provoked an active opposition to the committee’s action.

Prominent among those who criticized the committee for in effect applying the SEC’s cost rule instead of facing up to the accounting problems caused by the effects of changes in the general price level was George O. May,<sup>42</sup> who had been instrumental in creating the Study Group on Business Income. He served as consultant to and then as a member of the group and later would be a joint author of its report. He criticized the committee’s action for prejudging and undermining the Study Group’s efforts, thereby foreclosing any real discussion of “. . . the relation between changes in the price level and the concept of business income.”<sup>43</sup> He considered ARB 33 to be, however, only one of a number of missteps over the following decade that showed that the committee had lost its way. He also criticized the committee, among other things, for failing to cast aside out-

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<sup>40</sup>Blough, “Development of Accounting Principles in the United States,” page 10.

<sup>41</sup>*Changing Concepts of Business Income*, Report of the Study Group on Business Income (New York: The Macmillan Company, 1952), pages 1-4, 103-109.

<sup>42</sup>George O. May, “Should the LIFO Principle Be Considered in Depreciation Accounting When Prices Vary Widely?” *The Journal of Accountancy*, December 1947, pages 453-456.

<sup>43</sup>George O. May, “Income Accounting and Social Revolution,” *The Journal of Accountancy*, June 1957, page 38.

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moded conventions in favor of others more consonant with the changed conditions in the economy and for adopting public utility accounting procedures such as the Federal Power Commission's "original (or predecessor) cost"—cost to the corporate or natural person first devoting the property to the public service rather than cost to the present owner—that the committee itself earlier had held to be contrary to generally accepted accounting principles.<sup>44</sup>

Despite the criticisms, the committee held its course, though not without some wavering. It twice considered issuing a Bulletin approving upward revaluations of assets but each time dropped the attempt in the face of the unequivocal opposition of the SEC. Although the number of dissents to the cost rule increased each time the committee revisited the question of changing price levels, the committee "was unable to marshal a two-thirds majority in favor of a new policy"<sup>45</sup> and in 1958 dropped the subject from its agenda.

Whether it was influencing accounting practice directly through publishing rules or establishing them in informal rulings and private conferences with registrant companies or indirectly through the Committee on Accounting Procedure, the SEC generally seems to have had its way.

### **Decision to Issue Principles Piecemeal Reaffirmed**

The Committee on Accounting Procedure had to deal ad hoc with the SEC's comments on and objections to its Bulletins, issued or proposed, because it had no comprehensive statement of principles on which to base responses to the Commission's own ad hoc comments and rulings. Although the committee had decided early not to take the time required to develop a statement of broad principles on which to base solutions to practice problems (pages 15 and 16), the need for a comprehensive statement or codification of accounting principles continued to be raised occasionally, and the committee periodically revisited the question. Each time it decided against a project of that kind.

One of those occasions was in 1949, when the committee reconsidered its earlier decision and began work on a comprehensive statement of accounting principles. Ultimately, however, it again abandoned the project as not feasible and instead in 1953 issued ARB 43, *Restatement and Revision of Accounting Research Bulletins*. ARB 43 superseded the first 42 ARBs, except for three that were withdrawn as no longer applicable and eight that were reports of the Committee on Terminology and were reviewed and published

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<sup>44</sup>John Lawler, "A Talk with George O. May," *The Journal of Accountancy*, June 1955, pages 41-45; George O. May, "Business Combinations: An Alternative View," *The Journal of Accountancy*, April 1957, pages 33-36; and an unpublished memorandum dictated by May in 1958 and quoted in Paul Grady, ed., *Memoirs and Accounting Thought of George O. May* (New York: The Ronald Press Company, 1962), pages 277-279.

<sup>45</sup>Zeff, *Forging Accounting Principles in Five Countries*, pages 155-157 and 165-166.

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separately in Accounting Terminology Bulletin No. 1, *Review and Résumé*. Although ARB 43 brought together the earlier Bulletins and grouped them by subject matter, “this collection retained the original flavor of the bulletins, i.e., a group of separate opinions on different subjects.”<sup>46</sup>

Thus, the decision of the Committee on Accounting Procedure at its first meeting to put out brush fires as they flared up rather than to codify accepted accounting principles to provide a basis for solving financial accounting and reporting problems set the course that the committee pursued for its entire 21-year history. All 51 ARBs reflected that decision.

### **Influence of the American Accounting Association**

During the twenty-one years that the Committee on Accounting Procedure was issuing the ARBs, the AAA revised its 1936 “A Tentative Statement of Accounting Principles Underlying Corporate Financial Statements” in 1941, 1948, and 1957, including eight Supplementary Statements to the 1948 Revision. In the “Tentative Statement,” as already noted, the executive committee of the AAA emphasized that improvement in accounting practice could best be achieved by strengthening the theoretical framework that supported practice and attempted to formulate a comprehensive set of concepts and standards from which to derive and by which to evaluate rules and procedures. Principles were not merely descriptions of procedures but standards against which procedures might be judged.

The executive committee of the Association, like the committees of the Institute concerned with accounting principles, regarded the principles as being derived from accounting practice, although the means of derivation differed—distillation or compilation according to the Institute and theoretical analysis according to the Association. Thus, the “Tentative Statement” set forth twenty principles, each a proposition embodying “a corollary of this fundamental axiom”:

Accounting is . . . not essentially a process of valuation, but the allocation of historical costs and revenues to the current and succeeding fiscal periods. [page 188]

Although the AAA’s intent was to emphasize accounting’s conceptual underpinnings, the “Tentative Statement” was substantially less conceptual and more practice oriented than might appear, not only because its principles were derived from practice but also because its “fundamental axiom” was essentially a description of existing practice. The same description of accounting was inherent in the report of the Special Committee on

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<sup>46</sup>Storey, *The Search for Accounting Principles*, page 43.

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Co-operation with Stock Exchanges, was voiced by George O. May at the annual meeting of the Institute in October 1935,<sup>47</sup> and was evident in most of the ARBs.

That the principles in the Statements of the AAA were significantly like those in the ARBs should come as no surprise. "Inasmuch as both the Institute and the Association subscribed to the same basic philosophy regarding the nature of income determination, it was more or less inevitable that they should reach similar conclusions, even though they followed different paths."<sup>48</sup>

The AAA's 1941 and 1948 revisions generally continued in the direction set by the 1936 "Tentative Statement." Some changes began to appear in some of the Supplementary Statements to the 1948 Revision and in the 1957 Revision. They probably were too late, however, to have had much effect on the ARBs, even if the Committee on Accounting Procedure had paid much attention.

Long-lasting influence on accounting practice of the "Tentative Statement," as noted earlier, came some time after it was issued and mostly indirectly through two of its principles on "all-inclusive income" (one a corollary of the other) and a monograph by W. A. Paton and A. C. Littleton.

### *"All-Inclusive Income" versus "Avoiding Distortion of Periodic Income"*

"A Tentative Statement of Accounting Principles Underlying Corporate Financial Statements" strongly supported what was later called the "all-inclusive income" or "clean surplus" theory. The principle (No. 8, page 189), which gave the theory one of its names, was that an income statement for a period should include all revenues, expenses, gains, and losses properly recognized during the period "regardless of whether or not they are the results of operations in that period." The corollary (No. 18, page 191), which gave the theory its other name, was that no revenues, expenses, gains, or losses should be recognized directly in earned surplus (retained earnings or undistributed profits).

The SEC later strongly supported that accounting, and it became a bone of contention between the SEC and the Committee on Accounting Procedure. The committee generally favored the "current operating performance" theory of income, which excluded from net income extraordinary and nonrecurring gains and losses "to avoid distorting the net income for the period." The disagreement broke into the open with the issue of ARB No. 32, *Income and Earned Surplus [Retained Earnings]* (December 1947), whose publication in the January 1948 issue of *The Journal of Accountancy* was accompanied by a letter from SEC Chief Accountant Earle C. King saying that the "Commission has authorized the staff to take exception to financial statements which appear to be misleading, even though they reflect the application of Accounting Research Bulletin No. 32"

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<sup>47</sup>George O. May, "The Influence of Accounting on the Development of an Economy," *The Journal of Accountancy*, January 1936, page 15.

<sup>48</sup>Storey, *The Search for Accounting Principles*, page 45.

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(page 25). Two more Bulletins, ARB No. 35, *Presentation of Income and Earned Surplus* (October 1948), and ARB No. 41, *Presentation of Income and Earned Surplus (Supplement to Bulletin No. 35)* (July 1951), followed as the committee and the SEC tried to work out a number of compromises. Each effort proved unsatisfactory to one or both parties.

Years later the Accounting Principles Board would adopt an all-inclusive income statement in APB Opinion No. 9, *Reporting the Results of Operations* (December 1966). That accounting and reporting has since been modified by admitting some significant exceptions, primarily by FASB Statement No. 12, *Accounting for Certain Marketable Securities* (December 1975),<sup>49</sup> and FASB Statement No. 52, *Foreign Currency Translation* (December 1981). Thus, net income reported under current generally accepted accounting principles cannot accurately be described as all-inclusive income, but the idea of all-inclusive income is still generally highly regarded, and many still see it as a desirable goal to which to return.

### *“Matching of Costs and Revenues” and “Assets Are Costs”*

Two members of the AAA executive committee that issued “A Tentative Statement of Accounting Principles Underlying Corporate Financial Statements” in 1936 undertook to write a monograph to explain its concepts. The result, *An Introduction to Corporate Accounting Standards*, by W. A. Paton and A. C. Littleton (1940), easily qualifies as the academic writing that has been most influential in accounting practice. Although the monograph rejected certain existing practices—such as LIFO and cost or market, whichever is lower—it generally rationalized existing practice, providing it with what many saw as a theoretical basis that previously had been lacking.

The monograph accepted two of the premises that underlay the ARBs: (1) that periodic income determination was the central function of financial accounting—“the business enterprise is viewed as an organization designed to produce income”<sup>50</sup>—and (2) that (in the words of the “fundamental axiom” of the AAA’s 1936 “Tentative Statement”) accounting was “not essentially a process of valuation, but the allocation of historical costs and revenues to the current and succeeding fiscal periods.”

The fundamental problem of accounting, therefore, is the division of the stream of costs incurred between the present and the future in the process of measuring periodic income. The technical instruments used in reporting

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<sup>49</sup>FASB Statement 12 was superseded by FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (May 1993), which retained the provision requiring that unrealized holding gains and losses on certain securities be excluded from net income and directly added to or deducted from equity.

<sup>50</sup>W. A. Paton and A. C. Littleton, *An Introduction to Corporate Accounting Standards* (Ann Arbor, Michigan: American Accounting Association, 1940), page 23.



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this division are the income statement and the balance sheet. . . . The income statement reports the assignment [of costs] to the current period; the balance sheet exhibits the costs incurred which are reasonably applicable to the years to come.<sup>51</sup>

The monograph described the periodic income determination process as the “matching of costs and revenues,” giving it not only a catchy name but also strong intuitive appeal—a process of relating the enterprise’s efforts and accomplishments. The corollary was that most assets were “deferred charges to revenue,” costs waiting to be “matched” against future revenues:

The factors acquired for production which have not yet reached the point in the business process where they may be appropriately treated as “cost of sales” or “expense” are called “assets,” and are presented as such in the balance sheet. It should not be overlooked, however, that these “assets” are in fact “revenue charges in suspense” awaiting some future matching with revenue as costs or expenses.

The common tendency to draw a distinction between cost and expense is not a happy one, since expenses are also costs in a very important sense, just as assets are costs. “Costs” are the fundamental data of accounting. . . .

The balance sheet thus serves as a means of carrying forward unamortized acquisition prices, the not-yet-deducted costs; it stands as a connecting link joining successive income statements into a composite picture of the income stream.<sup>52</sup>

Not surprisingly, those who had supported the accounting principles developed in the ARBs but were uncomfortable with those principles’ apparent lack of theoretical support found highly attractive the theory that “matching costs and revenues” not only determined periodic net income but also justified the practice of accounting for most assets at their historical costs or an unamortized portion thereof.

However, just as the institutionalizing of a broad definition of accounting principles had caused problems for the Committee on Accounting Procedure itself and later for the Accounting Principles Board, the institutionalizing of “matching costs with revenues,” “costs are assets,” and “avoiding distortion of periodic income” also caused problems for the Financial Accounting Standards Board in developing a conceptual framework for financial accounting and reporting. The FASB found those expressions not only to be ingrained in accountants’ vocabularies and widely used as reasons for or against particu-

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<sup>51</sup>Paton and Littleton, *An Introduction to Corporate Accounting Standards*, page 67.

<sup>52</sup>Paton and Littleton, *An Introduction to Corporate Accounting Standards*, pages 25 and 67.

lar accounting or reporting procedures but also to be generally vague, highly subjective, and emotion laden (pages 47-66). They have proven to be of minimal help in actually resolving difficult accounting issues.

### **Failure to Reduce the Number of Alternative Accounting Methods**

The Institute's effort aimed at improving accounting by reducing the number of acceptable alternatives probably did improve accounting by culling out some "bad" practices.

There are those who seem to believe that very little progress has been made towards the development of accounting principles and the narrowing of areas of differences in the principles followed in practice.

It is difficult for me to see how anyone who has knowledge of accounting as it was practiced during the first quarter of this century and how it is practiced today can fail to recognize the tremendous advances that have taken place in the art.<sup>53</sup>

A number of the practices for whose acceptance Sanders, Hatfield, and Moore's *A Statement of Accounting Principles* had been lambasted<sup>54</sup> had disappeared by about 1950. It is uncertain, however, how much of that improvement was due to the ARBs and how much to other factors, such as the good professional judgment of corporate officials or auditors or the SEC's rejection of some egregious procedures.

Ironically, the end result was an overabundance of "good" practices that had survived the process. That plethora of sanctioned alternatives for accounting for similar transactions continued to thrive despite the committee's charge to reduce the number of alternative procedures because, just as Will Rogers never met a man he didn't like, the committee rarely met an accounting principle it didn't find acceptable.

Two factors contributed to the increase in the number of accepted alternatives: (1) the committee on accounting procedure failed to make firm choices among alternative procedures, and (2) the committee was clearly reluctant to condemn widely used methods even though they were in conflict with its recommendations. For example, in its very first pronouncement on a specific problem—unamortized discount and redemption premium on refunded bonds [ARB 2]—the committee considered three possible procedures, of which it rejected one and accepted two.

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<sup>53</sup>Blough, "Development of Accounting Principles in the United States," page 12.

<sup>54</sup>"The report contained statements to the effect that (1) impairments of net worth in the form of catastrophic losses might be listed on the asset side, (2) deficits of new companies might be shown as assets, (3) capital losses might be carried as deferred charges if charging them against the income of a single period would distort profit, etc." (Storey, *The Search for Accounting Principles*, page 30).

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The committee had a clear preference—it praised the method of amortization of cost over the remaining life of the old bonds as consistent with good accounting thinking regarding the relative importance of the income statement and the balance sheet. It condemned immediate writeoff as a hold-over of balance-sheet conservatism which was of “dubious value if attained at the expense of a lack of conservatism in the income account, which is far more significant” [ARB 2, page 13]. Nevertheless, the latter method had “too much support in accounting theory and practice and in the decisions of courts and commissions for the committee to recommend that it should be regarded as unacceptable or inferior” [ARB 2, page 20].

. . . The solution turned out to be a “live-and-let-live” policy. The major thing accomplished by the bulletin was the elimination of a method [amortization over the life of the new issue] which was not widely used anyway. And this type of solution was characteristic of the bulletins, rather than exceptional.

The extreme to which this attitude was sometimes carried is exemplified in the Institute’s inventory bulletin [ARB 29], a classic example of trying to please everyone. The committee accepted almost every conceivable inventory [pricing] procedure, except the discredited base-stock method. The committee therefore passed up the opportunity to narrow the range of acceptable alternative procedures in the area of inventory [pricing]. . . . Instead, the individual practitioner was left with the high-sounding but useless admonition that the method chosen should be the one which most clearly reflected periodic income.<sup>55</sup>

The proliferation of accepted alternative principles was probably inherent in an approach that championed disclosure and consistency in use of procedures over specific principles and consistency between principles.

Most of the controversial subjects covered by the Accounting Research Bulletins came back to haunt the Committee on Accounting Procedure’s successor, the Accounting Principles Board. The case-by-case, ad hoc, or piecemeal approach produced few lasting solutions to financial accounting and reporting problems.

### **ACCOUNTING PRINCIPLES BOARD—1959-1973**

The American Institute of Accountants changed its name to the American Institute of Certified Public Accountants in June 1957, and in October of that year the new president of the AICPA, Alvin R. Jennings, proposed that the Institute reorganize its efforts in the

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<sup>55</sup>Storey, *The Search for Accounting Principles*, pages 49 and 50.

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area of accounting principles.<sup>56</sup> His recommendation came at a time when the Committee on Accounting Procedure was under fire for, among other things, failing to reduce the number of alternative accounting procedures. A growing number of Institute members sensed that the committee's firefighting approach to accounting principles had gone about as far as it could and expressed an urgent need for the committee to abandon that effort and to do what it had theretofore been reluctant to do—formulate or codify a comprehensive statement of accounting principles.

Jennings called for an increased research effort to reexamine the basic assumptions of accounting and to develop authoritative statements to guide accountants. He appointed a Special Committee on Research Program, and its report, *Organization and Operations of the Accounting Research Program and Related Activities*, in December 1958, provided the basis for the organization of an Accounting Principles Board and an Accounting Research Division. The committee set a lofty goal:

The general purpose of the Institute in the field of financial accounting should be to advance the written expression of what constitutes generally accepted accounting principles, for the guidance of its members and others. This means something more than a survey of existing practice. It means continuing effort to determine appropriate practice and to narrow the areas of difference and inconsistency in practice. In accomplishing this, reliance should be placed on persuasion rather than on compulsion. The Institute, however, can, and it should, take definite steps to lead in the thinking on unsettled and controversial issues.<sup>57</sup>

The Accounting Principles Board in September 1959 replaced the Committee on Accounting Procedure as the senior technical committee of the Institute with responsibility for accounting principles and authority to issue pronouncements on accounting principles without the need for approval of the Institute's membership or governing Council. The Board's eighteen members were members of the Institute, and thus CPAs, who, like members of the Committee on Accounting Procedure, continued their affiliations with their firms, companies, and universities while serving without compensation on the Board.

The APB was originally envisioned as the instrument through which a definitive statement of accounting principles would finally be achieved—what the Wheat Report later

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<sup>56</sup>Alvin R. Jennings, "Present-Day Challenges in Financial Reporting," *The Journal of Accountancy*, January 1958, pages 28-34. [Reprinted in Stephen A. Zeff, *The Accounting Postulates and Principles Controversy of the 1960s* (New York and London: Garland Publishing, Inc., 1982).]

<sup>57</sup>"Report to Council of the Special Committee on Research Program," *The Journal of Accountancy*, December 1958, pages 62 and 63. [Reprinted in *Organization and Operations of the Accounting Research Program and Related Activities* (New York: American Institute of Certified Public Accountants, 1959); in Zeff, *Forging Accounting Principles in Five Countries*, pages 248-265; and in Zeff, *The Accounting Postulates and Principles Controversy of the 1960s*.]

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would call a “‘grand design’ of accounting theory upon which all else would rest.”<sup>58</sup> The report of the Special Committee on Research Program in 1958 outlined a hierarchy of postulates, principles, and rules to guide the APB’s work:

The broad problem of financial accounting should be visualized as requiring attention at four levels: first, postulates; second, principles; third, rules or other guides for the application of principles in specific situations; and fourth, research.

Postulates are few in number and are the basic assumptions on which principles rest. They necessarily are derived from the economic and political environment and from the modes of thought and customs of all segments of the business community. The profession . . . should make clear its understanding and interpretation of what they are, to provide a meaningful foundation for the formulation of principles and the development of rules or other guides for the application of principles in specific situations. . . .

A fairly broad set of co-ordinated accounting principles should be formulated on the basis of the postulates. The statement of this probably should be similar in scope to the statements on accounting and reporting standards issued by the American Accounting Association. The principles, together with the postulates, should serve as a framework of reference for the solution of detailed problems.

Rules or other guides for the application of accounting principles in specific situations, then, should be developed in relation to the postulates and principles previously expressed. Statements of these probably should be comparable as to subject matter with the present accounting research bulletins. They should have reasonable flexibility.

Adequate accounting research is necessary in all of the foregoing.<sup>59</sup>

The report of the Special Committee on Research Program contemplated that the APB would quickly concern itself with providing the conceptual context from which would flow the rules or procedures to be applied in specific situations. The APB would then use the postulates and principles in choosing between alternate rules and procedures to narrow the areas of difference and inconsistency in practice.

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<sup>58</sup>*Establishing Financial Accounting Standards*, Report of the Study on Establishment of Accounting Principles (New York: American Institute of Certified Public Accountants, March 29, 1972), page 15. [Often called the Wheat Report, after the group’s chairman, Francis M. Wheat, a former SEC commissioner.]

<sup>59</sup>“Report to Council of the Special Committee on Research Program,” page 63.

## **Postulates and Principles**

Following that prescription, the new Accounting Research Division published Accounting Research Study No. 1, *The Basic Postulates of Accounting*, by Maurice Moonitz in 1961, and Accounting Research Study No. 3, *A Tentative Set of Broad Accounting Principles for Business Enterprises*, by Robert T. Sprouse and Maurice Moonitz in 1962. Accounting Research Studies were not publications of the APB and thus did not constitute official Institute pronouncements on accounting principles. On the authority of the Director of Accounting Research, Maurice Moonitz, they were issued for wide exposure and comment.

In an article entitled “Why Do We Need ‘Postulates’ and ‘Principles’?” Moonitz explained that postulates and principles were necessary to give accounting “the integrating structure it needs to give more than passing meaning to its specific procedures. It will provide ‘experience’ with the aid it needs from ‘logic’ to explain why it is that some procedures are appropriate and others are not.”<sup>60</sup> An integrating structure would provide accounting with a mechanism by which to rid itself of procedures that clearly were not in harmony with the authoritatively stated principles.

Among the most significant contributions of those Accounting Research Studies was their development of the terms postulates and principles, especially postulates, which Moonitz explained in his article:

“[P]ostulates” is used . . . to denote those basic propositions of accounting which describe the accountant’s understanding of the world in which he lives and acts. The propositions are therefore generalizations about the environment of accounting, generalizations based upon a more or less comprehensive view and understanding of that environment. The term “principles” is used to denote those basic propositions which stem from the postulates and refer expressly to accounting issues.<sup>61</sup>

To qualify as a postulate, a proposition had to meet two conditions: it must be “self-evident,” an assertion about the environment in which accounting functions that is universally accepted as valid; and it must be “fruitful for accounting,” that is, it must “relate to (be inferred from) a world that does exist and not to one that is a fiction.” Moonitz also noted that self-evident is not, as some who commented on ARS 1 seemed to have be-

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<sup>60</sup>Maurice Moonitz, “Why Do We Need ‘Postulates’ and ‘Principles’?” *The Journal of Accountancy*, December 1963, page 46. [Reprinted in Zeff, *The Accounting Postulates and Principles Controversy of the 1960s*.]

<sup>61</sup>Moonitz, “Why Do We Need ‘Postulates’ and ‘Principles’?” page 43.

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lieved, the same as trivial.<sup>62</sup> An example from ARS 1 to which he referred made his point: “Most of the goods and services that are produced are distributed through exchange, and are not directly consumed by the producers” (Postulate A-2.—Exchange). In that straightforward observation lie the reasons that accounting is concerned with production and distribution of goods and services and with exchange prices; if it is further observed that most exchanges are for cash, the reasons that accounting is concerned with cash prices and cash flows become apparent. As Moonitz observed, the “proposition is an extraordinarily fruitful one for accounting.”<sup>63</sup>

Emphasis on a basis for accounting principles comprising self-evident propositions about the real-world environment in which accounting functions, and on which it reports, constituted a significant shift in thinking. Accountants’ earlier emphasis, largely in a conceptual vacuum, had been on the conventional nature of accounting and the resulting necessity for conventional procedures, allocations, opinion, and judgment to produce the numbers in income statements and balance sheets. That emphasis provided an unstable and uncertain basis for accounting principles.

Accounting is often described as “conventional” in nature, and its principles as “conventions.” The two terms, conventions and conventional, are ambiguous; the statement that accounting is conventional may be true or false depending on which meaning is intended. It is true if it refers to such things as the use of Arabic numerals, the use of the dollar sign, or the sequence in which assets, liabilities, revenues, and expenses are listed in financial statements because other symbols and forms could be used to convey precisely the same message. It is not true if the statement means that any proposition which accountants accept is a valid one. As a farfetched example, assume that all uninsured losses, without exception, were to be converted into “assets” by the expedient of calling them “deferred charges against future operations.” This convention would not make assets out of losses; it would merely give the approval of accountants to a false assertion concerning the enterprise that suffered the losses, and would place accountants and accounting in an unfavorable light in the eyes of those who knew what had happened.

Suppose, however, that the assertion about accounting principles as “conventions” is intended to convey the idea that they are generalizations, inferences drawn from a large body of data, and that they are not intended to be literal descriptions of reality. “Conventions” and “conventional” are clearly valid descriptions, then, but not because accounting is unique. Instead, ac-

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<sup>62</sup>Moonitz, “Why Do We Need ‘Postulates’ and ‘Principles’?” pages 44 and 45.

<sup>63</sup>Maurice Moonitz, *The Basic Postulates of Accounting*, Accounting Research Study No. 1 (New York: American Institute of Certified Public Accountants, 1961), page 22. [Reprinted in Zeff, *The Accounting Postulates and Principles Controversy of the 1960s*.]

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counting is like every other field of human endeavor in this one respect: its basic propositions are generalizations or abstractions and not minute descriptions of every aspect of “reality.”<sup>64</sup>

Postulates that were self-evident propositions about the real world and also fruitful for accounting were needed to provide a solid basis for accounting principles and rules—“a platform from which to start,” “a place to stand”—and “a place to stand” was prerequisite to real improvement in accounting practice. “Failure by accountants to agree on a ‘place to stand’ will mean continued operation in mid-air, as unstable and uncertain in the future as in the past.”<sup>65</sup>

In the more than thirty years since the two studies were published, their valuable contributions to accounting thought increasingly have been recognized. Some of the conclusions and recommendations of ARS 3, *A Tentative Set of Broad Accounting Principles for Business Enterprises*, such as use of replacement costs of inventories and plant and equipment and accounting for the effects of changes in the general price level, have remained controversial and still are largely unacceptable to many accountants. In contrast, most of the conclusions of ARS 1, *The Basic Postulates of Accounting*, long ago became commonplace in accounting literature. For example, the basic idea that the foundation for accounting principles lies in self-evident propositions about the environment in which accounting functions was incorporated into APB Statement No. 4, *Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises*, in 1970. By 1975 that basic idea had become an essential part of the Financial Accounting Standards Board’s conceptual framework.

When ARS 3 was published in April 1962, however, each copy contained a Statement of the Accounting Principles Board (later designated APB Statement 1) passing judgment on both studies: “The Board believes . . . that while these studies are a valuable contribution to accounting thinking, they are too radically different from present generally accepted accounting principles for acceptance at this time.”

It was not the APB’s finest hour. Even though general dissatisfaction with the state of existing practice had been the reason for the APB’s creation and the new emphasis on research, the Board, and many others, reacted as if they had been caught by surprise that the studies recommended some significant changes in existing practice. Moreover, instead of letting consideration of the studies follow the anticipated course of wide circulation and exposure and receipt of comments from interested readers before the Board considered the studies, the Board reacted first, spoiling any opportunity of receiving unbiased comments on the studies. The experience seems to have adversely affected for years the Board’s approach to postulates and principles.

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<sup>64</sup>Moonitz, “Why Do We Need ‘Postulates’ and ‘Principles’?” pages 45 and 46.

<sup>65</sup>Moonitz, “Why Do We Need ‘Postulates’ and ‘Principles’?” page 45.



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The experience may have made the APB “disillusioned with, or at least skeptical toward, the potential that fundamental or ‘theoretical’ research might have for solving accounting problems. . . . [T]he Board seemed to abandon the hope of the Special Committee on Research Program that such research could serve as a foundation for pronouncements on accounting principles.”<sup>66</sup> In any event, the Board did little or nothing more on accounting postulates and principles until 1965, except to authorize the project that in March 1965 became ARS No. 7, *Inventory of Generally Accepted Accounting Principles*, by Paul Grady, the second Director of Accounting Research. In 1965, the Board renewed efforts on fundamental matters—which it then called basic concepts and principles rather than postulates and principles—to comply with recommendations to the Institute’s governing Council by the Special Committee on Opinions of the Accounting Principles Board (the Seidman Committee), but most Board members seemed to lack enthusiasm for the effort.

By the summer of 1962, when the Board hoped that it had put behind it the fuss over the postulates and principles studies, three years had passed since an Institute committee had issued a pronouncement on accounting principles. The Board turned its attention from postulates and principles and toward solving specific problems, just as had the Committee on Accounting Procedure.

### **The APB, the Investment Credit, and the Seidman Committee**

When the Board decided to tackle the thorny issue of accounting for the investment credit, which was enacted in federal income tax law for the first time in October 1962, it inadvertently created an ideal scenario for fueling doubts about its effectiveness and authority. The law provided that a company acquiring a depreciable asset other than a building could deduct up to 7 percent of the cost of the asset from its income tax otherwise payable in the year the asset was placed in service. Two accounting methods sprang up—the “flow-through” method, by which the entire reduction in tax was included in income of the year the asset was placed in service, and the “deferral” method, by which the tax reduction was included in net income over the productive life of the acquired property.

APB Opinion No. 2, *Accounting for the “Investment Credit,”* was issued in December 1962, setting forth the Board’s choice of the deferral over the flow-through method. Some of the large accounting firms then popularly called the Big Eight almost immediately made it known that they would not expect their clients to abide by the Opinion. The SEC ruled that both methods had substantial authoritative support, making either acceptable and thereby effectively undercutting the Board’s position. Fifteen months later, the Board issued APB Opinion No. 4 (Amending No. 2), *Accounting for the “Investment Credit,”* reaffirming its opinion that the investment credit should be accounted for by the

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<sup>66</sup>Zeff, *Forging Accounting Principles in Five Countries*, pages 177 and 178.

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deferral method. It recognized, however, the inevitable effect of the SEC's action on the authority of APB Opinion 2:

[T]he authority of Opinions of this Board rests upon their general acceptability. The Board, in the light of events and developments occurring since the issuance of Opinion No. 2, has determined that its conclusions as there expressed have not attained the degree of acceptability which it believes is necessary to make the Opinion effective.

In the circumstances the Board believes that . . . the alternative method of treating the credit as a reduction of Federal income taxes of the year in which the credit arises is also acceptable. [paragraphs 9 and 10]

The APB's authority had been severely undermined. Did APB Opinions still have to pass the test of general acceptance, as did the Accounting Research Bulletins before them, or did they constitute generally accepted accounting principles solely because the APB had issued them? The Board voted to bring the matter to the Executive Committee and the governing Council of the AICPA.

In May 1964, after an extended and heated debate, Council adopted a resolution "that it is the sense of this Council that [audit] reports of members should disclose material departures from Opinions of the Accounting Principles Board. . . ." Pursuant to a directive in the resolution, the Institute formed a Special Committee on Opinions of the Accounting Principles Board to suggest ways of implementing the resolution and to review the entire matter of the status of APB Opinions and the development of accounting principles and practices for financial reporting.

The special committee reported to Council on its first charge in October 1964, and Council adopted a resolution and transmitted it to Institute members in a Special Bulletin, *Disclosure of Departures from Opinions of the Accounting Principles Board*. It declared that members of the Institute should see to it that a material departure from APB Opinions (or from ARBs still in effect)—even if the auditor concluded that the departure rested on substantial authoritative support—was disclosed in notes to the financial statements or in the auditor's report. Since Council adopted recommendations that "1. 'Generally accepted accounting principles' are those principles which have substantial authoritative support [and] 2. Opinions of the Accounting Principles Board constitute 'substantial authoritative support,'" the authority of APB Opinions no longer depended on their passing a separate test of general acceptability.

The special committee, commonly referred to as the Seidman Committee after its second chairman, J. S. Seidman,<sup>67</sup> reported to Council on its second charge in May 1965, reiterating that an authoritative identification of generally accepted accounting prin-

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<sup>67</sup>The first chairman, William W. Wernitz, died shortly after the special committee reported to Council on its first charge.

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ciples was essential if an independent CPA was to fulfill his or her primary function of attesting to the conformity of financial statements with generally accepted accounting principles. Its Recommendation No. 1 was that:

At the earliest possible time, the [Accounting Principles] Board should:

- (a) Set forth its views as to the purposes and limitations of published financial statements. . . .
- (b) Enumerate and describe the basic concepts to which accounting principles should be oriented.
- (c) State the accounting principles to which practices and procedures should conform.
- (d) Define such phrases in the auditor's report as "present fairly" and "generally accepted accounting principles." . . .
- (f) Define the words of art employed by the profession, such as "substantial authoritative support," "concepts," "principles," "practices," "procedures," "assets," "liabilities," "income," and "materiality."<sup>68</sup>

The committee made that recommendation acknowledging that the Special Committee on Research Program had contemplated that the APB would have accomplished the task described by that time in its life, but it exculpated the Board: "This planned course ran into difficulty because current problems commanded attention and could not be neglected."<sup>69</sup>

However, the need for a solid conceptual foundation for accounting no longer could be neglected either:

[I]t remains true that until the basic concepts and principles are formulated and promulgated, there is no official bench mark for the premises on which the audit attestation stands. Nor is an enduring base provided by which to judge the reasonableness and consistency of treatment of a particular subject. Instead, footing is given to controversy and confusion.<sup>70</sup>

. . . Accounting, like other professions, makes use of words of art. Since accounting talks to the public, the profession's meaning, as distinguished from the literal dictionary meaning, must be explained to the public.

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<sup>68</sup>*Report of Special Committee on Opinions of the Accounting Principles Board* (New York: American Institute of Certified Public Accountants, Spring 1965), page 12.

<sup>69</sup>*Report of Special Committee on Opinions of the APB*, page 13.

<sup>70</sup>*Report of Special Committee on Opinions of the APB*, page 13.

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For example, . . .

What is meant by the expression “generally accepted accounting principles”? How is “generally” measured? What are “accounting principles”? Where are they inscribed, and by whom? . . .

By “accepted,” is the profession aiming at what is popular or what is right? There may be a difference. The . . . Special Committee on Research Program said that “what constitutes generally accepted accounting principles . . . means more than a survey of existing practice.”

Then again, “accepted” by whom—the preparer of the financial statement, the profession, or the user?<sup>71</sup>

The profession has said that generally accepted accounting principles are those with “substantial authoritative support.” What does that expression mean? What yardstick is to be applied to the words “substantial” and “authoritative”? What are the guidelines to prevent mere declaration, or use by someone, somewhere, from becoming the standard?

Many other expressions in accounting need explanation and clarification for the public. They include such words as “concepts,” “principles,” “practices,” “procedures,” “assets,” “liabilities,” “income,” and “materiality.”

Until the profession deals with all these matters satisfactorily, first for itself and then for understanding by the consumer of its product, there will continue to be an awkward failure of communication in a field where clear communication is vital.<sup>72</sup>

### **APB Statement 4**

APB Statement No. 4, *Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises*, issued in October 1970, was the Board’s response to the Seidman Committee’s recommendations. For those who had hoped for definitive answers to the Seidman Committee’s questions or a statement of accounting’s fundamental concepts and principles, APB Statement 4 was a disappointment. The Board gave every indication of having issued it primarily to comply, somewhat grudgingly, with the Seidman Committee’s recommendations.

