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COMMENTARY

A Framework for Financial Reporting Standards: Issues and a Suggested Model

American Accounting Association's Financial Accounting Standards Committee (AAA FASC)

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SYNOPSIS: This paper addresses the issues that confront the FASB and IASB in developing a new conceptual framework document. First, we suggest characteristics that a conceptual framework ought to exhibit. Most of these suggestions are based on our critique of the existing framework and the FASB-IASB work in progress. Second, we present a model framework that exhibits these characteristics. We emphasize up front that this framework is quite explicit. It goes to the heart of what a framework document should do: it places specific restrictions on what constitutes admissible accounting standards. The purpose of our effort is to stimulate broad discussion of alternative approaches to foundational documents and to offer a specific example of such an alternative approach.

Keywords: FASB; IASB; conceptual framework; accounting standards; financial reporting.

JEL Classifications: M40.

In 2008, the American Accounting Association's Executive Committee asked the Financial Accounting Standards Committee (hereafter, the Committee) to develop alternative approaches to conceptual frameworks for financial reporting standards. The Committee agreed to add this assignment to its normal tasks of commenting on financial reporting proposals from standard setters and regulators. As a consequence of discussions about how to fulfill this assignment, the Committee determined that it would periodically author itself, or commission, examples of conceptual frameworks for consideration by interested parties, and would host a listening session on conceptual issues at the AAA Annual Meeting as long as such a session continued to make sense. The listening sessions began at the 2008 AAA Annual Meeting. The paper that follows, a product of the 2009 Committee, is the first conceptual framework produced under the Committee's auspices. Subsequent Committees may produce additional such efforts in the future. The framework presented in this paper was written by James Ohlson and Stephen Penman. Other members of the primary review group who provided comments were Karim Jamal, Stephen Moehrle, Thomas Stober, and Shyam Sunder. The entire Committee (including, in addition to those already mentioned, Robert Bloomfield, Ted Christensen, Robert Colson [chair], Gary Previts [executive committee liaison], and Ross Watts) participated through active reviews and discussions with the drafting group and drafters. While Committee members have their own ideas about ideal conceptual frameworks, our group goal focused on provoking interest, discussion, new thinking, and debate rather than on creating platitudes to which everyone would agree. This document was developed by the Committee and does not represent an official position of the American Accounting Association.

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INTRODUCTION

Standard setters and most academics maintain that accounting standards should be guided by a set of precepts and principles spelled out in a "conceptual framework" document. To that effect, the FASB and IASB are currently involved in a comprehensive project to replace existing documents. The project is ongoing so, at this point, one can only surmise what the defining features will be and what the final product will look like. The task at hand is arguably as challenging as it is intriguing. It is, of course, of great policy significance. This paper takes on the issues that confront the FASB and IASB, albeit in a condensed format.

There are two parts to the paper. First, we suggest characteristics that should define a conceptual framework. Most of these suggestions are based on our critique of the existing framework and the FASB-IASB work in progress. Second, we present a model framework that meets our criteria. We emphasize up front that this framework is quite explicit. It goes to the heart of what a framework document should do: it places specific restrictions on what constitutes admissible accounting standards.

ISSUES WITH THE EXISTING CONCEPTUAL FRAMEWORK

The current conceptual framework in the United States, laid down in Concept Statements Nos. 1 through 7 (hereafter, CON 1–7), has been with us for over 25 years. These documents have been quite limited in their influence. Though the FASB occasionally refers to CON 1–7, from what we can tell individuals familiar with standard setting cannot readily cite concrete examples showing how these documents governed or constrained final standards. The new FASB and IASB project implicitly recognizes that CON 1–7 has not withstood the test of time.

The framework in CON 1–7 addresses far too many disparate issues and, as a consequence, fails to distill into a coherent whole. It does not define the boundaries within which standard setters should operate, and defining boundaries is, of course, central. How, then, should the boundaries be drawn? Should a framework articulate definitions of accounting concepts, such as assets and liabilities that bind standard setters? Should it say something about the admissible set of measurement attributes? What about the recognition and de-recognition of assets? Should a framework be a statement of the purposes to be served in providing users with financial data, like "the prediction of the amount, timing, and uncertainty of future cash flows?" Should a framework consider qualitative characteristics like "reliability" and "relevance?" Should the document be specific enough to guide the resolution of such accounting issues as the proper way of accounting for transactions with future benefits but without formal property rights? These kinds of questions can be raised *ad infinitum*. They highlight that individuals working on a foundational framework project will be well served by framing the scope of what needs to be accomplished before they begin.

The current FASB-IASB conceptual framework discussion paper does not adequately address (if at all) the question of where standard setting and the supporting staff work is supposed to head. Such directions are needed so that work on a conceptual framework is guided by an understanding as to what constitutes end-product success. That question ought to be settled, as a matter of highest priority, before the various task forces produce reams of documents dealing with the full spectrum of what constitutes "good" financial accounting and reporting.

