

CONCEPTUAL FRAMEWORK

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INTRODUCTION

1. At the April joint IASB/FASB meeting, the Boards discussed a staff proposal to undertake a joint project to develop a common conceptual framework for both Boards. More specifically, the objective would be to develop a single framework that both converges and improves upon the existing frameworks of the two Boards. In other words, the project would aim to eliminate the differences between the existing frameworks, and also refine, update and complete the frameworks.
2. The staff proposal set out three possible approaches to conducting the project:
 - (a) Sequential approach: This is the most comprehensive and systematic approach. It would entail reconsidering all aspects of the framework, starting with the higher-level concepts (eg objectives) and working down to lower-level concepts (eg display).
 - (b) Add-on approach: This is the least comprehensive and systematic approach. It would entail reconsidering only those parts of the framework that require amendment because of standards-level projects. Other aspects of the framework would not be reconsidered.
 - (c) Hybrid approach: This falls between the ‘sequential’ and ‘add-on approach’. It would entail focusing on those issues that are most likely to yield benefits in the short term, ie “cross-cutting issues” that affect a number of different projects.
3. The Boards agreed with the objective of moving toward a single conceptual framework. They directed the staff to develop a plan for conducting the project using the hybrid approach, for discussion at the next joint meeting in October.
4. This paper covers the following:
 - (a) Initial analysis of existing frameworks, including

- Main differences between the two frameworks
- Key gaps or problems with the existing frameworks
- Links with existing projects

(b) Prioritisation of issues

(c) The form and structure of the converged framework

(d) Project output

(e) Project management.

5. Some might conclude that the analysis in this paper suggests that the project should be conducted in a more comprehensive manner than was indicated by the discussion of the hybrid approach at the April joint meeting. However, as the analysis in this paper shows, in every section of the two frameworks there are either differences between them, areas requiring improvement, or gaps (ie missing concepts). Also, many parts of the framework are connected to other parts, and the framework is intended to be an integrated whole. Therefore, particular issues cannot be considered in isolation. Indeed, it could be said that the notion of ‘cross-cutting issues’ applies not just to issues that cut across various standards-level projects but also issues that cut across various parts of the framework. Furthermore, the objective of developing a single converged framework means that it is necessary to look at every section of the existing frameworks sooner or later.
6. However, that does not mean a full reconsideration of every single word. For example, to the extent that there are parts of the two frameworks that are already similar and not in need of improvement, the task might be limited to developing converged wording. However, in doing so, any links with other parts of the framework will be considered.
7. Therefore, the analysis and discussion in this paper is intended to be consistent with the basic idea of the hybrid approach—focusing on issues that are more likely to yield benefits in the short term—but taking into account the objective of developing a converged, improved, comprehensive and internally consistent framework.

QUESTIONS FOR THE BOARDS

8. This paper raises a variety of issues, upon which the Boards will need to reach decisions during the course of the project, rather than at the October joint meeting. However, there are some key issues upon which the staff require the Boards' direction now. Therefore, the staff will ask the Boards the following questions during the October joint meeting:

Q1. Do the Boards wish to commence work on the project? At the April meeting, the Boards agreed with the objective of moving toward a single conceptual framework. However, neither Board has made a formal agenda decision. Each Board now needs to decide whether to add to its agenda a joint project to develop a common conceptual framework. (The remainder of the questions below assume that the Boards do wish to commence work on the project.)

Q2. To which sectors should the converged framework apply? Paragraphs 19 to 25 discuss the similarities and differences between the applicability of the two Boards' existing frameworks to the business, non-business, private and public sectors. An early decision on this issue will assist the staff in project planning.

Q3. Which areas of the framework should be given priority? The initial analysis of the existing frameworks includes some comments about which areas should be considered sooner rather than later. Those comments are summarised in the following section on prioritisation. It will greatly assist the staff in planning the ordering of issues if the Boards indicate now whether they agree or disagree with that prioritisation.

Q4. What should be the form and structure of the converged framework? The relevant section of this paper discusses some possible answers to this question. Although it is not *crucial* for the Boards to decide this now or work out all the details, it will help the staff if the Boards give some indication of whether they support the suggestions made, or have alternative ideas that they wish the staff to explore.

Q5. Should the project be conducted as a single phase, or divided into two or more phases? The section on project output discusses the advantages and disadvantages of conducting the project as a single or multi-phase project. It sets out three alternatives. The Boards may have other ideas. However, it will be essential for project planning purposes for the Boards to make an early decision on how the project should be conducted.

Q6. What should the initial document be, ie a neutral discussion paper, a discussion paper with preliminary views document or an exposure draft? It would assist the staff with project planning if the Boards could formulate a general policy now.

Q7. Do the Boards agree with the staff comments in the section on project management, in particular, that the success of the project depends on the Boards' agreeing to a substantial commitment of staff resources and Board time, both initially and on an on-going basis? Do the Boards agree to make that commitment?

ANALYSIS OF IASB AND FASB FRAMEWORKS

9. The following analysis compares the IASB and FASB frameworks to identify:
 - (a) Main differences between the frameworks
 - (b) Key gaps or problems with the existing frameworks
 - (c) Links with existing projects.
10. This analysis is presented in the following sections, that approximate the structure of the two frameworks (including missing parts):
 - (a) Purpose and Status
 - (b) Scope
 - (c) Objectives
 - (d) Fundamental concepts, including qualitative characteristics and elements.
 - (e) Operational concepts, including recognition and measurement.
 - (f) Display (presentation and disclosure).
11. It should be noted that although this analysis discusses the IASB and FASB frameworks only, that does not mean that the frameworks of other standard-setters are not relevant to the concepts project. The staff envisages that the task of developing a converged IASB/FASB framework will include considering those other frameworks. For example, some standard-setters have issued frameworks more recently than the IASB and FASB, and therefore those frameworks will probably contain improvements on various aspects of the IASB and FASB frameworks.¹
12. Similarly, existing standards will also be relevant to the project, particularly standards that have gone ahead of, or departed from, the frameworks. The task of analysing existing standards in relation to the frameworks will be undertaken as part of the project itself.
13. It should also be noted that the analysis in this paper is not intended to be a comprehensive, detailed analysis of the existing frameworks. Rather, the objective is to provide an overview of the differences between the two frameworks and the areas requiring improvement. This should give the Boards a broad picture of the issues to be covered in the project.

¹ The IASB partner standard-setters may also be involved in the project itself, for example, by conducting research on various issues (eg measurement, as discussed in paragraphs 73 to 75) or providing staff for the project team.

14. Once the Boards have made some decisions about the questions raised in this paper (paragraph 8), the staff will undertake a more detailed planning exercise based on those decisions. That will include considering how best to (a) ensure that all the issues to be addressed in the project are identified and (b) prioritise those issues.²

Purpose and Status

15. Both the IASB and FASB frameworks set out the purpose and status of the conceptual framework (CF).³ They have the following in common:
- (a) A purpose of the CF is to assist standard-setters in developing and revising accounting standards.
 - (b) The CF does not override accounting standards, and therefore in this respect it has a lower status than specific accounting standards.
16. There are also differences:
- (a) The IASB framework has a broader purpose than the FASB framework. The purpose of assisting the IASB in developing or revising accounting standards is one, but not the only, purpose of the framework. The framework also has other purposes, including assisting preparers in applying IFRSs and in dealing with topics not yet covered by an IFRS, auditors in forming an opinion about conformity of financial statements with IFRSs and users in interpreting the information in financial statements prepared in conformity with IFRSs. These purposes are not ranked in any way. The FASB CF places less emphasis on other purposes. It indicates that the Board itself is likely to be the major beneficiary of the guidance in the CF. The FASB CF does note that knowledge of the concepts should enable all who are interested in financial accounting standards to better understand the content and limitation of information provided by financial reporting, and that that knowledge, if used with care, may also provide guidance in resolving new or emerging problems of financial reporting in the absence of applicable authoritative pronouncements.⁴ But that purpose is clearly secondary to the main purpose.
 - (b) More importantly, this difference in purpose is also reflected in the difference in status of the frameworks. The IASB framework resides at a higher level in its GAAP

² For instance, one possibility is to assemble a group of people (eg past and present Board members, staff members, academics, etc) to assist with the issue identification process.

