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IASB`S & FASB´S joint conceptual framework project

International Financial Accounting
Introduction

In 2005, the IASB (International Accounting Standards Board) and FASB (US Financial Accounting Standards Board) launched a joint project to introduce convergence between their respective conceptual frameworks, and therefore convergence on national and international standards. The project is launched partly because the boards and other standard-setters have concluded that their existing frameworks do not fully meet their needs. Further there are several gaps in the current frameworks that need to be filled and a number of areas that need to be updated. This project is likely to influence the development of accounting standards for many years to come.

When launching a joint project between these two already existing frameworks IASB`S and FASB`s main objective is to create a common conceptual framework that is both complete and globally accepted. A framework like this would provide a sound foundation for developing future accounting standards and is essential to fulfilling the Boards’ goal of developing standards that are principles-based, internally consistent, internationally converged, and that lead to financial reporting that provides the information needed for investment, credit, and similar decisions. (McGregor & Street 2007). In order to achieve these objectives the boards are conducting this joint project in eight phases.

Purpose

The purpose of this thesis is to present FASB’s and IASB’s joint conceptual framework project and identify the objectives of this project. Another intention of the paper is to compare the current frameworks to this joint project in order to identify and comment the biggest differences

Background information

A conceptual framework of accounting is vital because it aims to make it easier to promulgate a coherent and consistent set of standards and rules. This will help decision makers solve accounting and financial reporting problems.

The Conceptual Framework is like a constitution for financial reporting, providing the foundation for accounting standards. Further it provides a structure to the process of creating financial reporting standards and makes sure that standards are based on fundamental principles. This will help prevent standards from becoming temporary and transitory. (Gore & Zimmerman 2007)

A conceptual framework makes standards setting more efficient by providing a common set of terms and premises for analyzing accounting issues. The boards expect that a common conceptual framework will promote the convergence of U.S. GAAP and International Financial Reporting Standards (IFRS). This will ultimately lead to a single set of high-quality global accounting standards. (Gore & Zimmerman 2007)
However even though the current conceptual frameworks, that initially were developed over twenty years ago, are helpful to standard-setters they are not good enough, according to Halsey Bullen (Haffes 2005). In order to efficiently and effectively improve, complete, and converge the existing frameworks the boards must focus on changes in the environment since the original frameworks were issued. (FASB 2009 a)

As can be seen above the primary motivation for this project is not only the convergence between the boards’ frameworks. Improvement is equally important. There are two aspects of improvement. One is referring to filling the gaps in the frameworks to achieve completeness; the other is referring to removing inconsistencies to improve coherence (Whittington 2008).

**Objectives of the joint conceptual framework project**

The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to present and potential equity investors, lenders, and other creditors in making decisions in their capacity as capital providers. This objective of financial reporting is the foundation of the joint conceptual framework project. Other aspects of the framework (qualitative characteristics, elements of financial statements, recognition and measurement etc) will build on that foundation with the aim of ensuring that financial reporting achieves its objective. (Kirsch)

As been mentioned the main objective of the conceptual framework project, is to develop an improved common conceptual framework that provides a sound foundation for developing future accounting standards. Such a framework is essential to fulfilling the Boards’ goal of developing standards that are principles-based, internally consistent, and internationally converged and that lead to financial reporting that provides the information capital providers need to make decisions in their capacity as capital providers. (FASB 2009 a)

Identifying and eliminate a variety of differences between IFRS (International Financial Reporting Standards) and US GAAP and then try to find the best global solution to these differences is another objective of this joint project. Further the boards’ are hoping to save money by working on rules together and also to increase the transparency of reports by conducting this joint project (Rimmel)

**Project Phases**

In order to fulfill the objectives described above and to improve the current frameworks the Boards’ are conducting this joint project in eight phases. Each of the first seven phases will address and involve planning, research, initial Board deliberations, public comment, and redeliberations on major aspects of the Boards’ frameworks. (FASB a) The eighth phase will be used to address any remaining issues. Each phase will further involve the issuance of a preliminary views document, followed by an exposure draft so that constituents can provide feedback concerning the boards' decisions. These eight phases will cover the entire spectrum of financial reporting, from the objectives and desired characteristics of financial reports, to the definition of the elements, the recognition and measurement of those elements, and the form and content of financial reports. There are only four active phases at the moment; those are A-D in the table below. The four inactive phases are shown in the table as well but will not be treated in this paper (Gore & Zimmerman 2007).
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Each phase has its' own objectives that contribute to the overall objective of the conceptual framework project. (Kirsch)