Because people come to accounting issues from many directions, they will naturally argue about what a conceptual framework should address and resolve. Controversy surrounds many issues, and defining the boundary between "good" and "bad" accounting particularly plays at the edge. There has to be some sense that, whatever a final framework document looks like, it convinces readers that it will enhance the quality and coherences of future accounting standards. In the spirit of furthering debate as the process moves forward, we focus on two issues and present our views on both as explicitly as we can. First, in the next section we spell out of some useful

(and not-so-useful) characteristics that a conceptual framework should (or should not) exhibit. Second, in the following section, we present our model framework in the form of five explicit principles that bear these characteristics and, most importantly, discriminate on "good" versus "bad" accounting. Our prescriptions contrast with the CON 1–7 documents and with what we have seen in the on-going FASB-IASB project. We hope that our implied critique allows those engaged in that project to evaluate whether they are on track to make a constructive impact on financial reporting practice.

CHARACTERISTICS OF A USEFUL FRAMEWORK

Our discussion of the characteristics is based on what we think of as a common-sense approach. It reflects our interpretation of the history of standard setting and what can be learned from it. We do not claim superior expertise in this matter, but believe we can encourage the debate by simply stating a number of points that we feel have not been appreciated as they should. To be clear upfront, we provide no schematic empirical evidence to back up our claims, let alone pretend that they follow from explicit premises and tight reasoning.

Here are the points that have informed our own attempt at explicating a framework document:

- A framework document best avoids general statements that are impossible to disagree with. In particular, sweeping claims about the nature of virtuous accounting can be cast aside. So our framework does not start with "motherhood" objectives, like "accounting standards should maximize the relevance and usefulness of financial reports" and "accounting standards should ensure that the reporting of firms' economic realities is fair and objective," because no one would ever disagree. Nor do more specific goals—like "accounting information should aid users to forecast the magnitude, timing, and uncertainty of future cash flows"—provide clear enough directions for determining what accounting should actually look like. Reasonable as that claim may seem, it, too, is not worth hanging on to. Such statements embellish narratives by vaguely implying that the production of financial statements is of economic significance. But they also maintain a pretense that actual standards will follow from carefully selected criteria when really they have no significant consequences. (Does the objective of providing information about future cash flows suggest that users will benefit by having an income statement? Though a "yes" answer would seem to be fair enough, anyone who tries to firm up the logic behind this claim certainly has his or her work cut out.) These statements, while relatively harmless (and even admirable) in isolation, distract from what really needs to be done: provide specific principles that have bite by restricting the future accounting standards that regulators can promulgate.[1]

[1] The FASB and IASB discussion paper with preliminary views of the conceptual framework refers to "relevance" and "faithful representation" as two primary, desirable characteristics of accounting information. Taken at face value as stand-alone requirements, we do not believe anyone would disagree and claim that these characteristics should occasionally be violated by standard setters. The real issue becomes: What are their implications as a practical matter? We have difficulty coming up with any consequences. Not even broad notions such as "accrual accounting provides useful information" seem to follow from "relevance." One can even argue that almost any information is relevant unless it violates the characteristic, "faithful representation." Of course, such discussions will serve no useful purpose, the root cause being that "relevance" is far too sweeping. Elaborations would seem to be needed to make the characteristics consequential. As to "faithful representation," in an attempt to elaborate one could state something like "it rules out treating R&D as having no carrying value when, in fact, there are related property rights that objectively have market values." We suspect that this is not what the authors of the discussion paper have in mind, but we cannot be sure. To avoid any such confusion, it helps if a conceptual framework spells out the practical implications of higher-level concepts sooner rather than later.

- By having a framework of guiding principles that impose broad restrictions, the standard-setting process will be simpler and more coherent because crucial accounting issues have been settled up front. On the other side of the coin, a framework must be careful in the delicate matter of setting boundaries to what falls within the domain of standard setters. While a framework cannot be vacuous by reliance on language without consequence, it cannot be so restrictive that it places standard setters in too tight a box when it comes to the specifics. For example (as arbitrary illustrations), "warranties outstanding must be approximated by their fair market values," and "inventories can be valued at the lower of cost and market only when the market is liquid and active" embed issues best left to standard setters to deal with in context.
- Coming to terms with admissible and non-admissible accounting is difficult enough, so it is important to avoid issues that raise more questions than they resolve: they will compound the complexity by introducing what will be loose ends. In this regard, we note that framework documents typically strive to provide free-standing working definitions of accounting terms that are supposed to help with the resolution of issues. In our view, we fail to see how it helps to dwell on the "proper" definitions of, say, assets and liabilities. Doing so typically reduces to what one might call thesaurus research, which, in fact, will not pin things down.[2] Nor is there any point in discussing accounting theory concepts such as what constitutes the set of conceivable measurement attributes or conceivable recognition principles when the implications remain open-ended. And it goes almost without saying that it would be futile to try to stipulate some acceptable formal assumptions and then derive accounting rules or standards as logical consequences. Accounting simply does not lend itself to these types of approaches. Nor does it serve a useful purpose to articulate its philosophical or epistemological underpinnings or to justify why alternative considerations have been dismissed. Instead, a framework should focus squarely on its restrictions on standards as a *practical* matter. A constructive framework thereby provides standard setters with consequential starting points when they attempt to resolve accounting issues.

It may seem harmless to include such things as "objectives" and "qualitative characteristics" in a conceptual framework. In the political environment that standard setters operate, such ingredients might serve a constructive role in signaling to constituents that their needs will be of overriding importance in the standard setters' minds. And dealing with definitions of assets and liabilities (for example) can signal that standard setters will base their promulgations on thoughtful accounting precepts. The ideal has its appeal, though is unsatisfactory if "insiders in the know" merely pay tribute for marketing their "good intentions."