³ IASB *Framework*, paragraphs 1 to 4; FASB CON1, subsection 'Statements of Financial Accounting Concepts' at the end of the 'Highlights' section.

⁴ FASB CON1, Introduction

hierarchy than does the FASB framework in the US GAAP hierarchy. For entities preparing financial statements under IFRSs, management is expressly required to consider the definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses in the IASB framework if there is no standard or interpretation that is specifically applicable or that deals with a similar and related issue.⁵ Under US GAAP, the FASB concepts statements are ranked no higher than accounting textbooks, handbooks, and articles, and below widely recognised and prevalent general or industry practices.⁶

17. The staff understands that recent changes in US law and regulation have removed responsibility for establishing the US GAAP hierarchy from the AICPA but have not yet reassigned that responsibility. Once responsibility is clarified, the FASB or another party will be able to revise the hierarchy, possibly including the status of its framework. Depending on the outcome of that process, the differences identified above might be eliminated. If not, then it will be necessary to consider how to accommodate any remaining differences in a converged IASB/FASB Framework. The staff therefore recommends deferring consideration of the above purpose and status issues until the process of revising the US GAAP hierarchy is completed.

Scope

18. There are three main issues related to the scope of the frameworks: (1) to which sectors does the framework apply, (2) to which entities does it apply and (3) to which statements/reports does the framework apply, ie what is the boundary of financial reporting?

Which sectors

19. The IASB framework applies to all business (sometimes called ‘for profit’) entities, whether in the private or public sector.⁷ The FASB framework applies to both business and non-business (sometimes called ‘not-for-profit’) entities in the private sector.⁸ Therefore, the following similarities and differences exist:

⁵ IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, paragraph 11.

⁶ AICPA AU Section 411, “The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles”, paragraphs 10–11

⁷ IASB *Framework*, paragraph 8. This section refers to ‘private’ and ‘public’ sectors without defining the terms. Generally speaking, ‘public’ means government-owned entities while ‘private’ means non-government-owned entities. However, the terms are used broadly. In other words, the staff is aware that the line between the private and public sector can be difficult to draw, and is likely to vary between different jurisdictions.

⁸ See FASB CON1 and CON4, eg paragraphs 1 to 5 of CON4.

- (a) Both frameworks apply to the private/business sector.
 - (b) The IASB framework applies to the public/business sector, whereas the FASB framework does not.
 - (c) The FASB framework applies to the private/non-business sector, whereas the IASB framework does not.
 - (d) Neither framework applies to the public/non-business sector.
20. The extent to which accounting standards apply to the various sectors differs from country to country. For example, in Australia and New Zealand, one set of accounting standards apply to all sectors. At present, in the United Kingdom, the ASB sets accounting standards that apply to the private sector (both business and non-business sectors), and some parts of the public sector (eg local government). The accounting requirements for the rest of the public sector are based on ASB standards.⁹ In the US, accounting standards for part of the public sector—governmental and business-type activities of state and local government—are set by the Governmental Accounting Standards Board, while standards for the rest of the public sector—all federal government activities—are set by the Federal Accounting Standards Advisory Board. Those two Boards are separate from the FASB and from each other; their respective jurisdictions are set by laws established after extensive negotiations, and the three sets of standards are quite different. Internationally, the Public Sector Committee of the International Federation of Accountants has an on-going project to develop public sector accounting standards, which are based on IASB standards. Appendix A summarises the applicability of accounting standards to various sectors in the jurisdictions of the IASB partner standard-setters.
21. Some might argue that the revised conceptual framework should apply across all sectors, because:
- (a) Collectively, the existing frameworks are already applicable to three of the four sectors (private/business, private/non-business and public/business).
 - (b) Some jurisdictions that will be adopting international accounting standards currently have sector-neutral standards, or standards that are intended to be broadly applicable to all sectors.
22. However, there are also arguments that the revised conceptual framework should focus, at least initially, on the private/business sector:

⁹ The ASB is also developing a public sector conceptual framework, based on its existing framework.

- (a) The IASB and FASB currently focus their standard-setting activities on the private/business sector.
 - (b) Additional issues may arise if the public and non-business sectors are included. Dealing with those issues might delay the completion of the revised framework.
23. Furthermore, the IASB and FASB are in somewhat different positions. The IASB could unilaterally decide to expand the scope of its conceptual framework to cover all sectors. However, the FASB has no power to change the current jurisdiction arrangements that place accounting standard setting for the public sector outside its purview and therefore is unable to expand the scope of its framework to the public sector.
24. The arguments in the preceding paragraphs suggest that the Boards should adopt one of the following approaches to developing the revised framework:
- (a) Initially, the revised framework should focus on the private/business sector. Its applicability to other sectors could be considered later.
 - (b) The revised framework should apply to the three sectors to which the Boards' existing frameworks collectively apply, ie private/business, private/non-business and public/business. Later, the Boards could consider expanding the scope to cover the public/non-business sector. However, legal or practical issues might oblige one or both Boards to limit application of the framework to certain sectors.
 - (c) The revised framework should cover all sectors.
25. Because the decision will affect the planning for the project, the staff recommends that the Boards decide now which approach they wish to adopt.

Which entities

26. The IASB and FASB frameworks do not establish a robust concept of the reporting entity, that is, the concept of what makes a legal or economic entity a 'reporting entity' to which the framework applies. Such a concept would also define the boundaries of the reporting entity for financial reporting purposes. For example, consolidated financial statements are prepared on the basis that the parent entity and other entities under its control collectively represent a reporting entity.
27. The IASB framework defines the reporting entity in one sentence with no further explanation.¹⁰ The FASB framework does not contain a definition, although some of its

¹⁰ IASB *Framework*, paragraph 8.

commentary is similar to that in the IASB CF.¹¹ (For many years the FASB had a project on its agenda to develop a concept of the reporting entity, as part of its project on consolidation and other related matters; a partial draft was developed in the 1980's, but the FASB never reached definitive conclusions or issued a Concepts Statement.) As a result, neither framework specifically addresses the reporting entity concept. Therefore, this is a gap in both frameworks.

28. However, developing a reporting entity concept can be deferred until later in the project, in the staff view. Although the concept is important, there are other parts of the CF that the staff believes should take priority, as discussed later in this paper. Furthermore, this will give time for related projects to progress, such as the IASB project on consolidations, which is examining the concept of control as the basis for consolidation.

Financial reporting boundaries - which statements/reports

29. There are similarities and differences in the boundaries of financial reporting, ie the statements or reports to which the framework applies.
30. Both the IASB and FASB frameworks apply to *general* purpose financial statements/reports.¹² These are financial statements/reports intended to meet the common information needs of a range of users, who may not have the power to specify the information they want from the entity. Hence, both frameworks do not apply to *special* purpose financial statements/reports, such as for example, those prepared for tax purposes or for regulators or to provide specified information to a class of bondholders.
31. The IASB framework applies to general purpose financial *statements*.¹³ That is, the primary financial statements (income statement, balance sheet, etc) and the accompanying notes (and other statements and explanatory material that are an integral part of the financial statements), but not additional financial or non-financial information, such as directors' reports, management discussion and analysis, etc. The FASB framework applies to general purpose external financial *reporting*.¹⁴ This includes not only the financial statements, but also other financial and non-financial information. Examples include other financial and non-financial information contained in company annual reports, company prospectuses, and service performance information in the annual reports of non-business entities.