The definition of generally accepted accounting principles in APB Statement 4 and its description of their nature and how they become accepted, although couched in the careful language that characterized the Statement, merely reiterated what the Institute had been saying about them for over 30 years.

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<sup>71</sup>*Report of Special Committee on Opinions of the APB*, pages 13 and 14.

<sup>72</sup>*Report of Special Committee on Opinions of the APB*, page 15.

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Generally accepted accounting principles incorporate the consensus<sup>38</sup> at a particular time as to . . . [the items that should be recognized in financial statements, when they should be recognized, how they should be measured, how they should be displayed, and what financial statements should be provided].

. . . Generally accepted accounting principles encompass the conventions, rules, and procedures necessary to define accepted accounting practice at a particular time. . . . includ[ing] not only broad guidelines of general application, but also detailed practices and procedures.

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<sup>38</sup>Inasmuch as generally accepted accounting principles embody a consensus, they depend on notions such as *general acceptance* and *substantial authoritative support*, which are not precisely defined. . . .

Generally accepted accounting principles are conventional—that is, they become generally accepted by agreement (often tacit agreement) rather than by formal derivation from a set of postulates or basic concepts. The principles have developed on the basis of experience, reason, custom, usage, and, to a significant extent, practical necessity.<sup>73</sup>

Generally accepted accounting principles were a mixture of conventions, rules, procedures, and detailed practices that were distilled from experience and identified as principles primarily by observing existing accounting practice.

The basic concepts in Chapters 3-5 of APB Statement 4 were a mixed bag. On one hand, the definitions of assets, liabilities, and other “basic elements of financial accounting” were what George J. Staubus, who gave the Statement a generally positive review, called “The Definitions Mess.” All of the definitions were defective because the only essential distinguishing characteristic of assets (or liabilities) was that they were “recognized and measured as assets [or liabilities] in conformity with generally accepted accounting principles,” and the other definitions depended on the definitions of assets and liabilities.<sup>74</sup>

On the other hand, the basic concepts also included new ideas (at least for Institute pronouncements) and normative propositions, and at least some of the concepts looked to what financial accounting ought to be in the future, not just to what it already was. These are examples:

- The basic purpose of financial accounting is to provide information that is useful to owners, creditors, and others in making economic decisions (paragraphs 40 and 73).

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<sup>73</sup>*Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises*, Statement of the Accounting Principles Board No. 4 (New York: American Institute of Certified Public Accountants, 1970), paragraphs 137-139.

<sup>74</sup>George J. Staubus, “An Analysis of APB Statement No. 4,” *The Journal of Accountancy*, February 1972, page 39.

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- Financial accounting is shaped to a significant extent by the nature of economic activity in individual business enterprises (paragraph 42).
- The transactions and other events that change an enterprise's resources, obligations, and residual interest include exchange transactions, nonreciprocal transfers, and other external events as well as production and other internal events (paragraph 62).
- Certain qualities or characteristics such as relevance, understandability, verifiability, neutrality, timeliness, comparability, and completeness make financial information useful (paragraphs 23 and 87-105).
- To make comparisons between enterprises as meaningful as possible, "differences between enterprises' financial statements should arise from basic differences in the enterprises themselves or from the nature of their transactions and not merely from differences in financial accounting practices and procedures" (paragraph 101).

Anyone familiar with the report of the Trueblood Study Group on objectives of financial statements and the FASB's conceptual framework will recognize that those and similar ideas later appeared in one or both of those sources.

Nevertheless, in describing itself, APB Statement 4 virtually ignored that it contained anything that was new, normative, or forward-looking, emphasizing instead that it looked only at the present and the past, even in describing its basic concepts. The Board was adamant that it had not passed judgment on the existing structure and apparently was almost equally reluctant to admit that it had broken new ground:

The Statement is primarily descriptive, not prescriptive. It identifies and organizes ideas that for the most part are already accepted. . . . [T]he Statement contains two main sections that are essentially distinct—(a) Chapters 3 to 5 on the environment, objectives, and basic features of financial accounting and (b) Chapters 6 to 8 on present generally accepted accounting principles. The description of present generally accepted accounting principles is based primarily on observation of accounting practice. Present generally accepted accounting principles have not been formally derived from the environment, objectives, and basic features of financial accounting [that is, from the basic concepts\*].

The aspects of the environment selected for discussion are those that appear to influence the financial accounting process directly. The objectives of financial accounting and financial statements discussed are goals toward which efforts *are presently directed*. [Emphasis added.] The accounting prin-

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\*For some unexplained reason, the Statement does not use the term *basic concepts* after defining it in paragraph 1: "The term *basic concepts* is used to refer to the observations concerning the environment, the objectives of financial accounting and financial statements, and the basic features and basic elements of financial accounting discussed in Chapters 3-5 of the Statement" (paragraph 1, footnote 2). The rest of the Statement uses instead the full definition in footnote 2 or, as in this sentence, some shorter variation of it.]

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principles described are those that the Board believes are generally accepted today. *The Board has not evaluated or approved present generally accepted accounting principles except to the extent that principles have been adopted in Board Opinions. Publication of this Statement does not constitute approval by the Board of accounting principles that are not covered in its Opinions.* [Emphasis in the original.] [paragraphs 3 and 4]

The expected contribution of the basic concepts in the Statement was generally vague, and still in the future.

The Statement is a step toward development of a more consistent and comprehensive structure of financial accounting and of more useful financial information. It is intended to provide a framework within which the problems of financial accounting may be solved, although it does not propose solutions to those problems and does not attempt to indicate what generally accepted accounting principles should be. Evaluation of present accounting principles and determination of changes that may be desirable are left to future pronouncements of the Board. [paragraph 6]

Those paragraphs seemed to deflate unduly the most laudable parts of the Statement, almost as if the Board had gone out of its way to disparage the effort or otherwise to lower expectations about it. Instead of emphasizing that APB Statement 4 had begun to lay a basis for delineating what accounting ought to be and suggesting positive steps needed to build on it, the Board chose to characterize the Statement as primarily descriptive, thereby casting it into the category of uncritical description of what accounting already was. Once again, accounting principles had been defined as being essentially the product of experience.

However, there were by then too many people within and outside the profession who could no longer be satisfied with that view of accounting principles. Principles distilled from experience could lead only so far, and that point had long since been reached. For fifteen to twenty years, principles distilled from experience had created more problems than they had solved, and a growing number of people interested in accounting principles had become convinced that principles had to be defined to mean a higher order of things than conventions or procedures. Dissatisfaction with the APB's performance in this area was mounting, and there was increasing pressure for the Board to state "the objectives of financial statements" as a basis for moving forward.

### **The End of the APB**

At the same time, the APB was constantly under pressure from the SEC and others to confront current, specific problems encountered in practice and to issue Opinions on sub-

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jects seemingly far removed from the domain of principles, such as the presumed overstating of sales prices in some real estate sales with long-term financing, accounting for non-monetary transactions, and reporting the effects of disposing of a segment of a business.

The SEC's urgency to deal with specific practice problems and widespread criticism of the use of the pooling of interests method influenced the APB and its staff to expend extra effort to produce an opinion on a highly controversial subject—accounting for business combinations—on which the Accounting Research Division had completed two related Accounting Research Studies: No. 5, *A Critical Study of Accounting for Business Combinations*, by Arthur R. Wyatt, and No. 10, *Accounting for Goodwill*, by George R. Catlett and Norman O. Olson.

Although the Board worked diligently and analyzed the problems about as well as could be expected in the absence of postulates and principles or other conceptual foundation, it became hopelessly deadlocked. It could find no solutions acceptable to a two-thirds majority to the problems of choosing between the purchase and pooling of interests methods for accounting for a business combination and of whether and how to capitalize goodwill and, if capitalized, whether to amortize it. Yet, it felt compelled to issue an Opinion because the SEC was almost certain to issue its own rule if the APB failed to do so.

The experience produced two Opinions in 1970, APB Opinion No. 16, *Business Combinations*, and No. 17, *Intangible Assets*, as well as more intense criticism of, and threats of legal action against, the Board. In a section entitled “Opinions 16 and 17—Vesuvius Erupts,” Stephen A. Zeff reported that neither the Board's “hard-won compromise” nor the “‘pressure-cooker’ manner in which it was achieved” pleased anyone. “These two Opinions, perhaps more than any other factor, seem to have been responsible for a movement to undertake a comprehensive review of the procedure for establishing accounting principles.”<sup>75</sup>

In January 1971 AICPA President Marshall S. Armstrong convened a conference to consider how the Institute might improve the process of establishing accounting principles, and two study groups were appointed to explore ways of improving financial reporting. The group chaired by Francis M. Wheat was formed to “examine the organization and operation of the Accounting Principles Board and [to] determine what changes are necessary to attain better results faster.”<sup>76</sup> The Wheat Group was primarily concerned with the processes and means by which accounting principles should be established. The Accounting Objectives Study Group, under the chairmanship of Robert M. Trueblood, was organized to review the objectives of financial statements and the technical problems in achieving those objectives.

The APB's days were numbered, although that was not yet clear, and perhaps not even suspected, in 1971, and the Board went on with its work. It issued almost half of its total

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<sup>75</sup>Zeff, *Forging Accounting Principles in Five Countries*, page 216.

<sup>76</sup>*Establishing Financial Accounting Standards*, page 87.



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of 31 Opinions after wheels were put in motion to develop an alternative structure that would eventually replace it.

Despite the criticisms the APB received for Opinions 16 and 17 and others and although some of its Opinions provided only partial solutions that would need to be revisited in the future, on balance its Opinions were successful. In several problem areas, the APB succeeded in remedying, sometimes almost completely and often to a significant degree, the greatest ill of the time by carrying out the charge it received at its creation: “to determine appropriate practice and to narrow the areas of difference and inconsistency in practice.”<sup>77</sup> APB Opinions such as No. 9, *Reporting the Results of Operations*; No. 18, *The Equity Method of Accounting for Investments in Common Stock*; and No. 20, *Accounting Changes*, laid to rest longstanding controversies. APB Opinion No. 22, *Disclosure of Accounting Policies*, required implementation in 1972 of one of the key recommendations made in *Audits of Corporate Accounts* in 1932: each company would disclose which methods it was using. Some of the most controversial APB Opinions—such as, No. 5, *Reporting of Leases in Financial Statements of Lessee*; No. 8, *Accounting for the Cost of Pension Plans*; No. 11, *Accounting for Income Taxes*; No. 16, *Business Combinations*; No. 17, *Intangible Assets*; No. 21, *Interest on Receivables and Payables*; and No. 26, *Early Extinguishment of Debt*—caused some consternation and often fierce opposition, but both industry and public accountants learned to live with them, and later the FASB encountered opposition when it proposed changing some of them.

The report of the Wheat Group in March 1972, *Establishing Financial Accounting Standards*, concluded that many of the APB’s problems were fatal flaws. The APB was weakened by nagging doubts about its independence, the inability of its part-time members to devote themselves entirely to the important problems confronting it, and the lack of coherence and logic of many of its pronouncements, which resulted from having to compromise too many opposing points of view. The group’s solution was directed toward remedying those flaws, which, in its opinion, required a new arrangement.

The Wheat Report proposed establishment of a Financial Accounting Foundation, with trustees whose principal duties would be to appoint the members of a Financial Accounting Standards Board and to raise funds for its operation. The Board would comprise seven members, all of whom would be salaried, full-time, and unencumbered by other business affiliations during their tenure on the Board, and some of whom would not have to be CPAs. The group recommended *Standards* Board rather than *Principles* Board because

the APB (despite the prominence in its name of the term “principles”) has deemed it necessary throughout its history to issue opinions on subjects which have almost nothing to do with “principles” in the usual sense [which “con-

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<sup>77</sup>“Report to Council of the Special Committee on Research Program,” pages 62 and 63.

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notes things basic and fundamental, of a sort which can be expressed in few words, relatively timeless in nature, and in no way dependent upon changing fashions in business or the evolving needs of the investment community”].<sup>78</sup>

*Standard*—which connotes something established by authority or common consent as a pattern or model for guidance or a basis of comparison for judging quality, quantity, grade, level, and so on, and may need to be spelled out in some detail—was more descriptive than principles for most of what the APB did and what the FASB was expected to do.

The Wheat Group’s diagnosis of the APB’s terminal condition became the popular explanation, but it was not the only one. Oscar S. Gellein, a member of the APB during its final years and a member of the FASB during its early years, offered a perceptive analysis:

The conditions most often identified with the problems of the APB were perceived conflicts of interests causing a waffling of positions and part-time effort where full-time effort was needed. In retrospect, those probably were not as significant as the absence of a structure of fundamental notions that would elevate the level at which debate begins and provide assurance of considerable consistency to the standards pronounced. The APB repetitively argued fundamentals. The same fundamentals were argued in taking up projects near the end of its tenure as were argued in connection with early projects. Even the most fundamental of fundamentals—assets, liabilities, revenue, expense—were never defined nor could the definitions be inferred from APB pronouncements.<sup>79</sup>

Thus, it may have been the Board’s continual rejection of the ineluctable need to develop an underlying philosophy as a basis for accounting principles in favor of the Committee on Accounting Procedure’s “brush fire” approach that most directly contributed to the way it was perceived and ultimately to its demise. The APB had never been able to achieve a consensus on the conceptual aspects of its work, which had effectively been pushed aside by the Board’s efforts to narrow the areas of difference in accounting practice by a problem-by-problem treatment of pressing issues. Although the Accounting Research Studies on basic postulates and broad principles of accounting and APB Statement 4 had made conceptual contributions that would prove fruitful in the hands of the Study Group on the Objectives of Financial Statements and the FASB, the APB steadfastly refused to take credit for, or even acknowledge, those contributions. Thus, account-

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<sup>78</sup>*Establishing Financial Accounting Standards*, page 13.

<sup>79</sup>Oscar S. Gellein, “Financial Reporting: The State of Standard Setting,” in *Advances in Accounting*, vol. 3, edited by Bill N. Schwartz (Greenwich, Connecticut: JAI Press Inc., 1986), page 13.

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ing was still without a statement of fundamental principles at the end of the APB's tenure, and its absence would continue to plague the profession until the FASB, mostly on its own initiative, did something about it.

### **THE FASB FACES DEFINING ASSETS AND LIABILITIES**

The FASB, which was not part of the AICPA, began operations in Stamford, Connecticut, on January 2, 1973, with Marshall S. Armstrong, the first chairman, and a small staff. The other six Board members and additional staff joined the group during the first half of the year, and the FASB was fully operational by the time it succeeded the APB at midyear.

Meanwhile, the Institute had approved a restated code of professional ethics that in a new Rule 203 covered for the first time infractions of the recommendations adopted by Council in 1964 regarding disclosure of departures from APB Opinions:

A member shall not express an opinion that financial statements are presented in conformity with generally accepted accounting principles if such statements contain any departure from an accounting principle promulgated by the body designated by Council to establish such principles. . . .

Council at its May 1973 meeting designated the FASB as the body to establish principles covered by Rule 203. The APB issued its final two Opinions—No. 30 and No. 31—and went out of business on June 30, 1973.

Later that year, the SEC's Accounting Series Release No. 150, *Statement of Policy on Establishment and Improvement of Accounting Principles and Standards*, reaffirmed the policy set forth 35 years earlier in ASR 4 and declared that the Commission would recognize FASB Statements and Interpretations as having, and contrary statements as lacking, substantial authoritative support.

The FASB set its first technical agenda of seven projects in early April 1973, including a project called "Broad Qualitative Standards for Financial Reporting." The Board undertook the project in expectation of receiving the report of the Trueblood Study Group, noting:

[A]s [the Board] develops specific standards, and others apply them, there will be a need in certain cases for guidelines in the selection of the most appropriate reporting. . . . [and] the report of the special AICPA committee on objectives of financial statements chaired by Robert Trueblood will be of substantial help in this project.<sup>80</sup>

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<sup>80</sup>FASB *Status Report*, June 18, 1973, pages 1 and 4.

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The FASB received the report of the Trueblood Study Group, *Objectives of Financial Statements*, in October 1973.<sup>81</sup> The Study Group had concluded:

Accounting is not an end in itself. . . . [T]he justification for accounting can be found only in how well accounting information serves those who use it. Thus, the Study Group agrees with the conclusion drawn by many others that “The basic objective of financial statements is to provide information useful for making economic decisions.” [page 61]

The report’s other eleven objectives were more specific; for example, the next two identified the purposes of financial statements with meeting the information needs of those with “limited authority, ability, or resources to obtain information and who rely on financial statements as their principal source of information about an enterprise’s economic activities” and with providing information useful to actual and potential owners and creditors in making decisions about placing resources available for investment or loan (page 62). The report also included a group of seven “qualitative characteristics of reporting” that information “should possess . . . to satisfy users’ needs” (page 57).

Soon afterward, the FASB announced that the scope of “Broad Qualitative Standards for Financial Reporting” had been broadened because

members of the Standards Board believe that the . . . project should encompass the entire conceptual framework of financial accounting and reporting, including objectives, qualitative characteristics and the information needs of users of accounting information.<sup>82</sup>

The Board also for the first time used the title, “Conceptual Framework for Accounting and Reporting.”

### **Were They Assets? Liabilities?**

In the meantime, two other original projects confronted the new Board with the key questions of what constituted and what did not constitute an asset or a liability. The FASB’s first technical agenda included some unfinished projects inherited from the APB. One was on accounting for research and development and similar costs, which eventually resulted in FASB Statement No. 2, *Accounting for Research and Development Costs* (October 1974), and FASB Statement No. 7, *Accounting and Reporting by Development*

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<sup>81</sup>*Objectives of Financial Statements*, Report of the Study Group on the Objectives of Financial Statements (New York: American Institute of Certified Public Accountants, October 1973). [Often called the Trueblood Report, after the group’s chairman, Robert M. Trueblood.]

<sup>82</sup>FASB *News Release*, December 20, 1973.

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Stage Enterprises (June 1975); the other was on accruing for future losses, which eventually resulted in FASB Statement No. 5, *Accounting for Contingencies* (March 1975). Principal questions raised by those projects were: Do expenditures for research and development, start-up, relocation, and the like result in assets? Do “reserves for self-insurance,” “provisions for expropriation of overseas operations,” and the like constitute liabilities? decreases in assets?

The Board quite naturally turned to the definitions of assets and liabilities in APB Statement 4, which were the pertinent definitions in the authoritative accounting pronouncements. The definitions proved to be of no use to the FASB in deciding the major questions raised by the projects or to anyone else in trying to anticipate how the Board would decide the issues in the two projects.

The Board had to turn elsewhere for useful definitions of assets and liabilities to resolve the issues in those projects, and Board members learned that an early priority of the Board’s conceptual framework project would have to be providing definitions of assets and liabilities and other elements of financial statements to fill a yawning gap in the authoritative pronouncements.

The reasons that the FASB found the definitions of assets and liabilities in APB Statement 4 to be useless underlay the Board’s subsequent actions on the conceptual framework project. The related topics, the proliferation of questionable deferred charges and credits, the pervasive influence of the belief in “proper matching to avoid distorting periodic net income,” and the common use of the expressions “assets are costs” and “costs are assets” help explain not only why Board members took the initiative in establishing a conceptual framework for financial accounting and reporting but also why the Board adopted the basic concepts that it did. Robert T. Sprouse used the term “what-you-may-call-its” to describe certain deferred charges and deferred credits routinely included in balance sheets as assets and liabilities without much consideration of whether they actually were assets or liabilities,<sup>83</sup> and the name has become widely used; expressions such as “proper matching,” “nondistortion of periodic net income,” and “assets are costs” originated in the 1930s and 1940s, as noted in describing the influence of the American Accounting Association on U.S. accounting practice, and became widely used in the 1950s, 1960s, and 1970s.

### **Assets, Liabilities, and What-You-May-Call-Its**

The introduction to the definitions of assets and liabilities in APB Statement 4 said: “The basic elements of financial accounting—assets, liabilities . . .—are related to . . . economic resources, economic obligations . . .” (paragraph 130), suggesting that the Statement’s discussion of economic resources and obligations provided a basis for the definitions of assets

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<sup>83</sup>Robert T. Sprouse, “Accounting for What-You-May-Call-Its,” *The Journal of Accountancy*, October 1966, pages 45-53.

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and liabilities. The Statement did define economic resources and economic obligations in a way that both accountants and nonaccountants would understand them to be, or to be synonymous with, what they also generally understood to be assets and liabilities:

Economic resources are the scarce means (limited in supply relative to desired uses) available for carrying on economic activities. The economic resources of a business enterprise include: 1. *Productive resources* . . . the means used by the enterprise to produce its product . . . 2. *Products*. . . 3. *Money* 4. *Claims to receive money* 5. *Ownership interests in other enterprises*.

The economic obligations of an enterprise at any time are its present responsibilities to transfer economic resources or provide services to other entities in the future. . . . Economic obligations include: 1. *Obligations to pay money* 2. *Obligations to provide goods or services*. [paragraphs 57 and 58]

Moreover, the first sentence of the parallel definitions of assets and liabilities in paragraph 132 did identify assets with economic resources and liabilities with economic obligations:

{ Assets—  
Liabilities— } economic { resources  
obligations } of an enterprise that are recognized and measured in conformity with generally accepted accounting principles. . . .

The second sentence of the definitions broke the relationships between assets and economic resources and between liabilities and economic obligations, however, by including what-you-may-call-its in both assets and liabilities:

{ Assets  
Liabilities } also include certain deferred { charges  
credits } that are not { resources  
obligations } but that are recognized and measured in conformity with generally accepted accounting principles.

The definitions actually defined nothing: assets were whatever (economic resources and what-you-may-call-its) generally accepted accounting principles recognized and measured as assets, and liabilities were whatever (economic obligations and what-you-may-call-its) generally accepted accounting principles recognized and measured as liabilities. The definitions also were circular: since the FASB was the body responsible for determining generally accepted accounting principles, research and development costs would be assets, and self-insurance reserves would be liabilities, if the Board said they were.

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Nevertheless, APB Statement 4's definitions of assets and liabilities actually were descriptions of items recognized as assets and liabilities in practice. But why should balance sheets include as assets and liabilities items that lacked essential characteristics of what most people would understand to be assets and liabilities—items that involved no scarce means of carrying out economic activities, such as consumption, production, or saving, or items that involved no obligations to pay cash or provide goods or services to other entities?

### **Proper Matching to Avoid Distorting Periodic Net Income**

The Board issued a Discussion Memorandum—a neutral document that describes issues and sets forth arguments for and against particular solutions or procedures but gives no Board conclusions—for each of the two projects and scheduled public hearings. At the hearings, respondents to the Discussion Memorandums were able to explain or clarify their analyses of the issues, and Board members could ask questions to pursue certain points made in comment letters and otherwise make sure they understood respondents' proposed solutions to the issues raised by the Discussion Memorandums and their underlying reasoning.

The Board discovered in the comment letters and the hearings that many respondents were less interested in what constituted assets and liabilities than in whether capitalizing and amortizing research and development costs and accruing self-insurance reserves “properly matched” costs with revenues and thus did not “distort periodic net income.” Many of the respondents argued that “proper matching” required research and development and similar costs to be capitalized and amortized over their useful lives. Similarly, many argued that “proper matching” required self-insurance and similar costs to be accrued or otherwise “provided for” each period, whether or not the enterprise suffered damage from fire, earthquake, heavy wind, or other cause during the period. Unless the Board required proper matching of costs and revenues, many respondents counseled, periodic income of the affected enterprises would be distorted.

Board members were largely frustrated in their attempts to pin down what respondents meant by “proper matching” and “periodic income distortion,” but the reasons for the proliferation of what-you-may-call-its emerged clearly. The following four snippets paraphrase what Board members heard at the hearings on research and development and similar costs and accounting for contingencies. Two of them are clear standing alone; two are understandable only if the questions being answered also are included.

1. **Q.** In other words, you would focus on the measurement of income?  
You would not be concerned about the balance sheet?  
**A.** Yes. I think that is the major focus.
2. Much of the controversy over accrual of future loss has focused on whether a company had a liability for future losses or not. However,

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the impact on income should be overriding. The credit that arises from a provision for self-insurance is not a liability in the true sense, but that in and of itself should not keep it out of the balance sheet. APB Opinion 11 recognized deferred tax credits in balance sheets even though all agreed that the credit balances were not liabilities. Income statement considerations were considered paramount in that case, and similar thinking should prevail in accounting for self-insurance.

3. Defining assets does not really solve the problem of accounting for research and development expenditures and similar expenses. If some items that do not meet the definition of an asset are included in expenses of the current period, they may well distort the net income of that period because they do not relate to the revenues of that period. That accounting also may distort the net income of other periods in which the items more properly belong. The Board should focus on deferrability that gets away from the notion of whether or not those costs are assets and concentrates on the impact of deferral on the determination of net income.
4. **Q.** One of your criteria for capitalization is that net income not be materially distorted. Do you have any operational guidelines to suggest regarding material distortion?  
**A.** The profession has been trying to solve that one for a great many years and has been unsuccessful. I really do not have an answer.  
**Q.** Then, is material distortion a useful criterion that we can work with?  
**A.** Yes, I believe it is. Despite the difficulty, I think it is necessary to work with that criterion. It is a matter of applying professional judgment.<sup>84</sup>

Board members were not satisfied with the kinds of answers just illustrated.

Members of the FASB concluded early that references to vague notions such as “avoiding distortion” and “better matching” were neither an adequate basis for analyzing and resolving controversial financial accounting

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<sup>84</sup>Public Record—Financial Accounting Standards Board, 1974, Vol. 1, *Discussion Memorandum on Accounting for Research and Development and Similar Costs* dated December 28, 1973 (1007), Part 2, pages 171 and 172, 189 and 190; 1974, Vol. 3, *Discussion Memorandum on Accounting for Future Losses* dated March 13, 1974 (1006), Part 2, pages 18 and 19, 65.



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issues nor an effective way to communicate with one another and with the FASB's constituency.<sup>85</sup>

Many of the responses indeed were vague, and it soon became clear that proper matching and distortion of periodic net income were largely in the eye of the beholder. Respondents said essentially that although they had difficulty in describing proper matching and distorted income, they knew them when they saw them and could use professional judgment to assure themselves that periodic net income was determined without distortion in individual cases. The thinking and practice described in the comment letters and at the hearings seemed to make income measurement primarily a matter of individual judgment and provided no basis for comparability between financial statements. To Board members, the arguments for including in balance sheets items that could not possibly qualify as assets or liabilities—what-you-may-call-its—sounded a lot like excuses to justify smoothing reported income, thereby decreasing its volatility.

The experience generally strengthened Board members' commitment to a broad conceptual framework—one beginning with objectives of financial statements and qualitative characteristics (the Trueblood Report) and also defining the elements of financial statements and including concepts of recognition, measurement, and display—and affected the kind of concepts it would comprise.

### **Nondistortion, Matching, and What-You-May-Call-Its**

The proliferation of what-you-may-call-its and durability of apparently widely held and accepted notions of accounting such as the overriding importance of “avoidance of distortion of periodic income” and “proper matching of costs with revenues” were the legacy of forty years of accountants' emphasis on the accounting process and accounting procedures instead of on the economic things and events on which financial accounting is supposed to report. As a result, an accounting convention or procedure with narrow application but a catchy name was elevated to the focal point of accounting: Matching of costs and revenues to determine periodic net income for a period became the major function of financial accounting, and whatever was left over from the matching procedure (mostly “unexpired” costs and “unearned” receipts) was carried over to future periods as assets or liabilities, depending on whether the leftover items were debits or credits.

Although Paton and Littleton's AAA monograph, *An Introduction to Corporate Accounting Standards* (1940), popularized the term “matching of costs and revenues” and provided existing practice with what many saw as a theoretical basis that previously had been lacking (as already briefly noted on pages 28-30), the roots of the emphasis on proper matching and nondistortion of periodic net income were older. For example, the

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<sup>85</sup>Robert T. Sprouse, “Commentary on Financial Reporting—Developing a Conceptual Framework for Financial Reporting,” *Accounting Horizons*, December 1988, page 127.

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basic rationale—that the single most important function of financial accounting was determination of periodic net income and that the function of a balance sheet was not to reflect the values of assets and liabilities but to carry forward to future periods the costs and credits already incurred and received but needed to determine net income of future periods—appeared in the report of the Institute’s Special Committee on Co-operation with Stock Exchanges:

It is probably fairly well recognized by intelligent investors today that the earning capacity is the fact of crucial importance in the valuation of an industrial enterprise, and that therefore the income account is usually far more important than the balance-sheet. In point of fact, the changes in the balance-sheets from year to year are usually more significant than the balance-sheets themselves.

The development of accounting conventions has, consciously or unconsciously, been in the main based on an acceptance of this proposition. As a rule, the first objective has been to secure a proper charge or credit to the income account for the year, and in general the presumption has been that once this is achieved the residual amount of the expenditure or the receipt could properly find its place in the balance-sheet at the close of the period, the principal exception being the rule calling for reduction of inventories to market value if that is below cost.<sup>86</sup>

That thinking led in two related directions that came together only later as the argument that proper matching was needed to avoid distorting periodic net income, which was so popular in the comment letters and hearings on whether to defer research and development expenditures or accrue future losses. The nondistortion and matching arguments seem to have developed separately in the 1940s and 1950s and made common cause only later.

### **Nondistortion and the Balance Sheet as Footnote**

Since the purpose of income measurement was to indicate the earning power of an enterprise as well as to help appraise the performance of the enterprise and the effectiveness of management, periodic income was expected to be an indicator of the long-run or normal trend of income. The usefulness of the net income of a period as a long-run or normal measure was distorted therefore by including in it the effects of unusual or random events—gains or losses with no bearing on normal performance because they were extraordinary, caused by chance, or tended to average out over time—that could cause significant extraneous fluctuations in reported net income.

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<sup>86</sup>*Audits of Corporate Accounts*, page 10.

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Emphasis on nondistortion of periodic net income surfaced in discussions of the effects of extraordinary and nonrecurring gains and losses in comparing the current operating performance and all-inclusive or clean-surplus theories of income, briefly described earlier (pages 27 and 28), but also was later applied to accounting for recurring transactions and other events. The emphasis on stability and nondistortion of reported net income seems to have increased in the late 1940s and 1950s. Herman W. Bevis, who described the need to avoid distorting periodic net income in more detail and with more careful terminology than many accountants, set forth the underlying philosophy.

If the corporation watches the general economy, the latter also watches the corporation. For example, one of the important national economic indicators is the amount of corporate profits (and the dividends therefrom). Fluctuations in this particular index have important implications both for the private sector and with respect to the government's revenues from taxation; they also have a psychological effect on the economic mood of the nation. There is no doubt that, given a free choice between steadiness and fluctuation in the trend of aggregate corporate profits, the economic well-being of the nation would be better served by the former. Thus . . . society will welcome any contribution that the accounting discipline can make to the avoidance of artificial fluctuations in reported yearly net incomes of corporations. Conversely, the creation by accounting of artificial fluctuations will be open to criticism.<sup>87</sup>

The primary accounting tool for avoiding artificial fluctuations was accrual accounting, which "reflects the fact that the corporation's activities progress much more evenly over the years than its cash outflow and inflow" and "attempts to transfer the income and expense effect of cash receipts and disbursements, other transactions, and other events from the year in which they arise to the year or years to which they more rationally relate."<sup>88</sup> However, accrual accounting was sometimes too general, and further guidance was needed. Bevis described four guidelines for repetitive transactions and events, which had been developed out of long experience, beginning with the transaction guideline and the matching guideline:

- 1) Record the effect on net income of transactions and events in the period in which they arise unless there is justification for recording them in some other period or periods.

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<sup>87</sup>Herman W. Bevis, *Corporate Financial Reporting in a Competitive Environment* (New York: The Macmillan Company, 1965), page 30.

<sup>88</sup>Bevis, *Corporate Financial Reporting*, page 96 and pages 94 and 96.

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- 2) Where a direct relationship between the two exists, match costs with revenues.<sup>89</sup>

To Bevis, in contrast to most accountants of the time, who tended to describe matching of costs and revenues very broadly, the matching guideline was of restricted application because “matching attempts to make a direct association of costs with *revenues*.” Its application to a merchandising operation was obvious: “Carrying forward of the inventory of unsold merchandise so as to offset its cost against the revenue from its sale is clearly useful in determining the net income of each of the two years,” although its use with some costing methods, such as LIFO, was at least questionable. Another clear application was to “the effecting of a sale [which] can be matched with a liability to pay a sales commission.” Otherwise, however, “the ordinary business operation is so complex that revenues are the end product of a variety of corporate activities, often over long periods of time; objective evidence is lacking to connect the cost of most of the activities with any particular revenues.” To emphasize that the matching guideline applied “to relatively few types of items,” Bevis illustrated the kind of situations to which it clearly did not apply: “The matching guideline can become potentially dangerous when it attempts to match *today’s real costs* with *hopes of tomorrow’s revenues*, as in deferring research and development costs to be matched against hoped-for, but speculative, future revenues.”<sup>90</sup>

In viewing matching narrowly, Bevis essentially agreed with George O. May, to whose memory the book was dedicated. May (in a report written with Oswald W. Knauth for the Study Group on Business Income) noted that it had become common, especially in academic circles, “to speak of income determination as being essentially a process of ‘matching costs and revenues’” but warned: “Only in part are costs ‘matched’ against revenues, and ‘matching’ gives an inadequate indication of what is actually done. . . . [I]t would be more accurate to describe income determination as a process of (1) matching product costs against revenues, and (2) allocating other costs to periods.”<sup>91</sup>

Bevis also noted that the matching guideline was “sometimes confused with the allocation of costs to periods. Taxes, insurance, or rent, for example, may be paid in advance and properly allocated to the years covered. However, this allocation is to a *period*, and one would be hard pressed to establish any direct connection between—i.e., to match—these costs and specific sales of the period to which they are allocated.” Those kinds of allocations came not under the matching guideline but rather under the much broader systematic and rational guideline:

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<sup>89</sup>Bevis, *Corporate Financial Reporting*, pages 97 and 100.

<sup>90</sup>Bevis, *Corporate Financial Reporting*, pages 100 and 101.

<sup>91</sup>*Changing Concepts of Business Income*, Report of the Study Group on Business Income (New York: The Macmillan Company, 1952), pages 28 and 29.

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- 3) Where there is justification for allocating amounts affecting net income to two or more years, but there is no direct basis for measuring how much should be associated with each year, use an allocation method that is systematic and rational.<sup>92</sup>

An essential companion of the systematic and rational guideline was the nondistortion guideline:

- 4) From among systematic and rational methods, use that which tends to minimize distortions of periodic net income.<sup>93</sup>

Illustrations of “specific allocation practices that are designed to avoid or minimize distortions of net income among years” included self-insurance provisions, provisions for costs of dry-docking ships for major overhauls, and provisions for costs of relining of blast furnaces. For all of them, “a rational practice is to spread the costs over a reasonable period of time.”

All three of the nondistortion practices described were potential what-you-may-call-its—deferred credits that did not qualify as liabilities. They were recognized not because they were liabilities incurred by the enterprise but because they would lessen the volatility of reported net income.

As already noted in describing the hearing on accruing future losses, not even those who advocated accruing self-insurance provisions and reserves argued that the reserves were liabilities. They argued for accruing the reserves to ensure proper matching and to avoid distorting periodic net income despite the fact that the resulting reserves were not liabilities. Similarly, the effect on net income, “to spread the costs over a reasonable period of time,” was the principal consideration in accruing provisions for dry-docking ships and relining blast furnaces.