Introducing "objectives," etc., has a potentially negative aspect if some individuals believe they have implications when in fact that is dubious. It may also be the case that some individuals are skeptical when in fact there are some implications. These problems can be avoided if a framework document spells out the major implications of the objectives and precepts immediately

[2] Definitions of assets and liabilities are tricky insofar that they can have unanticipated consequences. Consider, for example, the FASB-IASB definition of a liability: "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." Any reasonable reading of this definition ought to imply that preferred stock shows up as a liability in the balance sheet. That it does not should not surprise since one is presumably not supposed to take the definition too seriously (as a free-standing imperative). In a similar fashion, the FASB-IASB definition of an asset (which we do not restate here) ought to imply that internally developed brand names are no less an asset than a fabricating facility constructed by the firm itself. (The FASB-IASB definition does not distinguish between tangible and intangible assets, and hence an inadvertent consequence.) One might argue that there will be additional considerations (such as recognition criteria) that rule out "unintended consequences" of the definitions, but that puts us back to square one: What purpose does the definition then serve?

following their introduction. The document would thus move closer to the realities of (sometimes hard) accounting choices. For example, suppose a characteristic, "relevance," points in the direction of, say, fair value accounting, then why not spell it out *explicitly* in the framework document *following the introduction of the "relevance" concept*? Not to do so, while at some much later point in time argue that such is in fact the case, could look like a deliberate attempt to withhold information that constituents naturally care about. To avoid the indictment of not being transparent, a brute challenge would then stare the writers of the conceptual framework right in the face: Can one actually derive practical accounting implications from "objectives" etc.? If yes, what are they and how do they follow? To restate our point of view, we think on the whole the answers to these questions are in the negative because, put simply, "relevance," etc., are too lofty criteria for the making of accounting standards.

The section that follows provides our sense of what an actual framework should be. It consists of five principles, all of which are grounded in the accounting literature; we claim no originality whatsoever. Lack of novelty would seem to be desirable if the goal is a framework that has some chance of being broadly comprehended and achieving political success. At the end of the paper, Appendix A briefly discusses the reasoning behind the principles.

THE FRAMEWORK

The framework states accounting principles that rule in, and rule out, potential accounting standards that deal with the myriad measurement, recognition, and classification issues standard setters can encounter. In broad terms, therefore, the principles should guide the standard setters on a regular basis. We also discuss the formats of the financial reports—the income statement, the balance sheet, the statement of owners' equity, and the statement of cash flows—because these should depend directly on the stated principles.

Anyone who makes an attempt at stating a set of conceptual framework principles may of course consider how these differ, and perhaps reconcile with, U.S. GAAP or IFRS and other more or less "official" documents. We have not done so for the simple reason that the task would have been all too demanding and, when everything is said and done, not sufficiently insightful. What counts is what we propose, regardless of its uniqueness and origin. To the extent our proposed principles are reasonably clear, we believe a knowledgeable reader will encounter few problems in making assessments about how it compares to what is in place. And the reader has to recognize that to the extent some of our prescriptions are at variance with current practice, the critique of GAAP or IFRS is wholly implicit.

We do not think our principles could be labeled as "radical" or unrealistic as a matter of accounting practice. To the contrary, looking at the history of accounting thought, readers will recognize that much of what we offer has been proposed over the years by many others who have had their feet firmly planted on the ground. Nor is there any novelty. That said, we are not naïve as to the complexities of accounting standards and concepts, nor about what is likely to be acceptable to various parties. One can presumably make all sorts of arguments that our proposed principles are unconvincing when one looks for conceptual support, not to speak of "political" support. The latter is of course vitally important, but to deal with such matters is way beyond the scope of this paper.

The Principles

A. Recognition and Measurement Rest on Interpreting Transactions

The word "transactions" refers to actual, verifiable events that the firm is drawn into. Most critical are those that establish and change a firm's property rights and contractual obligations. These stand in contrast to events that can be broadly significant but lack the concreteness normally associated with transactions. It is understood that such transactions must be of "arms-length" and thus cut across self-dealing.

Changes in assets and liabilities result from transactions that transpired during the current period. It is implied that recognition and measurement depends on past and current events rather than on what the firm plans to do, could choose to do, or could subjectively estimate as consequences of some more or less likely future action. Hence, accounting for balance sheet items like inventories, PPE, prepaid expenses, accrued expenses, and deferred taxes should in essence refer to current and past events as opposed to subjective assessments of expected future dollar amounts. Current and past events include prudent assessments of a firm's experience with certain transactions (such as the accounting for bad debts, warranties, and depreciation). The principle is consistent with the notion of historical cost accounting as generally understood. It includes the idea that, as a firm incurs expenditures to run the business, accounting standards must stipulate the extent to which these pertain to periods or can be passed on to inventories or other assets in the balance sheet: product or period matching of expenditure flows should be viewed as acceptable.