¹¹ For example, CON1, paragraph 28.

¹² IASB *Framework*, paragraph 6; FASB CON1, paragraphs 28–31.

¹³ IASB *Framework*, paragraphs 6 and 7.

¹⁴ FASB CON1, paragraphs 5–8.

32. Hence, in this respect the scope of the FASB framework is broader than the IASB framework. Nevertheless, the main focus of the FASB framework is on financial statements rather than financial reporting (eg the concepts statements on elements, recognition and measurement all relate to financial statements). This suggests that, at least initially, a converged framework should focus on general purpose financial statements. Later, the Boards could consider expanding the scope to include other financial and non-financial information. This would entail considering what additional information, other than that contained in the financial statements, is required to satisfy the objectives of financial reporting. For example, ideas developed in the IASB research project on management commentary (also known as management discussion and analysis) could be considered.¹⁵
33. It should be noted that the ‘which statements/reports’ issue is related to the ‘which sectors’ issue discussed above. For example, some public and private non-business entities produce service performance information. The staff is aware of at least two conceptual frameworks that contain definitions of elements for service performance reporting. One is New Zealand’s and the other is that of the US Governmental Accounting Standards Board.¹⁶

Objectives

34. The FASB framework contains two statements on objectives—one relating to business entities (CON 1) and another relating to non-business entities (CON 4). The IASB framework, because of its more limited scope (see paragraph 19 above), discusses objectives in the context of business entities only. Therefore, depending on the Boards’ decision about the scope of the revised framework, this will determine the scope of its discussion on objectives. In the following paragraphs, the staff focuses on the objectives in the context of business entities.
35. Both frameworks start with a broad focus, by discussing the objectives in terms of information that is useful to a wide range of users in making economic decisions. Both list a wide variety of present and potential users.¹⁷ Both frameworks narrow that focus to a

¹⁵ This research is being conducted by a Working Party comprising representatives of the IASB’s partner standard-setters in New Zealand, Canada, Germany and the UK.

¹⁶ GASB Concepts Statement 2, *Service Efforts and Accomplishments Reporting*, April 1994.

¹⁷ IASB *Framework*, paragraph 9, discusses investors, employees, lenders, suppliers and other trade creditors, customers, governments and their agencies, and the public; FASB CON1, paragraph 24, mentions owners, lenders, suppliers, potential investors and creditors, employees, directors, customers, financial analysts and advisors, brokers, underwriters, stock exchanges, lawyers, economists, taxing authorities, regulatory authorities, legislators, financial

particular group of users.¹⁸ Reasons given include pragmatic reasons (eg a focus is needed to avoid being vague or highly abstract), and that meeting the information needs of that particular group of users is likely to meet most of the needs of other users. However, the composition of that group differs. The IASB framework focuses on the information needs of ‘investors’ (and their advisers), who are ‘providers of risk capital’. Although some might regard both equity and debt security holders as ‘providers of risk capital’, the reference to ‘investors’ appears to mean holders of equity instruments only, such as shareholders, because ‘lenders’ are listed as a separate group to ‘investors’.¹⁹ The FASB framework appears to focus more broadly on ‘investors’ and ‘creditors’ (and their advisers), with ‘investors’ *including* debt security holders.²⁰

36. Arguably, the differences between the objectives of the two frameworks could have significant implications for other parts of the framework. For example, it affects the scope of the framework—if the primary focus is on the information needs of shareholders, is this consistent with financial statements being ‘general purpose’? It also affects the elements, in particular the definitions of liabilities and equity—if the objective is to provide information that is useful to shareholders in making economic decisions, this implies that equity should be defined narrowly (ie the ‘pure equity’ approach), because shareholders are interested in the effect of transactions or events on the value of their shares (eg dilution). In contrast, if the purpose of financial reporting is to provide information to a range of users, this implies that accounting should focus on reporting the effect of transactions or events on the *entity*, not on the financial position of one particular group of users.²¹
37. The above discussion brings out a more fundamental point. There are two major accounting theories that underlie financial reporting—the proprietary theory and the entity theory. Under the proprietary theory, no fundamental distinction is drawn between the entity and its owners, ie the entity does not exist separately from the owners for accounting purposes. The primary focus is to report information useful to the owners, and therefore the financial statements are prepared from their perspective. Under the entity theory, the entity is regarded as having a separate existence from the owners. Therefore, the financial

press and reporting agencies, labor unions, trade associations, business researchers, teachers and students, and the public.

¹⁸ IASB *Framework*, paragraph 10; FASB CON1, paragraph 30.

¹⁹ IASB *Framework*, paragraph 9(a) and (c).

²⁰ FASB CON1, paragraph 35.

²¹ The staff is not implying that adopting a ‘pure equity’ approach is incompatible with the objective of producing general purpose financial statements for a wide range of users. However, before adopting such an approach, it would be necessary to consider whether the approach meets the information needs of users *other than* shareholders and their advisers.

statements are prepared from the perspective of the entity, not its owners. Appendix B contains further explanation of the two theories.

38. It has been said that many accounting issues cannot be resolved until it is decided which theory should be applied. This continues to be a difficult question, particularly as our constituents have different views on the subject.
39. A good illustration of these different perspectives is the arguments about whether stock-based compensation is an expense. Many investors and analysts support expense recognition because there is a cost to *shareholders*, in the form of dilution, and they draw no distinction between the cost to the shareholders and the cost to the entity. This is also why some investors and analysts support exercise date accounting. In contrast, some corporates have argued against expense recognition on the grounds that there is no cost to the *entity*, because there is no transfer of the entity's resources (cash or other assets); they argue that the only cost is to the shareholders, which is reported through diluted EPS. Of course, this argument overlooks the fact that the expense results from the consumption of assets (employee services), not from an outflow of cash or other assets. But it illustrates the different ways in which people view the entity, the relationship between the entity and its shareholders, and the objectives of financial statements/reports. The treatment of minority interests in consolidated financial statements is another example, as explained in Appendix B.
40. The above discussion indicates that determining the objectives of the financial statements/reports and, in particular, which group of users are the primary focus, could have a significant impact on the rest of the framework. Hence, converging the objectives should be dealt with early in the concepts project. Otherwise, there is a danger that:
 - (a) If other parts of the converged framework are developed first, they might be inconsistent with the objectives;
 - (b) Converging other parts of the framework might be difficult, because Board members might be considering those other concepts with different objectives in mind.

Fundamental concepts

Underlying assumptions

41. The IASB framework prominently features two underlying assumptions: the accruals basis and the going concern basis.²² These are not listed as underlying assumptions in the FASB framework. However, accrual accounting and related concepts are discussed extensively.²³ In contrast, the going concern basis is mentioned in a footnote only.²⁴
42. Hence, these differences need to be resolved. However, they need not be addressed separately. Instead, these concepts will be considered when related parts of the CF are considered.
43. The accruals basis is linked to the definitions of elements. The definitions demand accrual accounting rather than cash-basis accounting. Arguably, if the definitions of elements are sufficiently clear, there is no need to include the accruals basis in the CF, because the notion is already captured in the definitions of elements. But there are issues to consider. For example, a liability for employee remuneration is accrued over the period in which services are provided, including when some parts of that remuneration are subject to vesting conditions (eg pension liabilities, share appreciation rights, cash bonus schemes). Some argue that the existence of vesting conditions means that these obligations are conditional rather than unconditional, and therefore do not meet the definition of a liability. This issue may be considered during the discussion of elements.
44. Similarly, the going concern basis is related to other parts of the framework, especially measurement. For example, some specialised equipment that might be worth little or nothing if the entity cannot continue in business is commonly measured at an amount that assumes its utility in ongoing operations. Hence, the reconsideration and development of measurement concepts will include considering the relevance and implications of the going concern basis.
45. Therefore, the staff recommends considering whether and, if so, how to include these two underlying assumptions in the converged framework at the same time as related parts are considered.