An enterprise does not incur a liability for costs that later will be expended in dry-docking a ship or relining a blast furnace by operating the ship or using the furnace. Rather, it begins to incur the pertinent liabilities only when it dry-docks the ship and begins to scrape off the barnacles or otherwise overhaul her or when it shuts down the furnace and starts the relining, but certainly not before making a contract with one or more other entities to do the work.

Costs of dry-docking a ship or relining a furnace might legitimately be recognized between dry-dockings or relinings by recognizing them as decreases in the carrying amount of the asset because accumulations of barnacles reduce the ship’s efficiency or use of the furnace wears out the lining, but proponents of accruing costs to avoid distortion of periodic net income usually have not argued that way. Since their attention has focused

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<sup>92</sup>Bevis, *Corporate Financial Reporting*, page 101.

<sup>93</sup>Bevis, *Corporate Financial Reporting*, page 104.

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almost entirely on the effect on reported net income, they have not been much concerned with “niceties” of whether periodically recognizing the cost increased liabilities or decreased assets. They have been likely to dismiss questions of that kind on the grounds that they are “merely geography” in the financial statements—an insignificant detail. Lack of concern about assets and liabilities was a distinguishing characteristic of true believers in the matching or nondistortion “gospel.”

Bevis reflected that kind of focus on nondistortion of periodic net income and lack of concern about the resulting balance sheet:

[T]he amounts at which many assets and liabilities are stated in the balance sheet are a by-product of methods designed to produce a fair periodic net income figure. The objective is *not* to produce a liquidating value or a current fair market value of assets. This approach is consistent with the primary interest of the stockholder in periodic income, as opposed to liquidating or “pounce” values in a not-to-be-liquidated enterprise.<sup>94</sup>

Indeed, he came up with the most imaginative—and pertinent—description in the entire nondistortion and proper-matching literature of the way proponents see a balance sheet—as a footnote to an income statement:

[T]wo-thirds of the items on the asset side of the balance sheet [a “Composite Statement of Financial Position” of “100 Large Industrial Corporations” in the Appendix] . . . are not assets in the sense of either being or expected to be directly converted to cash. They represent a huge amount of “deferred costs,” mostly past cash expenditures, which are to be included as costs in future income statements. . . . Among all the footnotes explaining and elaborating on the income statement, this makes the balance sheet the biggest footnote of all.<sup>95</sup>

The same idea had been expressed less flatteringly by Professor William Baxter of the University of London (London School of Economics):

[A group] of accountants bent on belittling the balance-sheet and elevating the revenue account. . . . tend to dismiss the balance-sheet as a mere appendage of the revenue account—a mausoleum for the unwanted costs that the double-entry system throws up as regrettable by-products.<sup>96</sup>

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<sup>94</sup>Bevis, *Corporate Financial Reporting*, page 107.

<sup>95</sup>Bevis, *Corporate Financial Reporting*, page 94.

<sup>96</sup>W. T. Baxter, ed., *Studies in Accounting* (London: Sweet & Maxwell Ltd., 1950), “Introduction.” [Reprinted as “Introduction to the First Edition” in second and third editions: W. T. Baxter and Sidney Davidson, eds., *Studies in Accounting Theory* (London: Sweet & Maxwell Ltd., 1962) and Baxter and Davidson, eds., *Studies in Accounting* (London: The Institute of Chartered Accountants in England and Wales, 1977), page x.]

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Although Bevis defined matching narrowly and gave it only a limited place in periodic income determination, relying more on the rational and systematic guideline and the nondistortion guideline, his was probably a minority view. Most accountants who have emphasized the need for nondistorting income determination procedures have considered careful timing of recognition of revenues and expenses by proper matching to be critical in avoiding distortion of periodic income.

### **Proper Matching and “Assets Are Costs”**

In contrast to Bevis’s and May’s narrow definitions of matching, most accountants have described matching of costs and revenues broadly, making matching either (1) one of two central functions of financial accounting or (2) *the* central function of financial accounting. Either way, matching encompasses allocations of costs using systematic and rational procedures, such as depreciation and amortization, which Bevis explicitly excluded from matching.

Accountants of the first group, whose use of matching has been the narrower of the two, have described periodic income determination as a two-step process: revenue recognition or “realization” and matching of costs with revenues (expense recognition). To them, matching not only recognized perceived direct relationships between costs and revenues, such as between cost of goods sold (product costs) and sales, but also recognized perceived indirect relationships between costs and revenues through mutual association with the same period. The latter would include relationships such as those between, on the one hand, costs recognized as expenses in the period incurred and depreciation and other costs allocated to the same period by a rational and systematic procedure and, on the other hand, revenues allocated to the same period by “realization.” That is, matching encompassed both matching product costs with specific revenues (Bevis’s and May’s definitions) and what usually has been called allocation—matching other costs with periods. For example, this definition clearly encompassed both kinds of matching:

Matching is one of the basic processes of income determination; essentially it is a process of determining relationships between costs . . . and (1) specific revenues or (2) specific accounting periods.<sup>97</sup>

Accountants of the second group have used matching of costs and revenues in the broadest possible sense—as a synonym for periodic income determination—making matching *the* central function of financial accounting. To them, matching encompassed both revenue recognition or “realization” and expense recognition. Matching dictated what has been included in income statements, as it did in both of these definitions:

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<sup>97</sup>APB Opinion No. 11, *Accounting for Income Taxes* (1967), paragraph 14(d).

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**matching** 1. The principle of identifying related revenues and expense with the same accounting period.<sup>98</sup>

By means of accounting we seek to provide these test readings [of progress made] by a periodic matching of the costs and revenues that have flowed past “the meter” in an interval of time.<sup>99</sup>

The degree to which matching of costs and revenues had become the central function of financial accounting in the minds of many accountants by the time of the FASB’s projects on research and development expenditures and similar costs and accruing future losses was indicated by Delmer Hylton’s description in 1965, which was by no means an overstatement:

Concurrent with the ascendancy of the income statement in recent years, we have also witnessed increasing emphasis on the accounting convention known as “matching revenue with expense.” In fact, it seems that most innovations in accounting in recent years have been justified essentially as better performing this matching process. In the minds of many accountants, this single convention outweighs all others; in other words, if a given procedure can be asserted to conform to the matching concept, nothing else need be said: the matter is settled and the procedure is justified.<sup>100</sup>

That is basically what Board members read and heard in the comment letters and public hearings on accounting for research and development expenditures and similar costs and accruing future losses. The need for proper matching of costs and revenues to avoid distorting periodic net income was the overriding consideration in many letters and in the prepared statements and answers of a significant number of those who appeared at the hearings and responded to Board members’ questions. They showed little or no interest in whether research and development expenditures resulted in assets and whether reserves for self-insurance were liabilities.

Rather, those deferred charges and deferred credits belonged in the balance sheet because they were needed for proper matching to avoid distorting periodic net income. And what were most assets, anyway, except deferred or “unexpired” costs, as Paton and Littleton’s monograph had said:

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<sup>98</sup>Eric L. Kohler, *A Dictionary for Accountants*, fifth edition (Englewood Cliffs, New Jersey: Prentice-Hall, Inc., 1975), page 307.

<sup>99</sup>Paton and Littleton, *An Introduction to Corporate Accounting Standards* (1940), page 15.

<sup>100</sup>Delmer Hylton, “On Matching Revenue with Expense,” *The Accounting Review*, October 1965, page 824.



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[A]ssets are costs. “Costs” are the fundamental data of accounting, and. . . it is possible to apply the term “cost” equally well to an asset acquired, a service received, and a liability incurred. Under this usage assets, or costs incurred, would clearly mean charges awaiting future revenue, whereas expenses, or costs applied, would mean charges against present revenue, . . .<sup>101</sup>

That usage followed from the monograph’s view that periodic income measurement was not only a process of matching costs and revenues but also the focal point of accounting.

The factors acquired for production which have not yet reached the point in the business process where they may be appropriately treated as “cost of sales” or “expense” are called “assets,” and are presented as such in the balance sheet. . . [T]hese “assets” are in fact “revenue charges in suspense” awaiting some future matching with revenue as costs or expenses. . .

The fundamental problem of accounting . . . is the division of the stream of costs incurred between the present and the future in the process of measuring periodic income. . . The balance sheet . . . serves as a means of carrying forward unamortized acquisition prices, the not-yet-deducted costs; it stands as a connecting link joining successive income statements into a composite picture of the income stream.<sup>102</sup>

Long before the time of the FASB projects on research and development costs and self-insurance reserves, however, Paton had recognized that matching had become an obsession of many accountants. It had been carried much too far and had been the cause of downgrading the meaning and significance of assets.

For a long time I’ve wished that the Paton and Littleton monograph had never been written, or had gone out of print twenty-five years or so ago. Listening to Bob Sprouse take issue with the “matching” gospel, which the P & L monograph helped to foster, confirmed my dissatisfaction with this publication. . . The basic difficulty with the idea that cost dollars, as incurred, attach like barnacles to the physical flow of materials and stream of operating activity is that it is at odds with the actual process of valuation in a free competitive market. The customer does not buy a handful of classified and traced cost dollars; he buys a product, at prevailing market price. And the market price may be either above or below any calculated cost. . .

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<sup>101</sup>Paton and Littleton, *An Introduction to Corporate Accounting Standards*, pages 25 and 26.

<sup>102</sup>Paton and Littleton, *An Introduction to Corporate Accounting Standards*, pages 25 and 67.

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For a long time I've been touting the idea that the central element in business operation is the *resources* (in hand or in prospect) and that the main objective of operation is the efficient utilization of the available assets.<sup>103</sup>

His intermediate accounting textbook, published a mere dozen years after the monograph, was entitled *Asset Accounting*.<sup>104</sup>

### **An Overdose of Matching, Nondistortion, and What-You-May-Call-Its**

Board members had, as former chairman Donald J. Kirk once put it, cut their accounting teeth on matching, nondistortion, assets are costs, and similar notions. Some of them may have entertained some doubts about some of the ideas before serving on the Board, but it was the paramount importance that was attributed to those ideas in early comment letters and at the early hearings that made the Board increasingly uncomfortable with them. Those notions seemed to be open-ended; no one could explain the limits, if any, on matching or nondistortion procedures or how to verify that proper matching or nondistortion had been achieved. The experience made most, if not all, Board members highly skeptical about arguments that the need for proper matching to avoid distortion of periodic net income was the “be-all and end-all of financial accounting”<sup>105</sup> with little or no concern expressed about whether the residuals left over after matching actually were assets or liabilities.

Among other things, those early experiences had graphically demonstrated to Board members that once accountants had come to perceive assets primarily as costs, they often failed to distinguish assets in the real world from the entries in the accounts and financial statements. What-you-may-call-its were a consequence of the habit of using “costs” and “assets” interchangeably—“assets were costs; costs were assets”—without worrying about whether the costs actually represented anything in the real world.

The “Pygmalion Syndrome” (after the legendary sculptor who fell in love with his statue of a woman) was at work. That name was given by the noted physicist J. L. Synge to “the tendency of many people to confuse conceptual models of real-world things and events with the things and events themselves.”<sup>106</sup> Perhaps the most common example

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<sup>103</sup>William A. Paton, “Introduction,” in Williard E. Stone, ed., *Foundations of Accounting Theory: Papers Given at the Accounting Theory Symposium, University of Florida, March 1970* (Gainesville, Florida: University of Florida Press, 1971), pages x and xi.

<sup>104</sup>William A. Paton, with the assistance of William A. Paton, Jr., *Asset Accounting* (New York: The Macmillan Company, 1952).

<sup>105</sup>Sprouse, “Commentary on Financial Reporting—Developing a Conceptual Framework for Financial Reporting,” page 127.

<sup>106</sup>Lloyd C. Heath, “Accounting, Communication, and the Pygmalion Syndrome,” *Accounting Horizons*, March 1987, page 1.

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has been the habit of lawyers, accountants, corporate directors and officers, stockholders, and others to describe a dividend as paid “out of surplus (retained earnings).” That habit led a prominent lawyer to chide:

Distributions are never paid “out of surplus,” they are paid out of assets; surplus cannot be distributed—assets are distributed. No one ever received a package of surplus for Christmas.<sup>107</sup>

The fact that the matching literature was so full of references to “unexpired” costs that “expired” when matched against revenues also caused a prominent professor of finance to admonish that accountants had confused matters by defining

depreciation as “expired capital outlay”—in other words, as “expired cost”—thereby transferring the word from a value to a cost category. But this definition was a dodge rather than a solution, and the fact that it still enjoys some currency among accounting writers who must be aware of its spurious character illustrates the tenacity of convenient though specious phrases. For cost does not “expire.” What may be said gradually to expire is the economic significance of the asset as it grows older, in short, its utility or its value. “Expired cost” is therefore mumbo jumbo, and a reversion to the old association of depreciation with loss in value would be a far more sensible alternative.<sup>108</sup>

As Board members began to look at problems likely to come onto the Board’s agenda, they began to see more what-you-may-call-its in their future. In addition to self-insurance reserves and provisions for removing barnacles from ships or relining blast furnaces, which have already been described, a significant number of what-you-may-call-its were part of existing practice in the early 1970s, had been or were being proposed to become part of practice, or had recently been proscribed:

- Unamortized debt discount
- Deferred tax credits and deferred tax charges
- Deferred gains and losses on securities in pension funds
- Deferred gains on translating foreign exchange balances (The APB issued in late 1971 an exposure draft of a proposal to permit deferral of losses on foreign exchange balances but dropped the subject without issuing an Opinion.)
- Deferred gains or losses on sales of long-term investments

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<sup>107</sup>Bayless Manning, *A Concise Textbook on Legal Capital*, second edition (Mineola, New York: The Foundation Press, Inc., 1981), pages 33 and 34.

<sup>108</sup>James C. Bonbright, *Principles of Public Utility Rates* (New York: Columbia University Press, 1961), pages 195 and 196.

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- Deferred gains or losses on sale-and-leaseback transactions
- Negative goodwill remaining after reducing to zero the noncurrent assets acquired in a business combination.

Since several of those what-you-may-call-its were part of topics that might well come before the Board within a few years, Board members thought it essential to ensure that the Board would not have to face those kinds of matters without the necessary tools. They were not anxious to repeat their experiences with research and development expenditures and similar costs and accruing future losses. They not only wanted to get in place a broad conceptual framework to provide a basis for sound financial accounting standards but also had some firm ideas of the kinds of concepts that were needed.

Kirk later described his own thinking at the time, and other Board members probably would concur with most of what he said:

Among the projects on the Board's initial agenda were accounting for research and development costs and accounting for contingencies. The need for workable definitions of assets and liabilities became apparent in those projects and served as a catalyst for the part of the framework projects that became FASB Concepts Statement No. 3, *Elements of Financial Statements of Business Enterprises* (1980). . . .

To me, the definitions were the missing boundaries that were needed to bring the accrual accounting system back under control. The definitions have, I hope, driven a stake part way through the "nondistortion" guideline. But I am realistic enough to know, having dealt with the subjects of foreign currency translation and pension cost measurement, that the aversion to volatility in earnings is so strong that the notion of "nondistortion" will not die easily.<sup>109</sup>

Kirk's reference to volatility of reported net income was not accidental—that has been and will continue to be a major bone of contention between the FASB and its constituents. Managements have been and continue to be concerned that volatility of periodic net income will affect adversely the market prices of their enterprises' securities and hence their cost of capital. The Board's general response to that concern has been that accounting must be neutral, and if financial statements are to represent faithfully an entity's net income, the presence of volatility must be reported to investors and creditors. For example, former Board member Robert T. Sprouse probably expressed the thinking of many Board members:

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<sup>109</sup>Donald J. Kirk, "Looking Back on Fourteen Years at the FASB: The Education of a Standard Setter," *Accounting Horizons*, March 1988, page 15.

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I submit . . . that minimizing the volatile results of actual economic events should be primarily a matter for management policy and strategy, not a matter for accounting standards. To the extent volatile economic events actually occur, the results should be reflected in the financial statements. If it is true that volatility affects market prices of securities and the related costs of capital, it is especially important that, where it actually exists, volatility be revealed rather than concealed by accounting practices. Otherwise, financial statements do not faithfully represent the results of risks to which the enterprise is actually exposed.

To me, the least effective argument one can make in opposing a proposed standard is that its implementation might cause managers or investors to make different decisions. . . . The very reason for the existence of reliable financial information for lenders and investors . . . is to help them in their comparisons of alternative investments. If stability or volatility of financial results is an important consideration to some lenders and investors, all the more reason that the degree of stability or volatility should be faithfully reflected in the financial statements.<sup>110</sup>

That kind of problem is nothing new. For example, almost fifty years earlier Paton made essentially the same point as Sprouse in writing about the effects on income of the choice of inventory methods:

[Sanders, Hatfield, and Moore] quote, with apparent approval, the following statement from Arthur Andersen: “The practice of equalizing earnings is directly contrary to recognized accounting principles.” But . . . they go out of their way to support a European practice, the base-stock inventory method, which . . . has been vigorously revived and sponsored in recent years [in the United States] under the “last in, first out” label, which represents nothing more nor less than a major device for equalizing earnings, to avoid showing in the periodic reports the severe fluctuations which are inherent in certain business fields. . . . Actually, we do have good years and bad years in business, fat years and lean years. There is nothing imaginary about this condition—particularly in the extractive and converting fields, where this agitation centers. . . . It may be that in some situations the year is too short a period through which to attempt to determine net income (as surely the month and quarter often are), but if this is the case, the solution lies not in doctoring the annual report, but in lengthening the period. Cer-

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<sup>110</sup>Robert T. Sprouse, “Commentary on Financial Reporting—Economic Consequences: The Volatility Bugaboo,” *Accounting Horizons*, March 1987, page 88.

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tainly it is not good accounting to issue reports for a copper company, for example, which make it appear that the concern has the comparative stability of earning power of the American Telephone and Telegraph Co.<sup>111</sup>

The earlier description of the experiences of Board members that led them to support a broad conceptual framework project and to develop firm ideas about the kinds of concepts needed has focused on the projects on accounting for research and development expenditures and similar costs and accounting for contingencies, including accruing future losses. Those projects were highly significant experiences for Board members, as the preceding indicates, but later projects have provided additional or similar experiences. As the comments on volatility of income suggest, the education of Board members and members of the constituency is a continuing process in which the conceptual framework has been both a source of disagreement and controversy and a significant help in setting sound financial accounting standards.

### **Initiation of the Conceptual Framework**

Confronted with the fruits of decades of the profession's lethargy and inability to fashion a statement defining accounting's most basic concepts, the FASB, on its own initiative and motivated by the experiences of its members, decided to undertake the development of a statement of basic concepts that went beyond the objectives of financial statements to definition, recognition, measurement, and display of the elements of financial statements. In 1973 it initiated a conceptual framework project that was intended to be at once both the reasoning underlying procedures and a standard by which procedures would be judged.

A deliberative, authoritative body with responsibility for accounting standards finally had decided to do what the Committee on Accounting Procedure and the APB had been implored to do but had never felt strongly was a part of their mission. The FASB concluded that accounting did possess a core of fundamental concepts that were neither subject to nor dependent on the moment's particular, transitory consensus. Accounting had achieved the stage in its development that made it imperative and proper to place before its constituents a definitive statement of its fundamental principles.

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<sup>111</sup>William A. Paton, "Comments on 'A Statement of Accounting Principles,'" *The Journal of Accountancy*, March 1938, pages 199 and 200.

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In an open letter to the business and financial community, which prefaced the booklet, *Scope and Implications of the Conceptual Framework Project* (December 2, 1976), Marshall S. Armstrong, the first chairman of the FASB, expressed some of the Board's aspirations for the conceptual framework project:

The conceptual framework project will lead to definitive pronouncements on which the Board intends to rely in establishing financial accounting and reporting standards. Though the framework cannot and should not be made so detailed as to provide automatically an accounting answer to a set of financial facts, it will determine bounds for judgment in preparing financial statements. The framework should lead to increased public confidence in financial statements and aid in preventing proliferation of accounting methods.

The excerpt highlighted a significant characteristic of the conceptual framework project. Although Board members were aware of the widespread criticism directed at the Committee on Accounting Procedure and the Accounting Principles Board for their collective inability to provide the profession with an enduring framework for analyzing accounting issues, the FASB's stimulus was entirely different from that of its predecessors. It was not reacting to instructions or recommendations to establish basic concepts by groups such as the AICPA's Special Committees on Research Program or Opinions of the Accounting Principles Board, the Wheat Group, or the SEC. Rather, the Board undertook the self-imposed task of providing accounting with an underlying philosophy because Board members had concluded that to discharge their standards-setting responsibilities properly they needed a set of fundamental accounting concepts for their own guidance in resolving issues brought before the Board.

The idea that the conceptual framework was intended to benefit the FASB by guiding its ongoing work in establishing accounting standards was embodied in the Preface, entitled "Statements of Financial Accounting Concepts," to each Concepts Statement:

The Board itself is likely to be the most direct beneficiary of the guidance provided by the Statements in this series. They will guide the Board in developing accounting and reporting standards by providing the Board with a common foundation and basic reasoning on which to consider merits of alternatives.

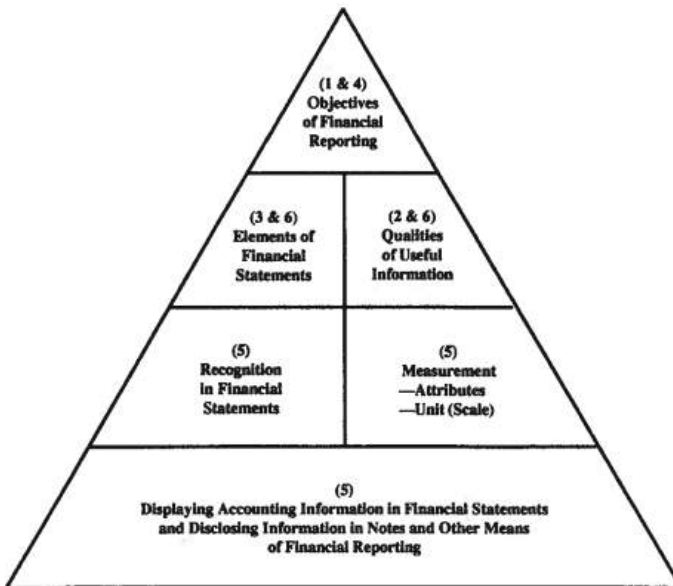
Armed with the conviction that a coordinated set of pervasive concepts was prerequisite to establishing sound and consistent accounting standards, the FASB in late 1973 formally expanded the scope of its original concepts project, "Broad Qualitative Stand-

ards for Financial Reporting,” and changed its name. The new title—“Conceptual Framework for Accounting and Reporting: Objectives, Qualitative Characteristics and Information”—for the first time used the words “conceptual framework” by which the project would become identified.

The Board concluded at the outset that it was unrealistic to attempt to devise a complete conceptual framework and adopt it by a single Board action. It already had experienced an urgent need for a definitive statement about some of the most fundamental components of the envisioned conceptual framework—the objectives of financial reporting and definitions of the elements of financial statements. The absence of meaningful definitions of assets and liabilities in the accounting literature had already hindered the FASB’s work on the other projects on its agenda.

The project was conceived as comprising six major parts, as illustrated by Figure 1. The parts were expected to be undertaken in the order shown by moving down the pyramid and from left to right at each level.

**Figure 1**  
**The FASB’s Conceptual Framework**  
**for Financial Accounting and Reporting**



The numbers in parentheses in Figure 1 reflect that although six Concepts Statements were issued, their numbers did not correspond to the order just described for the six boxes



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in the figure because (a) the Statement on qualities of useful information was finished before the Statement on elements of financial statements; (b) not-for-profit organizations were included within the scope of the framework, resulting in Concepts Statement 4, which pertained only to not-for-profit organizations, and in Concepts Statement 6, which amended Concepts Statement 2 and replaced Concepts Statement 3, making them applicable to not-for-profit organizations; and (c) little conceptual work was actually completed on the topics in the two lower levels of Figure 1, and what was done on all three topics was included in a single Concepts Statement, No. 5.

Figure 2 shows the six Concepts Statements by topic and date of issue and explains how they fit together in relation to Figure 1.

**Figure 2**  
**The Six Concepts Statements**

<b>No. 1 <i>Objectives of Financial Reporting by Business Enterprises</i></b> (November 1978)	<b>No. 4 <i>Objectives of Financial Reporting by Nonbusiness Organizations</i></b> (December 1980)
<b>No. 2 <i>Qualitative Characteristics of Accounting Information</i></b> (May 1980)	[No. 2 amended by No. 6 to apply to not-for-profit organizations as well as to business enterprises]
<b>No. 3 <i>Elements of Financial Statements of Business Enterprises</i></b> (December 1980)	<b>No. 6 <i>Elements of Financial Statements</i></b> (December 1985) [No. 3 superseded by No. 6, which applies to both business enterprises and not-for-profit organizations]
<b>No. 5 <i>Recognition and Measurement in Financial Statements of Business Enterprises</i></b> (December 1984)	[No. 5 also briefly covers display in financial statements and disclosure in notes and other means of financial reporting]

The conceptual framework constitutes the subject matter of the remainder of this book, which considers, among other things, the underlying philosophy of and emphases in the framework, the effects on it of matters discussed earlier in the book, the ways that it has been and might be used by the FASB and others in improving financial accounting and reporting practice, and a more detailed look at some of the concepts. The discussion is divided into two sections: It looks at the conceptual framework first as a body of concepts that underlies financial accounting and reporting in the United States and then as five interrelated Concepts Statements, each focused on one of four parts of the framework: objectives of financial reporting, qualitative characteristics of accounting information, elements of financial statements, and recognition and measurement and display in financial statements.

## THE FRAMEWORK AS A BODY OF CONCEPTS

The Concepts Statements as a group reflect a number of sources and other influences, most of which have already been introduced or otherwise noted, including:

- The Trueblood Study Group's report, *Objectives of Financial Statements* (October 1973), whose twelve objectives and seven "qualitative characteristics of reporting" and supporting discussion and analysis directly affected the two Concepts Statements on objectives and the one on qualitative characteristics and indirectly affected the others
- Board members' experiences in trying to set standards in the absence of an accepted conceptual basis, which was a significant factor both in the FASB's having a conceptual framework and in the kinds of concepts it comprises
- Conceptual work of the APB and Accounting Research Division, primarily Accounting Research Studies 1 and 3 on basic postulates and broad principles of accounting and the basic concepts part of APB Statement 4
- Conceptual work of others reported in the literature, including the work of individuals, the American Accounting Association's concepts and standards statements, and developments in Canada, the United Kingdom, Australia, New Zealand, and other countries
- Conceptual work of the FASB itself, including preparatory work on its original concepts project and development of Discussion Memorandums and Exposure Drafts that led to the Concepts Statements and related projects, such as that on materiality; and the fruits of "due process," such as some excellent comment letters and exchanges of views at a number of hearings.

Some of the most fundamental concepts in the framework had their roots in those sources and influences. The three examples of fundamental concepts under the next three headings combine ideas from one or more Concepts Statements and illustrate those connections.

### **Information Useful in Making Investment, Credit, and Similar Decisions**

**Financial accounting and reporting is not an end in itself but is intended to provide information that is useful to present and potential investors, creditors, other resource providers, and other users outside an entity in making rational investment, credit, and similar decisions about it.**

The FASB generally followed the report of the Trueblood Study Group on objectives of financial statements in focusing the objectives of financial reporting on information useful in investment, credit, and similar decisions, instead of on information about man-

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agement's stewardship to owners or information based on the operating needs of managers. The description of Concepts Statement 1 later in this book shows the influence of the Trueblood Study Group's objectives on the FASB's objectives.

That focus on information for decision making represented a fundamental change in attitude toward the purposes of financial statements. Before the Trueblood Study Group's report, APB Statement 4 was the only AICPA pronouncement identifying financial reporting with the needs of investors and creditors for decision making rather than with the traditional accounting purpose of reporting on management's stewardship. A vocal minority, which still is heard from occasionally, has insisted that the primary function of accounting by an enterprise is to serve management's needs and that the objectives should reflect that purpose. It has never been obvious why proponents of that view think that a body such as the APB or FASB should be establishing objectives and setting standards for information that is primarily for internal and private use and that management can require in whatever form it finds most useful. The message intended apparently is that management, not the APB, FASB, or similar body, should decide what information financial statements are to provide to investors, creditors, and others.

The Study Group, which may have been influenced to some extent by APB Statement 4, emphasized the role of financial statements in investors' and creditors' decisions and identified the purposes of financial statements with the decisions of investors and creditors, existing or prospective, about placing resources available for investment or loan. The Study Group's recommendations became the starting point for the FASB to build a conceptual framework.

### **Representations of Things and Events in the Real-World Environment**

**The items in financial statements represent things and events in the real world, placing a premium on representational faithfulness and verifiability of accounting information and neutrality of both standards setting and accounting information.**

The FASB's decision to ground its concepts in the environment in which financial accounting takes place and the economic things, events, and activities that exist or happen there, instead of on accounting processes and procedures, was influenced significantly by Accounting Research Study 1 on basic postulates of accounting and the section of APB Statement 4 on basic concepts. The postulates in ARS 1 were, as already described, self-evident propositions about the environment in which accounting functions—a world that does exist and not one that is a fiction—that were fruitful for accounting.

For example, the observation that most of the goods and services produced in the United States are not directly consumed by their producers but are sold for cash or claims to cash suggests both why financial accounting is concerned with production and distribution of goods and services and with exchange prices and why investors, creditors, and other users of financial statements are concerned with cash prices and cash flows.

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That focus of financial accounting on the environment and the things and events in it that are represented in financial statements constituted a fundamental change from the earlier emphasis on the conventional nature of accounting and the conventional procedures and allocations used to produce the numbers in financial statements. Thus, the Concepts Statements devote considerable space to describing activities such as producing, distributing, exchanging, saving, and investing in what they variously call the “real world,” “economic, legal, social, political, and physical environment in the United States,” or “U.S. economy,” and what is involved in representing those economic things and events in financial statements. Concepts Statement 1 notes a significant consequence of that focus on things and events in the environment that is pertinent to the definitions of the elements of financial statements.

The information provided by financial reporting pertains to individual business enterprises. . . . Since business enterprises are producers and distributors of scarce resources, financial reporting bears on the allocation of economic resources to producing and distributing activities and focuses on the creation of, use of, and rights to wealth and the sharing of risks associated with wealth. [paragraph 19]

Thus, the elements of financial statements are assets and liabilities and the effects of transactions and other events that change assets and liabilities—that change and transfer wealth.

### **Assets (and Liabilities)—The Fundamental Element(s) of Financial Statements**

**The fundamental elements of financial statements are assets and liabilities because all other elements depend on them:**

**Equity is assets minus liabilities;**

- **Investments by owners,**
  - **Distributions to owners, and**
  - **Comprehensive income and its components—revenues, expenses, gains, and losses—**
- inflows, outflows, or other increases and decreases in assets and liabilities.**

**Because liabilities depend on assets—liabilities are obligations to pay or deliver assets—assets is the most fundamental element of financial statements.**

Soon after its inception the FASB needed definitions of assets and liabilities and found many examples of two types of definition in the accounting literature.

Definitions of one type identified assets with economic resources and wealth, emphasizing the service potential, or benefits, and economic values that an asset confers on the holding or owning entity. Similarly, they identified liabilities with amounts or duties owed

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to other entities, emphasizing the payment or expenditure of assets required of the debtor or owing entity to satisfy the claim. They were definitions that described things that most people could recognize as assets and liabilities because they had experience in their everyday lives as well as in their business activities with rights to use economic resources and with obligations to pay debts.

Three sets of definitions of assets and liabilities by the AAA, Robert K. Mautz, and Eric L. Kohler, respectively,<sup>112</sup> are examples of the numerous definitions the FASB considered that had those characteristics:

Assets are economic resources devoted to business purposes within a specific accounting entity; they are aggregates of service-potentials available for or beneficial to expected operations.

An asset may be defined as anything of use to future operations of the enterprise, the beneficial interest in which runs to the enterprise. Assets may be monetary or nonmonetary, tangible or intangible, owned or not owned.

**asset** Any owned physical object (tangible) or right (intangible) having economic value to its owner; an item or source of wealth . . .

The interests or equities of creditors (liabilities) are claims against the entity arising from past activities or events which, in the usual case, require for their satisfaction the expenditure of corporate resources.

Liabilities are claims against a company, payable in cash, in other assets, or in service, on a fixed or determinable future date.

**liability** 1. An amount owing by one person (a debtor) to another (a creditor), payable in money, or in goods or services: the consequence of an asset or service received or a loss incurred or accrued . . .

The FASB also found a second type of definition of assets and liabilities that included economic resources and obligations but also let in some ultimately undefinable what-you-may-call-its—such as deferred tax charges and credits, deferred losses and gains, and self-insurance reserves—items that are not economic resources or obligations of an entity but were included in its balance sheet as assets or liabilities “to achieve ‘proper’ matching of costs and revenues” or “to avoid distorting periodic net income” (pages 47-66 of this book).

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<sup>112</sup>American Accounting Association, Committee on Concepts and Standards Underlying Corporate Financial Statements, *Accounting and Reporting Standards for Corporate Financial Statements and Preceding Statements and Supplements* (Iowa City, Iowa: American Accounting Association, 1957), pages 3 and 7.

Robert K. Mautz, “Basic Concepts of Accounting,” in *Handbook of Modern Accounting*, edited by Sidney Davidson (New York: McGraw-Hill Book Company, 1970), pages 1-5 and 1-8 [chapter 1, pages 5 and 8].  
Kohler, *A Dictionary for Accountants*, pages 39 and 291.

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Prime examples of the second type of definition were those in APB Statement 4, paragraph 132, which explicitly included what-you-may-call-its in its definitions of assets and liabilities:

*Assets*—economic resources of an enterprise that are recognized and measured in conformity with generally accepted accounting principles. Assets also include certain deferred charges that are not resources but that are recognized and measured in conformity with generally accepted accounting principles.

*Liabilities*—economic obligations of an enterprise that are recognized and measured in conformity with generally accepted accounting principles. Liabilities also include certain deferred credits that are not obligations but that are recognized and measured in conformity with generally accepted accounting principles.

Those definitions were circular and open-ended, however, being both determinants of and determined by generally accepted accounting principles and saying in effect that assets and liabilities were whatever the Board said they were.

In trying to use the definitions in APB Statement 4 to set financial accounting standards for research and development expenditures and accruing future losses, Board members found that assets and liabilities defined as fallout from periodic recognition of revenues and expenses were too vague and subjective to be workable (pages 51-54 and 62-64). That experience strongly reinforced the conceptual and practical superiority of definitions of assets and liabilities based on resources and obligations that exist in the real world rather than on deferred charges and credits that result only from bookkeeping entries.

APB Statement 4's definitions proved to be of little help to the Board in deciding whether results of research and development expenditures qualified as assets or whether reserves for self-insurance qualified as liabilities because they permit almost any debit balance to be an asset and almost any credit balance to be a liability. They were hardly better than the definitions that they had replaced, which also included what-you-may-call-its and were circular and open-ended in the same ways:

[T]he word "asset" is not synonymous with or limited to property but includes also that part of any cost or expense incurred which [according to generally accepted accounting principles] is properly carried forward upon a closing of books at a given date.

. . . Thus, plant, accounts receivable, inventory, and a deferred charge are all assets in a balance-sheet classification.

The last named is not an asset in the popular sense, but if it may be carried forward as a proper charge against future income, then in an accounting sense, and particularly in a balance-sheet classification, it is an asset. . . .