The principle severely confines the use of various fair market valuations as a measurement attribute. Fair value precepts transgress on the requirement that standards must refer to current and past transactions; this approach should therefore be viewed as an exception. If fair market valuation is to be applied, at a minimum the market in question must be liquid and reliable. Subjective assumptions about risks, transactions costs, and the performance of counterparties are fundamentally inconsistent with acceptable accounting standards; these approaches tend to degenerate into easy-to-manipulate versions of mark-to-market accounting. More generally, the possibility of using mark-to-market accounting for assets and liabilities because of perceived limits with a transactions-based approach should require extensive justification.

In sum, the transactions principle aligns with the traditional accounting adage that "accounting should be based on facts, not conjectures."

B. Operating Activities Separate from Financial Activities

This requirement means that operating and financial activities are not only mutually exclusive, but also exhaustive. Operating activities reflect transactions that logically connect to the generation of sales-revenues in current, future, or past periods. Financial activities, on the other hand, link borrowing and lending activities (possibly with no explicit interest rate) to the expenditures connected with operating activities.

As a practical matter, one can think of all non-financial activities as operating, where the term "operating" pertains to (net) capital expenditures (investments) as well as current operations. Balance sheet financial activities consist of cash and (liquid) marketable debt securities (long- and short-term), outstanding loans, bonds payables and other similar securities. Promulgated standards accordingly must resolve whether a recognized asset or liability and income and expense are financial or not. In this regard, difficult cases will arise for compensation options and leases. Such cases must be addressed by standard setters rather than resolved in the framework (as indeed is currently being done in the Boards' financial statement presentation project). Other issues that arise may be contextual due to the nature of the business, such as the classification of accounts receivable and accounts payable.

This principle also bears on the measurement attribute. A necessary condition for the use of fair value is its classification as a financial activity. Thus, as a point of principle, the carrying

values of operating assets and liabilities exclude (fair) market valuation approaches (and some financial items may not use fair as a measurement attribute). Exceptions to a transactions perspective on operating activities should be invoked by standard setters only if it can be shown that (1) the transactions history cannot meaningfully guide the asset or liability measurement, and (2) an (approximate) fair value approach will rectify otherwise obvious problems because period or product matching cannot reasonably work.

C. The Centrality of Operating Earnings Measurement

This principle recognizes the income statement as the centerpiece in financial reporting. Consequently, under most circumstances, the other three statements serve a useful role primarily because they enrich interpretations of the income statement. Thus, consecutive balance sheets, besides reporting the net financing position, pick up on the non-cash component of operating earnings and show the connection between growth and income measurement. Changes in operating assets and liabilities and their growth can be interpreted as a consequence of the period's accrual, which is one ingredient of operating earnings. Similarly, the statement of cash flows provides the input for an assessment of how those accruals differ from and yet reconcile to earnings.

Within the income statement, the key item is income before financial items; that is, operating income net of associated taxes. With operating income as primary, the principle recognizes that, to understand a business operation and the direction it is heading, a reader initially focuses on (1) the top-line number, current sales and its expected future growth, and (2) the current operating profit margin and how it might change in the future. Accordingly, balance sheets and the cash flow statement, in their supporting role, must contribute to an understanding of these central features of any business model. A focus on operating income means that accounting standards are most effective if they take a position that current operating earnings provides the natural starting point for forecasting future operating earnings. Assured of this focus, forecasters should, to a reasonable extent, expect that the current operating profit margin will remain unchanged if business conditions remain essentially the same. Thus, accounting standards strive to achieve a measurement of "permanent (operating) earnings." From a standard-setting perspective, this earnings concept has several implications. First, the balance sheet accounts that relate to operating activities can take on the role of smoothing (operating) earnings *via* explicit rules that pertain to deferred expense and deferred revenue accounts. This approach to earnings measurement enhances the predictability of earnings. (Non-recurring items, if present, must be shown explicitly in the income statement.) For example, gains and losses due to PPE transactions should generally be deferred *via* group depreciation methods; this accounting will then smooth the measurement of earnings. Second, accounting standards should generally discourage any attempt to convert non-recurring expenses in the current period into improved future profit margins. Standards should strongly discourage not only the use of capricious write-offs but also all kinds of accruals that have a discrete and material impact on operating earnings. Third, standards should recognize that, in the short term at least, the carrying values of assets and liabilities might well deviate from what many may view as fair values. The discrepancy is acceptable as long as it is gradually eliminated. Fourth, the focus on income measurement might well lead to operating assets and liabilities that do not relate to property rights or contractual obligations as usually thought of. Standards can thereby allow for purchased "goodwill" and "deferred tax liabilities," for example.

D. Balance Sheet Conservatism

Standards should work from the principle that tangible operating assets cannot exceed reasonably assessed fair values. To handle intangible assets, standards should also recognize that there must be rules in place to prevent the total of operating assets, net of operating liabilities, to

exceed a fair value assessment of the business in its entirety. This conservatism principle ensures that the return on net operating assets on average exceeds the cost of capital.