²² IASB *Framework*, paragraphs 22 and 23.

²³ Transactions, events, and circumstances, accrual, deferral, allocation, amortization, realization and recognition, and matching and allocation. CON 6, paragraphs 135–142

²⁴ FASB CON 1, footnote 10. The accruals basis is discussed in CON1, paragraph 44, but only as part of a broader discussion of enterprise performance and earnings.

Qualitative Characteristics

46. The qualitative characteristics section of the CF is linked to other parts of the CF, in particular, recognition and measurement, as is discussed below (paragraphs 62 to 77).
47. Both frameworks discuss qualitative characteristics of financial information in terms of attributes that make the information provided useful to users in making economic decisions. Both frameworks have similar qualitative characteristics, eg understandability, relevance, reliability and comparability. Both discuss constraints, such as cost/benefit considerations, and the trade-off between the various qualitative characteristics, such as relevance and reliability.²⁵
48. However, there are some differences between the two frameworks. For example, the FASB sets out the characteristics in a hierarchy, treating understandability as a user-specific quality separate from the others, relevance and reliability as the primary qualities, and comparability as a secondary quality. In contrast, the IASB framework treats all four as primary qualitative characteristics. The FASB framework includes verifiability, in addition to representational faithfulness, as a characteristic of reliability whereas the IASB framework does not. Conversely, the IASB framework includes substance over form in addition to representational faithfulness, whereas the FASB framework does not, because it concludes that the idea of substance over form is already captured in the quality of reliability and, in particular, representational faithfulness.²⁶ The IASB discusses materiality as part of relevance, whereas the FASB framework separates materiality from relevance and the other qualitative characteristics. However, both discuss materiality as being a threshold (albeit very briefly, in the case of the IASB framework).
49. Some improvements could be made to the qualitative characteristics of both frameworks. For example, both include neutrality, but also prudence or conservatism. Although both frameworks state that the exercise of prudence or conservatism does not allow the deliberate understatement of net assets and profits,²⁷ some argue that any concept of prudence or conservatism is inconsistent with the concept of neutrality.
50. Furthermore, discussions with constituents of both Boards suggest that important qualitative characteristics common to both frameworks may be misunderstood. For example, some constituents suggest that the Boards need a better balance between

²⁵ IASB *Framework*, paragraphs 24-46; FASB CON2.

²⁶ FASB CON 6, paragraph 160.

²⁷ IASB *Framework*, paragraph 37; FASB CON2, paragraph 93.

relevance and reliability, which generally precedes a suggestion that reporting of particular relevant information should not be required due to concerns about reliability. Some constituents seem to equate *reliability* with auditability or verifiability, overlooking the frameworks' meaning of correspondence between the accounting information and the economic conditions or events that it purports to represent.²⁸ Those discussions suggest a significant conceptual gap between the Boards and some of their constituents that needs to be bridged. Also, even amongst Board members, there could be different views about the meaning of some of the qualitative characteristics, such as 'representational faithfulness'.²⁹

51. On the one hand, it could be argued that converging the qualitative characteristics is not a high priority, compared to other parts of the CF, because:
 - (a) generally speaking, the differences do not seem that great, and therefore are unlikely to affect work in other areas of the framework;
 - (b) the staff is not aware of any urgent problems relating to this part of the frameworks.
52. However, on the other hand, it could be argued that converging and improving this part of the frameworks should be done sooner rather than later. If the misunderstanding and different viewpoints mentioned above impedes the progress of the Boards in developing accounting standards, there could be significant benefits to the Boards in giving priority to developing converged qualitative characteristics.
53. On balance, the staff recommends that priority should be given to the qualitative characteristics.

Elements

54. The two frameworks have broadly similar definitions of elements, such as assets, liabilities and equity.³⁰ In both frameworks, the asset definition has a central role, in that all other element definitions are based on the definition of assets.
55. However, there are differences, such as:
 - (a) The FASB framework includes 'probable' as part of the definition of assets and liabilities, whereas the IASB framework includes the term in its recognition criteria,

²⁸ FAS CON2, paragraph 62; IASB *Framework*, paragraph 61

²⁹ For example, some might argue that carrying an asset that was acquired many years ago at its historical cost is not a faithful representation of the asset. Others might argue that if the carrying amount purports to represent the historical cost of the asset, then that cost figure is a faithful representation of the asset's cost. This difference in view raises the question of whether the quality of faithful representation should be applied to the item itself or to its measurement attribute.

³⁰ IASB *Framework*, paragraphs 47-81; FASB CON6.

and the meaning of the word is not the same (discussed further in paragraph 66 below).

- (b) The FASB framework includes four elements relating to financial performance/comprehensive income (revenue, gains, expenses and losses), whereas the IASB framework includes only two (income and expenses).
- (c) In the IASB asset definition, the asset is the 'resource' from which future economic benefits are expected to flow, whereas in the FASB asset definition, the asset is the future economic benefits themselves.

56. There are also areas in which both frameworks could be improved. Problem areas (some inter-related) include:

- (a) The clarity of the liability definition, ie in determining whether or not a liability exists.
- (b) The distinction between liabilities and equity.
- (c) The relationship between the elements in the balance sheet and the elements in the income statement (ie ensuring consistency, in particular, consistency with the recognition criteria, as discussed in paragraph 68 below).
- (d) The effect of conditions, contingencies or uncertainties—when do these affect the definition (ie whether or not something meets the definition of an asset or liability), and when do these affect recognition or measurement.
- (e) Accounting for contractual rights and obligations, for example, leases and fully executory purchase-and-sale contracts.
- (f) Determining the 'unit of account', ie aggregation (including linkage) and segregation.
- (g) Understanding what 'control' means in the definition of assets. For example, does it mean 'denial of access to others' or is it more restrictive?

57. In the staff view, work on converging and improving the elements section of the CF should take a high priority, because this will assist the Boards in many existing and future projects. Collectively, the Boards already have on their agendas two projects that may lead to revisions to the definitions of elements—the revenue recognition project and the liabilities and equity project. Many existing and future projects include issues that relate to the definitions of elements, for example, financial instruments, leases, insurance, business

combinations, consolidations, extractive industries, employee benefits, and share-based payment. Even the project on reporting comprehensive income, which is intended to be a project on presentation, has issues that relate to the elements.

Capital and capital maintenance

58. The concepts of capital and capital maintenance are concerned with how an entity defines its capital (ie its store of wealth), for the purposes of distinguishing between an entity's return *on* capital and its return *of* capital.
59. The IASB CF briefly discusses two concepts of capital (and their associated capital maintenance concepts): financial and physical (or operating capability).³¹ It does not specify which of the two concepts should be adopted, other than to say that the selection of the appropriate concept of capital should be based on the needs of users of financial statements. In contrast, the FASB CF adopts the concept of financial capital maintenance.³² Therefore, there is a difference in the two frameworks that will need to be eliminated in the converged CF.
60. The concepts of capital and capital maintenance are also related to other aspects of the CF, in particular, measurement. A physical capital (or operating capability) concept is usually regarded as requiring a current cost measurement basis. Arguably, a financial capital concept does not require a particular measurement basis—although some would argue that the use of 'exit' prices is more consistent with the concept.
61. It might be argued that converging the two frameworks in this area is not a high priority because, in practice, the financial capital concept has been adopted. However, given the link between concepts of capital and measurement, the staff recommends that the Boards determine a converged position on the topic during their discussion of measurement concepts.