. . . Thus, the word ["liability"] is used broadly to comprise not only items which constitute liabilities in the popular sense of debts or obligations . . . but also credit balances to be ac-

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counted for which do not involve the debtor and creditor relation. For example, capital stock, deferred credits to income, and surplus are balance-sheet liabilities in that they represent balances to be accounted for by the company; though these are not liabilities in the ordinary sense of debts owed to legal creditors.<sup>113</sup>

Definitions of that kind provide no effective limits or restraints on the matching of costs and revenues and the resulting reported net income. If balance sheets at the beginning and end of a period include debits and credits that are labeled assets and liabilities but that result from bookkeeping entries and are assets only “in an accounting sense” or “in a balance-sheet classification” or are only “balance-sheet liabilities,” the income statement for the period will include components of income that are equally suspect—namely, debits and credits that are labeled revenues, expenses, gains, or losses but that result from the same bookkeeping entries as the what-you-may-call-its in the balance sheet. They have resulted not from transactions or other events that occurred during the period but from shifting revenues, expenses, gains, or losses from earlier or later periods to match costs and revenues properly or to avoid distorting reported periodic income.

Thus, when the Board defined the elements of financial statements in Concepts Statement 3 (and used the same definitions in Concepts Statement 6), it defined assets and liabilities in essentially the same way as the three sets of definitions by the AAA, Mautz, and Kohler, emphasizing the benefits that assets confer on their holders and the obligations to others that bind those with liabilities to pay or expend assets to settle them.

Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events. [Concepts Statement 6, paragraph 25]

Liabilities are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events. [Concepts Statement 6, paragraph 35]

The definitions that were adopted exclude all what-you-may-call-its. Deferred charges and credits that “need to be carried forward for matching in future periods” can no longer be included in assets and liabilities merely by meeting definitions no more restrictive than “assets are costs” and “liabilities are proceeds” (pages 28-30, 124-126, and 128-130).

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<sup>113</sup>Accounting Research Bulletin No. 9 (Special), *Report of the Committee on Terminology* (May 1941), pages 70 and 71.

The definitions in ARB 9 were carried over to Accounting Terminology Bulletin No. 1, *Review and Résumé* (August 1953), paragraphs 26 and 27, but, for some unexplained reason, “deferred credits to income,” the only part of the liability definition comparable to “deferred charges” in the asset definition, was deleted.

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Although definitions identifying assets with economic resources and wealth and liabilities with amounts or duties owed to other entities had been common in the accounting literature from the turn of the century to the 1970s, the definitions in APB Statement 4 actually reflected accounting practice at the time the FASB was developing its definitions. Thus, its definitions represented a fundamental change from the emphasis on financial accounting as primarily a process of matching costs and revenues.

### **Misunderstanding and Controversy about the FASB's Defining Assets and Liabilities as the Fundamental Elements**

Both of the other fundamental concepts described earlier—that the objective of financial reporting is to provide information useful in making investment, credit, and similar decisions and that items in financial statements represent things and events in the real-world environment—also constituted significant changes in perceptions of the purpose and nature of financial accounting and reporting. Both caused concern among many members of the FASB's constituency at the beginning and drew some criticism and opposition. With time, however, both concepts seem to have been understood reasonably well, their level of acceptance has increased, and active opposition has subsided.

In contrast, this third concept—that assets and liabilities are the fundamental elements of financial statements—still is undoubtedly the most controversial, and the most misunderstood and misrepresented, concept in the entire conceptual framework.

### *Two Views of Income*

The FASB's emphasis on assets and liabilities in the definitions of the elements of financial statements became a focus of controversy in the development of the conceptual framework because it highlighted the tension in accounting thought and practice between two widely held and essentially incompatible views about income:

- Income is an enhancement of wealth or command over economic resources.
- Income is an indicator of performance of an enterprise and its management.

That difference of opinion about income usually has involved the question of whether certain items should be reported in the net income for a period or should be excluded from net income and reported directly in equity. It most often has been described as the issue of how to display the effects of unusual, extraordinary, or nonrecurring happenings and prior period adjustments, which underlay the disagreement between the Securities and Exchange Commission and the Institute's Committee on Accounting Procedure over the all-inclusive and current-operating-performance types of income statement, described on pages 27 and 28, and has troubled accounting standards-setting bodies for more than half a century.



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Standard setters, including the Committee on Accounting Procedure, the Accounting Principles Board, and the Financial Accounting Standards Board, have issued more pronouncements dealing with display of the effects of unusual and nonrecurring events than any other subject.<sup>114</sup>

It also underlies differences between comprehensive income and earnings, described on pages 150-155, recently manifesting itself most prominently in the issue of whether to extend the traditional display of unusual, nonrecurring, or extraordinary events—to exclude them from net income and report them directly in equity—to recurring but often volatile holding gains and losses that largely are beyond the control of an entity and its management.

Difference of opinion about whether income is wealth enhancement or performance indicator likewise underlay the controversy that followed issue of the FASB Discussion Memorandum on definitions of elements of financial statements and their measurement (December 2, 1976), but the matter went deeper than financial statement display. In the FASB's conceptual framework, definitions of elements of financial statements are more fundamental than recognition, measurement, or display in financial statements (Figure 1, page 68), and the Discussion Memorandum emphasized definition rather than display.

The Board referred to the two views of income or earnings as the *asset and liability view* and the *revenue and expense view* and described the difference between them for purposes of defining elements of financial statements as whether definitions of assets and liabilities should be the controlling definitions or should depend on definitions of revenues and expenses.

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<sup>114</sup>Oscar S. Gellein, "Periodic Earnings: Income? or Indicator?" *Accounting Horizons*, June 1987, page 61. The pronouncements to which Gellein referred are:

### **Accounting Research Bulletins:**

- No. 8 *Combined Statement of Income and Earned Surplus* [Retained Earnings] (February 1941)
- No. 32 *Income and Earned Surplus* (December 1947)
- No. 35 *Presentation of Income and Earned Surplus* (October 1948)
- No. 41 *Presentation of Income and Earned Surplus (Supplement to Bulletin No. 35)* (July 1951)
- No. 43 *Restatement and Revision of Accounting Research Bulletins* (June 1953)
  - Chapter 2(b), "Combined Statement of Income and Earned Surplus"
  - Chapter 8, "Income and Earned Surplus"

### **APB Opinions:**

- No. 9 *Reporting the Results of Operations* [Income] (December 1966)
- No. 20 *Accounting Changes* (July 1971)
- No. 30 *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions* (June 1973)

### **FASB Statements:**

- No. 4 *Reporting Gains and Losses from Extinguishment of Debt* (an amendment of APB Opinion No. 30) (March 1975)
- No. 16 *Prior Period Adjustments* (June 1977)

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The conceptual issue in choosing between the asset and liability view and the revenue and expense view concerns selecting the most fundamental elements whose precise definitions control the definitions of the other elements. [page 35]

Former Board Member Oscar Gellein (writing in 1984) described the issue as one of identifying the elements that have what he called “conceptual primacy” and said that the question of which concepts had primacy was “[a] central issue [that] pervades the FASB’s effort to construct a conceptual framework.”<sup>115</sup> That question was the first issue in the Discussion Memorandum:

Should the asset and liability view . . . [or] the revenue and expense view . . . be adopted as the basis underlying a conceptual framework for financial accounting and reporting?<sup>116</sup> [page 36]

According to the Discussion Memorandum, proponents of the asset and liability view hold that assets should be defined as the economic resources of an enterprise (its scarce means of carrying out economic activities such as exchange, production, saving, and investment), that liabilities should be defined as its obligations to transfer assets to other entities in the future, and that definitions of income and its components should depend on the definitions of assets and liabilities. Thus, no revenues or gains can occur unless an asset increases or a liability decreases, and no expenses or losses can occur unless an asset decreases or a liability increases. As a result, income reflects an increase in wealth of the enterprise, and a loss reflects a decrease in its wealth.

Proponents of the revenue and expense view, in contrast, hold that income is a measure of performance of an enterprise and its management, that income results from proper matching of costs and revenues, and that most nonmonetary assets and liabilities are by-products of the matching process. Proper matching of costs and revenues involves timing their recognition to relate effort (expenses) and accomplishment (revenues) for a period. Thus, the effects of past expenditures or receipts that are deemed to be expenses or revenues of future periods are recognized as assets or liabilities (deferred charges or deferred credits) whether or not they relate to economic resources or obligations to transfer resources to other entities in the future.

### *Asset and Liability View and Conceptual Primacy of Assets and Liabilities*

Although Concepts Statements 3 and 6 neither mentioned the asset and liability view and the revenue and expense view nor explained how or why the Board had settled on one of them, the definitions themselves left no doubt about which view the Board had en-

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<sup>115</sup>Oscar S. Gellein, “Financial Reporting: The State of Standard Setting,” in *Advances in Accounting*, vol. 3, edited by Bill N. Schwartz (Greenwich, Connecticut: JAI Press, Inc., 1986), pages 14 and 15.

<sup>116</sup>A third view described in the Discussion Memorandum, the nonarticulation view, is omitted.

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dorsed. Following the steps it had set down in the Discussion Memorandum, it first identified assets and liabilities as “the most fundamental elements whose precise definitions control the definitions of the other elements” (page 35, quoted on page 78 of this book) and then used the most fundamental definitions—assets and liabilities—in defining all of the other elements. Equity is assets minus liabilities. Investments by and distributions to owners and comprehensive income and its components—revenues, expenses, gains, and losses—are inflows, outflows, or other increases and decreases in assets and liabilities. (Assets actually is the most fundamental element of financial statements because the definition of liabilities depends on the definition of assets—liabilities are obligations to pay or deliver assets.) The emphasis on assets and liabilities in the definitions of the elements of financial statements in Concepts Statement 3 showed that the Board had adopted the asset and liability view and rejected the revenue and expense view.

Assets and (to a lesser extent) liabilities have conceptual primacy, while income and its components—revenues, expenses, gains, and losses—do not.

Every conceptual structure builds on a concept that has primacy. That is simply another way of saying some element must be given meaning before meaning can be attached to others. I contend that assets have that primacy. I have not been able to define income without using a term like asset, resources, source of benefits, and so on. In short, meaning can be given to assets without first defining income, but the reverse is not true. That is what I mean by conceptual primacy of assets. No one has ever been successful in giving meaning to income without first giving meaning to assets.<sup>117</sup>

The Board's early experiences had convinced it that definitions of assets and liabilities that depended on definitions of income and its components did not work. As already noted, those kinds of definitions proved to be of little help to the Board in deciding whether results of research and development expenditures qualified as assets or whether reserves for self insurance qualified as liabilities because they permit almost any debit balance to be an asset and almost any credit balance to be a liability.

In addition, the Board had attempted to test whether revenues and expenses could be defined without first defining assets and liabilities. It asked respondents to the Discussion Memorandum to submit for its consideration precise definitions of revenues and expenses that were wholly or partially independent of economic resources and obligations (assets and liabilities) and capable of general application in a conceptual framework (page 13). That no one was able to do that without having to resort to subjective guides, such as proper matching and nondistortion of income, was a significant factor in the Board's ultimate rejection of the revenue and expense view.

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<sup>117</sup>Oscar S. Gellein, “Primacy: Assets or Income?” in *Research in Accounting Regulation*, vol. 6, edited by Gary John Previts (Greenwich, Connecticut: JAI Press, 1992), page 198.

## *The Framework of Financial Accounting Concepts and Standards*

Attempts to identify a good match based on the primacy of revenue and expense have been unsuccessful so far. There is a serious question as to whether revenue and expense can be defined independent of assets and liabilities.<sup>118</sup>

Thus, revenues and expenses could not fulfill the function of concepts having primacy, which

are the concepts used to define other concepts. They prevent the systems from being open-ended and potentially circular. They are the concepts that are used to test for unity and maintenance of a consistent direction—they are the anchor.<sup>119</sup>

Instead, the Board found that definitions that made assets and liabilities essentially fallout of the process of matching revenues and expenses provided no anchor. They excluded almost nothing from income because they excluded almost nothing from assets and liabilities. The definitions were primarily conventional, not conceptual, and had made periodic income measurement largely a matter of individual judgment and personal opinion. The resulting accounting lacked the conceptual underpinning that provides, among other things, “the means for judging whether one solution is better than another. . . . [and] the restraints necessary to prevent proliferation of perceptions and resulting diversity of accounting methods for substantially similar circumstances.”<sup>120</sup> That is, the Board found the revenue and expense view to be part of the problem rather than part of the solution.

In contrast, the Board’s definitions of assets and liabilities limited what can be included in all of the other elements. The Board’s choice of the asset and liability view limited the population of assets and liabilities to the underlying economic resources and obligations of an enterprise. The resulting definitions impose limits or restraints not only on what can be included in assets and liabilities but also on what can be included in income. The only items that can meet the definitions of income and its components—revenues, expenses, gains, and losses—are those that increase or decrease the wealth of an enterprise.

The Board based its definitions of elements of financial statements on the conceptual primacy of assets and liabilities for both conceptual and practical reasons. However, that decision was to put the Board at odds with many of its constituents because, among other reasons, “both [conceptual primacy], and the implications of the FASB position on it are still rather widely misunderstood.”<sup>121</sup>

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<sup>118</sup>Gellein, “Financial Reporting: The State of Standard Setting,” page 17.

<sup>119</sup>Gellein, “Financial Reporting: The State of Standard Setting,” page 15.

<sup>120</sup>Gellein, “Financial Reporting: The State of Standard Setting,” page 13.

<sup>121</sup>Gellein, “Financial Reporting: The State of Standard Setting,” page 14.

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### *Revenue and Expense View and Its Hold on Practice*

The revenue and expense view had been the basis for accounting practice and for most authoritative accounting pronouncements for over forty years when the Board looked closely at it in the 1970s. The FASB saw clear evidence of its pervasiveness in practice and in accountants' minds in its early projects on research and development expenditures and accruing future losses. An emphasis on the "proper matching of costs and revenues," a concern for avoiding "distortion of periodic net income," and a willingness to allow "what-you-may-call-its" to appear in balance sheets are all characteristics of the revenue and expense view of income, which has been described extensively earlier in this book without referring to it by that name.<sup>122</sup> When the Board issued the Discussion Memorandum, the revenue and expense view was the only view of accounting that most of its constituents knew.

Many of them apparently could not, or would not, believe that the Board's primary concern was the need for a set of definitions that worked. That reaction probably was to have been expected. Definitions of assets and liabilities have not been significant in the thinking underlying the revenue and expense view, which has focused on the need to measure performance by relating efforts expended with the resulting accomplishments and has emphasized proper matching and nondistortion of periodic net income as the means of achieving that association of effort and accomplishment. Its proponents might find it difficult to believe that definitions of assets and liabilities could be considered to be fundamental concepts.

Unfortunately, the issue became highly emotional, and many of those who did not accept the Board's explanations looked for other explanations for its decision. Although the Board had defined assets and liabilities in a way that could accurately be described as venerable, many members of the Board's constituency found something unusual, perhaps even sinister, in the Board's definitions of elements of financial statements.

For example, a popular criticism of the asset and liability view charged the FASB with having the intent

- To downgrade the importance of net income and the income statement by making the balance sheet more important than the income statement
- To supplant accounting based on completed transactions and matching of costs and revenues with a "new" accounting based on the valuation of assets and liabilities at current values or costs.

That many of the comment letters the Board received on the Discussion Memorandum echoed those charges mostly reflected the success of an illustrated-lecture tour by Robert K. Mautz, partner of Ernst & Ernst (now Ernst & Young LLP), in which he urged

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<sup>122</sup>Most accountants had never heard the terms *revenue and expense view* and *asset and liability view* until the FASB used them in its 1976 Discussion Memorandum on elements of financial statements.

## *The Framework of Financial Accounting Concepts and Standards*

members of 65 to 70 chapters of the Financial Executives Institute to reject the asset and liability view.<sup>123</sup>

Board and staff members became concerned that discussion of the FASB's decision to base its definitions of elements of financial statements on the conceptual primacy of assets and liabilities had gone astray. The focus had been shifted from the definitions to some oversimplified and essentially irrelevant distinctions between the asset and liability and revenue and expense views concerning which financial statement is more useful and which measurement basis goes with which view.

Conceptual primacy has nothing to do with the question of what information is most useful or of how it is measured. It refers only to the matter of definitional dependency.<sup>124</sup>

The Discussion Memorandum had tried to keep the emphasis on the definitions, explaining why the relative usefulness of income statements and balance sheets was never a real issue between the two views:

[A]dvocates of the asset and liability view agree with advocates of the revenue and expense view that the information in a statement of earnings is likely to be more useful to investors and creditors than the information in a statement of financial position. That is, both groups agree that earnings measurement is the focus of financial accounting and financial statements. [paragraph 45]

Concepts Statement 1 was unequivocal in identifying information about income as most useful to investors, creditors, and other users:

The primary focus of financial reporting is information about an enterprise's performance provided by measures of earnings and its components. Investors, creditors, and others who are concerned with assessing the prospects for enterprise net cash inflows are especially interested in that information. [paragraph 43]<sup>125</sup>

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<sup>123</sup>Pelham Gore, *The FASB Conceptual Framework Project, 1973–1985, An Analysis* (Manchester and New York: Manchester University Press, 1992), pages 94 and 95.

<sup>124</sup>Gellein, "Financial Reporting: The State of Standard Setting," page 15.

<sup>125</sup>That paragraph echoed paragraph 171 of *Tentative Conclusions on Objectives of Financial Statements of Business Enterprises*, which was issued in a package with the Discussion Memorandum:

Earnings for an enterprise for a period measured by accrual accounting [is] generally considered to be the most relevant indicator of relative success or failure of the earning process of an enterprise in bringing in needed cash. Measures of periodic earnings are widely used by investors, creditors, security analysts, and others.

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Thus, to say that the asset and liability view downgrades the significance of net income and the income statement by making the balance sheet more significant than the income statement at best reflects misunderstanding of the conceptual primacy of assets and liabilities and of the asset and liability view used by the Board. At worst, it misrepresents the Board's reasons for accepting the asset and liability view and rejecting the revenue and expense view of income.

The idea that the Board chose the asset and liability view to impose some kind of current value accounting on an unwilling world reflects the same misunderstanding and misrepresentation. None of the Concepts Statements except No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, say anything about how assets or liabilities should be measured, and Concepts Statement 5 does not embrace a "new" accounting based on the valuation of assets and liabilities at current values or costs. If anything, it favors "historical-cost accounting" and erects barriers to current values or costs, for example, placing a higher hurdle for recognizing current values or costs than for recognizing historical costs: "Information based on current prices should be recognized if it is sufficiently relevant and reliable to justify the costs involved and more relevant than alternative information" (paragraph 90). Moreover, Concepts Statement 5 and numerous speeches made and articles written by Board members while the Concepts Statements were in progress furnish abundant evidence that Board members never were sufficiently of the same mind on the relative merits and weaknesses of current cost or value and so-called historical cost for measuring assets and liabilities for the Board accurately to be characterized as "having the intent" to adopt any particular measurement model for assets and liabilities.

Since Board members' continual public denials of that kind of intent and their explanations of what the Board actually was trying to accomplish were publicly brushed aside by many members of the Board's constituency, the unfortunate result was a generally unenlightening digression that served no purpose except to cast aspersions on Board members' veracity and integrity and to polarize opinion. It made little or no contribution to the conceptual framework, but it did reveal a deep-seated distrust of a conceptual framework, or perhaps of concepts generally, on the part of many accountants and a fear, easily triggered by, for example, labeling the asset and liability view a "valuation approach," that the FASB might be in the process of turning the world of accounting upside down.

The revenue and expense view is still deeply ingrained in many accountants' minds, and their first reaction to an accounting problem is to think about "proper matching of costs and revenues." Time will be needed for them to become accustomed to thinking first about effects of transactions or other events on assets or liabilities (or both) and then about how the effect on assets and liabilities has affected revenues, expenses, gains, or losses. Many will be able to make that adjustment only with difficulty, and a significant number simply will make no attempt to do so, clinging instead to the revenue and expense view. The FASB's experience suggests that a long tradition of *ad hoc* accounting principles has fostered a propensity to resist restraints on flexibility, especially those that limit an enterprise's ability to decide what can be included in income for a period.

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Yet, the hold of the revenue and expense view on practice is destined to decline. Definitions reflecting the revenue and expense view have been weighed in the balance and found wanting, not only by the FASB but also by other standards-setting bodies.

The conceptual frameworks of the standard-setting bodies [in Australia, Canada, the United Kingdom and the United States and the International Accounting Standards Committee] do rest on the bedrock of the balance sheet. This may be inevitable, given that advocates of a p[rofit] & l[oss] account-driven approach have so far failed to produce rigorous, coherent and consistent definitions of its elements that refer to underlying events rather than the recognition process itself.<sup>126</sup>

Countries besides the United States that have adopted or are in the process of adopting conceptual frameworks or statements also generally have developed definitions of elements of financial statements that reflect the conceptual primacy of assets and liabilities. Thus, standards setters in Australia, Canada, and the United Kingdom, as well as the International Accounting Standards Committee, all have definitions that are generally similar to those of the Financial Accounting Standards Board.

To those familiar with the FASB's experience with the Discussion Memorandum on elements of financial statements, the related Exposure Drafts, and Concepts Statement 3, what has happened recently in some of those countries is (in the words of Yogi Berra) "déjà vu all over again." At the annual *Financial Times* financial reporting conference in the United Kingdom in September 1993, for example,

David Lindsell, senior technical partner at Ernst & Young, reiterated his firm's criticism of the A[ccounting] S[tandards] B[oard]'s conceptual approach (*Accountancy*, October 1993, page 11). Whereas the ASB's Statement of Principles makes the balance sheet the "focal point of the accounts" and "treats financial reporting primarily as a process of valuation," E&Y believes that the primary focus should be on "the measurement of earnings, and that the balance sheet should be seen as a residual statement, derived after measuring the company's profits and not the other way round."<sup>127</sup>

Essentially E&Y accuses the ASB of focusing on the balance sheet at the expense of the p[rofit] & l[oss] account and argues for a return to pure historical cost accounting. . . . [S]ince E&Y went public with its criticism, it

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<sup>126</sup>Brian Rutherford, "Accountancy Issues—They Manipulate. You Smooth. I Self-hedge: Perhaps the World's Finest Know a Thing or Two After All," *Accountancy*, June 1995, page 95.

<sup>127</sup>"News—ASB under Fire," *Accountancy*, November 1993, page 16.



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has heard from a lot of people, particularly finance directors, who have expressed sympathy with its arguments.<sup>128</sup>

International harmonization of accounting practice is likely to continue to be in the direction of phasing out the revenue and expense view.

However, change is likely to be rather deliberate, and at least in the United States, features of the revenue and expense view are likely to be part, though a shrinking part, of financial statements for some time to come. The Board has said that it “intends future change to occur in the gradual, evolutionary way that has characterized past change” (Concepts Statement 5, paragraph 2). And, although it precluded self-insurance reserves and similar what-you-may-call-its in balance sheets, the Board has permitted other what-you-may-call-its to avoid unduly disrupting practice. For example, it explicitly responded to concerns about volatility of reported net income expressed by respondents to the Exposure Draft that preceded FASB Statement No. 87, *Employers' Accounting for Pensions* (December 1985), concluding that to require accounting that was conceptually appropriate under the definitions in Concepts Statement 3 would be too great a change from past practice to be adopted in a single step. Thus, Statement 87 “retains three fundamental aspects of past pension accounting” despite their conflict with the Concepts Statements and accounting principles applied elsewhere (paragraph 84). One of the three—delaying recognition of actuarial gains and losses to spread over future periods the recognition of gains or losses that have already occurred to a liability for pensions or pension plan assets—requires recognizing in the accounts a number of what-you-may-call-its even though they do not qualify as assets or liabilities under the Board's definitions. The Board's perception of a need for expedients of that kind means that at least some “what-you-may-call-its” in balance sheets and the related arguments about “proper matching of costs and revenues” and “avoiding distortion of periodic net income” are likely to disappear only gradually.

### **Functions of the Conceptual Framework**

The Preface of each FASB Concepts Statement has carried the following, or a similar, description (this excerpt is from Concepts Statement 6):

The conceptual framework is a coherent system of interrelated objectives and fundamentals that is expected to lead to consistent standards and that prescribes the nature, function, and limits of financial accounting and reporting. It is expected to serve the public interest by providing structure and direction to financial accounting and reporting to facilitate the provi-

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<sup>128</sup>Brian Singleton-Green, “The ASB: Critics That Won't Be Pacified,” *Accountancy*, November 1993, page 26.

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sion of evenhanded financial and related information that helps promote the efficient allocation of scarce resources in the economy and society, including assisting capital and other markets to function efficiently.

Establishment of objectives and identification of fundamental concepts will not directly solve financial accounting and reporting problems. Rather, objectives give direction, and concepts are tools for solving problems.

The FASB's conceptual framework is intended to be primarily a set of tools to help the Board in setting sound financial accounting standards and to help members of the Board's constituency not only understand and apply those standards but also contribute significantly to their development. It is not expected automatically to provide ready-made, unique, and obviously logical answers to complex financial accounting or reporting problems, but it should help to solve them by

- Providing a set of common premises as a basis for discussion
- Providing precise terminology
- Helping to ask the right questions
- Limiting areas of judgment and discretion and excluding from consideration potential solutions that are in conflict with it
- Imposing intellectual discipline on what traditionally has been a subjective and ad hoc reasoning process.

Those contributions of the conceptual framework have all been introduced at least indirectly earlier in this book, and the last two were cited as factors in the FASB's conclusions in the preceding discussion of assets as the fundamental element of financial statements. The following paragraphs add a few points on the first three.

A critical function of the conceptual framework is to provide a set of common premises from which to begin discussing specific accounting problems and developing solutions for them. The accounting profession's earlier efforts to establish accounting principles have shown that if experience is the frame of reference, no one can be sure of the starting point, if one exists at all, because everyone's experience is different. The FASB's predecessors tried to use experience as a common point of departure, but when confronted with the same problems, people with different experiences too often offered widely different solutions, and financial accounting was inundated with multiple solutions to the same problems. The problems of communication and understanding between those supporting the revenue and expense view and those supporting the asset and liability view offer a striking illustration.

A framework of coordinated concepts as the frame of reference, in contrast, can change that picture. The FASB and its constituency start from common ground, vastly increasing the likelihood that they can communicate with and understand each other on the complex and difficult problems that often arise in financial accounting and reporting. A set of common premises does not guarantee agreement, but it does avoid the problems and

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wasted time that result if those discussing a matter talk past each other because they actually are not talking about the same thing. It also promotes consensus once a problem is solved. For example, Donald J. Kirk, former chairman of the FASB, noted that the conceptual framework was undertaken “with the expectation that it would articulate definitions and concepts that would diminish the need for and details in standards; it was to be the ‘relief’ from the so-called ‘firefighting’ [approach] for which the FASB’s predecessors had been criticized.”<sup>129</sup>

A related purpose of the conceptual framework is to provide a precise terminology. Good terminology serves much the same function as a set of common premises: “Loose terminology encourages loose thinking. Precision in the use of words does not solve human controversies, but at least it paves the way for clear thinking.”<sup>130</sup> The FASB’s conceptual framework has contributed significantly to precise terminology through its careful definitions of the elements of financial statements in Concepts Statement 6 and the qualitative characteristics of accounting information in Concepts Statement 2.

The conceptual framework helps to ask the right questions. Indeed, the FASB has emphasized that contribution as much as any. For example, the definitions of elements of financial statements not only make clear which are the right questions but also the order in which to ask them:

- What is the asset?
- What is the liability?
- Did an asset or liability or its value change?
  - Increase or decrease?
  - By how much?
- Did the change result from:
  - An investment by owners?
  - A distribution to owners?
  - Comprehensive income?
- Was the source of comprehensive income what we call:
  - Revenue?
  - Expense?
  - Gain?
  - Loss?

To start at the bottom and work up the list will not work. That is what ad hoc accounting has tried to do over many years, resulting in assets and liabilities in balance sheets that cannot meet the definitions.

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<sup>129</sup>Kirk, “Looking Back on Fourteen Years at the FASB: The Education of a Standard Setter,” *Accounting Horizons*, March 1988, page 11.

<sup>130</sup>Austin Wakeman Scott, *Abridgement of the Law of Trusts* (Boston: Little, Brown and Company, 1960), page 28.

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The conceptual framework does not guarantee logical solutions to accounting problems. The results depend significantly on those who use the concepts to establish financial accounting standards. But it does provide valuable tools to standards setters.

Standard setters' instincts alone are not adequate to maintain direction—to discriminate between a solution that better lends usefulness to a standard than another solution, and at the same time maintain consistency. Their instincts need conceptual guidance.

... The objectives build on the role of financial reporting and underlie the definitions of financial statement elements. Acceptance of the definitions provides the necessary discipline for order. Instead of arguing about the definitions, the FASB, as well as its constituents, now focuses attention on whether a matter in a given situation meets the conditions of a definition. That contributes to efficiency and furthers the chances of consistency.<sup>131</sup>

### **THE FASB CONCEPTS STATEMENTS**

The Concepts Statements set forth the objectives and conceptual foundation of financial accounting that are the basis for the development of financial accounting and reporting standards. This section of the book discusses the individual Concepts Statements in a logical order according to their subject matter. The objectives of financial reporting constitute the subject matter of Concepts Statement No. 1, *Objectives of Financial Reporting by Business Enterprises*, and Concepts Statement No. 4, *Objectives of Financial Reporting by Nonbusiness Organizations*. The qualities that make accounting information useful for investment, credit, and other resource allocation decisions are described in Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*. Concepts Statements No. 3 and No. 6 define the *Elements of Financial Statements*. Finally, Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, describes a complete set of financial statements and what is meant by recognition and measurement.

#### **Objectives of Financial Reporting**

After the FASB received the report of the Trueblood Study Group, *Objectives of Financial Statements*, in October 1973, it issued a Discussion Memorandum, *Conceptual Framework for Accounting and Reporting: Consideration of the Report of the Study Group on the Objectives of Financial Statements*, in June 1974. The Discussion Memorandum was based primarily on the Trueblood Report's twelve objectives of financial statements and seven qualitative characteristics of reporting. The Board held a public hearing in September and began to develop its own conclusions on the objectives.

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<sup>131</sup>Gellein, "Financial Reporting: The State of Standard Setting," page 13.

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### **Concepts Statement No. 1**

In December 1976, the Board published for comment a draft entitled *Tentative Conclusions on Objectives of Financial Statements of Business Enterprises* and a Discussion Memorandum, *Conceptual Framework for Financial Accounting and Reporting: Elements of Financial Statements and Their Measurement*. Although the Trueblood Report included an objective of financial statements for governmental and not-for-profit organizations, the FASB had decided to concentrate its initial efforts on formulating objectives of financial statements of business enterprises. Following a public hearing on those publications the following August, the Board issued an Exposure Draft, *Objectives of Financial Reporting and Elements of Financial Statements of Business Enterprises*, in December 1977. Concepts Statement No. 1, *Objectives of Financial Reporting by Business Enterprises*, was issued in November 1978.

The change in title between the Tentative Conclusions and the Exposure Draft indicated a change in the Board's perspective from a focus on financial statements to financial reporting. To a significant extent, it reflected comments received on the Tentative Conclusions document. The change also emphasized that financial statements were the primary, but not the only, means of conveying financial information to users. During the Board's consideration of objectives, it had decided that for general purpose external financial reporting, the objectives of financial statements and the objectives of financial reporting are essentially the same, although, as the Statement said, some information is better provided by financial statements and other information is better provided by other means of financial reporting (paragraph 5).

That brief sketch of the background of the Statement has touched only certain points. Concepts Statement 1, like all of the Concepts Statements, contains an appendix on its background (paragraphs 57-63).

### ***Concepts Statement No. 1 and the Trueblood Group's Objectives***

The FASB accepted the starting point and basic objective in the report of the Trueblood Study Group and, although some differences in direction had begun to appear in the supporting discussion, accepted in a general way the group's second and third objectives. These excerpts are from the Study Group's report:

Accounting is not an end in itself. . . .

The basic objective of financial statements is to provide information useful for making economic decisions.

An objective of financial statements is to serve primarily those users who have limited authority, ability, or resources to obtain information and who rely on financial statements as their principal source of information about an enterprise's economic activities.

An objective of financial statements is to provide information useful to investors and creditors for predicting, comparing, and evaluating potential

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cash flows to them in terms of amount, timing, and related uncertainty. [pages 61 and 62]

These excerpts are from Concepts Statement 1:

Financial reporting is not an end in itself but is intended to provide information that is useful in making business and economic decisions—for making reasoned choices among alternative uses of scarce resources in the conduct of business and economic activities. [paragraph 9]

The objectives in this Statement . . . stem primarily from the informational needs of external users who lack the authority to prescribe the financial information they want from an enterprise and therefore must use the information that management communicates to them. [paragraph 28]

Potential users of financial information most directly concerned with a particular business enterprise are generally interested in its ability to generate favorable cash flows because their decisions relate to amounts, timing, and uncertainties of expected cash flows. To investors, lenders, suppliers, and employees, a business enterprise is a source of cash in the form of dividends or interest and perhaps appreciated market prices, repayment of borrowing, payment for goods or services, or salaries or wages. They invest cash, goods, or services in an enterprise and expect to obtain sufficient cash in return to make the investment worthwhile. They are directly concerned with the ability of the enterprise to generate favorable cash flows and may also be concerned with how the market's perception of that ability affects the relative prices of its securities. [paragraph 25]

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. [paragraph 34]

None of the other nine objectives of the Study Group were adopted in recognizable form in Concepts Statement 1. Many of them were about matters that the Board had decided to include in the recognition, measurement, and display parts of the conceptual framework.

### **Concepts Statement No. 4**

By 1977 the fiscal problems of a number of large cities, including New York and Cleveland, had prompted public officials and private citizens increasingly to question the relevance and reliability of financial reporting by governmental and not-for-profit organizations. That concern was reflected in many legislative initiatives and widely publicized allegations of serious deficiencies in the financial reporting of various kinds of not-for-profit organizations.

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The Board began to consider concepts underlying general purpose external financial reporting by not-for-profit organizations by commissioning a research report to identify the objectives of financial reporting by organizations other than business enterprises. That report, *Financial Accounting in Nonbusiness Organizations*, by Robert N. Anthony, was published in May 1978. Rather than delay progress on the objectives of financial reporting by business enterprises by attempting to include not-for-profit organizations within its scope, the Board decided to proceed with two separate objectives projects. It issued a Discussion Memorandum based on the research report, followed by an Exposure Draft. Then, *Objectives of Financial Reporting by Nonbusiness Organizations* was issued as Concepts Statement 4 in December 1980. After Concepts Statement 4 was issued, the FASB changed the key term from *nonbusiness* to *not-for-profit* organizations.

### **Effects of Environment and Information Needs of Resource Providers**

Concepts Statement 1 and Concepts Statement 4 have the same structure. Both sets of objectives are based on the fundamental notion that financial reporting concepts and standards should be based on the information needs of users of financial statements who make decisions about committing resources to either business enterprises or not-for-profit organizations with the expectation of pecuniary reward or to not-for-profit organizations for reasons other than expectations of monetary return or return on resources committed. From that broad focus, the Statements narrow the focus, on the one hand, to the primary interest of investors, creditors, and other users in the prospects of receiving cash from their investments in or loans to business enterprises and the relationship of their prospects to those of the enterprise, and on the other hand, to the needs of resource providers for information about a not-for-profit organization's services, its ability to continue to provide them, and the relationship of management's stewardship to the organization's performance. Finally, both Statements focus on the kinds of information that financial reporting can provide to meet the respective needs of both groups.