Consistent with principle C and the objective of smoothing operating earnings, if carrying value exceeds a fair value assessment then the resulting adjustment should not generally be implemented with a discrete, one-time write-down. Rather, the adjustment should take the form of an acceleration of expensing over many periods. To satisfy this requirement, overvalued PPE should generally be handled by a modified depreciation schedule that speeds up the expensing as opposed to a one-time charge. Overvalued inventory should not generally be reduced with a discrete charge unless it is essentially worthless. A business should be viewed as ongoing in the absence of compelling evidence to the contrary, and standards should accordingly disallow firms to use an accounting that suggests otherwise. Conservatism applied in this fashion prevents firms from converting a business with low margins to high ones in subsequent periods *via* use of one-time charges that reduce carrying values of operating assets. Discontinuity in the business model itself should be a necessary condition for one-time charges; adverse conditions or poor outcomes do not suffice *per se*.

In sum, the stipulated conservatism should embed the traditional maxim that unfavorable events or circumstances, in contrast to favorable ones, generally modify the accounting rules. This conservatism should generally be implemented without the use of one-time charges to maintain a smooth earnings stream. Thus the accounting standards will ensure that neither tangible assets nor the totality of net operating assets will be more than their corresponding fair values, except for limited periods when the accelerated expensing has not yet occurred.

E. Owners' Equity Accounting Rests on a Proprietorship Perspective

This principle requires that owners' equity pertains to the residual interest, which for most practical purposes correspond to the common shareholders' equity. The principle implies that only liabilities and common shareholders' equity can be presented on the credit side of the balance sheet; there can be no "mezzanine" category. As a consequence, claims like preferred stock, warrants and other contingent claims, and minority interests must be part of the liabilities.

The income statement must be consistent with a residual interest perspective. Preferred dividends, gains and losses due to the extinguishing of contingent claims, and changes in minority interest must be included in comprehensive income. The change in common shareholders' equity thereby equals the comprehensive income adjusted only for common cash dividends and other capital transactions with common shareholders. All transactions with common shareholders must be accounted for at cash equivalent value when cash is not involved.

The principle does not prejudice the use of other comprehensive income as a special category. This category might well include realized and unrealized gains and losses related to preferred stock and equity-linked contingent securities that are financial in nature.

The Financial Statements

This section develops the implications of the five principles we have outlined for the financial statements. As stated, these implications broadly restrict the accounting, yet at the same time leave ample room for the judgments spelling out the accounting for specific assets and liabilities.

The Balance Sheet

Due to principle B, the balance sheet should partition, in an exhaustive and mutually exclusive fashion, all assets and liabilities as either financial or operating. With respect to the financial items, it should also be clear whether the valuation is based on mark-to-market measurement or not. As to the valuation and measurement of operating assets and liabilities, their carrying values should generally rest on traditional accrual accounting, consistent with what is understood by the

term "historical cost accounting." This approach implies that operating assets and liabilities can deviate materially from their fair values. Such a possibility reflects that (consecutive) balance sheets serve as a means to an end, namely the preparation of an income statement. As has been the case through the history of accounting regulation, recognition and the details of measurement fall squarely within the standard setters' domain. This is especially true for operating assets and liabilities because in such cases there is no practical possibility to refer sweepingly to fair valuation as being the appropriate approach.

The Income Statement

Because operating activities differ from financial activities, the income statement should distinguish operating income (associated with operating items in the balance sheet) from income and expense associated with financial items. Operating income in turn rests on the interpretation of transactions and the matching of expenses with the period or with products and services for which revenues have been recognized.

The centrality of the income statement requires that earnings provide a useful starting point for the forecasting of future earnings; net operating earnings should, to the extent feasible, be permanent. Accordingly, both operating and financial earnings should be split into non-recurring and recurring components. Thus, looking at the income statement in its totality, it splits into four parts: operating recurring, operating non-recurring, financial recurring, and financial non-recurring all net of allocated taxes. In this framework, operating income on a recurring basis serves as the primary performance metric. Accounting principles accordingly benefit from disallowing discretionary balance sheet conservatism, which builds in non-recurring expensing. To the extent practically feasible, principles should allocate firms operating expenditures over periods in a consistent fashion without arbitrary lumps.

Owners' Equity Statement

Consistent with the proprietorship principle, this statement tracks the firm's residual interest, the common shareholders' equity. Two elements should fully account for the change in common shareholders' equity: namely, (1) the period's value creation as determined by comprehensive earnings, minus (2) the net distribution of value to the common shareholders as determined by common (cash) dividends and stock repurchases net of all common shareholders' capital contributions. With respect to the second element, to maintain homogeneity across transactions, all distributions and contributions should be recorded at fair market values. If a transaction in shares embeds a gain or loss relative to fair market valuation, the gain or loss must be included in comprehensive earnings.

Cash Flow Statement

One can argue that the cash flow statement supplies information that is not governed by accounting precepts in the five principles: Why should ideas about, say, the relevance of operating earnings or the proprietorship principle constrain the way one generates the most useful cash flow information? Might this statement be orientated more to creditors concerned with liquidity rather than shareholders? These questions are good ones, especially in light of the history of standards related to cash flows. Standard setters have always recognized that the big picture of cash flows raises its own uniquely intricate problems (such as the concept of "cash" and the distinction between so-called operating flows and investing flows) that have little, if anything, to do with such things as measurement attributes of assets and liabilities or whether the preferred stock is treated as equity or debt.

That said, one can ask what a cash flow statement would look like if it were to honor our principles. The principles imply that the cash flow statement must embed the idea of proprietorship (with its focus on a residual interest as the "bottom line"), operating versus financial activities

(which embeds the idea of accrual accounting for operating income measurement versus accounting for cash flows to claimants), and the centrality of income measurement (so that the cash flow statement, like the balance sheet, is presented in support of the income statement).