Operational concepts

Recognition

62. The recognition criteria are linked to other parts of the CF, in particular, the elements, qualitative characteristics and measurement, as explained below. Hence, the converged recognition criteria will need to be consistent with other parts of the framework.

³¹ IASB *Framework*, paragraphs 102-110.

³² FASB CON5, paragraphs 45-48.

63. Both the IASB and FASB frameworks contain recognition criteria that must be satisfied before items are recognised in the financial statements.³³ The frameworks have some criteria in common:
- (a) The item meets the definition of an element
 - (b) The item has a measurement attribute (cost or value) that can be measured with (sufficient) reliability.
64. There are also some differences:
- (a) The FASB CF includes the criterion that the item is relevant—information about it is capable of making a difference in user decisions. Relevance also affects the measurement attribute criterion mentioned above—the item must have a *relevant* attribute that can be measured reliably, not just any measurement attribute. The IASB CF does not include relevance, either as a separate recognition criterion or as a qualifier of the measurement attribute criterion.
 - (b) The IASB CF includes the criterion that it is probable that any future economic benefit associated with the item will flow to or from the entity. The FASB CF does not include probability as a recognition criterion.
65. The absence of relevance as a recognition criterion in the IASB CF does not necessarily indicate that it regards relevance as unimportant, as indicated by the discussion of relevance in the qualitative characteristics section of the CF. It could be reasonably assumed that if an item meets the recognition criteria, then information about that item is relevant. However, explicitly including relevance, particularly in the context of measurement, would provide a context for assessing whether an item can be measured with sufficient reliability for recognition purposes. For example, academic research shows that the greater the relevance of a particular measure, then the greater the amount of measurement uncertainty that users are prepared to accept.
66. The IASB CF includes a ‘probable’ criterion in its recognition criteria, while the FASB CF includes ‘probable’ in its definitions of assets and liabilities (and the meaning of the word differs too). Furthermore, the inclusion of a ‘probable’ recognition criterion can be problematic, particularly when interpreted as ‘more likely than not’ and applied to a single asset or liability. When developing IFRS 3 *Business Combinations*, the IASB noted that there is an inconsistency between the probability recognition criterion in the IASB CF and

³³ IASB *Framework*, paragraphs 82-98; FASB CON5, in particular, paragraphs 58-90.

a fair value or expected value measurement basis. It concluded that the probability of future inflows or outflows of future economic benefits should be taken into account when measuring assets and liabilities, rather than determining whether an asset or liability exists or should be recognised.³⁴ However, more recently, the IASB has developed a way to resolve the apparent inconsistency between the ‘probable’ recognition criterion in its CF and the use of a fair value measurement basis.³⁵ Nevertheless, there are still unresolved issues about whether some notion of probability has a role in either the definition of elements or the recognition criteria, as well as measurement.

67. Furthermore, neither framework discusses *derecognition*, the removal of a previously recognised asset or liability. One might conclude that this is unnecessary—an item should be derecognised if it no longer meets all the criteria for recognition. For example, an item that continued to meet the definition of an element but no longer could be measured with sufficient reliability should be derecognised. However, some argue that both Boards have developed standards on financial instruments that require *other things* to occur before financial assets can be derecognised (and *different* other things to occur before liabilities can be derecognised.)³⁶ Some argue that those standards-level decisions do not rely on any stated (or implied) concept. Irrespective of whether Board members agree or disagree with that conclusion, there are conceptual issues relating to derecognition that should be considered as part of the process of converging and improving the recognition criteria in the CF.
68. In addition to converging the recognition criteria in the two frameworks and dealing with derecognition, some improvements are also needed, to remove any inconsistency with the definitions of elements. In particular, the FASB CF includes guidance in applying recognition criteria that revenue and gains should be realised or realisable, and should be earned (ie the revenue-earning activities are substantially accomplished), before being recognised. The IASB CF also mentions the requirement applied in practice that revenue must be earned before being recognised, and describes this practice as an application of the recognition criteria. However, as has been discussed in the Boards’ joint revenue recognition project, there are concerns that using an ‘earnings process’ notion as the basis

³⁴ IFRS 3, Basis for Conclusions, paragraphs BC111 and BC112.

³⁵ This entailed applying ideas developed in the Boards’ joint revenue recognition project, whereby conditional rights and obligations are distinguished from accompanying unconditional rights and obligations. For example, an entity that has issued a product warranty has an unconditional obligation to provide a warranty service. The IASB concluded that an outflow of future economic benefits (the warranty service) is probable, irrespective of the likelihood of a claim occurring. [For more information, see IASB *Insight*, July 2004, page 14]

³⁶ IAS 39 *Financial Instruments: Recognition and Measurement* and FAS 140 *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*.

for revenue recognition can create inconsistencies with the definitions of elements.

Revenue and gains (collectively referred to as income in the IASB CF) are defined in terms of changes in assets and/or liabilities, not the completion of an earnings process. However, some disagree that there is any major inconsistency—they argue that the ‘earnings process’ notion is a tool to help determine when changes in assets and liabilities have occurred.

69. Therefore, the inter-relationships between recognition and other parts of the framework must be considered when converging the recognition criteria. Given these inter-relationships and the importance of converging the elements definitions (as discussed above), the staff recommends that work on recognition should follow, or take place at the same time as, work on the elements definitions.

Measurement

70. Measurement is one of the most undeveloped areas of the two frameworks. Both the IASB and FASB frameworks contain lists of measurement attributes that are used in practice.³⁷ Those lists are broadly consistent, and comprise historical cost, current cost, gross or net realisable (settlement) value, current market value³⁸ and present value. Both frameworks indicate that the use of different measurement attributes is expected to continue. However, neither provides guidance on how to choose between the different measurement attributes that exist. In other words, the frameworks lack fully developed measurement concepts. Those measurement concepts would need to cover both initial measurement and subsequent measurement. Subsequent measurement includes revaluations, impairment and depreciation.³⁹
71. Developing these measurement concepts is likely to take some time, because of the complexity of the issues and the divergent views that exist. However, there is work underway that will assist with this process.
72. As the part of the first phase of what is contemplated as a multi-phase project, the FASB has recently issued an exposure draft on how to carry out fair value measurement when that attribute is permitted or required by other accounting standards. The comment period on that draft has closed and the FASB has held several round table discussions with constituents on the draft, and soon will begin its redeliberations on the proposed guidance.

³⁷ IASB *Framework*, paragraphs 99-101; FASB CON5, in particular, paragraphs 66-71.

³⁸ Current market value is listed as a separate measurement attribute in the FASB framework only.

³⁹ For example, one issue to consider is the distinction between attributes that are based on allocations (eg depreciation) and those based on direct measurements.

73. Additionally, the Canadian AcSB is currently working on a research project on measurement for the IASB (that predates the conceptual framework project). The project has been divided into two stages:

- (a) Stage 1 – initial measurement and impairment
- (b) Stage 2 – remeasurement (other than impairment), when remeasurement is required by accounting standards.

Research papers for stage 1 of the project will be ready for publication in the near future. Work on stage 2 has commenced.