The objectives of financial reporting cannot be properly understood apart from the environmental context in which they have been developed—the real world in which financial accounting and reporting takes place. They are affected by the economic, legal, political, and social environment of the United States. The objectives “stem largely from the needs of those for whom the information is intended, which in turn depend significantly on the nature of the economic activities and decisions with which the users are involved” (Concepts Statement 1, paragraph 9). Thus, Concepts Statement 1 describes the highly developed exchange economy of the United States, in which:

- Most goods and services are exchanged for money or claims to money instead of being consumed by their producers.
- Most productive activity is carried on through investor-owned business enterprises whose operations are controlled by directors and professional managers acting in the interests of investor-owners.

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- Well-developed securities markets tend to allocate scarce resources to enterprises that use them efficiently.
- Productive resources are generally privately rather than government owned, although government intervenes in the resource allocation process through taxation, borrowing and spending for government operations and programs, regulation, subsidies, or monetary and fiscal policy.

Cash is important in the economy “because of what it can buy. Members of the society carry out their consumption, saving, and investment decisions by allocating their present and expected cash resources” (Concepts Statement 1, paragraph 10). Entities’ efficient allocation of cash and other economic resources is a means to the desired end of a well-functioning, healthy economy. The following excerpt from Concepts Statement 1 describes how financial reporting can contribute to achieving that social good. It refers to reporting about business enterprises, but its premise relates as well to the objectives of financial reporting of not-for-profit organizations.

The effectiveness of individuals, enterprises, markets, and government in allocating scarce resources among competing uses is enhanced if those who make economic decisions have information that reflects the relative standing and performance of business enterprises to assist them in evaluating alternative courses of action and the expected returns, costs, and risks of each. The function of financial reporting is to provide information that is useful to those who make economic decisions about business enterprises and about investments in or loans to business enterprises. [paragraph 16]

Business enterprises and not-for-profit organizations have both similarities and differences in their operating environments that affect the information needs of those who make decisions about them and thus affect the objectives of financial reporting. Both kinds of entities have transactions with suppliers of goods and services who expect to be paid for what they provide, with employees who expect to be paid for their work, and with lenders who expect to be repaid with interest. Both entities may sell the goods or services they produce, although to survive, business enterprises charge prices sufficient to cover their costs, usually plus a profit, whereas not-for-profit organizations often may sell below cost or at nominal prices or may even give their outputs to beneficiaries without charge.

Not-for-profit organizations commonly need certain kinds of control arrangements more than do business enterprises. Although not-for-profit organizations must often compete not only with each other but also with business enterprises for goods and services, employees, and lendable funds, the operating performance of business enterprises generally is subject to the discipline of market controls to a greater extent than is the performance of not-for-profit organizations because business enterprises must compete in equity markets for funds to finance their operations while not-for-profit organizations do not.



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Spending mandates and budgets to control uses of resources are significant factors in obtaining and allocating resources for not-for-profit organizations to compensate for the lesser influence of direct market competition.

Business enterprises and not-for-profit organizations also differ in their relationships to some significant resource providers. Business enterprises have stockholders or other owners who invest with the expectation of receiving profits commensurate with the risks incurred. In contrast, not-for-profit organizations have no owners in the same sense as business enterprises and often receive significant amounts of resources by gift or donation from those who do not expect pecuniary returns. Those contributors are interested in the services the organizations provide and receive compensation for their contributions by nonfinancial means, such as by seeing the purposes and goals of the organizations advanced.

### **Objectives of Financial Reporting by Business Enterprises**

The objectives of financial reporting by business enterprises are derived from the information needs of investors, creditors, and others outside an enterprise who generally lack the authority to prescribe the information they want and thus must rely on information that management communicates to them. They are the primary users of the information provided by general purpose external financial reporting, whose primary objective is to

provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit, and similar decisions. [Concepts Statement 1, paragraph 34]

The objectives of general purpose external financial reporting are not derived from and do not comprehend satisfying the information needs of all potential users. Regulatory and taxing authorities, for example, have needs for special kinds of financial information that is not normally provided by financial reporting but also have the statutory authority to obtain the specific information they need. Thus they do not have to rely on information provided to other groups. Management is interested in the information provided by external financial reporting but also has ready access not only to that information but also to a great deal of internal information that is normally unavailable to those outside the enterprise. Management's primary role in external financial reporting is that of a provider or communicator of information for use by investors, creditors, and others outside the enterprise who must rely on management for information.

In emphasizing the information needs of investors, creditors, and similar users, the FASB recognized that external financial reporting cannot satisfy the particular and perhaps diverse needs of various individual users who look to the information provided by financial reporting for assistance in making resource allocation decisions. However, those

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who make investment, credit, and similar decisions do have common, overlapping interests in the ability of a business enterprise to generate favorable cash flows. It is the common interest in an enterprise's cash flow potential that the objectives of external financial reporting seek to satisfy.

The objectives in Concepts Statement 1 focus financial reporting on a particular kind of economic decision—the decision to commit or to continue to commit cash or other resources to a business enterprise with the expectation of payment or of future return of and return on the investment, usually in cash but sometimes in other goods and services. That kind of decision is made by investors, creditors, suppliers, employees, and other potential users of financial information, and they are interested in net cash inflows to the enterprise because their own prospects for receiving cash flows from investments in, loans to, or other participation in an enterprise depend significantly on its ability to generate favorable cash flows.

Financial reporting should provide information to help present and potential investors and creditors and other users in assessing the amounts, timing, and uncertainty of prospective cash receipts from dividends or interest and the proceeds from the sale, redemption, or maturity of securities or loans. The prospects for those cash receipts are affected by an enterprise's ability to generate enough cash to meet its obligations when due and its other cash operating needs, to reinvest in operations, and to pay cash dividends and may also be affected by perceptions of investors and creditors generally about that ability, which affect market prices of the enterprise's securities. Thus, financial reporting should provide information to help investors, creditors, and others assess the amounts, timing, and uncertainty of prospective net cash inflows to the related enterprise. [Concepts Statement 1, paragraph 37]

Concepts Statement 1 explicitly recognizes that financial reporting does not and cannot provide all of the information needed by those who make economic decisions about business enterprises. It is but one source. Information provided by financial reporting needs to be combined with information about, among other things, the general economy, political climate, and prospects for an enterprise's particular industry or industries.

The objectives ultimately focus on the kind of information that fulfills the users' needs described and that the accounting system can provide better than other sources: information about assets, liabilities, and changes in them. Thus financial reporting should

provide information about the economic resources of an enterprise, the claims to those resources (obligations of the enterprise to transfer resources to other entities and owners' equity), and the effects of transactions, events, and circumstances that change resources and claims to those resources. [Concepts Statement 1, paragraph 40]

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That includes information about an enterprise's assets, liabilities, and owners' equity; information about enterprise performance provided by measures of comprehensive income (called *earnings* in Concepts Statement 1) and its components; information about liquidity, solvency, and funds flows; information about management stewardship and performance; and management's explanations and interpretations (paragraphs 41-54).

### **Objectives of Financial Reporting by Not-for-Profit Organizations**

The objectives of financial reporting by not-for-profit organizations are derived from the information needs of external resource providers who, like investors and creditors of business enterprises, generally cannot prescribe the information they want and thus must rely on information that management communicates to them. They are the primary users of the information provided by general purpose external financial reporting, whose primary objective is to

provide information that is useful to present and potential resource providers and other users in making rational decisions about the allocation of resources to those organizations. [Concepts Statement 4, paragraph 35]

Resource providers encompass those who receive direct compensation for providing resources, including lenders, suppliers, and employees, as well as members, contributors, taxpayers, and others who are concerned with a not-for-profit organization's activities but who are not directly and proportionately compensated financially for their involvement.

The objectives flow from the common interests of those who provide resources to not-for-profit organizations in the services those organizations provide and in their continuing ability to provide services. Because the goals of not-for-profit organizations are to provide services rather than to generate profits,

[f]inancial reporting should provide information to help present and potential resource providers and other users in assessing the services<sup>17</sup> that a [not-for-profit] organization provides and its ability to continue to provide those services. They are interested in that information because the services are the end for which the resources are provided. The relation of the services provided to the resources used to provide them helps resource providers and others assess the extent to which the organization is successful in carrying out its service objectives. [Concepts Statement 4, paragraph 38]

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<sup>17</sup>The term *services* in this context encompasses the goods as well as the services a [not-for-profit] organization may provide.

The kinds of controls imposed on the operations of not-for-profit organizations to compensate for the reduced influence of markets significantly affect the objectives of their financial reporting. Alternative controls, such as specific budgetary appropriations that

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may limit the amount an organization is allowed to spend for a particular program or donor-imposed restrictions on the use of resources, usually place a special stewardship responsibility on managers to ensure that resources are used for their intended purposes. Those kinds of spending mandates tend to have a pervasive effect on the conduct and control of the activities of not-for-profit organizations. Because of the nature of the resources entrusted to managers of not-for-profit organizations, Concepts Statement 4 identifies the evaluation of management stewardship and performance information as an objective of the financial reporting of not-for-profit organizations:

Financial reporting should provide information that is useful to present and potential resource providers and other users in assessing how managers of a [not-for-profit] organization have discharged their stewardship responsibilities and about other aspects of their performance. [Concepts Statement 4, paragraph 40]

Management stewardship is of concern to investors and creditors of business enterprises and resource providers of not-for-profit organizations. Both kinds of resource providers hold management accountable not only for the custody and safekeeping of an organization's resources but also for their efficient and effective use. Concepts Statement 1 identifies comprehensive income as the common focus for assessing management's stewardship or accountability (paragraph 51). Since profit figures are not available for not-for-profit organizations, Concepts Statement 4 instead delineates information about an organization's performance as the focus for assessing management stewardship. It says that financial reporting can provide information about the extent to which managers have acted in accordance with provisions specifically designated by donors. Information about departures from budget mandates or donor-imposed stipulations that may adversely affect an organization's financial performance or its ability to provide a satisfactory level of services is important in assessing how well managers have discharged their stewardship responsibilities.

The objectives of not-for-profit organizations, like those of business enterprises, ultimately focus on the kind of information that the accounting system can provide better than other sources:

Financial reporting should provide information about the economic resources, obligations, and net resources of an organization and the effects of transactions, events, and circumstances that change resources and interests in those resources. [Concepts Statement 4, paragraph 43]

Resources are the lifeblood of an organization in the sense that it must have resources to render services. Since resource providers tend to direct their interest to information about how an organization acquires and uses its resources, financial reporting should provide information about an organization's assets, liabilities, and net assets; information about

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its performance, such as about the nature of and relation between resource inflows and outflows and about service efforts and accomplishments; information about liquidity; and managers' explanations and interpretations (paragraphs 44-55).

### **Keeping the Objectives in Perspective**

Financial accounting information is not intended to measure directly the value of a business enterprise. Nor is it intended to determine or influence the decisions that are made with information it provides about business enterprises and not-for-profit organizations. Its function is to provide the neutral or unbiased information that investors, creditors, various resource providers, and others who are interested in the activities of business enterprises and not-for-profit organizations can use in making those decisions. If financial information were directed toward a particular goal, such as encouraging the reallocation of resources toward particular business enterprises or industries or in favor of certain programs or activities of not-for-profit organizations, it would not be serving its broader objective of providing information useful for resource allocation decisions.

Moreover, as Concepts Statement 1 says, financial reporting is not financial analysis:

Investors, creditors, and others often use reported [income] and information about the components of [income] in various ways and for various purposes in assessing their prospects for cash flows from investments in or loans to an enterprise. For example, they may use [income] information to help them (a) evaluate management's performance, (b) estimate "earning power" or other amounts they perceive as "representative" of long-term earning ability of an enterprise, (c) predict future [income], or (d) assess the risk of investing in or lending to an enterprise. They may use the information to confirm, reassure themselves about, or reject or change their own or others' earlier predictions or assessments. Measures of [income] and information about [income] disclosed by financial reporting should, to the extent possible, be useful for those and similar uses and purposes.

However, accrual accounting provides measures of [income] rather than evaluations of management's performance, estimates of "earning power," predictions of [income], assessments of risk, or confirmations or rejections of predictions or assessments. Investors, creditors, and other users of the information do their own evaluating, estimating, predicting, assessing, confirming, or rejecting. For example, procedures such as averaging or normalizing reported [income] for several periods and ignoring or averaging out the financial effects of "nonrepresentative" transactions and events are commonly used in estimating "earning power." However, both the concept of "earning power" and the techniques for estimating it are part of financial

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analysis and are beyond the scope of financial reporting. [paragraphs 47 and 48; *income* has been substituted for *earnings*, which the Board replaced with *comprehensive income* after Concepts Statement 1]

### **Qualitative Characteristics of Accounting Information**

“The objectives of financial reporting underlie judgments about the qualities of financial information, for only when those objectives have been established can a start be made on defining the characteristics of the information needed to attain them” (Concepts Statement 2, paragraph 21). Having concluded in Concepts Statement 1 that to provide information useful for making investment, credit, and similar decisions is the primary objective of financial reporting, the FASB elaborated on the corollary to that objective in Concepts Statement 2: that the usefulness of financial information for decision making should be the primary quality to be sought in determining what to encompass in financial reporting. The qualities that make accounting information useful have been designated its “qualitative characteristics.” The term was originally used by the Trueblood Study Group, but the idea of articulating the qualities of information that contribute to its usefulness in decision making has its genesis in the authoritative literature in APB Statement 4. That Statement described them as “qualitative objectives,” which “aid in determining which resources and obligations and changes should be measured and reported and how they should be measured and reported to make the information most useful” (paragraph 84).

Both APB Statement 4 and the Trueblood Report are direct antecedents of the FASB Concepts Statements because emphasis on decision making by investors and creditors represented a departure from the AICPA’s traditional view that financial statements primarily reported to present stockholders on management’s stewardship of the corporation. Unless stewardship means mere custodianship, however, stockholders need essentially the same information for that purpose as they do for making investment decisions (Concepts Statement 1, paragraphs 50-53).

### **Concepts Statement No. 2**

Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*, is described as a bridge between Concepts Statement 1 and the other Statements on elements of financial statements, recognition and measurement, and display. It connects the Statements on objectives, which concern the purposes of financial reporting, with the later Concepts Statements and Standards Statements, which deal with how to attain those purposes, by sharing “with its constituents [the Board’s] thinking about the characteristics that the information called for in its standards should have. It is those characteristics that distinguish more useful accounting information from less useful information” (paragraph 1).

When Concepts Statement 2 was issued, the Board noted that its discussion of the qualitative characteristics referred primarily to business enterprises but that it had tenta-

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tively concluded that the qualities also applied to the financial reporting of not-for-profit organizations. In Concepts Statement 6, in 1985, the Board formally amended Concepts Statement 2 to apply to both business enterprises and not-for-profit organizations by giving it a new paragraph 4:

The qualities of information discussed in this Statement apply to financial information reported by business enterprises and by not-for-profit organizations. Although the discussion and the examples in this Statement are expressed in terms commonly related to business enterprises, they generally apply to not-for-profit organizations as well. “Objectives of financial reporting by business enterprises,” “investors and creditors,” “investment and credit decisions,” and similar terms are intended to encompass their counterparts for not-for-profit organizations, “objectives of financial reporting by not-for-profit organizations,” “resource providers,” “resource allocation decisions,” and similar terms.

Accountants are required to make a large number of choices—about the criteria by which assets and liabilities and revenues and expenses are to be recognized and the attribute(s) of assets and liabilities to be measured; about methods of allocation; about the level of aggregation or disaggregation of the information to be disclosed in financial reports. Accounting standards issued by the designated standards-setting body narrow the scope for individual choice, but accounting choices will always have to be made, whether between choices for which no standard has been promulgated or between alternative ways of implementing a standard.

To maximize the usefulness of accounting information, subject to considerations of the cost of providing it, entails choices between alternative accounting methods. Those choices will be made more wisely if the ingredients that contribute to “usefulness” are better understood. [Concepts Statement 2, paragraph 5]

By defining the qualities that make accounting information useful, Concepts Statement 2 is intended to enable the Board and its staff to provide direction for developing accounting standards consistent with the objectives of financial reporting, which are oriented toward providing useful information for making investment, credit, and similar decisions:

The central role assigned here to decision making leads straight to the overriding criterion by which all accounting choices must be judged. The better choice is the one that, subject to considerations of cost, produces from among the available alternatives information that is most useful for decision making. [Concepts Statement 2, paragraph 30]

### **A Hierarchy of Accounting Qualities**

Concepts Statement 2 examines the characteristics that make accounting information useful, and the FASB has gone to considerable effort to lay out what *usefulness* means. Usefulness for making investment, credit, and similar decisions is the most important quality in its “Hierarchy of Accounting Qualities”: “The characteristics of information that make it a desirable commodity guide the selection of preferred accounting policies from among available alternatives. . . . Without usefulness, there would be no benefits from information to set against its costs. The hierarchy is represented in [Figure 3]” (Concepts Statement 2, paragraph 32).

Usefulness is a high-level abstraction. To serve as a meaningful criterion or standard against which to judge the results of financial accounting, usefulness needs to be made more concrete and specific by analyzing it into its components at lower levels of abstraction. The two primary components of usefulness are relevance and reliability. While those concepts are more concrete than usefulness, they are still quite abstract. That is why Concepts Statement 2 focuses at a still more concrete level, where the concepts of predictive value and feedback value, timeliness, representational faithfulness, verifiability, neutrality, and comparability together serve as criteria for determining information’s usefulness.

For accounting standards setting, usefulness cannot be interpreted to mean whatever a particular individual interprets it to mean. A judgment that a piece of information is useful must be the result of a careful analysis that confirms first that the information possesses the qualities at the most concrete level of the hierarchy. Is it timely and does it have predictive or feedback value or both? Is it representationally faithful, verifiable, and neutral? If it has those characteristics, it is relevant and reliable. Only then, if information has survived that kind of examination, can it be deemed useful.

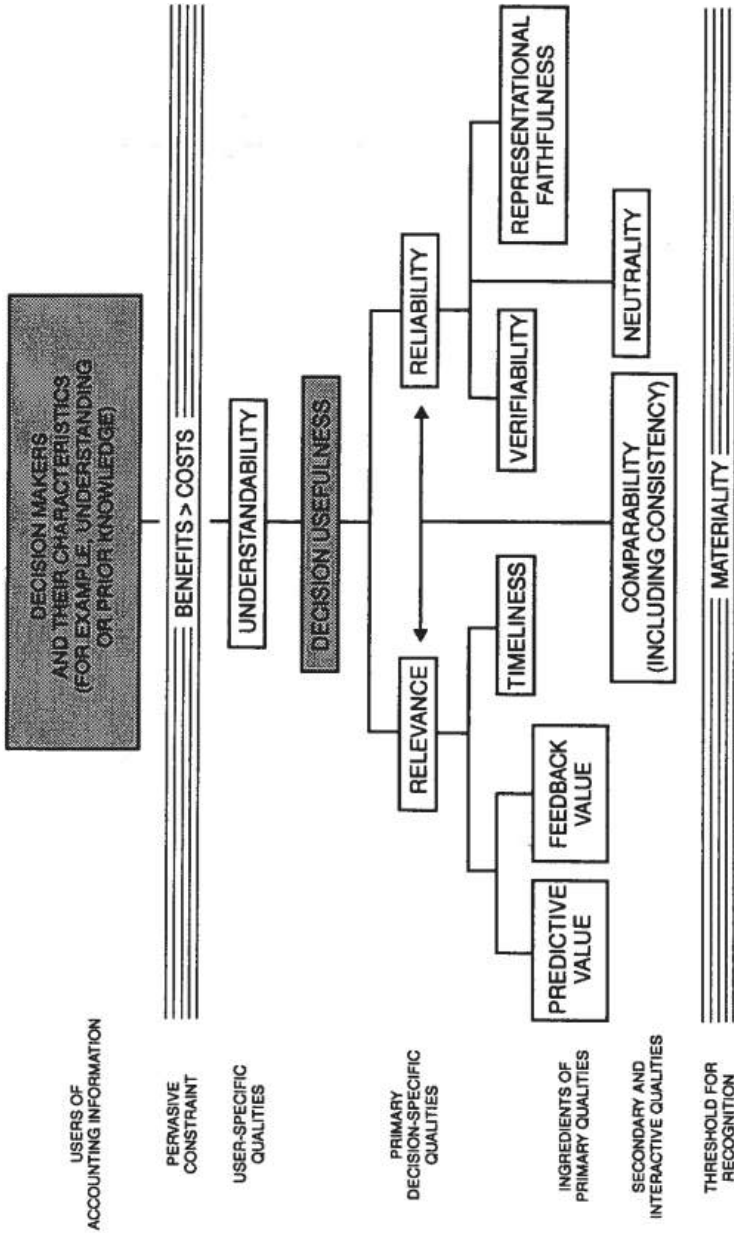
The chart also shows two constraints, primarily quantitative rather than qualitative in nature. The *pervasive constraint* is that the benefits of information should exceed its cost. Information that would be useful for a decision may be just too expensive to justify providing it. The second constraint is a *materiality threshold*, meaning that “the requirement that information be reliable can still be met even though it may contain immaterial errors, for errors that are not material will not perceptibly diminish its usefulness” (paragraph 33).

The hierarchy distinguishes between user-specific and decision-specific qualities because whether a piece of information is useful to a particular decision by a particular decision maker depends in part on the decision maker. Usefulness depends on a decision maker’s degree of prior knowledge of the information as well as on his or her ability to understand it.

The better informed decision makers are, the less likely it is that any new information can add materially to what they already know. That may make the new information less useful, but it does not make it less relevant to the



Figure 3  
A Hierarchy of Accounting Qualities



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situation. If an item of information reaches a user and then, a little later, the user receives the same item from another source, it is not less relevant the second time, though it will have less value. For that reason, relevance has been defined in this Statement (paragraphs 46 and 47) in terms of the capacity of information to make a difference (to someone who does not already have it) rather than in terms of the difference it actually does make. The difference it actually does make may be more a function of how much is already known (a condition specific to a particular user) than of the content of the new messages themselves (decision-specific qualities of information). [Concepts Statement 2, paragraph 37]

Similarly, the ability to understand a pertinent piece of information relates more to the characteristics of users for whom the information is intended than to the information itself. Even though information may be relevant to a decision, it will not be useful to a person who cannot understand it.

In Concepts Statement 1, the Board said that information provided by financial reporting “should be comprehensible to those who have a reasonable understanding of business and economic activities and are willing to study the information with reasonable diligence” (paragraph 34). But information’s relevance may transcend the ability of a user to recognize its import:

Financial information is a tool and, like most tools, cannot be of much direct help to those who are unable or unwilling to use it or who misuse it. Its use can be learned, however, and financial reporting should provide information that can be used by all—nonprofessionals as well as professionals—who are willing to learn to use it properly. Efforts may be needed to increase the understandability of financial information. Cost-benefit considerations may indicate that information understood or used by only a few should not be provided. Conversely, financial reporting should not exclude relevant information merely because it is difficult for some to understand or because some investors or creditors choose not to use it. [Concepts Statement 1, paragraph 36]

Understandability of information is governed by a combination of user characteristics and characteristics inherent in the information, which is why understandability and other user-specific characteristics occupy a position in the hierarchy of qualities as a link between the characteristics of users (decision makers) and decision-specific qualities of information. [Concepts Statement 2, paragraph 40]

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The two primary decision-specific qualities that make accounting information useful for decision making are relevance and reliability. If either is missing completely from a piece of information, the information will not be useful. In choosing between accounting alternatives, one should strive to produce information that is both as relevant and as reliable as possible, but at times it may be necessary to sacrifice some degree of one quality for a gain in the other.

### **Relevance**

“To be relevant to investors, creditors, and others for investment, credit, and similar decisions, accounting information must be capable of making a difference in a decision by helping users to form predictions about the outcomes of past, present, and future events or to confirm or correct expectations” (Concepts Statement 2, paragraph 47). That definition of relevance is more explicit than the dictionary meaning of relevance as bearing on or relating to the matter in hand. As alluded to earlier, prior knowledge of information may diminish its value but not its relevance and, hence, its usefulness, for it is information’s ability to “make a difference” that makes it relevant to a decision.

Statements about relevance of financial statement information must answer the question “relevant to whom for what purpose?” For information to be judged relevant, an object to which it is relevant must always be understood.

### *Predictive Value and Feedback Value*

To be relevant, information must have predictive value or feedback value or both.

Information can make a difference to decisions by improving decision makers’ capacities to predict or by confirming or correcting their earlier expectations. Usually, information does both at once, because knowledge about the outcome of actions already taken will generally improve decision makers’ abilities to predict the results of similar future actions. Without a knowledge of the past, the basis for a prediction will usually be lacking. Without an interest in the future, knowledge of the past is sterile. [Concepts Statement 2, paragraph 51]

David Solomons, consultant on and major contributor to Concepts Statement 2, said in his book, *Making Accounting Policy*, that “whereas predictive value is forward-looking and is derived directly from its power to guide decisions, feedback value is derived from what information tells about the past.” He gives as an example of a balance sheet item with predictive value the allowance for uncollectible receivables, which is the amount of accounts receivable that is not expected to produce future cash flows. The

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most important figure in financial statements with feedback value is the earnings figure, which “conveys information about the success of the ventures that have been invested in and also about the performance of the managers who have been responsible for running the business.”<sup>132</sup>

To say that accounting information has predictive value is not to say that in itself it constitutes a prediction (Concepts Statement 2, paragraph 53). Predictive value means value as an input into a predictive process, not value directly as a prediction. It is “the quality of information that helps users to increase the likelihood of correctly forecasting the outcome of past or present events” (Concepts Statement 2, glossary). Information about the present state of economic resources or obligations or about an enterprise’s past performance is commonly a basis for expectations. Information is relevant if it can reduce the uncertainty surrounding a decision. It is relevant “if the degree of uncertainty about the result of a decision that has already been made is confirmed or altered by the new information; it need not alter the decision” (Concepts Statement 2, paragraph 49).

### ***Timeliness***

To be relevant, information also must be timely. Timeliness means “[h]aving information available to a decision maker before it loses its capacity to influence decisions” (Concepts Statement 2, glossary). Information that is not available when it is needed or becomes available only long after it has value for future action is useless. “Timeliness alone cannot make information relevant, but a lack of timeliness can rob information of relevance it might otherwise have had” (Concepts Statement 2, paragraph 56).

### ***Reliability***

Reliability is the quality of information that allows those who use it to depend on it with confidence. “The reliability of a measure rests on the faithfulness with which it represents what it purports to represent, coupled with an assurance for the user, which comes through verification, that it has that representational quality” (Concepts Statement 2, paragraph 59). The hierarchy of qualities decomposes reliability into two components, representational faithfulness and verifiability, with neutrality shown to interact with them.

### ***Representational Faithfulness***

Representational faithfulness is “correspondence or agreement between a measure or description and the phenomenon it purports to represent. In accounting, the phenomena to be represented are economic resources and obligations and the transactions and events that change those resources and obligations” (Concepts Statement 2, paragraph 63). The

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<sup>132</sup>David Solomons, *Making Accounting Policy: The Quest for Credibility in Financial Reporting* (New York: Oxford University Press, Inc., 1986), pages 89 and 90.

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FASB's conceptual framework emphasizes that accounting is a representational discipline. It represents things in the financial statements that exist in the real world. Therefore, the correspondence between the accounting representation and the thing being represented is critical.

Concepts Statement 2 uses an analogy with mapmaking to illustrate what it means by representational faithfulness:

A map represents the geographical features of the mapped area by using symbols bearing no resemblance to the actual countryside, yet they communicate a great deal of information about it. The captions and numbers in financial statements present a "picture" of a business enterprise and many of its external and internal relationships more rigorously—more informatively, in fact—than a simple description of it. [paragraph 24]

Just as the lines and shapes on a road map represent roads, rivers, and geographical boundaries, so also descriptions and amounts in financial statements represent cash, property, sales, and a host of things owned or owed by an entity as well as transactions and other events and circumstances that affect them or their values. The items in financial statements have a higher degree of reliability as quantitative representations of economic things and events in the real world—and therefore more usefulness to investors and other parties interested in an entity's activities—if they faithfully represent what they purport to represent. Since the benefit of the information is representational and not aesthetic, to take "artistic license" with the data decreases rather than increases its benefit. Just as a cartographer cannot add roads, bridges, and lakes where none exist, an accountant cannot add imaginary items to financial statements without spoiling the representational faithfulness, and ultimately the usefulness, of the information.

Striving for representational faithfulness does not comprehend creating an exact replica of the activities of an enterprise. Perfect information is as beyond the reach of accountants as it is of nonaccountants.

The financial statements of a business enterprise can be thought of as a representation of the resources and obligations of an enterprise and the financial flows into, out of, and within the enterprise—as a model of the enterprise. Like all models, it must abstract from much that goes on in a real enterprise. No model, however sophisticated, can be expected to reflect all the functions and relationships that are found within a complex organization. To do so, the model would have to be virtually a reproduction of the original. In real life, it is necessary to accept a much smaller degree of correspondence between the model and the original than that. One can be satisfied if none of the important functions and relationships are lost. . . . The mere fact that a model works—that when it receives inputs it produces outputs—gives no assurance that it faithfully represents the original. Just as

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a distorting mirror reflects a warped image of the person standing in front of it . . . , so a bad model gives a distorted representation of the system that it models. The question that accountants must face continually is how much distortion is acceptable. [Concepts Statement 2, paragraph 76]

### *Completeness*

Completeness of information is an important aspect of representational faithfulness, and thus of reliability, because if financial statements are to faithfully represent an enterprise's financial position and changes in financial position, none of the significant financial functions of the enterprise or its relationships can be lost or distorted. Completeness is defined as "the inclusion in reported information of everything material that is necessary for faithful representation of the relevant phenomena" (Concepts Statement 2, glossary). Financial statements are incomplete, and therefore not representationally faithful, if, for example, an enterprise owns an office structure but reports no "building" or similar asset on its balance sheet.

Completeness also is necessary to relevance, the other primary quality that makes accounting information useful:

Relevance of information is adversely affected if a relevant piece of information is omitted, even if the omission does not falsify what is shown. For example, in a diversified enterprise a failure to disclose that one segment was consistently unprofitable would not, before the issuance of FASB Statement No. 14, *Accounting for Segments of a Business Enterprise*, have caused the financial reporting to be judged unreliable, but that financial reporting would have been (as it would now be) deficient in relevance. [Concepts Statement 2, paragraph 80]

Although completeness implies showing what is material and feasible, it must always be relative. Financial statements cannot show everything or they would be prohibitively expensive to provide.

### *Verifiability*

Verifiability is "the ability through consensus among measurers to ensure that information represents what it purports to represent or that the chosen method of measurement has been used without error or bias" (Concepts Statement 2, glossary). Verifiability is an essential component of reliability—to be reliable, accounting information must be both representationally faithful and verifiable: "The reliability of a measure rests on the faithfulness with which it represents what it purports to represent, coupled with an assurance for the user, which comes through verification, that it has that representational

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quality” (Concepts Statement 2, paragraph 59). Verifiability fulfills a significant but relatively narrow function.

In summary, verifiability means no more than that several measurers are likely to obtain the same measure. It is primarily a means of attempting to cope with measurement problems stemming from the uncertainty that surrounds accounting measures and is more successful in coping with some measurement problems than others. . . . [A] measure with a high degree of verifiability is not necessarily relevant to the decision for which it is intended to be useful. [Concepts Statement 2, paragraph 89]

Three ideas are the focus of the discussion in Concepts Statement 2 of verifiability and its relation to reliability:

1. Accounting information is verifiable if accounting measures obtained by one measurer can be confirmed or substantiated by having other measurers measure the same phenomenon with essentially the same results.

Verification implies consensus. Verifiability can be measured by looking at the dispersion of a number of independent measurements of some particular phenomenon. The more closely the measurements are likely to be clustered together, the greater the verifiability of the number used as a measure of the phenomenon.

Some accounting measurements are more easily verified than others. Alternative measures of cash will be closely clustered together, with a consequently high level of verifiability. There will be less unanimity about receivables (especially their net value), still less about inventories, and least about depreciable assets. . . . [Concepts Statement 2, paragraphs 84 and 85]

2. The purpose of verification is to confirm the representational faithfulness of accounting information—to provide a significant degree of assurance to a user that accounting measures essentially agree with or correspond to the economic things and events that they represent (Concepts Statement 2, paragraphs 59, 81, and 86). Accounting information may not be representationally faithful because measurer bias or measurement bias (or both) gives a measure the tendency to be consistently too high or too low instead of being equally likely to fall above and below what it represents. Measurer bias is introduced if a measurer, unintentionally through lack of skill or intentionally through lack of integrity, or both, wrongly applies the chosen measurement method. Measurement bias results from using a biased measurement method (Concepts Statement 2, paragraphs 77, 78, and 82). Representational faithfulness is adversely affected if information is intentionally biased to attain a predetermined result

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or induce a particular mode of behavior, a possibility that is discussed in the next section on neutrality.

3. The extent to which verifiability adds reliability to accounting information depends on whether

an accounting measure itself has been verified or only . . . the procedures used to obtain the measure have been verified. For example, the price paid to acquire a block of marketable securities or a piece of land is normally directly verifiable, while the amount of depreciation for a period is normally only indirectly verifiable by verifying the depreciation method, calculations used, and consistency of application. . . . [Concepts Statement 2, paragraph 87]

In present practice, for example, the result of measuring the quantity of an inventory is directly verifiable, while the result of measuring the carrying amount or book value of the inventory is only indirectly verifiable—the auditing process checks on the accuracy or verity of the inputs and recalculates the outputs but does not verify them.

For quantities there is a well-defined formal system (perpetual inventory system) which specifies the relevant empirical inputs (receipts and issues) and the output provides an expectation or prediction of the quantity on hand. The physical count is a separate [or direct] verification of that output.

For book values there is disagreement about the formal system (lifo or fifo) and disagreement about the relevant inputs (which costs are to be attached [to inventory] and which are to be expensed). The output [book value of the inventory on hand] . . . is not separately verifiable.<sup>133</sup>

Measures of the quantity of the inventory resulting from the perpetual inventory system and the physical count verify each other if they essentially agree. Independent measures of a phenomenon need not use the same measurement process. In the absence of a perpetual inventory system, however, verifying the quantity of the inventory requires at least two independent physical counts or a third way to measure the quantity of the inventory.

It makes a difference to the reliability of accounting information whether an accounting measure itself is verified or only the procedures used to obtain the measure are veri-

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<sup>133</sup>Robert R. Sterling, "On Theory Construction and Verification," *The Accounting Review*, July 1970, page 450, footnote 16.



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fied because even if disagreements about choice of method and relevant inputs are ignored or resolved, merely rechecking the mechanics does not verify the representational faithfulness of the measure, leaving its reliability in doubt.

Direct verification of accounting measures tends to minimize both personal bias introduced by a measurer (measurer bias) and bias inherent in measurement methods (measurement bias). Verification of only measurement methods tends to minimize measurer bias but usually preserves any bias there may be in the selection of measurement or allocation methods. [Concepts Statement 2, paragraph 87]

The elimination of measurer bias alone from information does not insure that the information will be reliable. Even though several independent measurers may agree on a single measurement method and apply it honestly and skillfully, the result will not be reliable if the method used is such that the measure does not represent what it purports to represent. [Concepts Statement 2, paragraph 86]

The distinguishing characteristic of accounting measures that normally are directly or separately verifiable as representing what they purport to represent is that they measure market prices in transactions between independent entities (Concepts Statement 2, paragraphs 65 and 67). Two or more independent measurers are likely to obtain essentially the same measures in each instance, and the separate measures will tend to cluster. Some will show more dispersion than others, and relatively few, if any, will be as tightly clustered as separate measures of cash, but whether or not they reasonably represent what they purport to represent is verifiable.