The cash flow statement, accordingly, should be formatted like an income statement: it has a top line related to sales. There is no particular demand that the deductions in the cash flow statement and the income statement have a one-to-correspondence (useful though it may be, it can be too complicated to accomplish), but the cash flow statement should nevertheless have the texture of an income statement that now is independent of accrual measurement. Thus the cash flow statement reports the income statement on a cash basis, rather than an accrual basis. The concept of "cash" rests on the financing activities so that the statement of cash flows can be reconciled through the change in financial assets and financial liabilities in consecutive balance sheets. The concept of cash is thus broad rather than narrow in the sense that "cash" can include not only equivalents such as short-term investments but also bonds payable and other financial liabilities.

Similar to the income statement, the statement of cash flows should provide a sub-total showing operating earnings on a cash basis; that is, comprehensive earnings on a cash basis before financial items (net of taxes). In effect, this approach to the cash flow statement means that change in operating assets (net of change in operating liabilities) corresponds to the period's total net accrual.

To implement this "direct method" cash flow statement, the standards that relate to principle B will be of overriding importance. It captures the idea that the cash concept, and the flows, cannot be divorced from the idea that a firm's financing activities can be conceived as being identified by a pool of "cash and their approximate positive or negative equivalents." This approach can readily handle the demand to distinguish cash outflows due to current activities as opposed to those that have long-term benefits, e.g., capital expenditures and R&D. This can be done via supporting schedules or in a columnar layout that explains the differences between the income statement and the cash flow statement.

APPENDIX A
ARGUMENTS SUPPORTING THE FIVE PRINCIPLES

A. Transactions-Based Accounting

This principle has had a long history of apparent utility. It reflects that accounting needs to be reliable, objective, and based on observable and verifiable events. While it also means that anticipated events (such as an apparent future demand for a product) do not show up in the accounts immediately—the accounting is less timely—the alternative of accounting for events based on relatively subjective interpretation causes more problems—potential manipulations of accounts in particular—than it is worth. Accounting should not rest on standards under which reasonable and honest individuals can disagree materially on what asset and liability values on the balance sheet ought to be. Sticking to rigid, event-dependent principles makes it easier to agree about the consequences, and it will be much harder to "manage earnings." Analysts, while recognizing that the financial statements can only paint an incomplete picture of the firm's performance, are assured that the accounts have some integrity (assuming they have been properly audited). Of course there is ample room for more "subjective" and "forward-looking" data, but this information belongs in the footnotes. With this "below-the-line" designation, analysts will recognize that much caution is required about such information, for even reasonable people can disagree about such matters. In sum, this reasoning makes the case that the focus in accounting statements should be

on interpreting transactions and their explicit characteristics rather than adding all sorts of subjective elements, even when the latter are forward looking and potentially highly relevant to understand the business prospects.

The principle effectively rejects fair value concepts, unless the asset or liability satisfies a narrow condition of being traded in liquid markets with depth. In turn, this means that the carrying values of assets and liabilities do not purport to tie to fair values, even in an approximate sense. Proponents of (modified) historical cost accounting spell out why this drawback is not as serious at it may initially look. It is mitigated by the fact that the "missing" values in the ending and starting balance sheets partially cancel each other from the perspective of earnings measurement. (If the "missing" values are the same, then these "errors" cancel each other fully).

Even a narrow transactions-based accounting cannot avoid some anticipation of the future, as the accounting for "product warranties" and PPE accounting clearly illustrate. But the related accruals tend to rely on historical experience or broadly valid rules that, to considerable extent, eschew "subjective" input. Nevertheless, it is apparent that standard setters will always have their work cut out as to how one "best" factors in future-oriented information in the standards. As they engage in such activity, they need to keep foremost in their minds that (1) standards that allow for manipulation sooner or later are almost guaranteed to cause problems no matter how well-structured otherwise; (2) fair value approaches in the absence of liquid markets tend to allow for a considerable subjective inputs; and (3) in the absence of liquid markets, accounting standards can avoid forward-looking information and manipulations substantially by focusing on the interpretation on actual, verifiable transactions and their attributes as key input.

B. Operating versus Financial Activities

Contemporary finance theory, and related financial statement analysis, depends on splitting a firm's activities into financial and non-financial (operating) activities. This scheme is put in place for good reasons. Operating activities identify the (*ex ante*) value creating activities, with the concept of a top line in the income statement, namely revenues from customers and a string of matched operating expenses. Financial activities, on the other hand, are so-called zero NPV activities (at least as a first cut); they are means to an end, namely the implementation of operating activities. Hence the financial activities provide a necessary condition for the application of mark-to-market accounting. Thus the invocation of the operating versus financing principle should help equity analysts and other users of financial statements when they assess a firm's performance. Analysts are keenly aware of the prominence of operating activities to asses future prospects and that the financial policy magnifies or dampens the equity risk. Much time-consuming work will be eliminated by making the financial statements consistent with this elementary user need.