**Phase A Objectives and qualitative characteristics**

The aim of phase A, the Objectives and Qualitative Characteristics phase of Financial Reporting, is to consider:

- The objective of financial reporting
- The qualitative characteristics of financial reporting information
- The trade-offs among qualitative characteristics and how they relate to the concepts of materiality and cost-benefit relationships. (FASB 2009 b)

This first phase is very important for two reasons. First, it is crucial that a consensus can be reached concerning the objectives and desirable features of financial reports in order to provide legitimacy and momentum for the rest of the project. Second, the objectives and qualitative characteristics will provide the basis for evaluating alternatives related to the critical recognition and measurement issues to be decided in later phases of the project (Gore & Zimmerman 2007)
According to IFRS the objective of financial statements (exposure drafts uses the term financial reporting) is to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions (Rasches).

According to FASB in SFAC NO.1 the objective of financial reporting is much the same. It states that financial reporting should provide information that helps in making investment and credit decisions. Financial reporting should also provide information to users that enables assessing future cash flows and enables users to learn about economic resources, claims against those resources, and changes in them.

In the conceptual framework project the information function is the only objective of financial reporting. According to the exposure draft (ED.OB 2) “the objective of general purpose financial reporting is to provide information about the reporting entity that is useful to present and potential investors, lenders and other creditors in making decisions in their capacity as capital providers”. Generating information to help present and potential investors, creditors and others to assess the amounts, timing and the uncertainty of the entity’s future cash inflows and outflows is relevant for achieving this objective. This definition is wider and broader than today and reaches to a broader circle of users. It contains present and potential investors, lenders and other creditors instead of former concentration on investors. (Kirsch) This broader “entity perspective” is more inclusive than a narrow “proprietary perspective” (Whittington 2008). The same exposure draft also states that information that satisfies the needs of the investors and creditors is also likely to be useful to the other interested parties as well. It is an assumption that both stakeholder groups have common interests.

The management’s stewardship as an independent objective of financial reporting has been eliminated in the conceptual framework project. The first preliminary views (PV) document “Conceptual Framework for Financial Reporting: Objective of Financial Reporting and Qualitative Characteristics of Decision-Useful Financial Reporting Information,” was published jointly by FASB and the IASB in July 2006. This preliminary view states that the sole objective of financial reporting is to provide information to users in making resource allocation decisions. Thus, stewardship, which may be defined as accounting for the resources entrusted to management, is no longer considered by the boards to be a separate objective of financial accounting. Instead, the PV suggests that stewardship is encompassed in the objective of providing useful information regarding resource allocation decisions (Gore & Zimmerman 2007)

**Qualitative Characteristics of decision-useful financial information**

The qualitative characteristics are the attributes that make financial information useful. In developing standards, the boards will consider the qualitative characteristics so that information reported in financial reports is useful to capital providers, thus meeting the objective of general purpose financial reporting

**Definitions of qualitative characteristics**

- **Relevance** is defined as information that is capable of making a difference in the decisions of users by helping them to evaluate the potential effects of past, present, or future transactions, or other events on future cash flows (predictive value) or to confirm or correct previous evaluations (confirmatory value).
Faithful representation is defined as information must be a faithful representation of the real-world economic phenomena that it purports to represent.

Completeness should make sure that financial reporting is including all information that is necessary for faithful representation of economic phenomena that the information purports to represent.

Neutrality is supposed to ensure that there is no bias intended to attain a predetermined result or to induce a particular behavior.

Comparability enables users to identify similarities and differences between two sets of economic phenomena.

Consistency refers to the use of the same accounting policies and procedures, either from period to period within an entity or in a single period across entities.

Verifiability means that different knowledgeable and independent observers would reach general consensus, although not necessarily complete agreement.

Timeliness ensures that information is available to decision makers before it loses its capacity to influence decisions.

Understandability enables users who have reasonable knowledge of business and economic activities and financial reporting and studying with due diligence, to comprehend its meaning.