74. The staff envisages that all of this material, along with the comments received from constituents, will provide significant input into the development of measurement concepts. (Assuming that the Boards decide to proceed with the conceptual framework project, it will be necessary to consider in more detail exactly how the work currently underway on measurement fits in with the development of measurement concepts. This point also applies to work currently underway on presentation and disclosure, as discussed below in paragraphs 78-80. Furthermore, this point raises a broader issue relating to the conduct of future projects in general, about the relationship between the ‘research’ phase of a project and work undertaken to develop a discussion paper or preliminary views document. These issues will be addressed at a later date.)

75. The staff recommends that work on developing measurement concepts should follow the work on elements because:

- (a) We need to be clear about what we are measuring before we can determine how to measure it.
- (b) This will allow time for the FASB to consider the comments it has received and for the Canadian AcSB to complete its research work on measurement.

76. The Boards will also need to consider whether the CF should include not just measurement concepts, but also guidance on the techniques of measurement. The FASB CF includes CON 7, on the use of cash flow information to measure present value as an estimate of fair value for the purposes of initial recognition and fresh-start accounting. The IASB CF does not include any discussion of the techniques of measurement. In other words, the Boards will need to decide where to draw the line between what belongs in the CF and what belongs in standards-level guidance.

77. In the staff view, considering this point should be delayed until the Boards have developed the measurement concepts. It is not necessary to make the decision now in order for the project to proceed. Once the measurement concepts have been developed, the Boards will have more information upon which to base a decision on this issue.

Display

78. The display section of the CF would cover both presentation and disclosure, ie concepts for determining how recognised information should be presented and what information should be disclosed.

79. Neither framework explicitly sets out any definitive concepts of display. There is some discussion of presentation and disclosure in other parts of the frameworks, (eg both frameworks contain some discussion of information to be disclosed to meet the objectives of financial reporting, what belongs in a full set of financial statements, and the roles of notes and supplementary information).⁴⁰ However, that commentary needs to be pulled together and developed further, to develop concepts of display.

80. The Canadian AcSB has begun a research project for the IASB to develop a disclosure framework.⁴¹ The project began in response to demands from users for more and better quality disclosures. At the same time, users are concerned about the growth in disclosures, together with poor presentation, which makes the disclosures difficult to understand. The objective of the project is to develop a framework that provides a more thorough conceptual basis for specifying presentation and disclosure requirements in new and revised accounting standards. This research work should provide substantial input into developing the display section of the CF.

81. The Boards also have a joint project on reporting comprehensive income. The principles developed in this project are likely to help in developing concepts of display. Although some might argue that this is ‘putting the cart before the horse’, the fact is that the Boards are already working on the project. Moreover, given the lack of display concepts in the current frameworks, ideas developed in current projects will be helpful.

82. The staff recommends that work on display be undertaken later in the project, to allow:

- (a) the Boards to focus first on other parts of the framework that are likely to provide greater benefits to the Boards in the short term,

⁴⁰ In fact, the FASB issued a discussion document in 1980 focusing on such matters (FASB Invitation to Comment, *Financial Statements and Other Means of Financial Reporting*).

⁴¹ The US GASB also is conducting a concepts project on disclosure.

- (b) time for the Canadian AcSB to complete its research project, and
- (c) time for both segments of the project on reporting comprehensive income to progress, at least to the issue of an initial document.

PRIORITISATION OF ISSUES

83. This section summarises the recommendations made in the above initial analysis of the frameworks.
84. That analysis suggests the following parts of the CF should be addressed earlier:
- objectives
 - qualitative characteristics
 - elements (including issues relating to accruals)
 - recognition
85. And the following parts should be addressed later:
- measurement (including going concern basis and techniques of measurement)
 - scope—reporting entity concept
 - scope—expanding to cover other sectors (if not all sectors covered initially) and other types of financial information
 - display (presentation and disclosure)
 - purpose and status.
86. However, the exact ordering of issues will need to take into account the inter-relationships between the various parts of the framework and inter-relationships with standards-level projects. For example, considering the issue of where ‘probable’ fits into the CF affects the definitions of elements, recognition criteria and measurement concepts. Hence, in addressing issues relating to one part of the CF (eg elements), it will also be necessary to consider how those issues affect other related parts of the CF (eg recognition or measurement), to ensure that the resulting converged framework is internally consistent. The purpose of structuring the above prioritisation in the form of list of various parts of the CF is to:
- (a) provide a overview of the areas upon which the Boards should focus first, and
 - (b) ensure that the project covers all areas of the CF sooner or later, so that the resulting converged framework is complete.
87. Moreover, the ordering of issues will be affected by whether the Boards decide to conduct the project as a single phase, or divide it into two or more phases. That issue is discussed

in a subsequent section of this paper, on project output. For example, if the project is divided into phases, with the first phase focusing principally on convergence, or convergence and improvement of the existing contents of the frameworks, then work on measurement might be divided into phases, with the first phase consisting of updating and converging the measurement attributes. The development of measurement concepts and the techniques of measurement could be considered in later phases.

THE FORM AND STRUCTURE OF THE JOINT CONCEPTUAL FRAMEWORK

88. At the April joint meeting, several Board members queried what the converged document would look like, for example:
- (a) Would it be a single document or a series of documents?
 - (b) How long will the document(s) be, given that the IASB framework is much shorter than the FASB framework?
89. Before considering these questions, there is one point that should be borne in mind. The project to develop a converged conceptual framework should be the first stage in an on-going process. The existing frameworks require significant improvement not only because they were never fully completed in the first place, but also because there was no on-going process to update and improve them. Just as the body of accounting standards is revised, updated and improved over time, so too should the framework. And given that the framework is intended to be the conceptual foundation for IASB and FASB standards, ongoing “repairs and maintenance” and “research and development” will be important if it is to serve that function.
90. Therefore, although the remainder of this paper focuses on the initial task of developing a single framework—a major task in of itself—that does not necessarily imply that the completion of this task means that the concepts project is completed.

One document or several?

91. The FASB was the first standard-setter to develop a conceptual framework. This was done in stages over an extended period, during the 1970’s and 1980’s. A concepts statement was issued as each stage was completed. Collectively, these statements comprise the FASB CF. In contrast, the IASC used a ‘big bang’ approach, in which it developed its CF at one time, resulting in the issue of a single document.
92. The CF, irrespective of its form, is intended to be a comprehensive, integrated whole. Dividing it into a series of statements does not change that objective. However, in the staff view, the objective is more likely to be achieved if the revised framework is produced as a single document. Also, a single document will not require references between documents, ie will have less redundancy. Furthermore, we are not starting from scratch (unlike the FASB when it developed its existing framework), and therefore producing a single document within a reasonable timeframe should be possible.