The "measurement attribute" conclusion that fair market valuation is not appropriate for operating activities combines this perspective with the transaction principle: operating activities are the nexus of value creation but value should not be recognized until the business strategy is validated by transacting with customers. The need for forward-looking information is thereby reduced. On the other hand, the application of market values to financing activities is justified because their values typically do not depend on the firm's own activities and choices.

An apparent difficulty with the classification scheme arises when firms engage in transactions where the classification is a matter of, more or less, subjective opinion. The financial industry is a case in point; there the dichotomy is indeed blurred to the extreme. For industrial companies, investments in non-liquid equity shares and non-strategic real estate investments beg the question: Do these situations invalidate the usefulness of the proposed principle? We think not, once the basic idea behind it is understood (some transactions are not part of the strategic value-creating process and, if there is doubt that the transaction falls into this category, then the activity can be classified as operating). Thus, the users of the financial statements will be well served because the

accounting recognizes that firms engage in strategic activities, and the consequences of those need to be understood separately from the (financing) activities that broadly support the value-adding activities. The fact that the line may not always be clear-cut does not invalidate the principle.

C. The Centrality of the Income Statement and Earnings Measurement

Cursory observation of the use of financial statements validates this point: it is earnings that is forecast, anticipated, and reported. It hardly requires discussion at all, but needs emphasis given the apparent balance sheet (asset and liability measurement) approach in the FASB-IASB conceptual framework discussion documents. The balance sheet, with individual assets and liabilities reported and summed as if they were separable (and many [intangible] assets missing), cannot hope to provide an overall performance measure for assets and liabilities used jointly. But the income statement provides a summary number, earnings, from this joint use (including earnings from assets not on the balance sheet).

Less apparent, we further would argue that users of financial statements, particularly equity analysts, tend to analyze the income statement in search for some number that is useful as a starting point in forecasting next year's (or quarter's) net income. Hence, it makes sense that accounting standards evaluate transactions in a systematic fashion such that income will be "smoothed" over periods. If this means that some operating assets and liabilities do not correspond to their perceived "fair values," so be it. Our motivation therefore depends on the powerful idea that income statements can be extremely useful as long as the "errors" in the beginning and ending net asset values on the balance sheet substantially cancel each other. Current R&D accounting according to GAAP illustrates this point: the income statement will generally be not much affected by its capitalization. In fact, this idea is among the most important to justify the usefulness of traditional historical cost accounting.

D. Conservatism

This principle may seem somewhat redundant. Nonetheless, it is not so if one allows standards to work such that (1) over-valuation is allowable unless it is material and (2) the existence of over-valuation generally leads to an acceleration of expensing over many periods rather than a discrete write-down. In other words, the conservatism keeps fair values on the average greater than carrying values without discrete and arbitrary schemes. Conservatism properties are consistent with earnings measurement because they exploit the (partial) canceling of error concept. The principle is desirable because it builds in the idea that earnings recognition is pushed into the future until crucial uncertainty-resolving events have occurred. Thus it is important that the conservatism does not degenerate into a discretionary conservatism triggering an abundance of more or less hidden non-recurring items. GAAP accounting has always built in balance sheet conservatism, and it has rarely (if ever) been claimed to be inappropriate unless "overdone." Properly implemented conservatism should thereby reflect the idea that (*ex ante*) operational risk in outcomes and delayed profit recognition are two sides of the same coin.

E. Proprietorship Perspective

Elementary financial statement analysis in the context of equity valuation always underscores that the residual interest in the balance sheet and the income statement pertains to common shareholders. Hence, the principle should be adopted if one accepts that equity markets are the main users of financial reports. In terms of dollar trading, there is no question that contemporary equity markets now dominate bond markets. Moreover, it is far from clear whether, in fact, creditors prefer an entity perspective in financial reporting. We are not aware that such a case has ever been made. Indeed, clear identification of the property rights (claims) of common shareholders also delineates claims by others, including minority interests. Another advantage with the

common equity perspective is that it simplifies the calculation of EPS insofar that there should be no need to adjust for contingent equity securities (warrants, compensation options, convertible bonds, and put options in particular). If these securities are treated as liabilities and income or expenses, then neither the numerator nor the denominator requires adjustments for so-called potentially diluted effects. In sum, the proprietorship theory of accounting provides for a more coherent perspective than the entity theory.

APPENDIX B
COMMUNICATIONS FROM COMMITTEE MEMBERS NOT ENDORSING

Rob Bloomfield's Dissent

I am honored to be part of a Committee that strives to rethink the foundations of accounting standards, and I hope that this document will inspire some constructive debate on issues about which many academic researchers (not just those on this Committee) disagree with accounting standard setters. However, I find I must dissent because I believe that a conceptual framework must clearly define the objectives of financial reporting and the desirable qualities of financial reports. By eschewing a framework that does so, this Committee has denied itself a powerful tool with which to defend the restrictions they seek to impose on standard setters and persuade those who do not already agree with their positions.

In the "Characteristics of a Useful Framework" section, the majority states that a conceptual framework should avoid general statements that are impossible to disagree with, and in particular should avoid statements of objectives and specific goals, because they "maintain a pretense that actual standards will follow from carefully selected criteria when really they have no significant consequences" and because they "distract from what really needs to be done: provide specific principles that have bite by restricting the future accounting standards that regulators can promulgate."