The distinguishing characteristic of accounting measures whose representational faithfulness normally cannot be verified because only the procedures used to obtain the measure are verifiable is that they result from allocations, which interpose between the resulting measures and the market prices on which they are based a calculation or other means of allotting the cost or other past price to time periods or individual assets. As a result, the inputs and procedures of the allocation process often are readily verifiable, but the outputs—the resulting measures—are not (Concepts Statement 2, paragraphs 65-67). Two or more independent measurers are unlikely to obtain essentially the same measures in each instance, and the separate measures will tend to be dispersed or scattered rather than clustered. The reliability of the accounting measures themselves cannot be verified because verifying only the procedures that produced them does not confirm or substantiate their representational faithfulness.

Since the point is likely to be misunderstood, it should explicitly be noted that the inability to verify the representational faithfulness of an accounting measure does not necessarily mean that the measure does not represent what it purports to represent. It

generally means only that no one can know the extent to which the measure has or does not have that representational quality. Since the extent to which it represents faithfully the economic phenomenon it purports to represent is unknown, however, the measure cannot accurately be described as reliable.

Concepts Statement 2 also uses the difference between verifying a measure and verifying the method used to obtain it to show that reliability requires both representational faithfulness and verifiability. It illustrates how an accounting measure may be unreliable despite the verifiability of the allocation process that produced it using as an example the once-widespread practice, proscribed by FASB Statement No. 5, *Accounting for Contingencies*, for reasons described earlier in this book, of accruing “self-insurance reserves” by recognizing an annual expense or loss equal to a portion of expected future losses from fire, flood, or other casualties. Expectations of future losses could be actuarially computed for an enterprise with a large number of “self-insured” assets, and the methods of allocating expected losses to periods could be readily verified. Nevertheless, the representational faithfulness of the resulting measures would be extremely low, if not missing entirely. The “reserve for self insurance” in a balance sheet was a “what-you-may-call-it”—a deferred credit that did not qualify as a liability because the “self-insured” enterprise owed no one the amount of the reserve, or anything like it—and the allocated expense or loss in an income statement reported hypothetical effects of non-existent transactions or events in years in which the enterprise suffered no casualties and, except by coincidence, grossly underreported losses incurred in years in which the enterprise’s uninsured assets actually were damaged or destroyed by fire, flood, earthquake, hurricane, or the like.

Since the representational faithfulness of measures resulting from allocation procedures cannot be verified by rechecking the mechanics of how the measures were obtained, so-called historical cost accounting and other systems or models that depend heavily on allocations of prices in past transactions generally are considerably less reliable than is usually supposed. Concepts Statement 2 puts in perspective the oft-heard generalization that historical costs are “hard” information while current market prices are “soft” information—that historical cost information is reliable while current price information is not:

More than one empirical investigation has concluded that accountants may agree more about estimates of the market values of certain depreciable assets than about their carrying values. Hence, to the extent that verification depends on consensus, it may not always be those measurement methods widely regarded as “objective” that are most verifiable. [paragraph 85]

Considerable confusion about reliability of accounting information results from the propensity of accountants and others to use *reliable*, *objective*, and *verifiable* interchangeably even though the three terms are not synonyms if used precisely. Reliable is a broader term than verifiable, comprising not only verifiability but also representational

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faithfulness. Objective is a narrower term than verifiable. It means being independent of the observer, implying that objective accounting information is free of measurer bias—not affected by the hopes, fears, and other thoughts and feelings of the measurer—but saying little or nothing about measurement bias. Objectivity and objective should assume the narrower meaning in accountants' vocabularies and be replaced by verifiability and verifiable to describe measures whose representational faithfulness can be confirmed through consensus of independent measurers and thus are reliable.

### **Neutrality**

Neutrality is concerned with bias and thus is a factor in reliability of accounting information. It is the “absence in reported information of bias intended to attain a predetermined result or to induce a particular mode of behavior” (Concepts Statement 2, glossary). Accounting information is neutral if it “report[s] economic activity as faithfully as possible, without coloring the image it communicates for the purpose of influencing behavior in *some particular direction*” (paragraph 100).

A common perception and misconception is that displaying neutrality means treating everyone alike in all respects. It would not necessarily show a lack of neutrality to require less disclosure of a small company than of a large one if it were shown that an equal disclosure requirement placed an undue economic burden on the small company. Solomons says that neutrality “does not imply that no one gets hurt.” His response to the argument that accounting policy can never be neutral because in any policy choice someone gets his or her preference and someone else does not clarifies the meaning of neutrality:

The same thing could be said of the draft, when draft numbers were drawn by lot. Some people were chosen to serve while others escaped. It was still, by and large, neutral in the sense that all males of draft age were equally likely to be selected. It is not a necessary property of neutrality that everyone likes the results; the absence of intentional bias is at the heart of the concept.<sup>134</sup>

Neutrality requires that information should be free from bias toward a predetermined result, but that is not to say that standards setters or those who provide information according to promulgated standards should not have a purpose in mind for financial reporting. Accounting should not be without influence on human behavior, but it should not slant information to influence behavior in a particular way to achieve a desired end.

Neutrality in accounting is an important criterion by which to judge accounting policies, for information that is not neutral loses credibility. If information can be verified and can be relied on faithfully to represent what it

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<sup>134</sup>Solomons, *Making Accounting Policy*, page 234.

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purports to represent—and if there is no bias in the selection of what is reported—it cannot be slanted to favor one set of interests over another. [Concepts Statement 2, paragraph 107]

Former Board member Arthur R. Wyatt emphasized the crucial nature of the quality of neutrality in Concepts Statement 2 to the FASB's process and to the widespread acceptability of its resulting standards:

Early on . . . the FASB undertook work to develop a conceptual framework, in part so that it could develop standards that had a logical cohesion, and in part so that the results of its deliberations could be evaluated to assess whether the resulting standards flowed from logical premises or may have been the result of lobbying activities or pressure politics.<sup>135</sup>

The Board unequivocally rejected the view that financial accounting standards should be slanted to foster a particular government policy or to favor one economic interest over another:

The notion of neutrality within the Board's conceptual framework is that in resolving issues the Board will attempt to reach conclusions that result in reliable and relevant information and not conclusions that favor one segment of society to the detriment of one or more other segments. . . . [T]he notion of neutrality emphasizes that in developing the standard the Board . . . is not overtly striving to reallocate resources for the benefit of one group to the detriment of others.<sup>136</sup>

On several occasions, Donald J. Kirk, former Board chairman, also made the point that neutrality is essential to fulfilling the objective of providing relevant and reliable information to investors, creditors, and other users, and to prevent standards setting from becoming an exercise in directing resources to a preferred group. For example:

[N]eutrality of information keeps financial reporting standards as a part of a measurement process, rather than a purposeful resource allocation process. . . . It is the emphasis on neutrality of information, as well as the independence of the standard setters from undue influence, that ensures the continued success of private sector standard setting.<sup>137</sup>

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<sup>135</sup>Arthur R. Wyatt, "Accounting Standards and the Professional Auditor," *Accounting Horizons*, June 1989, page 97.

<sup>136</sup>Wyatt, "Accounting Standards and the Professional Auditor," page 97.

<sup>137</sup>Kirk, "Looking Back on Fourteen Years at the FASB: The Education of a Standard Setter," page 13.

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To protect the public interest in useful accounting information, what is needed is *not* “good business sense,” *nor* even “good public policy,” but rather “neutrality” (i.e., “absence in reported information of bias intended to attain a predetermined result or to induce a particular mode of behavior”). The chairman of the SEC made the point about the importance of neutrality in his statement on oil and gas accounting:

If it becomes accepted or expected that accounting principles are determined or modified in order to secure purposes other than economic measurement—even such virtuous purposes as energy production—we assume a grave risk that confidence in the credibility of our financial information system will be undermined.<sup>138</sup>

Neutrality in standards setting is so significant that it has been incorporated into the FASB's Mission Statement, and Concepts Statement 2 itself explains why neutrality is so critical to the Board and to the standards-setting process. The first and last words in the section entitled “Neutrality” are:

Neutrality in accounting has a greater significance for those who set accounting standards than for those who have to apply those standards in preparing financial reports, but the concept has substantially the same meaning for the two groups, and both will maintain neutrality in the same way. Neutrality means that either in formulating or implementing standards, the primary concern should be the relevance and reliability of the information that results, not the effect that the new rule may have on a particular interest.

The Board's responsibility is to the integrity of the financial reporting system, which it regards as its paramount concern. [Concepts Statement 2, paragraphs 98 and 110]

### **Comparability**

Comparing alternative investment or lending opportunities is an essential part of most, if not all, investment or lending decisions. Investors and creditors need financial reporting information that is comparable, both for single enterprises over time and between

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<sup>138</sup>Donald J. Kirk, “Reflections on a ‘Reconceptualization of Accounting’: A Commentary on Parts I-IV of Homer Kripke’s Paper, ‘Reflections on the FASB’s Conceptual Framework for Accounting and on Auditing,’” *Journal of Accounting, Auditing & Finance*, Winter 1989, page 95. The excerpt quoted is from Harold M. Williams, chairman, Securities and Exchange Commission, “Accounting Practices for Oil and Gas Producers” (Washington, D.C., 1978), page 12.

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enterprises at the same time. Comparability is a quality of the relationship between two or more pieces of information—“the quality of information that enables users to identify similarities in and differences between two sets of economic phenomena” (Concepts Statement 2, glossary). Comparability is achieved if similar transactions and other events and circumstances are accounted for similarly and different transactions and other events and circumstances are accounted for differently.

Comparability has been the subject of much disagreement among accountants. Some have argued that enterprises and their circumstances are so different from one another that comparability between enterprises is an illusory goal, and to include it as an aim of financial reporting is to promise to investors and creditors something that ultimately cannot be delivered. In that view, the best that can be hoped for is that individual enterprises will use their chosen accounting procedures consistently over time to permit comparisons with other enterprises and that honorable auditors will be able to attest to the consistent application of “generally accepted accounting principles.”

The problem with that view of comparability is that it allows an excessive degree of latitude in reporting practice. It was the dominant view during the 1930s and 1940s and did permit, or even encouraged, the proliferation of alternative accounting procedures that characterized the period, many in situations in which few significant differences in enterprises or circumstances were ever reasonably substantiated. The result was an intolerable lack of comparability, which was responsible for much of the criticism directed toward financial accounting and eventually led to the replacement of the Committee on Accounting Procedure by the Accounting Principles Board.

Today, with the objectives of financial reporting focused on decision making, comparability is one of the most essential and desirable qualities of accounting information. Investors and creditors can no longer be expected to tolerate blanket claims of differences in circumstances to justify undue use of alternative accounting procedures. Only actual differences in transactions and other events and circumstances warrant different accounting.

Concepts Statement 2 notes that the need for comparable information is a fundamental rationale for standards setting:

The difficulty in making financial comparisons among enterprises because of the use of different accounting methods has been accepted for many years as the principal reason for the development of accounting standards. [paragraph 112]

Some critics have focused on the standards setter’s pursuit of comparability, calling it “uniformity,” and mistakenly implying that standards are issued to require all enterprises to use the same accounting methods despite underlying differences. Comparability is, however, the antithesis of uniformity:

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Comparability should not be confused with identity, and sometimes more can be learned from differences than from similarities if the differences can be explained. The ability to explain phenomena often depends on the diagnosis of the underlying causes of differences or the discovery that apparent differences are without significance. . . . Greater comparability of accounting information, which most people agree is a worthwhile aim, is not to be attained by making unlike things look alike any more than by making like things look different. [Concepts Statement 2, paragraph 119]

In fact, uniformity of practice may be a greater threat to comparability than is too much flexibility in choice of accounting method. Investors and creditors can often discern and compensate for lack of comparability caused by alternative procedures, but they usually have no way of detecting a lack of comparability caused by forced uniformity of practice.

Consistency, meaning “conformity from period to period with unchanging policies and procedures” (Concepts Statement 2, glossary), has long been regarded as an important quality of information provided by financial statements. For example, it was an explicit part of the recommendation of the Special Committee on Co-operation with Stock Exchanges in 1932 (pages 4 and 5 and page 12 of this book). Auditors are required to point out changes in accounting principles or in the method of their application that have a material effect on the comparability of a client’s financial statements.

Consistent use of accounting methods, whether from one period to another within a single firm or within a single period across firms, is a necessary but not a sufficient condition of comparability. Consistency in applying accounting methods over time contributes to comparability, provided that the methods consistently applied were reasonably comparable to begin with. Lack of comparability will never be transformed into comparability by consistent application. If what is measured and reported has representational faithfulness, an accurate analysis of similarities and differences will be possible, and comparability is enhanced. However, in the same way that lack of timeliness can deprive information of relevance it might otherwise have had, inconsistent use of comparable information can ruin whatever comparability the information might otherwise have had.

Concern for consistency does not mean that accountants should not be open to new and better methods and standards. A change need not inhibit comparability if its effects are properly disclosed.

### **Conservatism**

A word needs to be said about conservatism, an important doctrine in most accountants’ minds, but not a separate qualitative characteristic in the FASB’s hierarchy of qualities that make accounting information useful. The FASB has described conservatism as “a prudent reaction to uncertainty to try to ensure that uncertainties and risks inherent in business situations are adequately considered” (Concepts Statement 2, paragraph 95). That is quite different from the traditional meaning of conservatism in financial report-

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ing, which usually connoted deliberate, consistent understatement of net assets and profits, summed up by the admonition to “anticipate no profits but anticipate all losses.” That view developed during a time when balance sheets were considered the primary (and often only) financial statement, and bankers or other lenders were their principal external users. Since understating assets was thought to provide a greater margin of safety as security for loans and other debts, deliberate understatement was considered a virtue.

The traditional application of conservatism introduced into reporting a preference “that possible errors in measurement be in the direction of understatement rather than overstatement of net income and net assets” (APB Statement 4, paragraph 171). In practice that often meant depressing reported net income by excessive depreciation or undervaluation of inventory or deferring recognition of income until long after sufficient evidence of its existence became available.

That kind of conservatism has now become discredited because it conflicts with the information’s comparability, with its representational faithfulness and neutrality, and thus with its reliability. Any kind of bias, whether overly conservative or overly optimistic, influences the timing of recognition of net income or losses and may mislead investors as they attempt to evaluate alternative investment opportunities. Information that adds to uncertainty is inimical to informed and rational decision making and betrays the fulfillment of the objectives of financial reporting.

The appropriate way to treat uncertainty is to disclose its nature and extent honestly, so that those who receive the information may form their own opinions of the probable outcome of the events reported. That is the only kind of conservatism that can, in the long run, serve all of the divergent interests that are represented in a business enterprise. It is not the accountant’s job to protect investors, creditors, and others from uncertainty, but only to inform them about it. Any attempt to understate earnings or financial position consistently is likely to engender skepticism about the reliability and the integrity of what is reported. Moreover, it will probably be ultimately self-defeating.<sup>139</sup>

### **Materiality**

The final item on the hierarchy, characterized as a constraint or *threshold for recognition*, is materiality, which is a *quantitative*, not a qualitative, characteristic of information. Materiality judgments pose the question: “Is this item large enough for users of the information to be influenced by it?” (Concepts Statement 2, paragraph 123). Materiality means

the magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the

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<sup>139</sup>Solomons, *Making Accounting Policy*, page 101.



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judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement. [Concepts Statement 2, glossary]

Popular usage of *material* often makes it a synonym for *relevant*, but the two are not synonymous in Concepts Statement 2. Information may be relevant in the sense that it is capable of making a difference and yet the amounts involved are immaterial—too small to matter in a decision. To illustrate the difference between materiality and relevance, Concepts Statement 2 (paragraph 126) provides an example of an applicant for employment who is negotiating with an employment agency. On one hand, information about the nature of the duties, salary, hours, and benefits is relevant, as well as material, to most prospective employees. On the other hand, whether the office floor is carpeted and whether the cafeteria food is of good quality are relevant, but probably not material, to a decision to accept the job. The values placed on them by the applicant are too small to influence the decision.

However, materiality judgments go beyond magnitude itself to the nature of the item and the circumstances in which the judgment has to be made. Items too small to be thought material if they result from routine transactions may be considered material if they arise in abnormal circumstances. Therefore, one must always think in terms of a threshold over which an item must pass, considering its nature and the attendant circumstances as well as its relative amount, that separates material from immaterial items.

Where the threshold for recognition occurs with regard to a materiality decision is a matter of judgment. Many accountants would like to have more quantitative guidelines or criteria for materiality laid down by the SEC, the FASB, or other regulatory agency. The FASB's view has been that materiality judgments can best be made by those who possess all the facts. In recognition of the fact that materiality guidance is sometimes needed, the appendices to Concepts Statement 2 include a list of quantitative guidelines that have been applied both in the law and in the practice of accounting. However, if and when those guidelines specify some minimum size stipulated for recognition of a material item, they do not preclude recognition of a smaller segment. There is still room for individual judgment in at least one direction.

### **Costs and Benefits**

Information is subject to the same pervasive cost-benefit constraint that affects the usefulness of other commodities: unless the benefits to be derived from information equal or exceed the cost of acquiring it, it will not be pursued. Financial information is unlike other commodities, however, in being a partly private and partly public good since “the benefits of information cannot always be confined to those who pay for it” (Concepts Statement 2, paragraph 135), and the balancing of costs and benefits cannot be left to the market.

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Cost-benefit decisions about accounting standards generally have to be made by the standards-setting body—now the FASB. Both costs and benefits of accounting standards cut across the whole spectrum of the Board's constituency, with the benefits only partly accruing to those who bear the costs and the balance between costs and benefits reacting very imperfectly to supply and demand considerations. Moreover, individuals, be they providers, users, or auditors of accounting information, are not in a position to make cost-benefit assessments due to lack of sufficient information as well as probable biases on the matter.

Cost-benefit decisions are extremely difficult because both costs and benefits often are subjective and difficult or impossible to measure reliably. Cost-benefit analysis is at best a fallible tool. Although the Board is committed to doing the best it can in making cost-benefit assessments and Board members indeed have taken the matter seriously in facing the question in several standards in which it has arisen, cost-benefit measures and comparisons are too unreliable to be the deciding factor in crucial standards-setting decisions.

### **Impact of the Qualitative Characteristics**

In the almost twenty-five years since the Trueblood Study Group, and later the FASB, authoritatively clarified the objectives of financial reporting and the consequent primacy of usefulness of financial information for decision making, an evolution in accounting thought has slowly taken place:

Once decision making is seen as the primary objective of financial reporting, it is inevitable that the usefulness of financial information for making decisions should be the primary quality to be sought in deciding what is to be reported and how that reporting is to be done. This is not quite the truism that it seems to be, for . . . only a minority of the respondents to an FASB inquiry in 1974 favored the adoption of that objective. Since 1974 there has been a striking change in attitude among persons interested in financial reporting, and decision usefulness has become widely accepted as the most important quality that financial information should have.<sup>140</sup>

The qualitative characteristics have also had an impact on practice. Former FASB vice chairman, Robert T. Sprouse, in an appearance at a Harvard Business School conference entitled "Conceptual Frameworks for Financial Accounting" in October 1982, described their contribution to accounting debate:

I must confess that initially, although it was clear that certain identified qualitative characteristics of accounting information constituted an essential component of a conceptual framework for general purpose, external

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<sup>140</sup>Solomons, *Making Accounting Policy*, page 86.

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financial reporting, I was skeptical about their contribution to the standard setting process. It seemed to go without saying that accounting information should be relevant and reliable; I doubted that explicit acknowledgment of such qualities would be very useful to preparers, auditors, users, and standard setters in making decisions about financial reporting issues. I was wrong.

The qualitative characteristics project has proven to be extremely valuable, particularly in improving communications among the many and varied organizations and individuals who are involved in resolving financial reporting issues. Statement No. 2 has established a language that has significantly enhanced the degree of precision and level of understanding in discussions of those matters. Increasingly, position papers and comment letters submitted to the FASB refer to specific qualitative characteristics to support positions that are advocated, recommendations that are proffered, and criticisms that are aimed at Board proposals. Similarly, in Board discussions and deliberations it is no longer sufficient to argue that something is relevant or irrelevant and reliable or unreliable. One must specify whether it is predictive value that is enhanced or lacking or whether representational faithfulness would be achieved or be absent, or whether it is some other aspect of relevance or reliability that is affected. The result has been greater precision in thinking about issues and greater understanding in communicating about them.<sup>141</sup>

### **Elements of Financial Statements**

Concepts Statement 1 said that “financial reporting should provide information about the economic resources of an enterprise, the claims to those resources (obligations of the enterprise to transfer resources to other entities and owners’ equity), and the effects of transactions, events, and circumstances that change resources and claims to those resources” (paragraph 40). Concepts Statement 6 (and previously Concepts Statement 3) provides the means for carrying out that objective. It defines the elements of financial statements—the economic resources of an entity, the claims to those resources, and changes in them—about which information is relevant to investors, creditors, and other users of financial statements for investment, credit, and similar decisions.

The elements defined in this Statement are a related group with a particular focus—on assets, liabilities, equity, and other elements directly related to measuring performance and status of an entity. Information about an entity’s performance and status provided by accrual accounting is the primary focus of financial reporting. . . . [Concepts Statement 6, paragraph 3]

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<sup>141</sup>*Conceptual Frameworks for Financial Accounting* [Proceedings of a conference at the Harvard Business School, October 1-2, 1982], edited by H. David Sherman (Cambridge: President and Fellows of Harvard College, circa 1984), page 33.

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### **Concepts Statement No. 3**

Concepts Statement No. 3, *Elements of Financial Statements of Business Enterprises*, issued in December 1980, defined ten elements: assets, liabilities, equity, investments by owners, distributions to owners, and comprehensive income and its components: revenues, expenses, gains, and losses. The Statement introduced the term *comprehensive income*, the name adopted by the Board for the concept that was called *earnings* in Concepts Statement 1 and the other conceptual framework documents previously issued, including the *Tentative Conclusions on Objectives of Financial Statements of Business Enterprises* (December 1976); the Discussion Memorandum, *Conceptual Framework for Financial Accounting and Reporting: Elements of Financial Statements and Their Measurement* (December 1976); and the Exposure Draft, *Objectives of Financial Reporting and Elements of Financial Statements of Business Enterprises* (December 1977). As its title shows, the first Exposure Draft in the conceptual framework project dealt with both objectives and elements.

During 1978, the Board divided the subject matter of the Exposure Draft. One part developed into Concepts Statement 1 on objectives, and another part became the basis for a revised Exposure Draft, *Elements of Financial Statements of Business Enterprises*, which was issued in December 1979. The substance of that Exposure Draft became Concepts Statement 3.

The Board's work on not-for-profit reporting was advancing concurrently, and Concepts Statement No. 4, *Objectives of Financial Reporting by Nonbusiness Organizations*, was issued with Concepts Statement 3 in December 1980. The four Concepts Statements constituted a single conceptual framework for financial accounting and reporting by all entities. The Board voiced its expectation in Concepts Statements 2 and 3 that the qualitative characteristics and definitions of elements of financial statements should apply to both business enterprises and not-for-profit organizations.

Although the discussion of the qualities of information and the related examples in this Statement refer primarily to business enterprises, the Board has tentatively concluded that similar qualities also apply to financial information reported by nonbusiness organizations. [Concepts Statement 2, paragraph 4]

Assets and liabilities are common to all organizations, and the Board sees no reason to define them differently for business and nonbusiness organizations. The Board also expects the definitions of equity, revenues, expenses, gains, and losses to fit both business and nonbusiness organizations. [Concepts Statement 3, paragraph 2]

The Board saw no need for two separate statements on elements as it had for the objectives.

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To solicit views on applying the qualitative characteristics and definitions of elements to both business enterprises and not-for-profit organizations, the Board issued an Exposure Draft, *Proposed Amendments to FASB Concepts Statements 2 and 3 to Apply Them to Nonbusiness Organizations*, in July 1983. The Board reaffirmed the conclusion that the qualitative characteristics applied to not-for-profit organizations and issued a revised Exposure Draft, *Elements of Financial Statements*, in September 1985. Concepts Statement No. 6, *Elements of Financial Statements*, was issued in December 1985, superseding Concepts Statement 3 and extending that Statement's definitions to not-for-profit organizations. Most of Concepts Statement 3 was carried over into the parts of Concepts Statement 6 concerned with business enterprises or with both kinds of entities. Paragraph numbers were changed, however, because Concepts Statement 6 has numerous paragraphs that relate only to not-for-profit organizations or that explain how the definitions in Concepts Statement 3 apply to not-for-profit organizations.

### **Concepts Statement No. 6**

Concepts Statement 6 defines the same ten elements of financial statements that Concepts Statement 3 had defined: seven are elements of the financial statements of both business enterprises and not-for-profit organizations—assets, liabilities, equity (business enterprises) or net assets (not-for-profit organizations), revenues, expenses, gains, and losses; and three are elements of financial statements of business enterprises only—investments by owners, distributions to owners, and comprehensive income. The Statement also defines three classes of net assets of not-for-profit organizations, characterized by the presence or absence of donor-imposed restrictions, and the changes in those classes during a period—changes in permanently restricted, temporarily restricted, and unrestricted net assets. For business enterprises, equity is defined only in total.

To try to avoid later confusion, Concepts Statement 6 is precise about what is an element and what is not. For example, cash, inventories, land, and buildings are items that fit the definition of assets, but they are not elements. Assets is the element:

Elements of financial statements are the building blocks with which financial statements are constructed—the classes of items that financial statements comprise. *Elements* refers to broad classes, such as assets, liabilities, revenues, and expenses. Particular economic things and events, such as cash on hand or selling merchandise, that may meet the definitions of elements are not elements as the term is used in this Statement. Rather, they are called *items* or other descriptive names. This Statement focuses on the broad classes and their characteristics instead of defining particular assets, liabilities, or other items. [paragraph 5]

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The Statement then emphasizes that the elements in financial statements stand for things and events in the real world:

The items that are formally incorporated in financial statements are financial representations (depictions in words and numbers) of certain resources of an entity, claims to those resources, and the effects of transactions and other events and circumstances that result in changes in those resources and claims. That is, symbols (words and numbers) in financial statements stand for cash in a bank, buildings, wages due, sales, use of labor, earthquake damage to property, and a host of other economic things and events pertaining to an entity existing and operating in what is sometimes called the “real world.” [paragraph 6]

The definitions are of the real-world things and events, not of what is recognized in financial statements. That is, the definition of assets, for example, refers to assets such as the inventory in the warehouse, not to the word inventory and the related amount in the balance sheet.

A thing or event and its representation in financial statements commonly are called by the same name. For example, both the amount deposited in a checking account and its representation in the balance sheet are called cash in bank.

Elements of financial statements are of two types: those that constitute financial position or status at a moment in time and those that are changes in financial position over a period of time. Assets, liabilities, and equity or net assets describe levels or amounts of resources or claims to or interests in resources at a moment in time. All other elements—revenues, expenses, gains, and losses (and for business enterprises, comprehensive income, and investments by and distributions to owners)—describe the effects of transactions and other events and circumstances that affect an entity over a period of time. The interrelation between the two types of elements is called *articulation*:

The two types of elements are related in such a way that (a) assets, liabilities, and equity (net assets) are changed by elements of the other type and at any time are their cumulative result and (b) an increase (decrease) in an asset cannot occur without a corresponding decrease (increase) in another asset or a corresponding increase (decrease) in a liability or equity (net assets). Those relations are sometimes collectively referred to as “articulation.” They result in financial statements that are fundamentally interrelated so that statements that show elements of the second type depend on statements that show elements of the first type and vice versa. [Concepts Statement 6, paragraph 21]

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The elements of financial statements are defined in relation to particular entities, which may be business enterprises, not-for-profit organizations, other economic units, or people. For example, items that qualify as assets under the definition are assets of particular entities.

### **Definition of Assets**

There is no more fundamental concept in accounting than assets. Assets, or economic resources, are the lifeblood of both business enterprises and not-for-profit organizations. Without assets—to exchange for, combine with, or transform into other assets—those entities would have no reason to exist.

Economic resources or assets and changes in them are central to the existence and operations of an individual entity. Both business enterprises and not-for-profit organizations are in essence resource or asset processors, and a resource's capacity to be exchanged for cash or other resources or to be combined with other resources to produce needed or desired scarce goods or services gives it utility and value (future economic benefit) to an entity.

Since resources or assets confer their benefits on an enterprise by being exchanged, used, or otherwise invested, changes in resources or assets are the purpose, the means, and the result of an enterprise's operations, and a business enterprise exists primarily to acquire, use, produce, and distribute resources. [Concepts Statement 6, paragraphs 11 and 15]

Because the concept of assets is so fundamental, one would think that the issue of what is or is not an asset would have been settled long ago. All accountants claim to know an asset when they see one, yet differences of opinion arise about whether some items called assets are assets at all and should be included in balance sheets. Those differences of opinion surfaced at the FASB's first hearings, as already described, and those experiences convinced early Board members that workable definitions of assets and liabilities were imperative.

The FASB decided on the conceptual primacy of assets and liabilities, meaning that the definitions of all the other elements of financial statements are derived from the definitions of assets and liabilities. Since the definition of assets is critical, Concepts Statement 6 provides a carefully worded definition with three essential facets, adds nine paragraphs explaining the characteristics of assets, and devotes a significant part of Appendix B to the Statement to elaborating the concept of assets. All of those sections are part of the definition of assets.

The definition of assets is in paragraph 25:

Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.

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Paragraph 26 then describes the trio of characteristics that qualify an item as an asset:

An asset has three essential characteristics: (a) it embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows, (b) a particular entity can obtain the benefit and control others' access to it, and (c) the transaction or other event giving rise to the entity's right to or control of the benefit has already occurred.

The definition indicates the appropriate questions to ask in trying to decide whether or not a particular item is an asset: Is there a future economic benefit? If so, to which entity does it belong? What made it an asset of that entity?

### *Future Economic Benefits*

Assets commonly are items that also can be characterized as economic resources—the scarce means through which people and other economic units carry out economic activities such as consumption, production, and exchange. All economic resources or assets have “service potential” or “future economic benefit,” the scarce capacity to provide services or benefits to the people or other entities that use or hold them.

Future economic benefit is the essence of an asset (paragraphs 27–31). An asset has the capacity to serve the entity by being exchanged for something else of value to the entity, by being used to produce something of value to the entity, or by being used to settle its liabilities.

The most obvious evidence of future economic benefit is a market price. Anything that is commonly bought and sold has future economic benefit. . . . Similarly, anything that creditors or others commonly accept in settlement of liabilities has future economic benefit, and anything that is commonly used to produce goods or services, whether tangible or intangible and whether or not it has a market price or is otherwise exchangeable, also has future economic benefit. Incurrence of costs may be significant evidence of acquisition or enhancement of future economic benefits. . . . [Concepts Statement 6, paragraphs 172 and 173]

All value of economic (scarce) goods and services derives ultimately from the utility of consumers' goods and services, which are used primarily by individuals and families. Their capacity to satisfy human needs or wants creates demand not only for them but also for the producers' goods and services, used primarily by business enterprises and other producers, that provide economic benefit by being used, directly or indirectly, to produce consumers' goods and services or other producers' goods and services. Cash



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is the asset par excellence because of what it can buy. "It can be exchanged for virtually any good or service that is available or it can be saved and exchanged for them in the future" (Concepts Statement 3, paragraph 23) and is the medium for settling most liabilities.<sup>142</sup>

At least two questions need to be asked about the presence or absence of future economic benefit to determine whether or not an entity has an asset:—did the item obtained by an entity truly represent a future economic benefit in the first place, and does all or any of the future economic benefit to the entity remain at the time the issue of its being an asset is considered?

Concepts Statement 6 says that most assets presently included in financial statements qualify as assets under its definition because they have future economic benefits (paragraph 177). They include cash, accounts and notes receivable, interest and dividends receivable, and investments in the securities of other entities. Inventories of raw materials, work-in-process, and finished goods and productive resources such as property, plant, and equipment also qualify as assets, but some "assets" that have often been described in accounting literature as "deferred costs" or "deferred charges to revenues" either fail to qualify as assets or may perhaps represent assets but cannot reliably be recognized as assets.

Deferred costs that fail to qualify as assets are what-you-may-call-its—deferred costs that do not represent economic resources but are said to be assets "because they must be deferred and matched with future revenues to avoid distorting net income." For reasons described earlier, the Board firmly rejected the argument that "costs are assets," and Concepts Statement 6 is explicit:

Although an entity normally incurs costs to acquire or use assets, costs incurred are not themselves assets. The essence of an asset is its future economic benefit rather than whether or not it was acquired at a cost. . . .

. . . [I]ncurrence of a cost may be evidence that an entity has acquired one or more assets, but it is not conclusive evidence. Costs may be incurred without receiving services or enhanced future economic benefits. Or, entities may obtain assets without incurring costs—for example, from investment in kind by owners or contributions of securities or buildings by donors. The ultimate evidence of the existence of assets is the future economic benefit, not the costs incurred. [paragraphs 179 and 180]

Deferred costs that may or may not represent assets are victims of the pervasive uncertainty in business and economic affairs that often obscures whether or not some items have the capacity to provide future economic benefits to an entity and thus should be recognized as assets. A question arises whether an item received should be recognized as

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<sup>142</sup>L. Todd Johnson and Reed K. Storey, *Recognition in Financial Statements: Underlying Concepts and Practical Conventions*, FASB Research Report (Stamford, Connecticut: Financial Accounting Standards Board, 1982), pages 91-94.

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an asset or as an expense or loss if the value of future benefit obtained is uncertain or even doubtful or if the future benefit may be short-lived or of highly uncertain duration. Expenditures for research and development, advertising, training, development of new markets, relocation, and goodwill are examples of items for which management's intent clearly is to obtain or augment future economic benefits but for which there is uncertainty about the extent, if any, to which the expenditures succeeded in creating or increasing future economic benefits. That uncertainty led to FASB Statement No. 2, *Accounting for Research and Development Costs*, in which the Board for primarily practical reasons required entities to recognize the expenditures as expenses or losses rather than as assets. If research and development or advertising costs actually result in new or greater future economic benefit, that benefit qualifies as an asset. The practical problems are in determining whether future economic benefit is actually present and in quantifying it, especially if realization of benefits is far down the road, or perhaps never.<sup>143</sup>

Services provided by other entities can be assets of an entity only momentarily as they are received and used, and they commonly are recognized as expenses when received, but the right to receive services for specified or determinable future periods qualifies as an asset.

### ***Control by a Particular Entity***

The definition defines assets in relation to specific entities. An asset is an asset of some entity. No asset can simultaneously be an asset of more than one entity, although some physical assets may provide future economic benefits to two or more entities at the same time. That is, some assets comprise separable bundles of benefits that may be unbundled and held simultaneously by two or more entities so that each has an asset. For example, a building may provide future economic benefits to its owner, to an entity that leases space in it, and to an entity that holds a mortgage on it. Each has an interest in a different aspect of the same building, and each expects to receive cash flows from having one or more of the bundles of benefits.

An entity must control an item's future economic benefit to be able to consider the item as its asset. To enjoy an asset's benefits, an entity generally must be in a position to deny or regulate access to that benefit by others, for example, by permitting access only at a price.