Reliability Information in financial statements is reliable if it is free from material error and bias and can be depended on by users to represent faithfully that which it either purports to represent or could reasonably be expected to represent.

Substance over form ensures that the financial statements will show the financial reality of the entity (substance), other than the legal form of transaction (form).

Prudence is the inclusion of a degree of caution in the exercise of the judgments needed in making the estimates required under conditions of uncertainty, such that assets or income are not overstated and liabilities or expenses are not understated.

Definitions of constraints

Materiality – Information is material if its omission or misstatement could influence decisions that users make on the basis of an entity’s financial information.

Cost vs. Benefit – The benefit of financial reporting information should justify the costs of providing and using it.

Weighing qualitative characteristics – Sometimes qualitative characteristics can be contradicting.

(Kirsch)

How these qualitative characteristics are categorized in the current IASB and FASB frameworks are shown in the annex to this paper. From these two different ways of categorizing qualitative characteristics the IASB and the FASB are trying to work out a new, globally accepted and improved way of categorizing the qualitative characteristics. How these qualitative characteristics are categorized in the joint conceptual framework project can be seen in the following picture
There are two fundamental qualitative characteristics in the joint conceptual framework, relevance and faithful representation. Faithful representation consists of three ancillary characteristics; neutrality, completeness and free from material errors. Further there are four enhancing qualitative characteristics: comparability, verifiability, timeliness and understandability. These are complementary to the two fundamental qualitative characteristics and enhance the fundamental qualitative characteristics by distinguishing more useful information from less-useful information. They should also be maximized to the extent possible, but will not on their own make information decision-useful. Finally there are two constraints that might limit the information provided by financial reporting: materiality and cost.

As can be seen in the picture above there are some changes in both form and language compared to the existing IASB and FASB frameworks. These changes will probably affect the interpretation of the underlying principles. One main change of language is the replacement of reliability by faithful representation. The central change in form is the sequential approach to applying the qualitative characteristics. This is replacing the hierarchy of qualitative characteristics used by FASB. It will also replace IASB’s simultaneous approach in which explicit trade-offs was made. Larger emphasis is also being put on relevance and faithful representation as the only two fundamental qualitative characteristics. In the current IAS Framework there are four equal important fundamental qualitative characteristics. The possible trade-off between relevance and reliability which by many is regarded as an important aspect of the present IAS Framework can be eliminated through these two changes. This trade-off is commonly invoked as a reason for not using fair value measurements, which are perceived as often being relevant but unreliable. (Wittington 2008)
For financial information to be decision-useful and therefore meet the objective of general purpose financial reporting it must possess both relevance and faithful representation. Relevance should be considered initially because it is essential and faithful representation should be considered next. Thus these two qualitative characteristic works in concert with each other. However there are different levels of relevance and faithful representation and this might lead to a potential trade-off between them. This seems to be overlooked and can lead to a selection first on the basis of the highest level of relevance and then subjecting this selection into a filter based on some absolute minimum level of faithful representation. You can also say that greater representational faithfulness might compensate for less relevance. (Wittington 2008)

Furthermore prudence is removed due to being too cautious and therefore giving a biased view of the reporting entity. It has agreed upon that neutrality is of larger importance and it is incompatible with conservatism (prudence) and therefore prudence has been left out of the conceptual framework. This is a change from the IAS-Framework where both neutrality and prudence were used. The principle that says that financial reporting should be free from material errors substitutes the former principle of prudence in the case of uncertainty. Regarding to completeness there can be potential conflicts with materiality, considering benefits and costs of information and also understandability. (Kirsch)

When it comes to the enhancing qualitative characteristics understandability is reduced in importance compared to IAS. There is no exclusion of information only because it is to complex or difficult for some users to understand, these users may need to seek the aid of an advisor. Understandability is enhanced when information is classified, characterized, and presented clearly and concisely. Comparability also enhances understandability. The term comparability includes consistency and if financial information easily can be compared this increases the quality of different allocation decisions. When amending or issuing a new standard the standard setters have to balance between a new potential better standard and a temporary reduction of consistency. Timeliness should ensure that information is available to decision makers before it loses its capacity to influence decisions. Lack of timeliness can rob information of its usefulness. One big difference from the IAS Framework is that timeliness is an enhancing qualitative characteristic instead of a constraint to all qualitative characteristic. (Kirsch)

Although the qualitative characteristics are the most abstract part of the Conceptual Framework, some of these changes mentioned above likely will result in considerable changes in the future direction of financial reporting. Accountants have to pay close attention to what is included in the qualitative characteristics and what is not (Gore & Zimmerman 2007).