Length of document (level of detail)

93. Many would argue that the IASB CF is too short (ie too summarised) and the FASB CF is too long (ie too detailed). The FASB CF contains some material that was included for historical reasons, and material that could be moved to a Basis for Conclusions. However, even with such material removed, the FASB CF would still be much longer than the IASB CF. Hence, the question of the appropriate length (ie amount of detail) remains.
94. If the CF is too short, fundamental concepts might not be clearly explained, which makes them difficult to apply to particular accounting issues. However, if the CF is too long, fundamental concepts might be obscured, because it may be hard to find those concepts amongst all the other explanatory material.
95. Therefore, an appropriate balance needs to be found, somewhere between the length of the two Boards' frameworks. The difficulty will be in finding that balance, particularly because the two Boards and their constituents may have different views about what constitutes the 'appropriate' amount of detail. Although both Boards would probably agree that the objective is to ensure that the CF contains sufficient explanation that it will be understood—and not misunderstood, ie not capable of being interpreted in divergent ways—it is a matter of determining how much explanation is necessary to meet that objective.
96. One idea is to structure the CF as follows:
- (a) An executive summary that sets out all of the key concepts, similar to the 'highlights' section at the start of each FASB concepts statement. For example, the section of the executive summary on elements would set out all the elements, including their definitions. The executive summary would present a high-level 'big picture' view of the framework. It would be structured in the same order as the more detailed sections that follow it.
 - (b) Following the executive summary, the main body of the CF would contain a section for each part of the framework, eg objectives, qualitative characteristics, elements, etc. Each section would contain all of the relevant key concepts, repeated from the executive summary. Each key concept would be accompanied by further explanatory material. The key concepts could be highlighted in some manner, eg presented in bold type with the explanatory material in plain type, similar to the structure of IASB standards. This enables the reader to easily identify the key concepts within each section. It also enables a reader who starts with the executive

summary to easily locate the appropriate part of the framework that gives more explanation on particular concepts.

- (c) In addition, a Basis for Conclusions would be included. This would explain why the Boards reached decisions on particular issues, including why they rejected any alternative approaches.⁴² Hence, the explanatory material included in the main body of the CF would focus on explaining the key concepts, not why the Boards concluded that those concepts should be included in the framework. The latter material would be included in the Basis.

⁴² However, sometimes it might be necessary to include a description of alternative approaches in the main body of the CF, for example, to help explain the selected approach. But the Boards' reasons for choosing one approach over another would be explained in the Basis.

PROJECT OUTPUT

Single or multi-phase project

97. An important issue to address is whether the project should be split into two or more phases:
- (a) Phase 1 – converge the two frameworks
 - (b) Phase 2 (or Phase 2, 3, 4 etc) – improve the converged framework (ie reconsider parts that are already similar but in need of improvement and fill in the gaps mentioned above).
98. The advantage of dividing the project into phases is that it will be possible to produce some output more quickly. Some staff are concerned that trying to conduct the project as a single phase—that converges, improves and completes the CF—will take many years, perhaps ten years or more, to complete. In the meantime, the Boards will lack a common conceptual framework that has been developed through due process upon which to base their decisions when developing accounting standards. By dividing the project into phases, with phase one focusing on convergence, this will help the two Boards in developing converged standards, because one barrier (differences in their respective frameworks) will be removed. Furthermore, it will demonstrate the willingness of the two Boards to work together to achieve convergence.
99. Ideally, the objective of the first phase of the project would be to produce a converged framework that is no less complete than the two existing frameworks. Some staff believe that this is achievable, because the frameworks are much more similar than they are different. And where differences exist, some are not very substantive, and could be resolved without great difficulty.
100. For those differences that may be more substantive, the Boards could pursue one of several approaches:
- (a) Try to resolve those differences in the first phase of the project, with the goal of producing a converged framework in which all differences have been resolved.
 - (b) Simply pick the better of the two alternatives in the existing frameworks, similar to the approach taken in the Boards’ short-term convergence projects.
 - (c) Defer resolution of differences not readily resolved to a subsequent phase of the project. This would result in a partially-converged framework, to serve as partial

tool for the Boards to use, as well as a platform upon which the other phases of the project could build. (The logistics of this approach would need to be worked out, for example, how to link or cross-refer the partially converged framework to the non-converged parts of each Board's existing framework. This would be particularly important for the IASB, given the status of its existing framework in its GAAP hierarchy.)

101. Other phases of the project could be conducted sequentially or, in some cases, simultaneously. This would depend on matters such as (a) the relative independence or interdependence of the issues, (b) the urgency of addressing certain issues to support and facilitate related standard-setting efforts, and (c) the nature and amount of staff resources that the Boards make available to the project.
102. The disadvantage of dividing the project into phases, with the first phase focusing on convergence, is that it could be very difficult to restrict the discussion to convergence only. For example, some staff question whether it is realistic to try to converge the definition of elements without considering what the current definitions mean and what the problems are with those definitions. The alternative approach of trying to pick the 'better' of the two existing alternatives might be more problematic than trying to agree on improved definitions, particularly given the interrelationships between various parts of the framework.
103. In the view of some staff, there is a significant danger that everything other than 'easy' issues will be deferred until later phases. If that happens, it is likely that the phase one product will be less comprehensive than the existing frameworks.
104. As noted earlier, the frameworks have a lot in common. Hence, some staff believe that the major problem with the two frameworks is not so much the differences between them but rather that they both require improvement. If the first phase focuses mainly on eliminating differences rather than improvements, the resulting product may not be of much direct technical help to the Boards in developing accounting standards, because significant issues remain unresolved.
105. However, if the Boards are concerned with the size of the task if the project is conducted as a single phase, other approaches could be explored. An alternative approach might be to have a first phase that converges *and improves* the existing contents of the frameworks, for example, the elements and recognition sections. The sections of the framework that are currently missing or substantially incomplete (eg measurement and display) could be

deferred until a later phase. This approach will mostly avoid the problems identified above that will arise if the Boards try to confine phase one to convergence. Also, in the view of some staff, this approach is more likely to result in a phase one product that improves the existing frameworks, is no less complete than the existing frameworks, and will be more helpful technically to the Boards in developing accounting standards.

106. The above discussion contains three suggested approaches for the conduct of the project:
- A. A single phase only, ie converge, improve and complete the two existing frameworks.
 - B. A multi-phase project, with phase one focusing principally on convergence, but also including some improvements. Other improvements and filling the gaps in the existing frameworks would be deferred until later phases.
 - C. A multi-phase project, with phase one focusing on converging and improving the existing contents of the two frameworks. Filling the gaps in the existing frameworks would be deferred until later phases.
107. Approaches B and C are similar, but there are differences. Approach C places more emphasis on improving the existing frameworks than Approach B. If the Boards agreed to approach C, they would have to *commit at the start of the project* to resolving any differences between the frameworks by developing improved, converged solutions. They would not have the option of deferring any difficult-to-resolve issues until a later phase. Hence, Approach C will put more pressure on the Boards to reach a converged solution than Approach B, and therefore it is likely that Approach C will take longer than Approach B to complete phase one of the project.
108. In choosing between the three approaches, the Boards will need to weigh up the relative importance of producing some output sooner rather than later. It is likely that Approach B will produce some output sooner than the other two approaches, followed by Approach C, with Approach A taking the longest. The Boards will also need to consider the relative importance of the objectives of *converging*, *improving* and *completing* the existing frameworks. All three approaches have all three objectives as their ultimate goal. However, by dividing the project into phases, Approaches B and C focus first on some but not all of these objectives—in phase one, Approach B focuses principally on convergence, ahead of improvements and completion, while Approach C focuses principally on convergence and improvements, ahead of completion.

109. The Boards should also consider whether they believe it is appropriate to develop new or revised accounting standards based on decisions made in the CF project before the existing frameworks have been formally amended. If the Boards conclude that the frameworks should be amended first, this suggests that the project should be divided into phases, to avoid lengthy delays to standards-level projects.
110. However, the Boards might conclude that it is not necessary to formally amend the frameworks before ideas developed in the CF project can be applied in standards-level projects. In the past, the Boards have not necessarily felt constrained by the existing frameworks, if they concluded that particular aspects of the existing frameworks were no longer appropriate or in need of refinement. Moreover, any new or revised accounting standards will be subject to their own due process, in addition to the due process to amend the frameworks.
111. Nevertheless, dividing the project into phases would provide more flexibility for the Boards to decide, on a case-by-case basis, which should come first—an amendment to framework or the issue of a new or revised standard. In other words, it would enable a two-way interaction between the conceptual framework and related standards-level projects—sometimes ideas developed in standards-level projects might lead to amendments to the framework, and sometimes ideas developed in the framework project might lead to amendments to accounting standards. But either way, there would be a full due process to amend both the framework and the related standards. That process would include considering whether an idea developed at one level (eg concepts-level) should be applied at another level (eg standards-level).