Statements describing objectives that command near-universal agreement can be powerful instruments for guiding policy. Perhaps the most famous examples are the opening words of the Declaration of Independence ("We hold these truths to be self-evident …") and the Preamble to the Constitution of the United States ("We the people of the United States, in order to form a more perfect union, establish justice, insure domestic tranquility, provide for the common defense, promote the general welfare, and secure the blessings of liberty to ourselves and our posterity, do ordain and establish this Constitution for the United States of America.") Appendix A unintentionally demonstrates the power of the existing conceptual framework to shape thought and frame persuasive arguments by referring to relevance, reliability, verifiability, timeliness, and neutrality in its first paragraph.

I readily grant that practical considerations and political pressures often trump conceptual goals. However, the same can be said of the Constitution. In effect, the majority is arguing that the difficulties in interpreting the First Amendment are so severe that we should simply draft specific laws restricting the government's ability to limit free speech. However, without mooring those laws to a clear description of their larger policy goals, how would one balance practical considerations, resist political pressure. Without being able to refer agreed-upon objectives, how would one persuade others to take a position they do not initially prefer?

The majority also errs by claiming that the purposes of financial reporting, as stated in the existing conceptual framework, command universal agreement. Many do agree with the existing framework's statement that financial reporting should be (as stated in the framework's first paragraph) "to provide information that is useful to present and potential investors and creditors and others in making investment, credit, and similar resource allocation decisions." However, in the

wake of the financial crisis, some policy-makers have argued that financial reporting should promote macroeconomic stability. Even before the crisis, some academics have argued implicitly that financial reporting should facilitate contracting between the firm and its counterparties. In my view, both of these objectives differ from those stated in the existing conceptual framework.

Recognizing disagreement about objectives is important because it raises two possible explanations for why the principles stated by the majority conflict with existing and proposed standards. The majority may disagree with the standard setters' views of the objectives of financial reporting, or may simply believe that existing standards fail to achieve those goals. The reasoning presented in this document is not precise enough to allow me to distinguish between these alternatives. Early in the document the majority relies on appeals to "common sense." Later, the Committee justifies the principle that recognition and measurement rest on interpreting transactions is justified by "the traditional accounting adage that 'accounting should be based on facts, not conjectures.'" However, it is not clear why readers should agree with this statement. Without the common ground of clearly voiced objectives, reasoning like this seems unlikely to result in a productive conversation among parties who disagree about specific principles or standards.

On the five specific principles proposed by the Committee, I share many of the Committee's sentiments, despite a number of quibbles that I will not air here. However, some of the principles seem to be based implicitly on one objective of financial reporting that I do not accept: that accounting standards should provide summary numbers (such as a measure of permanent operating earnings) that analysts and other financial statement users can employ with a minimum of adjustment. It is undeniable that the asset-liability view, which has been embraced by the FASB and IASB, and rejected by the majority, results in comprehensive income measures that include highly transitory and subjective components, as well as more persistent and objective components. Analysts will surely need to discriminate among these diverse components as they project future cash flows and other aspects of firm performance. However, users differ in the summary measures they find most helpful, and the more this summary measure differs from comprehensive income, the more easily preparers will be able to manipulate it through self-serving classifications and judgments.

The power to construct summary statistics (such as core operating income) is better placed in the hands of the financial statement users, not financial statement preparers. Thus, my own recommendation for a conceptual framework would specify that the objective of financial reporting is to assist the decision-making of the most sophisticated users who are willing and able to process all available information given the best widely-available technology and financial theory. Disaggregation of disclosure should be considered a key desirable quality of financial reports, and the privileged presentation of any income number other than total comprehensive income should be considered a key undesirable quality of financial reports. Calculating performance on a per-share basis, or adjusting it for items deemed more permanent or more tied to operations, should remain the prerogative of the user, not the preparer.

I think it's great that the AAA has a Committee that is rethinking foundational issues, and this paper has certainly forced me to think more carefully about the role of the conceptual framework. But in the end, I just feel that the document throws out the baby with the bathwater, and does not recognize the value of "platitudes to which everyone would agree" (as the preface puts it).

Thanks and congratulations to the authors for writing a thought-provoking document.

Ted Christensen's Dissent

The authors have done a great job of expressing their views in the conceptual framework document. I provided some editorial suggestions to them on the first round and hoped that it would continue to progress. However, as it currently stands, I'm still uncomfortable with endorsing it (at least in its current form). After reading Rob Bloomfield's dissent, I'm much more in line with his

views than those presented in the document. There are many aspects of the document that are quite thought provoking, but others that don't totally fit my way of thinking. I considered abstaining, but after reading Rob's dissent, I've decided to join him. Since he has authored the dissenting view, I'm happy to simply be listed as "joining" his dissenting opinion.

Ross Watts' Dissent

The authors have responded to my concerns about the verifiability of the balance sheet items that would arise from concentrating on the income statement by dropping the discussion of those items. Those items would be at least as unverifiable as some fair valuations and would enable considerable misleading financial reporting. Given that, I request that it be noted that I dissent for that reason and for the lack of concern for the net asset role of the balance sheet (opportunity cost of continuing in business). In my opinion, the financial statements can, *via* dirty surplus, address both the income role envisaged in the paper (subject to verifiability constraints) and the opportunity cost role.