**Phase B Elements and recognition**

Phase B is concentrated on the definition of two basic elements, assets and liabilities. The objectives of the elements and recognition phase are to refine and converge the Boards frameworks by revising and clarify the definitions of assets and liabilities. Then to resolve differences regarding other elements and their definitions and finally to revise the recognition criteria concepts to eliminate differences and provide a basis for resolving issues such as derecognition and unit of account. (FASB 2009 c)
The current definition of an asset in IASB Framework is:
“An asset is a resource controlled by an entity as a result of past events and from which future benefits are expected to flow to the entity”
In the proposed definition of an asset the boards have removed two important phrases, as a result of past events and from which future benefits may be expected to flow. The present proposed definition by the boards is:
“An asset is a present economic resource to which the entity has a present right or other privileged access”
IASB’s current definition of a liability is:
“A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits”
The liability definition mirrors the asset definition and so do the changes in the definition. The references to past events and to expectations of future flows are removed. The current proposed definition of a liability by the boards is:
“A liability is a present economic burden for which the entity has a present economic obligation” (Whittington 2008)

IASB and FASB have agreed that their present frameworks definitions of assets and liabilities have some shortcomings. Some users might misinterpret the terms “expected” in IASB’s definition and “probable” in FASB’s definition to mean that there must be a high possibility of future economic benefits for the definition of an asset to be met. In case of a liability these users wrongly conclude that there must be a high likelihood of future outflow of economic benefits for the definition to be met. This would exclude asset items with a low likelihood of future economic benefits and liability items with a low likelihood of a future outflow of economic benefits. The current definitions are placing too much weight on identifying the future flow or outflow of economic benefits, instead of focusing on the economic resource or an economic obligation that currently exists. The definitions also place too much emphasis on identifying the past transactions or events that gave rise to the asset or the liability, instead of focusing on whether the entity had access to the economic resource or the economic obligation at the balance sheet date. Thus by changing the definitions the boards are trying to overcome these shortcomings (FASB 2009 c). Changing the definitions also means that there is a change in how assets and liabilities are recognized.

The other elements defined in the present IASB Framework, equity, income and expenses, have not yet been addressed, and neither has been the important and potentially contentious issue of recognition.(Whittington 2008) The Boards’ approach will focus initially on converging and defining only those key elements that are defined today in the IASB and FASB Frameworks. As well, the Boards will need to consider the extent to which, and if so how, to define elements that are not defined today, such as comprehensive income. (FASB 2009 c)

Phase C Measurement

The objective of the Measurement phase is to provide guidance for selecting measurement bases that satisfy the objectives and qualitative characteristics of financial reporting.
The objective of this phase is further to create specific measurement concepts, principles, and terms. (FASB 2009 d). The biggest gap that needs to be filled is to develop guidance on measurement. Measurement is the most incomplete component of the existing conceptual
frameworks and has been affected most by the passage of time. One of the most pervasive measurements attributes in IASB and FASB literature, fair value, is not identified as a measurement basis in either of the boards’ frameworks. In addition, the existing frameworks identify “present value” as a measurement basis but it is in reality a measurement technique. Also, neither framework fully explains the nature of the mixed attribute. (FASB 2007)

It is clear that measurement is a critical aspect of financial reporting. However, it is also as been mentioned one of the most under-developed areas of the present conceptual frameworks. For example, the FASB framework, simply provides a list of measurement bases (or attributes) used in current practice and indicates that the use of different bases is expected to continue. Similarly, the IASB Framework merely lists examples of measurement bases that standard setters might consider.

In addition neither of the current frameworks provides any analysis of the strengths and weaknesses of the various measurement bases, nor do they offer any guidance on choosing among the listed bases or considering other alternatives. An overall objective of this phase is therefore to fill in these gaps in coverage. This will allow standard-setters to have clear, up-to-date guidance to use in determining the measurement requirements for specific accounting standards.