Thus, an asset of an entity is the future economic benefit that the entity can control and thus can, within limits set by the nature of the benefit or the entity's right to it, use as it pleases. The entity having an asset is the one that can exchange it, use it to produce goods or services, exact a price for others' use of it, use it to settle liabilities, hold it, or perhaps distribute it to owners. [Concepts Statement 6, paragraph 184]

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<sup>143</sup>This paragraph paraphrases paragraphs 44, 45, and 173 of Concepts Statement 6 and briefly summarizes the conclusions of FASB Statement No. 2, *Accounting for Research and Development Costs*, whose development raised questions that helped Board members decide that a definition of assets was essential.

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An entity usually gains the ability to control an asset's future economic benefits through a legal right. However, an entity still may have an asset without having an enforceable legal right to it if it can obtain and control the benefit some other way, for example, by maintaining exclusive access to the asset's benefits by keeping secret a formula or process.

### ***Occurrence of a Past Transaction or Event***

Items become assets of an entity as the result of transactions or other events or circumstances that have already occurred. An entity has an asset only if it has the present ability to obtain that asset's future economic benefits. If an entity anticipates that it may in the future control an item's future economic benefits but as yet does not have that control, it cannot claim that item as its asset because the transaction, other event, or circumstance conferring that control has not yet occurred.

Since the transaction or event giving rise to the entity's right to the future economic benefit must already have occurred, the definition excludes from assets items that may in the future become an entity's assets but have not yet become its assets. An entity has no asset for a particular future economic benefit if the transactions or events that give it access to and control of the benefit are yet in the future. [Concepts Statement 6, paragraph 191]

Similarly, once acquired, an asset continues as an asset of an entity as long as the transactions, other events, or circumstances that use up or destroy its future economic benefit or deprive the entity of its control are in the future.

### **Definition of Liabilities**

The definition of liabilities in paragraph 35 of Concepts Statement 6 has the same structure as the definition of assets in paragraph 25. The parallelism of the two definitions was deliberate.

Liabilities are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.

Paragraph 36 describes the three characteristics that an item must possess to be a liability:

A liability has three essential characteristics: (a) it embodies a present duty or responsibility to one or more other entities that entails settlement by probable future transfer or use of assets at a specified or determinable date,

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on occurrence of a specified event, or on demand, (b) the duty or responsibility obligates a particular entity, leaving it little or no discretion to avoid the future sacrifice, and (c) the transaction or other event obligating the entity has already happened.

The definition prompts the following questions when trying to decide if a particular item constitutes a liability: Is there an obligation requiring a future sacrifice of assets? If so, which entity is obligated? What past transaction or event made it a liability of that entity?

### *Required Future Sacrifice of Assets*

Liabilities commonly arise as the consequence of financial instruments, contracts, and laws invented to facilitate the functioning of a highly developed economy by permitting delays in payment and delivery in return for interest or other compensation as the price for enduring delay. Entities routinely incur liabilities to acquire the funds, goods, and services they need to operate and just as routinely settle the liabilities they incur, usually by paying cash. For example: borrowing cash results in an obligation to repay the amount borrowed, usually with interest; using employees' knowledge, skills, time, and effort results in an obligation to pay compensation for their use; or selling products with warranties results in an obligation to pay cash or to repair or replace the products that prove defective. Liabilities come in a vast array of forms, but they all entail a present obligation requiring a nondiscretionary future sacrifice of some economic benefit:

The essence of a liability is a duty or requirement to sacrifice assets in the future. A liability requires an entity to transfer assets, provide services, or otherwise expend assets to satisfy a responsibility to one or more other entities that it has incurred or that has been imposed on it. [Concepts Statement 6, paragraph 193]

Although most liabilities arise from exchanges between entities, most of which are contractual in nature, some obligations are imposed by laws or governmental regulations that require sacrificing assets to comply.

Receipt of proceeds—cash, other assets, or services—without an accompanying cash payment is often evidence that a liability has been incurred, but it is not conclusive evidence. Other transactions and events generate proceeds—cash sales of goods or services or other sales of assets, cash from donors' contributions, or cash investments by owners—without incurring liabilities. Liabilities can be incurred without any accompanying receipt of proceeds, for example, by imposition of taxes. It is the obligation to sacrifice economic benefits in the future that signifies a liability, not whether proceeds were received by incurring it.

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Most liabilities presently included in financial statements qualify as liabilities under the definition because they require a future sacrifice of assets. They include accounts and notes payable, wages and salaries payable, long-term debt, interest and dividends payable, and obligations to honor warranties and to pay pensions, deferred compensation, and taxes. Subscriptions or rents collected in advance or other “unearned revenues” from deposits and prepayments received for goods or services to be provided are also liabilities because they obligate an entity to provide goods or services to other entities in the future. Those kinds of items sometimes have been referred to as “deferred credits” or “reserves” in the accounting literature.

### *Obligation of a Particular Entity*

To have a liability, an entity must be obligated to sacrifice its assets in the future—that is, it must be bound by a legal, equitable, or constructive duty or responsibility to transfer assets or provide services to one or more other entities. [Concepts Statement 6, paragraph 200]

A liability entails an obligation—legal, moral, or ethical—to one or more other entities to convey assets to them or provide them with services in the future. Not all probable future sacrifices of assets are liabilities of an entity. An intent or expectation to enter into a contract or transaction to transfer assets does not constitute a liability until an obligation to another entity is taken on.

The obligation aspect of liabilities is not emphasized as strongly in the definition in the Concepts Statement as it perhaps might have been. The Board became enamored with making the one-sentence definitions of assets and liabilities parallel to accentuate the symmetry between future benefits of assets and future sacrifices of liabilities.

The definition of an asset emphasizes its “service potential” or “future economic benefit,” “the scarce capacity to provide services or benefits to the entities that use them” (paragraph 28), the common characteristic possessed by all assets. The definition of a liability puts first “future sacrifices of assets” to make it parallel with the asset definition, but it would have been more precise to focus on an entity’s *obligation* to another entity to transfer assets or to provide services to it in the future. Future sacrifices of assets, after all, are the consequence—not the cause—of an obligation to another entity. Liabilities are present obligations of a particular entity to transfer assets or provide services to other entities in the future requiring probable future sacrifices of economic benefits as a result of past transactions or events.

Some kinds of assets and liabilities are mirror images of one another. Receivables and payables are the most obvious example. Entity X has an asset (a receivable) because Entity Y has a liability (a payable) to transfer an asset (most commonly cash) to Entity X. Unless Entity Y has the liability, Entity X has no asset. Those relationships hold for rights to receive and obligations to pay or deliver cash, goods, or services. In

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fact, they hold for most contractual relationships involving a right to receive and an obligation to deliver. Receivables and payables cancel each other in national income accounting, for example, leaving land, buildings, equipment, and similar assets as the stock of productive resources of the economy.

Most kinds of assets are not receivables, and a host of assets have no liabilities as mirror images. For example, the benefit from owning a building does not stem from an obligation of another entity to provide the benefit. The building itself confers significant benefits on its owner. The owner may, of course, enhance the benefits from the building by obtaining the right to services provided by others, who incur corresponding obligations, but that is a separate contractual arrangement involving both rights and obligations for the contracting parties.

Consequently, the Board's concern with the symmetry between the future benefits of assets and the future sacrifices of liabilities tended to overshadow the obligation to another entity that is the principal distinguishing characteristic of a liability. The definition of liabilities in Concepts Statements 3 and 6 and the accompanying explanations might well have profited from a brief description such as that in FASB Statement No. 5, *Accounting for Contingencies*, paragraph 70.

The economic obligations of an enterprise are defined in paragraph 58 of *APB Statement No. 4* as "its present responsibilities to transfer economic resources or provide services to other entities in the future." Two aspects of that definition are especially relevant to accounting for contingencies: first, that liabilities are *present* responsibilities and, second, that they are obligations to *other entities*. Those notions are supported by other definitions of liabilities in published accounting literature, for example:

Liabilities are claims of creditors against the enterprise, arising out of past activities, that are to be satisfied by the disbursement or utilization of corporate resources.<sup>11</sup>

A liability is the result of a transaction of the past, not of the future.<sup>12</sup>

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<sup>11</sup>American Accounting Association, *Accounting and Reporting Standards for Corporate Financial Statements and Preceding Statements and Supplements* (Sarasota, Fla.: AAA, 1957), p. 16.

<sup>12</sup>Maurice Moonitz, "The Changing Concept of Liabilities," *The Journal of Accountancy*, May 1960, p. 44.

### ***Occurrence of a Past Transaction or Event***

Items become liabilities of an entity as the result of transactions or other events or circumstances that have already occurred. An entity has a liability only if it has a present obligation to transfer assets to another entity. Budgeting the payments required to enact

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a purchase results neither in acquiring an asset nor in incurring a liability because no transaction or event has yet occurred that gives the entity access to or control of future economic benefits or binds it to transfer assets.

Once incurred, a liability remains a liability of an entity until it is satisfied, usually by payment of cash, in another transaction or is otherwise discharged or nullified by another event or circumstance affecting the entity.

### **Nonessential Characteristics of Assets and Liabilities**

The word probable is included in the asset and liability definitions with its general, not accounting or technical, meaning and refers to that which can reasonably be expected or believed on the basis of available evidence or logic but is neither certain nor proved.<sup>144</sup> Its use was intended to indicate that something does not have to be certain or proved to qualify as an asset or liability. The first Exposure Draft did not contain the word probable. It identified assets with “economic resources—cash and future economic benefits—” saying that a “resource other than cash . . . must, singly or in combination with other resources, contribute directly or indirectly to future cash inflows . . .” and identified liabilities with “obligations . . . to other entities,” saying that “the obligation must involve future sacrifice of resources. . . .”<sup>145</sup> The Board received many comment letters that said, in essence, “almost nothing can ever be an asset or liability because you have said that it has to be certain, and everything except cash is uncertain.”

The Board thus inserted “probable” into the definition, but perhaps “expected” would have been a better word. As long as someone thinks that an item has value and is willing to pay for it, the item has value and meets the definition of assets, even if the expectation turns out to have been mistaken. It is easy to read more into the use of probable than was intended. Probable is not an essential part of the definitions; its function is to acknowledge the presence of uncertainty and to say that the future economic benefits or sacrifices do not have to be certain to qualify the items in question as assets and liabilities, not to specify a characteristic that must be present.

Although the application of the definitions of assets and liabilities commonly requires some assessment of probabilities, degrees of probability are not part of the definitions. The degree of probability of a future economic benefit (or of a future cash outlay or other sacrifice of future economic benefits) and the degree to which its amount can be estimated with reasonable reliability, both of which are required to recognize an item as an asset (or a liability), are recognition and measurement matters.

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<sup>144</sup>Webster's *New World Dictionary of the American Language*, second college edition (New York: Simon and Schuster, 1982), page 1132.

<sup>145</sup>FASB Exposure Draft, *Objectives of Financial Reporting and Elements of Financial Statements of Business Enterprises* (December 29, 1977), paragraphs 47 and 49.

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The asset and liability definitions screen out items that lack one or more of the three essential characteristics that assets and liabilities, respectively, must possess. Assets and liabilities have other features that help identify them. Assets may be acquired at a cost, tangible, exchangeable, or legally enforceable. Liabilities usually require the obligated entity to pay cash to one or more entities and are also legally enforceable. However, the difference between those features and the three characteristics identified by Concepts Statement 6 as essential to assets and liabilities is that the absence of a nonessential feature, by itself, is not sufficient to disqualify an item from being an asset or liability. For example, absence of a market price or exchangeability of an asset does not negate future economic benefit that can be obtained by use of the asset instead of by its exchange, although it may cause recognition and measurement problems. In contrast, absence of even one of the three essential characteristics does preclude an item from being an asset or liability:

[A]n item does not qualify as an asset of an entity under the definition in paragraph 25 if (a) the item involves no future economic benefit, (b) the item involves future economic benefit, but the entity cannot obtain it, or (c) the item involves future economic benefit that the entity may in the future obtain, but the events or circumstances that give the entity access to and control of the benefit have not yet occurred (or the entity in the past had the ability to obtain or control the future benefit, but events or circumstances have occurred to remove that ability). Similarly, an item does not qualify as a liability of an entity under the definition in paragraph 35 if (a) the item entails no future sacrifice of assets, (b) the item entails future sacrifice of assets, but the entity is not obligated to make the sacrifice, or (c) the item involves a future sacrifice of assets that the entity will be obligated to make, but the events or circumstances that obligate the entity have not yet occurred (or the entity in the past was obligated to make the future sacrifice, but events or circumstances have occurred to remove that obligation). [Concepts Statement 6, paragraph 168]

### **Equity or Net Assets**

Equity of business enterprises and net assets of not-for-profit organizations have the same definition.

Equity or net assets is the residual interest in the assets of an entity that remains after deducting its liabilities.

The equity or net assets of both a business enterprise and a not-for-profit organization is the difference between the entity's assets and its liabilities. [Concepts Statement 6, paragraphs 49 and 50]



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Nevertheless, both terms should be used with care to assure that the referent is clear. Differences between business enterprises and not-for-profit organizations and the ways they carry out their respective missions, particularly the relative importance of transactions with owners to business enterprises and of gifts or donations to not-for-profit organizations, result in significant differences between the equity or net assets of the two kinds of entities.

A major distinguishing characteristic of the equity of a business enterprise is that it may be increased through investments of assets by owners who also may, from time to time, receive distributions of assets from the entity. Owners invest in a business enterprise with the expectation of obtaining a return on their investment as a result of the enterprise's providing goods or services to customers at a profit. . . .

In contrast, a not-for-profit organization has no ownership interest or profit purpose in the same sense as a business enterprise and thus receives no investments of assets by owners and distributes no assets to owners. Rather, its net assets often is increased by receipts of assets from resource providers (contributors, donors, grantors, and the like) who do not expect to receive either repayment or economic benefits proportionate to the assets provided but who are nonetheless interested in how the organization makes use of those assets and often impose temporary or permanent restrictions on their use. . . . [Concepts Statement 6, paragraphs 51 and 52]

Thus, whether a particular use of either equity or net assets refers to a business enterprise or a not-for-profit organization often is significant to investors, creditors, and other resource providers.

A footnote referenced to paragraph 50 notes that although the terms are interchangeable, “[t]his Statement generally applies the term *equity* to business enterprises, which is common usage, and the term *net assets* to not-for-profit organizations, for which the term *equity* is less commonly used.” That terminology has the advantage of being both common and consistent, but what assures consistent clarity of meaning is Concepts Statement 6's careful use of the terms. It usually gives the complete names—equity of a business enterprise and net assets of a not-for-profit organization—using the short-cuts equity and net assets only if the referent is clear from the context. As a result, even if it interchanged the terms—net assets of a business enterprise or equity of a not-for-profit organization—the meaning would still be unmistakable.

### *Equity or Net Assets as a Measure of Wealth*

Although the term wealth is not part of most accountants' technical vocabularies, as explained earlier the definitions of the elements of financial statements in Concepts Statement 6 (carried over from Concepts Statement 3) make an enterprise's wealth and changes

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therein the major subject matter of financial accounting and reporting. The definitions of assets, liabilities, and equity in Concepts Statement 6 are all in terms of wealth. The Statement identifies assets with “economic resources. . . the scarce means that are useful for carrying out economic activities, such as consumption, production, and exchange,” whose “common characteristic . . . is ‘service potential’ or ‘future economic benefit,’ the scarce capacity to provide services or benefits to the entities that use them” (Concepts Statement 6, paragraphs 27 and 28). That is, the definition of assets refers to economic resources, rights to economic resources, and other things in the real-world environment in which financial accounting and reporting takes place that constitute wealth, and the definition of liabilities refers to obligations to transfer wealth to other entities. As a result, the definition of equity or net assets refers to net wealth of a business enterprise or a not-for-profit organization, and the remaining definitions refer to increases and decreases in wealth over time.

### **Equity of Business Enterprises**

Equity of business enterprises represents the ownership interests of those who invest funds in a business enterprise with the expectation of obtaining a return on their investment as a result of the enterprise’s operating at a profit. Since equity ranks after liabilities as a claim to or interest in the assets of the enterprise, it is a *residual* interest. Changes in it result from profits and losses as well as from investments by and distributions to owners. Equity is often referred to as “risk capital,” for in an uncertain world owners not only benefit if an enterprise is profitable but also are the first to bear the risk that an enterprise may be unprofitable.

Equity in a business enterprise is the ownership interest, and its amount is the cumulative result of investments by owners, comprehensive income, and distributions to owners. That characteristic, coupled with the characteristic that liabilities have priority over ownership interest as claims against enterprise assets, makes equity not determinable independently of assets and liabilities. Although equity can be described in various ways, and different recognition criteria and measurement procedures can affect its amount, equity always equals net assets (assets minus liabilities). That is why it is a residual interest. [Concepts Statement 6, paragraph 213]

Liabilities and equity are mutually exclusive claims to or interests in an enterprise’s assets by other entities, and liabilities take precedence over ownership interests. Although the line between equity and liabilities is clear in concept, it increasingly has been obscured in practice by introduction of financial instruments having characteristics of both liabilities and equity. Convertible debt instruments and redeemable preferred stock are common examples of securities with both debt and equity characteristics, which may cause problems in accounting for them.

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### **Investments by and Distributions to Owners**

Equity of a business enterprise is increased and decreased by investments by owners and distributions to owners—unique transactions “between an enterprise and its owners *as owners* rather than as employees, suppliers, customers, lenders, or in some other non-owner role” (Concepts Statement 6, paragraphs 60 and 68).

Investments by owners are increases in equity of a particular business enterprise resulting from transfers to it from other entities of something valuable to obtain or increase ownership interests (or equity) in it. Assets are most commonly received as investments by owners, but that which is received may also include services or satisfaction or conversion of liabilities of the enterprise.

Distributions to owners are decreases in equity of a particular business enterprise resulting from transferring assets, rendering services, or incurring liabilities by the enterprise to owners. Distributions to owners decrease ownership interest (or equity) in an enterprise. [Concepts Statement 6, paragraphs 66 and 67; footnote reference omitted]

Not-for-profit organizations (pages 140-142) have no comparable transactions.

A business enterprise may make discretionary distributions to owners, usually by the formal act of declaring a dividend, but it is not obligated to do so. Many enterprises have several classes of equity, each with different priority claims on enterprise assets in discretionary distributions or in the event of liquidation, depending on the degree to which they bear relatively more of the risk of unprofitability. All classes of equity depend to some extent on enterprise profitability for distributions of assets, and no class has an unconditional right or absolute claim to the assets of an enterprise except in the event of liquidation of the enterprise, and even then, owners must stand behind creditors, who have a priority right to enterprise assets (Concepts Statement 6, paragraph 62).

### **Comprehensive Income of Business Enterprises**

Investors, creditors, and others focus on comprehensive income to help them assess an enterprise's prospects for generating net cash inflows because, in the long run, it is through comprehensive income that they obtain a return on their investments, loans, or other association with an enterprise. Thus, the Concepts Statements recognize the significance of income and information about income of an enterprise to investors, creditors, and others.

Equity is originally created by owners' investments in an enterprise and may from time to time be augmented by additional investments by owners. Equity is reduced by distributions by the enterprise to owners. However,

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the distinguishing characteristic of equity is that it inevitably is affected by the enterprise's operations and other events and circumstances affecting the enterprise (which together constitute comprehensive income . . .). [Concepts Statement 6, paragraph 63]

The primary focus of financial reporting is information about an enterprise's performance provided by measures of [comprehensive income]<sup>146</sup> and its components. [Concepts Statement 1, paragraph 43]

Concepts Statement 6 defines comprehensive income as

the change in equity of a business enterprise during a period from transactions and other events and circumstances from nonowner sources. It includes all changes in equity during a period except those resulting from investments by owners and distributions to owners. [paragraph 70]

Comprehensive income and investments by and distributions to owners—class B in Figure 4—account for all changes in equity of a business enterprise during a period. The figure not only distinguishes the sources of changes in equity in class B from each other but also distinguishes them from other transactions and events affecting the enterprise during a period. Class A comprises exchange transactions that change assets or liabilities, or both, but do not change equity. They are common in most business enterprises. Events in class C are less familiar—changes within equity that do not affect assets or liabilities or change the amount of equity, such as stock dividends, conversions of preferred stock into common stock, and some stock recapitalizations.

### *Revenues, Expenses, Gains, and Losses*

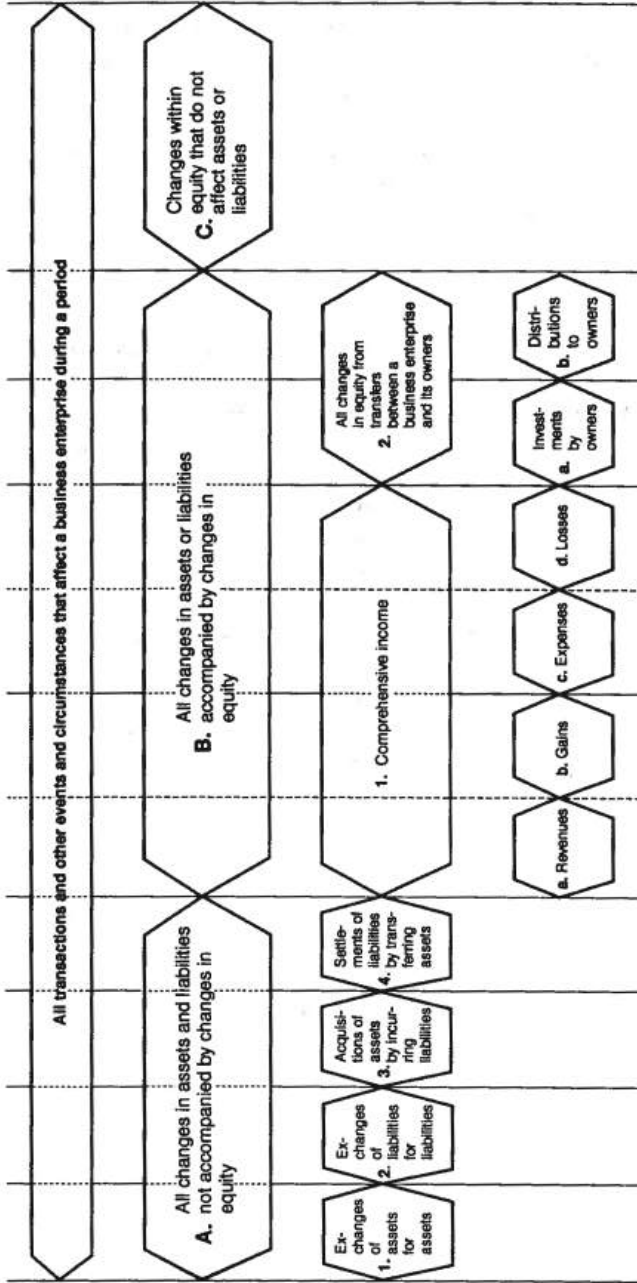
Concepts Statements 3 and 6 define the components of comprehensive income—revenues, expenses, gains, and losses—as well as comprehensive income (paragraph references are from Concepts Statement 6):

*Revenues* are inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations. [paragraph 78]

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<sup>146</sup>Concepts Statement 1 said *earnings*, but in Concepts Statement 3 (paragraph 1, footnote 1) the Board changed the name of the concept to *comprehensive income* and reserved the term *earnings* for possible use to designate a component part of comprehensive income. The Board used *earnings* in that way in Concepts Statement 5.

Figure 4  
Transactions and Other Events That Change Assets, Liabilities, and Equity of Business Enterprises



Source: Concepts Statement 6, paragraph 64.

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*Expenses* are outflows or other using up of assets or incurrences of liabilities (or a combination of both) from delivering or producing goods, rendering services, or carrying out other activities that constitute the entity's ongoing major or central operations. [paragraph 80]

*Gains* are increases in equity (net assets) from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity except those that result from revenues or investments by owners. [paragraph 82]

*Losses* are decreases in equity (net assets) from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity except those that result from expenses or distributions to owners. [paragraph 83]

Revenues and expenses represent actual or expected cash inflows and outflows usually associated with the ongoing major operations and earning and financing activities of an enterprise, leaving other more peripheral and incidental changes in equity to be described as various kinds of gains and losses.

Revenues and gains are similar, and expenses and losses are similar, but some differences are significant in conveying information about an enterprise's performance. Revenues and expenses result from an entity's ongoing major or central operations and activities—that is, from activities such as producing or delivering goods, rendering services, lending, insuring, investing, and financing. In contrast, gains and losses result from incidental or peripheral transactions of an enterprise with other entities and from other events and circumstances affecting it. Some gains and losses may be considered “operating” gains and losses and may be closely related to revenues and expenses. Revenues and expenses are commonly displayed as gross inflows or outflows of net assets, while gains and losses are usually displayed as net inflows or outflows.

. . . Distinctions between revenues and gains and between expenses and losses in a particular entity depend to a significant extent on the nature of the entity, its operations, and its other activities. Items that are revenues for one kind of entity may be gains for another, and items that are expenses for one kind of entity may be losses for another. For example, investments in securities that may be sources of revenues and expenses for insurance or investment companies may be sources of gains and losses in manufacturing or merchandising companies. Technological changes may be sources of

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gains or losses for most kinds of enterprises but may be characteristic of the operations of high-technology or research-oriented enterprises. . . . [Concepts Statement 6, paragraphs 87 and 88]

The definitions of revenues, expenses, gains, and losses are less precise and serve a different purpose than the definitions of the six elements described in the preceding pages—assets, liabilities, equity, investments by owners, distributions to owners, and comprehensive income. Those six constitute the complete set of definitions of fundamental elements of financial statements of business enterprises. They are mutually exclusive and collectively are both necessary and sufficient to account for the wealth and net wealth of an enterprise at any time and for all changes in its net wealth during a period, including the changes comprising profit or loss (or income) for the period.<sup>147</sup>

In contrast, distinctions between revenues and gains and between expenses and losses are not needed to determine comprehensive income. Since comprehensive income is determined by changes in assets and liabilities, it can be derived without separating it into its various components.

Revenues, expenses, gains, and losses are useful not to define comprehensive income but to show how it is obtained.

In the diagram [Figure 4], dashed lines rather than solid boundary lines separate revenues and gains and separate expenses and losses because of display considerations . . . . [T]his Statement . . . do[es] not precisely distinguish between revenues and gains on the one hand or between expenses and losses on the other. Fine distinctions between revenues and gains and between expenses and losses, as well as other distinctions *within* comprehensive income, are more appropriately considered as part of display or reporting. [Concepts Statement 6, paragraph 64]

Definitions of the components of comprehensive income are significant because to satisfy the objectives of financial reporting, that is, to provide information intended to be useful to investors and creditors in assessing an enterprise's performance or profitability, requires more information about comprehensive income than just its amount. Investors and creditors want and need to know how and why equity has changed, not just the amount that it has changed. The sources of comprehensive income are significant to those at-

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<sup>147</sup>As noted earlier, the definitions in Concepts Statements 3 and 6 are of things and events in the real world and not of their representations in financial statements. Limitations on financial statements' reporting of an enterprise's wealth and changes in wealth stem from accounting's inability to recognize all wealth and changes in wealth in financial statements and accountants' historic reluctance to recognize even what can be recognized and measured with reasonable reliability.

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tempting to use financial statements to help them with investment, credit, and similar decisions.

Information about various components of comprehensive income is usually more useful than merely its aggregate amount to investors, creditors, managers, and others who are interested in knowing not only that an entity's net assets have increased (or decreased) but also *how* and *why*. The amount of comprehensive income for a period can, after all, be measured merely by comparing the ending and beginning equity and eliminating the effects of investments by owners and distributions to owners, but that procedure has never provided adequate information about an entity's performance. Investors, creditors, managers, and others need information about the causes of changes in assets and liabilities. [Concepts Statement 6, paragraph 219]

Comprehensive income is an all-inclusive income concept and results from many and varied sources. The primary source of comprehensive income is an enterprise's major or central operations, but income also can often be generated by peripheral or incidental activities in which an enterprise engages. Moreover, the economic, legal, social, political, and physical environment in which an enterprise operates creates events and circumstances—such as, price changes, interest rate changes, technological changes, impositions of taxes and regulations, discovery, growth or accretion, shrinkage, vandalism, thefts, expropriations, wars, fires, and natural disasters—that can affect comprehensive income but that may be partly or wholly beyond the control of individual enterprises and their managements (Concepts Statement 6, paragraphs 74 and 75; the examples are from paragraph 32).

Those many and varied transactions and other events that constitute sources of comprehensive income—central and peripheral, planned and unplanned, controllable and noncontrollable—result in receipts that may differ in stability, risk, and predictability. Thus the desire for information about the various sources of comprehensive income underlies the distinctions between revenues, expenses, gains, and losses.

Different components of income are useful to distinguish revenue generated from the production and sale of products from return on investments in marketable securities in an income statement. The primary purpose of separating comprehensive income into revenues and expenses and gains and losses is to make the display of information about an enterprise's sources of comprehensive income as useful as possible.

### **Net Assets of Not-for-Profit Organizations**

A not-for-profit organization has no ownership interests that can be sold or transferred or that convey entitlement to a share of a residual distribution of resources in the event of liquidation of the organization. It thus does not receive investments of assets by owners



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and is generally prohibited from distributing assets as dividends to its members or officers. Increases in its net assets result from receipt of assets from resource providers who expect to receive neither repayment nor return on the assets. However, some resource providers may impose permanent or temporary restrictions on the uses of the assets they contribute to be able to influence an organization's use of those assets. Thus, Concepts Statement 6 (paragraphs 92-94) divides net assets of not-for-profit organizations into three mutually exclusive classes—permanently restricted net assets, temporarily restricted net assets, and unrestricted net assets. Restrictions restrain the organization from using part of its resources for purposes other than those specified, for example, to settle liabilities or to provide services outside the purview of the restrictions.

Briefly, permanently restricted net assets is the part of net assets resulting from inflows of assets whose use by the organization is limited by donor-imposed stipulations that neither expire nor can be satisfied or otherwise removed by any action of the organization. Stipulations that require resources to be permanently maintained but that permit the organization to use the income derived from the donated assets are often called *endowments*.

Temporarily restricted net assets is the part of net assets governed by donor-imposed stipulations that can expire or be fulfilled or removed by actions of the organization in accordance with those stipulations. Once the stipulation is satisfied, the restriction is gone.

Unrestricted net assets is the part of net assets resulting from all revenues, expenses, gains, and losses that are not changes in permanently or temporarily restricted net assets. The only limits on unrestricted net assets are the broad limits encompassing the nature of the organization, which are specified in its articles of incorporation or bylaws, and perhaps limits resulting from contractual agreements (for example, loan covenants) entered into by the organization in the course of its operations.

Although a not-for-profit organization does not have ownership interests or comprehensive income in the same sense as a business enterprise, to be able to continue to achieve its service and operating objectives, it needs to maintain net assets such that resources made available to it at least equal the resources needed to provide services at levels satisfactory to resource providers and other constituents. To assess an organization's success at maintaining net assets, resource providers need information about the components of changes in net assets—revenues, expenses, gains, and losses. The definitions of revenues, expenses, gains, and losses of business enterprises also apply to not-for-profit organizations and

include all transactions and other events and circumstances that change the amount of net assets of a not-for-profit organization. All resource inflows and other enhancements of assets of a not-for-profit organization or settlements of its liabilities that increase net assets are either revenues or gains and have characteristics similar to the revenues or gains of a business enterprise. Likewise, all resource outflows or other using up of assets or in-

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currences of liabilities that decrease net assets are either expenses or losses and have characteristics similar to expenses or losses of business enterprises. [Concepts Statement 6, paragraph 111]

A not-for-profit organization's central operations—its service-providing efforts, fund-raising activities, and most exchange transactions—by which it attempts to fulfill its service objectives, are the sources of its revenues and expenses. Gains and losses result from activities that are peripheral or incidental to its central operations and from interactions with its environment, which give rise to price changes, casualties, and other effects that may be largely beyond the control of an individual organization and its management.

### **Accrual Accounting and Related Concepts**

Concepts Statement 6 also defines several “terms of art” or significant financial accounting and reporting concepts that are used extensively in the conceptual framework.

### *Transactions, Events, and Circumstances*

*Transactions and other events and circumstances* affecting an entity is a phrase used throughout the conceptual framework to describe the sources or causes of changes in assets, liabilities, and equity. Real-world occurrences that are reflected in financial statements divide into two categories: events and circumstances. They can be further divided into this hierarchy:

- Events
  - Transactions
    - Exchanges
    - Nonreciprocal transfers
  - Other external events
  - Internal events
- Circumstances

Events are by far the most important, encompassing external happenings, including transactions, and internal happenings. The breakdown of events into those various components highlights differences that are important to financial accounting.

An event is a happening of consequence to an entity. It may be an internal event that occurs within an entity, such as using raw materials or equipment in production, or it may be an external event that involves interaction

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between an entity and its environment, such as a transaction with another entity, a change in price of a good or service that an entity buys or sells, a flood or earthquake, or an improvement in technology by a competitor. [paragraph 135]

Transactions are external events that include reciprocal transfers of assets and liabilities between an entity and other entities called *exchanges* and *nonreciprocal transfers* between an entity and its owners or between an entity and entities other than its owners in which one of the participants is often a passive beneficiary or victim of the other's actions:

A transaction is a particular kind of external event, namely, an external event involving transfer of something of value (future economic benefit) between two (or more) entities. The transaction may be an exchange in which each participant both receives and sacrifices value, such as purchases or sales of goods or services; or the transaction may be a nonreciprocal transfer in which an entity incurs a liability or transfers an asset to another entity (or receives an asset or cancellation of a liability) without directly receiving (or giving) value in exchange. Nonreciprocal transfers contrast with exchanges (which are reciprocal transfers) and include, for example, investments by owners, distributions to owners, impositions of taxes, gifts, charitable or educational contributions given or received, and thefts. [paragraph 137]

Investments by and distributions to owners are nonreciprocal transfers because they are events in which an enterprise receives assets from owners and acknowledges an increased ownership interest or disperses assets to owners whose interests decrease. They are not exchanges from the point of view of the enterprise because it neither incurs any obligations nor sacrifices any of its assets in exchange for owners' investments, and it receives nothing of value to itself in exchange for the assets it distributes with the payment of a dividend.

Circumstances, in contrast, are not events but the results of events. They provide evidence of often imperceptible events that may already have happened but that are discernible only in retrospect by the resulting state of affairs. They are important in financial reporting because they often have accounting consequences.

Circumstances are a condition or set of conditions that develop from an event or a series of events, which may occur almost imperceptibly and may converge in random or unexpected ways to create situations that might otherwise not have occurred and might not have been anticipated. To see the circumstance may be fairly easy, but to discern specifically when the event or events that caused it occurred may be difficult or impossible. For ex-

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ample, a debtor's going bankrupt or a thief's stealing gasoline may be an event, but a creditor's facing the situation that its debtor is bankrupt or a warehouse's facing the fact that its tank is empty may be a circumstance. [paragraph 136]

### *Accrual Accounting*

The objectives of financial reporting are served by accrual accounting, which generally provides a better indication of an entity's assets, liabilities, and performance than does information about cash receipts and payments. Accrual accounting is defined in paragraph 139 of Concepts Statement 6:

Accrual accounting attempts to record the financial effects on an entity of transactions and other events and circumstances that have cash consequences for the entity in the periods in which those transactions, events, and circumstances occur rather than only in the periods in which cash is received or paid by the entity. Accrual accounting is concerned with an entity's acquiring of goods and services and using them to produce and distribute other goods or services. It is concerned with the process by which cash expended on resources and activities is returned as more (or perhaps less) cash to the entity, not just with the beginning and end of that process. It recognizes that the buying, producing, selling, distributing, and other operations of an entity during a period, as well as other events that affect entity performance, often do not coincide with the cash receipts and payments of the period.