In April 2007 the Boards discussed issues related to primary measurement basis candidates. The Boards agreed to a list of nine candidates, past entry price, past exit price, modified past amount, current entry price, current exit price, current equilibrium price, value in use, future entry price, and future exit price. The boards lists the nine measurement basis candidates, and classifies them according to time frame. They also provides two definitions for each measurement basis candidate—one from the perspective of an asset and one from the perspective of a liability.

Two of the most talked-about measurement basis terms, historical cost and fair value are noticeably excluded from the list. That is because there is no common understanding of those terms, and their use often leads to miscommunication and misunderstanding. Historical cost and fair value have not been overlooked completely though. The measurement basis candidates relating to the past (past entry price, past exit price, and modified past amount) together constitute the notion of historical cost. Similarly, the list of candidates relating to the present (current entry price, current exit price, current equilibrium price, and value in use) encompasses the various notions of fair value (FASB 2007)

**Phase D Reporting entity**

The objective of this phase of the project is to develop a reporting entity concept for inclusion in the boards’ common conceptual framework. Like other phases of the conceptual framework project, the reporting entity phase focuses on developing a reporting entity concept in the context of general purpose financial reporting (FASB 2009 e). But the boards still needs to determine what constitutes a reporting entity for the purposes of financial reporting. The term reporting entity, in its most general sense, refers to the entity that is the subject of a particular set of financial reports.
The General purpose of financial reports is to provide information about a particular reporting entity. Those reports provide information about the entity’s economic resources, claims on those resources, and the effects of transactions and other events and circumstances that change an entity’s resources and the claims on them. It is the entity itself that is the subject of financial reporting, not its owners or others that have an interest in the entity. There is a distinction between the subject of general purpose financial reports and the users of those reports like equity investors and lenders.

The boards’ current existing conceptual frameworks do not contain a reporting entity concept. As a result of this, neither framework specifically addresses the reporting entity concept. Because of that there is no reporting entity concept in the boards’ existing conceptual frameworks, there is no obvious established starting point. The first task must be to more clearly establish the objective of this phase of the project.

Furthermore, this phase of the project does not seek to resolve all accounting issues relating to the reporting entity, in particular, issues that arise in standards-level projects or in accounting practices about consolidated financial statements. Therefore, once a reporting entity concept is developed, many issues will probably remain to be addressed at the standards level (FASB 2008).

Conclusions

There are some changes in the conceptual framework compared to the existing frameworks. For example, the management’s stewardship is removed as an independent objective of financial reporting.

The qualitative characteristics are categorized in a different way in the joint conceptual framework. The central change in form is the sequential approach in applying the qualitative characteristics. This is replacing the hierarchy of qualitative characteristics used by FASB. It will also replace IASB’s simultaneous approach in which explicit trade-offs were made. Further, reliability is removed in the conceptual framework and replaced by faithful representation. The possible trade-off between relevance and reliability is a main reason for these changes.

The current frameworks do not fully meet the needs of IASB and FASB. They are very “thin” in the areas of recognition criteria and measurement. A main objective of this joint conceptual project must therefore be to improve the existing frameworks. The boards have put a lot of emphasis on revising their current frameworks that will lead to an improvement in general. It is hard to conclude whether the project will lead to a development in the “thin” areas of recognition and measurement because the boards have quite a lot work left to consider in those phases (B, C) of the project.

Further there are several objectives of the joint conceptual framework project. The main objective is to develop an improved common conceptual framework that provides a sound foundation for developing future accounting standards. If this objective is going to be fulfilled is yet to be determined but it is not an unrealistic objective. The Boards have already reached a consensus about the objective of general purpose financial reporting which is a crucial step because it serves as a foundation of the project. I think that the boards will manage to fulfill the objectives of the framework and develop internationally converged accounting standards. This will simplify comparison between entities in different countries and continents.
Annex A

Current Framework – IASB
Annex B

Current Framework - FASB

Diagram content:
- Decision makers and their characteristics
  - Cost - Benefit
  - Materiality
  - Understandability
  - Decision usefulness
    - Relevance
      - Predictive value
      - Feedback value
      - Timeliness
    - Reliability
      - Verifiability
      - Faithful representation
      - Neutrality
      - Consistency
  - Secondary qualities
  - Primary qualities
    - Ingredients of primary qualities
  - User-specific qualities
  - Constraints
    - Users of Accounting information