Accrual accounting is based not only on cash transactions but also on all the transactions, events, and circumstances that have cash consequences for an entity but involve no concurrent cash movement. By accounting for noncash assets, liabilities, and comprehensive income, accrual accounting links an entity's operations and other transactions, events, and circumstances that affect it with its cash receipts and outlays, thereby providing information about its assets, liabilities, and changes in them that cannot be obtained by accounting only for its cash transactions.

Concepts Statement 6 also provides technical definitions of the following procedures used to apply accrual accounting [emphasis added]:

*Accrual* is concerned with expected future cash receipts and payments: it is the accounting process of recognizing assets or liabilities and the related liabilities, assets, revenues, expenses, gains, or losses for amounts expected to be received or paid, usually in cash, in the future. *Deferral* is concerned with past cash receipts and payments—with prepayments received (often described as collected in advance) or paid: it is the accounting process of

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recognizing a liability resulting from a current cash receipt (or the equivalent) or an asset resulting from a current cash payment (or the equivalent) with deferred recognition of revenues, expenses, gains, or losses. Their recognition is deferred until the obligation underlying the liability is partly or wholly satisfied or until the future economic benefit underlying the asset is partly or wholly used or lost. [paragraph 141]

*Allocation* is the accounting process of assigning or distributing an amount according to a plan or a formula. It is broader than and includes *amortization*, which is the accounting process of reducing an amount by periodic payments or write-downs. Specifically, amortization is the process of reducing a liability recorded as a result of a cash receipt by recognizing revenues or reducing an asset recorded as a result of a cash payment by recognizing expenses or costs of production. [paragraph 142]

*Realization* in the most precise sense means the process of converting noncash resources and rights into money and is most precisely used in accounting and financial reporting to refer to sales of assets for cash or claims to cash. . . . *Recognition* is the process of formally recording or incorporating an item in the financial statements of an entity. [paragraph 143]

*Matching* of costs and revenues is simultaneous or combined recognition of the revenues and expenses that result directly and jointly from the same transactions or other events. In most entities, some transactions or events result simultaneously in both a revenue and one or more expenses. The revenue and expense(s) are directly related to each other and require recognition at the same time. In present practice, for example, a sale of product or merchandise involves both revenue (sales revenue) for receipt of cash or a receivable and expense (cost of goods sold) for sacrifice of the product or merchandise sold to customers. . . . [paragraph 146]

That is a narrow definition of matching, similar to the definitions of Herman W. Bevis and George O. May (page 56 of this book). The definition excludes from matching the systematic and rational allocation of revenues or costs to periods by a formula and makes matching a single process in measuring comprehensive income, not a synonym for the entire periodic income determination process, as it commonly has been (pages 59 and 60).

Concepts Statement 6 also includes an example on debt discount, premium, and issue cost (paragraphs 235-239) to illustrate precise technical differences between some of those terms.

### **Recognition and Measurement**

Recognition and measurement originally had been viewed as separate components of the conceptual framework. Two research studies on recognition matters were commis-

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sioned by the FASB: *Recognition of Contractual Rights and Obligations: An Exploratory Study of Conceptual Issues* (1980), by Yuji Ijiri, and *Survey of Present Practices in Recognizing Revenues, Expenses, Gains, and Losses* (1981), by Henry R. Jaenicke. Those studies focused, respectively, on the timing of the initial recognition of assets and liabilities and on the related subsequent timing of recognition of revenues and expenses. A third study, *Recognition in Financial Statements: Underlying Concepts and Practical Conventions*, by L. Todd Johnson and Reed K. Storey, was published in 1982.

Meanwhile, a project on financial reporting and changing prices was to consider measurement. The direction of the original measurement project was changed, however, because of the urgency caused by the increasing prices of the late 1960s and 1970s and the SEC's issuance of ASR No. 190, *Notice of Adoption of Amendments to Regulation S-X Requiring Disclosure of Certain Replacement Cost Data*, which required certain publicly held companies to disclose replacement cost information about inventories, cost of sales, productive capacity, and depreciation. Instead of remaining part of the conceptual framework, the measurement project resulted in FASB Statement No. 33, *Financial Reporting and Changing Prices* (1979).

### **Concepts Statement No. 5**

Recognition decisions often cannot be separated from measurement decisions, particularly if the decision relates to when to recognize changes in assets and liabilities. Recognition and measurement were eventually combined in the conceptual framework because most Board members became convinced that certain recognition questions, which were among the most important to be dealt with, were so closely related to measurement issues that it was unproductive to try to handle them separately. The product of that union was Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, issued in December 1984.

### **Financial Statements**

Concepts Statement 5 includes concepts that relate recognition and measurement to the earlier Concepts Statements. For example, it is the part of the conceptual framework in which the FASB describes the financial statements that should be provided and how those financial statements contribute to the objectives of financial reporting.

Financial statements are a central feature of financial reporting—a principal means of communicating financial information to those outside an entity. In external general purpose financial reporting, a financial statement is a formal tabulation of names and amounts of money derived from accounting records that displays either financial position of an entity at a moment in time or one or more kinds of changes in financial position of the entity during a period of time. Items that are recognized in financial statements

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are financial representations of certain resources (assets) of an entity, claims to those resources (liabilities and owners' equity), and the effects of transactions and other events and circumstances that result in changes in those resources and claims. The financial statements of an entity are a fundamentally related set that articulate with each other and derive from the same underlying data. [paragraph 5]

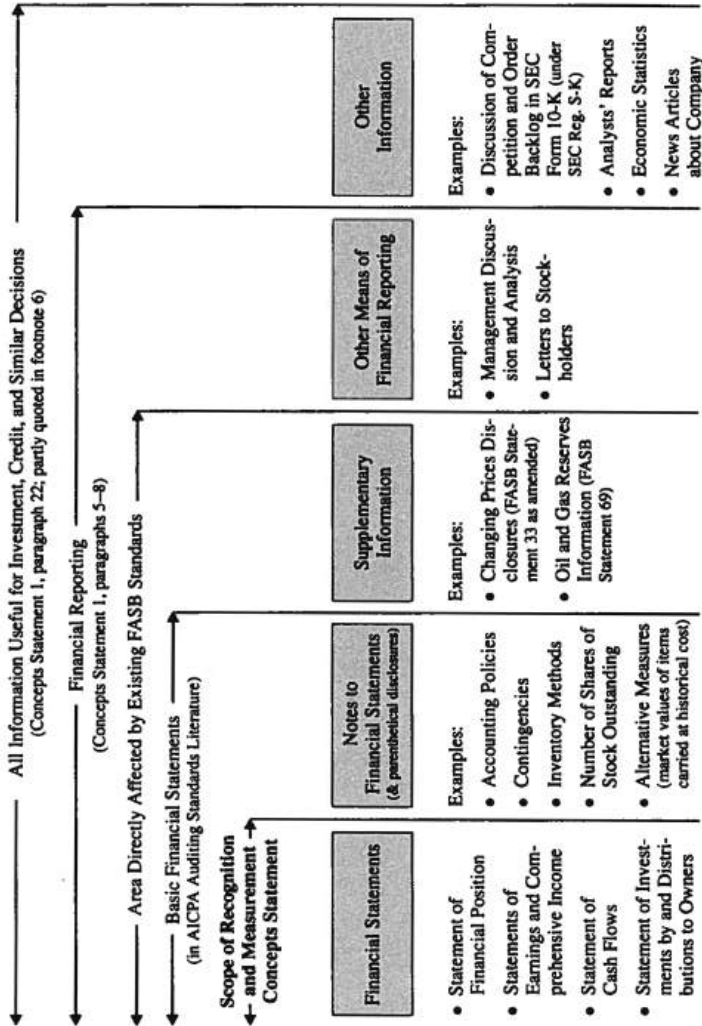
To satisfy the objectives of financial reporting—to provide information that is useful to investors and creditors and other users in making rational investment, credit, and similar decisions; to provide information to help them assess the amounts, timing, and uncertainty of prospective net cash inflows to an enterprise; and to provide information about the economic resources, claims to those resources (obligations to transfer resources to other entities and owners' equity), and changes in and claims to those resources—requires a full set of articulated financial statements that report:

- Financial position at the end of the period
- Earnings (net income) for the period
- Comprehensive income (total nonowner changes in equity) for the period
- Cash flows during the period
- Investments by and distributions to owners during the period. [Concepts Statement 5, paragraph 13]

A full set of financial statements provides information about an entity's financial position and changes in its financial position. Financial position, as depicted in a balance sheet, is determined by the relationship between an entity's economic resources (assets) and obligations (liabilities), leaving a residual (net assets or owners' equity). In addition, information about earnings, comprehensive income, cash flows, and transactions with owners are different kinds of information about the effects of transactions and other events and circumstances that change assets and liabilities during a period—that is, they are information about different kinds of changes in financial position.

Not all information useful for investment, credit, and similar decisions that financial accounting is able to provide can be reported in financial statements. Concepts Statement 5 includes a diagram (Figure 5) illustrating the many kinds of information that investors and creditors may contemplate consulting when deciding whether to invest in or loan funds to an enterprise. Financial statements provide only part of the information useful for investment, credit, and similar decisions. Financial reporting also encompasses notes to financial statements and parenthetical disclosures, which provide information about accounting policies or explain information recognized in the financial statements. Supplementary information about the effects of changing prices or management discussion and analysis provides information that may also be relevant for making decisions but is deemed not to meet the criteria necessary for recog-

Figure 5  
Information Useful for Investment, Credit, and Similar Decisions



Source: Concepts Statement 5, paragraph 5.



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inition in financial statements. Financial statements are unique because the information they provide is distinguished by its capacity and need to withstand the scrutiny of accounting recognition.

Concepts Statement 5, expanding the one-sentence definition in Concepts Statement 3, defines *recognition* as

the process of formally recording or incorporating an item into the financial statements of an entity as an asset, liability, revenue, expense, or the like. Recognition includes depiction of an item in both words and numbers, with the amount included in the totals of the financial statements. For an asset or liability, recognition involves recording not only acquisition or incurrence of the item but also later changes in it, including changes that result in removal from the financial statements. [paragraph 6]

A slight shift in emphasis discloses another characteristic of recognition: “Recognition attempts to represent or depict in financial statements the effects on an entity of real-world economic things and events.”<sup>148</sup> That description is congruent with the idea expressed throughout the conceptual framework that financial reporting is concerned with providing information about things and events that occur in the real world in which accounting takes place.

Concepts Statement 5 affirms the value of information disclosed in notes or other supplementary information as essential to understanding the information recognized in financial statements, but it also makes it clear that

disclosure by other means is *not* recognition. Disclosure of information about the items in financial statements and their measures that may be provided by notes or parenthetically on the face of financial statements, by supplementary information, or by other means of financial reporting is not a substitute for recognition in financial statements for items that meet recognition criteria. Generally, the most useful information about assets, liabilities, revenues, expenses, and other items of financial statements and their measures (that with the best combination of relevance and reliability) should be recognized in the financial statements. [paragraph 9]

Although information provided by notes to financial statements or by other means is valuable and ought to be made available to investors, creditors, and other users, it is not a substitute for recognition in the body of financial statements with the amounts included in the financial statement totals.

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<sup>148</sup>Johnson and Storey, *Recognition in Financial Statements*, page 2.

## *The Framework of Financial Accounting Concepts and Standards*

### *Comprehensive Income and Earnings*

Concepts Statement 5 says that a full set of financial statements should report both comprehensive income and earnings. Since the distinction between comprehensive income and earnings in the Statement is another manifestation of the difference of opinion about whether income is an enhancement of wealth (command over economic resources) or an indicator of performance of an enterprise and its management (pages 27 and 28 and pages 76-78 of this book), the Statement implies that financial statements should report both kinds of information. Present practice reports neither earnings nor comprehensive income, although a statement of net income based on present generally accepted accounting principles may report either or both if there are no changes in accounting principles or no holding gains or losses reported as direct increases or decreases in equity instead of in net income.

Comprehensive income was defined in Concepts Statement 3 as an all-inclusive income concept:

Comprehensive income is the change in equity (net assets) of an entity during a period from transactions and other events and circumstances from nonowner sources. It includes all changes in equity during a period except those resulting from investments by owners and distributions to owners.  
[paragraph 56]

The same definition was carried over into Concepts Statement 6, paragraph 70.

Comprehensive income is the only concept of income defined in the FASB's conceptual framework.<sup>149</sup> Although Concepts Statement 5 referred a half dozen times to "the concept of earnings" and gave earnings much more attention than comprehensive income, neither Concepts Statement 5 nor any other Concepts Statement defined earnings or its close relative net income. Instead, Concepts Statement 3, paragraph 1, footnote 1 [carried over into Concepts Statement 6], explained that the Board had changed to *comprehensive income* the name of the concept that was called *earnings* in Concepts Statement 1 and other conceptual framework documents previously issued and had reserved the term earnings for possible use to designate a component part of comprehensive income.

Later, Concepts Statement 5 did use the term earnings to describe a component part of comprehensive income that corresponds to net income in current practice, except that it

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<sup>149</sup>Comprehensive income is one of six mutually exclusive elements of financial statements of business enterprises whose definitions are necessary and sufficient to form a complete or closed set. The other five are assets, liabilities, equity, investments by owners, and distributions to owners (page 139 of this book).

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excludes the so-called catch-up adjustment required by paragraph 19(b) of APB Opinion No. 20, *Accounting Changes*, to be included in net income.<sup>150</sup>

Earnings and comprehensive income have the same broad components—revenues, expenses, gains, and losses—but are not the same because certain classes of gains and losses are included in comprehensive income but are excluded from earnings. [paragraph 42]

The Statement described a two-step relationship between earnings and comprehensive income:

$$\begin{aligned} & \text{Revenues} - \text{expenses} + \text{most gains} - \text{most losses} = \text{Earnings} \\ & \pm \text{Cumulative effect on prior years of a change in accounting principle} \\ & \qquad \qquad \qquad = \text{Net income} \\ & \pm \text{Gains and losses included in comprehensive income but excluded from} \\ & \qquad \qquad \qquad \text{net income}^{151} \\ & \qquad \qquad \qquad = \text{Comprehensive income.} \end{aligned}$$

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<sup>150</sup>Both earnings and net income as Concepts Statement 5 uses the terms are what Concepts Statements 3 and 6 described as intermediate components of comprehensive income: "Comprehensive income consists of not only its basic components—revenues, expenses, gains, and losses—but also various intermediate components or measures that result from combining the basic components. . . . in various ways to obtain several measures of enterprise performance with varying degrees of inclusiveness. . . . Those intermediate components or measures are, in effect, subtotals of comprehensive income and often of one another . . ." (Concepts Statement 3, paragraph 62; Concepts Statement 6, paragraph 77 is almost the same). Each Statement explains that: "Although cash resulting from various sources of comprehensive income is the same, receipts from various sources may vary in stability, risk, and predictability. . . . indicating a need for information about various components of comprehensive income" (paragraphs 61 and 76, respectively).

<sup>151</sup>This term, which is more descriptive and accurate than Concept Statement 5's *other nonowner changes in equity*, was used in FASB Statement No. 109, *Accounting for Income Taxes* (February 1992), and implied in a number of other FASB Statements. This entry is from Statement 109's glossary:

### **Gains and losses included in comprehensive income but excluded from net income**

Under present practice, gains and losses included in comprehensive income but excluded from net income include certain changes in market values of investments in marketable equity securities classified as noncurrent assets, certain changes in market values of investments in industries having specialized accounting practices for marketable securities, adjustments from recognizing certain additional pension liabilities, and foreign currency translation adjustments. Future changes to generally accepted accounting principles may change what is included in this category. [paragraph 289]

Concepts Statement 5, FASB Statement 109, and other FASB Statements refer only to *gains and losses* that are included in comprehensive income but excluded from earnings. In some kinds of enterprises, however, increases and decreases in equity from holding assets or owing liabilities while their prices change involve activities that constitute ongoing major or central operations and thus qualify as revenues and expenses instead of gains and losses (pages 136–140 of this book).

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The Concepts Statements describe but do not define earnings and net income because they cannot be defined. Both result from applying generally accepted accounting principles and are determined by what is done in practice at a particular time—the meaning of each changes with changes in generally accepted accounting principles. Thus, paragraph 35 of Concepts Statement 5 says:

The Board expects the concept of earnings to be subject to the process of gradual change or evolution that has characterized the development of net income. Present practice has developed over a long time, and that evolution has resulted in significant changes in what net income reflects, such as a shift toward what is commonly called an “all-inclusive” income statement. Those changes have resulted primarily from standard-setting bodies’ responses to several factors, such as changes in the business and economic environment and perceptions about the nature and limitations of financial statements, about the needs of users of financial statements, and about the need to prevent or cure perceived abuse(s) in financial reporting. Those factors sometimes may conflict or appear to conflict. For example, an all-inclusive income statement is intended, among other things, to avoid discretionary omissions of losses (or gains) from an income statement, thereby avoiding presentation of a more (or less) favorable report of performance or stewardship than is justified. However, because income statements also are used as a basis for estimating future performance and assessing future cash flow prospects, arguments have been advanced urging exclusion of unusual or nonrecurring gains and losses that might reduce the usefulness of an income statement for any one year for predictive purposes.

Those kinds of arguments also have been advanced urging exclusion of recurring gains and losses that increase the volatility of reported net income, and the FASB has to some extent responded. For example, FASB Statement No. 12, *Accounting for Certain Marketable Securities* (1975), and FASB Statement No. 52, *Foreign Currency Translation* (1981), excluded from net income certain holding gains and losses (gains and losses from holding assets or owing liabilities while their prices change). Briefly, Statement 12 required the carrying amount of a marketable equity securities portfolio to be the lower of its aggregate cost and market value but required that changes in the carrying amount of a noncurrent marketable equity securities portfolio “be included in the equity section of the balance sheet [that is, not included in net income] and shown separately” (paragraph 11). Similarly, Statement 52 provided that “translation adjustments [as defined in the Statement] shall not be included in determining net income but shall be reported separately and accumulated in a separate component of equity” (paragraph 13). The Board had taken a step away from the Accounting Principles Board’s decision to make reported net income all-inclusive—“net income should reflect all items of profit and loss recognized during the period with the sole exception of the prior period adjustments” (APB Opinion No. 9, *Reporting the Results of Operations* [December 1966], paragraph 17)—

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and had set the stage for the distinction between earnings and comprehensive income that it made in Concepts Statement 5.

As might have been expected, comprehensive income generally has been criticized for being too inclusive, among other things including volatile holding gains and losses that are excluded from net income or earnings. For example, John W. March's dissent to Concepts Statement 5 reflected the common view that periodic income determination should focus on performance rather than report gains and losses from all sources that increase or decrease wealth. These are the first and penultimate paragraphs of his dissent:

Mr. March dissents from this Statement because (a) it does not adopt measurement concepts oriented toward what he believes is the most useful single attribute for recognition purposes, the cash equivalent of recognized transactions reduced by subsequent impairments or loss of service value—instead it suggests selecting from several different attributes without providing sufficient guidance for the selection process; (b) it identifies all nonowner changes in assets and liabilities as comprehensive income and return on equity, thereby including in income, incorrectly in his view, capital inputs from nonowners, unrealized gains from price changes, amounts that should be deducted to maintain capital in real terms, and foreign currency translation adjustments; (c) it uses a concept of income that is fundamentally based on measurements of assets, liabilities, and changes in them, rather than adopting the Statement's concept of earnings as the definition of income; and (d) it fails to provide sufficient guidance for initial recognition and derecognition of assets and liabilities.

The description of earnings (paragraphs 33-38) and the guidance for applying recognition criteria to components of earnings (paragraphs 78-87) is consistent with Mr. March's view that income should measure performance and that performance flows primarily from an entity's fulfillment of the terms of its transactions with outside entities that result in revenues, other proceeds on resource dispositions (gains), costs (expenses) associated with those revenues and proceeds, and losses sustained. However, Mr. March believes that those concepts are fundamental and should be embodied in definitions of the elements of financial statements and in basic income recognition criteria rather than basing income on measurements of assets, liabilities, and changes in them.<sup>152</sup>

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<sup>152</sup>March's dissent to Concepts Statement 5 constituted a retroactive dissent to Concepts Statement 3, to which he had assented. The dissent explicitly repudiated Concepts Statement 3's definition of comprehensive income and would replace it in the definitions of the elements of financial statements with Concepts Statement 5's "concept of earnings."

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As March suggested, Concepts Statement 5 contains good, brief descriptions of the goal of periodic income determination in the minds of those who think it should focus on performance.

. . . Earnings is a measure of performance for a period and to the extent feasible excludes items that are extraneous to that period—items that belong primarily to other periods. . . . [paragraph 34]

Earnings focuses on what the entity has received or reasonably expects to receive for its output (revenues) and what it sacrifices to produce and distribute that output (expenses). Earnings also includes results of the entity's incidental or peripheral transactions and some effects of other events and circumstances stemming from the environment (gains and losses). [paragraph 38]

Concepts Statement 5, as noted earlier, devoted much more attention to earnings than to comprehensive income, and for more than ten years the Board did nothing more about its conclusion that a full set of financial statements reports comprehensive income (paragraph 13). Most people had, to their knowledge, never seen a statement that reports comprehensive income and may have had difficulty picturing it and its relation to an income statement in present practice.

As a result of Statements 12 and 52 and other FASB Statements of which they were forerunners, net income is less all-inclusive than it was, say, after issuance of APB Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions* (June 1973). Since the FASB has not required a statement of comprehensive income, pronouncements such as Statements 12 and 52 that exclude volatile holding gains and losses from net income and bury them directly in equity have made it possible for many U.S. enterprises to report periodic income that reflects their domestic and foreign operations as less risky than they actually are.

That may be about to change. The Board recently has been talking about how to report both earnings, or its close relative net income, and comprehensive income and has issued an Exposure Draft, *Reporting Comprehensive Income* (June 20, 1996).<sup>\*</sup> The Board's effort seems to have been encouraged by *Financial Reporting in the 1990s and Beyond* (1993), a report by the Financial Accounting Policy Committee of the Association for Investment Management and Research intended to express the views of AIMR members on financial reporting.

Throughout the report, there are repeated recommendations that the FASB needs to develop its concept of “comprehensive income.” [page 5]

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<sup>\*</sup>Authors' note: FASB Statement No. 130, *Reporting Comprehensive Income*, was issued in June 1997.

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We refer to comprehensive income several times above and have urged the FASB to construct the bridge from concept to standard. It is needed for better and more useful financial reporting in several areas.

. . . The F[inancial] A[ccounting] P[olicy] C[ommittee] has consistently supported the all-inclusive income statement format. . . . We consider income to include all of an enterprise's wealth changes except those engendered from transactions with its owners. We have profound misgivings about the increasing number of wealth changes that elude disclosure on the income statement. Yet individual items may be interpreted differently. That calls for a display of comprehensive income that allows components of different character to be seen and evaluated separately. [page 63]

### **Capital Maintenance**

Maintenance of capital is a financial concept or abstraction needed to measure comprehensive income. Since comprehensive income is a residual concept, not all revenues of a business enterprise for a period are comprehensive income because the sacrifices necessary to produce the revenues must be considered. Capital used up during the period must be recovered from revenues or other increases in net assets before any of the return may be considered comprehensive income. A concept of capital maintenance is critical for distinguishing an enterprise's return *on* investment from return *of* investment because an enterprise receives a profit or income—a return on investment—only after its capital has been maintained or recovered.

Two major concepts of capital maintenance exist, the financial capital concept and the physical capital concept (which is often described as maintaining operating capability, that is, maintaining the capacity of an enterprise to provide a constant supply of goods or services).

In Concepts Statement 5, the Board decided that the concept of financial capital maintenance is the basis for a full set of articulated financial statements.

A return on financial capital results only if the financial (money) amount of an enterprise's net assets at the end of a period exceeds the financial amount of net assets at the beginning of the period after excluding the effects of transactions with owners. The financial capital concept is the traditional view and is the capital maintenance concept in present financial statements. [paragraph 47]

Financial capital maintenance can be measured either in units of money (for example, nominal dollars) or in units of constant purchasing power (for example, 1982-1984 dollars or 1996 dollars).

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The Board rejected the physical capital concept, which holds that

a return on physical capital results only if the physical productive capacity of the enterprise at the end of the period (or the resources needed to achieve that capacity) exceeds the physical productive capacity at the beginning of the period, also after excluding the effects of transactions with owners. [paragraph 47]

The general procedure for maintaining physical capital is to value assets, such as inventories, property, plant, and equipment at their current replacement costs and to deduct expenses, such as cost of goods sold and depreciation, at replacement costs from revenues to measure periodic return on capital. The increases and decreases in replacement costs of those assets while they are held by the enterprise are included in owners' equity as a "capital maintenance adjustment" rather than in return on capital as "holding gains and losses." The idea underlying the measurement of return on capital in the physical capital concept is that increases in wealth that are merely increases in prices of things that an enterprise must continue to hold to engage in operations do not constitute return on capital but part of the capital to be maintained.

The principal difference between the two concepts is in the treatment of holding gains and losses resulting from the effects of price changes during a period on assets while held and on liabilities while owed.

Under the financial capital concept, if the effects of those price changes are recognized, they are conceptually holding gains and losses . . . and are included in the return on capital. Under the physical capital concept, those changes would be recognized but conceptually would be capital maintenance adjustments that would be included directly in equity and not included in return on capital. Both earnings and comprehensive income as set forth in this Statement, like present net income, include holding gains and losses that would be excluded from income under a physical capital maintenance concept. [paragraph 48]

### **Measurement and Attributes**

By definition, recognition includes the depiction of an item in both words and numbers. The need to quantify the information about an item to be recognized introduces the issue of its *measurement*.

Measurement involves choice of an attribute by which to quantify a recognized item and choice of a scale of measurement (often called "unit of measure"). [Concepts Statement 5, paragraph 3]



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*Attribute* is defined and explained in footnote 2 to paragraph 2 of Concepts Statement 1:

“Attributes to be measured” refers to the traits or aspects of an element to be quantified or measured, such as historical cost/historical proceeds, current cost/current proceeds, etc. Attribute is a narrower concept than measurement, which includes not only identifying the attribute to be measured but also selecting a scale of measurement (for example, units of money or units of constant purchasing power). “Property” is commonly used in the sciences to describe the trait or aspect of an object being measured, such as the length of a table or the weight of a stone. But “property” may be confused with land and buildings in financial reporting contexts, and “attribute” has become common in accounting literature and is used in this Statement.

Since recognition often involves recording changes in assets and liabilities, it often raises the question of whether the amount of an attribute should be changed or whether a different attribute should be used in its place. In any event, since the changes in an asset or liability and in the attribute occur at the same time, it is often difficult to separate recognition from measurement problems.

Five different attributes of assets and liabilities are used in present accounting practice. The following is based on paragraph 67 of Concepts Statement 5, which describes the attributes and gives examples of the kinds of assets for which each attribute is commonly reported:

1. *Historical cost.* The amount of cash or its equivalent paid to acquire an asset, usually adjusted after acquisition for amortization or other allocations (for example, property, plant, equipment, and most inventories).
2. *Current cost.* The amount that would have to be paid if the same or an equivalent asset were acquired currently (for example, some inventories).
3. *Current market value.* The amount that could be obtained by selling an asset in orderly liquidation (for example, marketable securities).
4. *Net realizable value.* The nondiscounted amount into which an asset is expected to be converted in due course of business less direct costs necessary to make that conversion (for example, short-term receivables).
5. *Present (or discounted) value of future cash flows.* The present value of future cash inflows into which an asset is expected to be converted in due course of business less present values of cash outflows necessary to obtain those inflows (for example, long-term receivables).

**Recognition and Measurement—Description Rather Than Concepts**

The preceding pages have described several areas in which Concepts Statement 5 has furthered the conceptual framework, at least to some extent—in identifying what a full set of financial statements comprises, in expanding and clarifying what constitutes recognition, in explaining the relationship between comprehensive income and its component part, earnings, and in endorsing financial capital maintenance.

Although the Statement's name implies that it gives conceptual guidance on recognition and measurement, its conceptual contributions to financial reporting are not really in those two areas. As the result of compromises necessary to issue it, much of Concepts Statement 5 merely describes present practice and some of the reasons that have been used to support or explain it but provides little or no conceptual basis for analyzing and attempting to resolve the controversial issues of recognition and measurement about which accountants have disagreed for years.

The FASB knew all along that recognition and measurement concepts would be controversial. Each component of the conceptual framework—the objectives, the qualitative characteristics, the elements of financial statements, recognition and measurement—is successively less abstract and more concrete than the one before. Recognition and measurement are the most concrete and least abstract of the components because they are necessarily at the point at which concepts and practice converge. They are the components in which practicing accountants have been most interested because they determine what actually gets into the numbers and totals in the financial statements. While few practitioners may be interested in what they may see as abstractions—such as objectives, qualitative characteristics, and definitions—most are interested in a change in revenue recognition or the measured attribute of an asset, or perhaps in reporting the effects of inflation, and they usually feel that they have a vested interest in the Board's decisions regarding recognition and measurement and in resisting changes that may adversely affect their future reporting.

Accountants have strongly-held, and ultimately-polarizing, views about which is the most relevant and reliable attribute to be measured and about the circumstances needed for recognizing changes in attributes and changes in the amounts of an attribute. Proponents of the present model—which often is mislabeled *historical cost accounting* because it is actually a mixture of historical costs, current costs, current exit values, net realizable values, and present values—fiercely defend it and broach no discussion of alternatives for fear that any change would portend its abandonment in favor of *current value accounting*, a term that is used generically to refer to the continuous use of any attribute other than historical cost. Similarly, proponents of various current cost or current value models are equally unyielding, often almost as critical of other current value or current cost models that compete with their own favorite model as they are of the historical-cost model for its failure to recognize the realities of changing values and changing prices.

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The Board was as badly split on recognition and measurement as the constituency. Although most Board members could see the deficiencies in the current model, a majority of the Board could not accept a current value or current cost measurement system, even at a conceptual level. Therefore, instead of indicating a preferred accounting model or otherwise offering conceptual guidance about measurement, Concepts Statement 5 merely acknowledged that present practice consists of a mix of five attributes for measuring items in financial statements and said that the Board “expects the use of different attributes to continue” (paragraph 66). Beyond that, it said that “information based on current prices should be recognized if it is sufficiently relevant and reliable to justify the costs involved and more relevant than alternative information” (paragraph 90), which was extremely weak guidance. Whereas a neutral exposition of alternatives was appropriate for a Discussion Memorandum, a litany of present measurement practices with neither conceptual analysis or evaluation nor guidance for making choices was not proper for a Concepts Statement.

In merely describing current practice, Concepts Statement 5 is a throwback to statements of accounting principles produced by the “distillation of experience” school of thought—an essentially practical, not a conceptual, effort. Its prescriptions for improving practice are reminiscent of those of the Committee on Accounting Procedure or the Accounting Principles Board: measurement problems will be resolved on a case-by-case basis. Unfortunately, that approach worked only marginally well for those now-defunct bodies.

Oscar Gellein called the discussion of recognition in the Exposure Draft that ultimately became part of Concepts Statement 5 “a helpful distillation of current recognition practices.” However, he also saw that the Statement would not advance financial reporting in the area of recognition and measurement:

The umbrella is broad enough to cover virtually all current practices, but not conceptually directed toward either narrowing those practices or preventing their proliferation. . . . Recognition is the watershed issue in the conceptual framework in the sense that hierarchically it is the ultimate stage of conceptual concreteness. Without that kind of conceptual guidance, there is the risk of reversion to ad hoc rules in determining accounting methods.<sup>153</sup>

David Solomons criticized Concepts Statement 5 for distorting the process of formulating future accounting standards.<sup>154</sup> He noted that in several places it asserts that concepts are to be developed as the standards-setting process evolves, citing these examples:

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<sup>153</sup>Gellein, “Financial Reporting: The State of Standard Setting,” page 14.

<sup>154</sup>David Solomons, “The FASB’s Conceptual Framework: An Evaluation,” *The Journal of Accountancy*, June 1986, page 122.

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The Board expects the concept of earnings to be subject to the process of gradual change or evolution that has characterized the development of net income. [paragraph 35]

Future standards may change what is recognized as components of earnings. . . . Moreover, because of the differences between earnings and comprehensive income, future standards also may recognize certain changes in net assets as components of comprehensive income but not as components of earnings. [paragraph 51]

The Board believes that further development of recognition, measurement, and display matters will occur as the concepts are applied at the standards level. [paragraph 108]

Solomons was not at all persuaded by the Board's apparent argument, represented by those excerpts, that concepts could be a by-product of the standards-setting process:

These appeals to evolution should be seen as what they are—a cop-out. If all that is needed to improve our accounting model is reliance on evolution and the natural selection that results from the development of standards, why was an expensive and protracted conceptual framework project necessary in the first place? It goes without saying that concepts and practices should evolve as conditions change. But if the conceptual framework can do no more than point that out, who needs it? And, for that matter, if progress is simply a matter of waiting for evolution, who needs the FASB?<sup>155</sup>

Concepts Statement 5 almost seems to have anticipated the challenges to its legitimacy as a Statement of recognition and measurement concepts and capitulated in its second and third paragraphs, which could serve as its epitaph:

The recognition criteria and guidance in this Statement are generally consistent with current practice and do not imply radical change. Nor do they foreclose the possibility of future changes in practice. The Board intends future change to occur in the gradual, evolutionary way that has characterized past change.

This Statement also . . . notes that . . . the Board expects the use of different attributes. . . . [and] nominal units of money (that is, unadjusted for changes in purchasing power over time) . . . to continue.

Concepts Statement 5 does make some noteworthy conceptual contributions—they are just not on recognition and measurement.

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<sup>155</sup>Solomons, "The FASB's Conceptual Framework: An Evaluation," page 122.

## INVITATION TO LEARN MORE

This book is more of a generous introduction to the FASB's conceptual framework than a comprehensive description or analysis of it. About half of the book is concerned with the antecedents of the conceptual framework, why the FASB undertook it, and why it contains the particular set of concepts that it does. The framework cannot really be understood without that background. The descriptions of the various Concepts Statements emphasized their major conclusions and some of the explanation they provide but did not go into them deeply enough to provide a substitute for reading them. Readers are urged to read the Concepts Statements themselves.

The FASB has used the completed parts of the framework with considerable success. The Board's constituents also have learned to use the framework, partly at least because they have discovered that they are more likely to influence the Board if they do. Both the Board and the constituents have also found that at times the concepts appear to work better than at other times, and undoubtedly they sometimes could have been more soundly applied. As much of the book suggests, some parts of the conceptual framework are still controversial, partly at least because long-held views die hard. The framework remains unfinished, although the Board gives no sign of completing it in the near future.

Despite the fact that the Board has left it incomplete, the FASB's conceptual framework

- Is the first reasonably successful effort by a standards-setting body to formulate and use an integrated set of financial accounting concepts
- Has fundamentally changed the way financial accounting standards are set in the United States
- Has provided a model for the International Accounting Standards Committee and several national standards-setting bodies in other English-speaking countries, which not only have set out their own concepts but also clearly have been influenced by the FASB's Concepts Statements, sometimes to the point of adopting the same or virtually the same set of concepts.

The Concepts Statements can continue to contribute significantly to better financial accounting and reporting standards. However, the conceptual framework is primarily a set of tools in the hands of standards setters. To live up to their promise, sound concepts require "the right blend of characteristics in standard setters—independence of mind, intellectual integrity, judicial temperament, and a generous portion of wisdom."<sup>156</sup>

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<sup>156</sup>Kirk, "Looking Back on Fourteen Years at the FASB: The Education of a Standard Setter," page 17.



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