Initial due process document

112. Another issue the Boards will need to consider is the type of document that will be the initial output of their due process, ie neutral discussion paper, discussion paper with preliminary views or exposure draft.
113. The IASB now has a policy of issuing discussion papers on major projects, which typically would include its preliminary views on major issues relating to the project concerned. This policy would apply to the conceptual framework project. The FASB's traditional process begins by issuing a neutral discussion memorandum; of late, the FASB has sometimes departed from that tradition, sometimes by issuing a preliminary views document or sometimes going directly to an exposure draft. Given the interest of constituents in the

project, they could reasonably criticise our due process if the Boards issued an exposure draft without first issuing a discussion paper or preliminary views document.

114. Some staff recommend that, in general, the initial due process document should be a discussion paper that includes the Boards' preliminary views. This does not necessarily mean a discussion paper that covers the entire framework. That depends on how the project is conducted, for example, as a single phase or divided into two or more phases (as discussed above). However, in the view of some staff, dividing the project into phases affects the scope of the initial document, not its type. In other words, some staff recommend that the Boards adopt a general policy of beginning with a discussion paper with the Boards' preliminary views, no matter whether that document covers the entire framework or only parts of the framework.
115. In contrast, if the project is divided into phases, some staff recommend that the Boards should assess what the initial due process document should be for each phase of the project. For example, if a particular project phase converged parts of the framework that are already substantially similar, an exposure draft might suffice. However, for major issues or if significant changes are proposed, then the Boards should issue a discussion paper, preferably containing the Boards' preliminary views, followed by one or more further rounds of public consultation.
116. The Boards will also need to consider whether an initial due process document should be published as specific issues are resolved, or for each section of the framework, or for the entire framework. In other words, do the Boards issue an initial document as work on particular issues is completed, or when each section of the framework is completed, or do we wait until the whole document is assembled before publishing an initial document? This issue is relevant if the project is conducted as a single phase. It is also relevant to the first phase of a multi-phase project.
117. One advantage of publishing an initial due process document for each section of the framework or when work on particular issues is completed (eg issues that affect several sections of the framework), is that some output is produced more quickly. It will demonstrate progress is being made, and could help make the project more manageable. Also, this might enable feedback to be received before work on related sections of the framework is completed.
118. One disadvantage is that it might impair the objective of creating a comprehensive, integrated framework. It might also be difficult for constituents to provide informed

comments, if they only have part of the picture. Indeed, constituents might reasonably expect the Boards to publish a document covering the whole framework, even if we have already published initial documents for various sections or issues, so that they can give us comments on the framework as a whole, eg whether they regard it as internally consistent.

119. One suggestion is to combine the above approaches. That is, the Boards could publish an initial due process document as work on particular issues or particular sections are completed, and then later publish a comprehensive document that brings everything together, to obtain comments on the framework as a whole.

PROJECT MANAGEMENT

120. Ideally, this section of the paper would include an overview of project management issues. For example, it would outline the composition of the project team and the roles of various team members, including some discussion of how various tasks might be divided amongst team members. It would include a tentative timetable for major milestones in the project. It would also outline how the conceptual framework project will interact with other related projects, for example, how the timetable for those related projects fits in with the timetable for the conceptual framework project.
121. However, at this stage, it is difficult to address those issues until the Boards have addressed related issues. For example, the conduct of joint IASB and FASB projects is currently under review. That process needs to be completed before it can be determined how to apply any new or revised policies and procedures to the conceptual framework project. Also, whether the Boards decide to conduct the project as a single or multi-phase project has significant implications for project planning and, more generally, project management. For example, it will affect the project timetable, both in terms of the timing of major milestones and determining what those major milestones will comprise.
122. Therefore, once the Boards have made decisions on the questions raised at the start of this paper and on related issues (eg the conduct of joint projects), it will be possible for the staff to address project management issues.
123. However, no matter what decisions are made about these issues, it is important for Board members to be aware *and accept* that the conceptual framework project will require a substantial amount of staff resources and Board time. For example, the staff proposal discussed at the April joint meeting noted that the project would require at least six staff members on a full-time basis.⁴³ No matter whether the project is conducted as a single or multi-phase project, it is likely that the task of converging, improving and completing the existing frameworks will take at least five years, perhaps ten years or more, depending on the level of staff resources allocated to the project, the time taken to resolve difficult and controversial issues, and other factors. Furthermore, as noted earlier (paragraph 89), the resulting converged framework will require regular “repairs and maintenance”, for it to serve its function as the conceptual basis for converged accounting standards. Although

⁴³ One issue to clarify at an early stage is whether this should mean six people, who work full-time on this project only, or six full-time-equivalents.

this subsequent task is likely to require fewer resources than the initial task of developing a common conceptual framework, an on-going commitment will be required.

124. In summary, in the staff view, the success of the project will depend on the Boards' making a substantial commitment to the project, both initially and on an on-going basis. The staff asks the Boards whether they agree with this assessment, and therefore whether they agree with making such a commitment.

Applicability of accounting standards/requirements to various sectors⁴⁴

Country (IASB partner standard-setter)	Private, business sector	Private, non-business sector	Public, business sector	Public, non-business sector
Australia (AASB)	Yes	Yes	Yes	Yes
Canada (AcSB)	Yes	Yes	Yes	No ⁴⁵
France (CNC)	Yes	Yes	Yes	No ⁴⁶
Germany (DRSC)	Yes	No ⁴⁷	Yes	No ⁴⁷
Japan (ASBJ)	Yes ⁴⁸	No ⁴⁸	No ⁴⁸	No ⁴⁸
New Zealand (FRSB)	Yes	Yes	Yes	Yes
UK (ASB)	Yes	Yes	Some entities ⁴⁹	Some entities ⁴⁹
US (FASB)	Yes	Yes	No ⁵⁰	No ⁵⁰
International (IASB)	Yes	No	Yes	No ⁵¹

⁴⁴ In some cases, accounting requirements are included in legislation rather than in accounting standards. The above table is prepared on the basis of considering whether accounting requirements applying to the private, business sector are also applied to other sectors.

⁴⁵ The Canadian Public Sector Accounting Board sets accounting standards for public, non-business entities. These standards are generally based on AcSB standards, although the PSAB is in the process of developing its own framework and definition of GAAP.

⁴⁶ Until recently, these entities reported on a cash basis of accounting. Reform is underway to move to standards based on the public sector standards developed by IFAC, which are based on IASB standards.

⁴⁷ Accounting in the non-business sector (private and public) is based on cash accounting, called Kameralistik.

⁴⁸ A special working group, chaired by the Chairman of the ASBJ, is developing a Discussion Memorandum on a conceptual framework for Japan. This Discussion Memorandum will deal with the corporate sector only.

⁴⁹ The ASB sets accounting standards that apply to some parts of the public sector (eg local government). The accounting requirements for the rest of the public sector are based on ASB standards.

⁵⁰ The FASB standards apply to private sector entities. There are other bodies responsible for setting standards for the public sector (eg the Government Accounting Standards Board sets standards for state and local government).

⁵¹ The Public Sector Committee of IFAC has an on-going project to develop public sector accounting standards based on IASB standards.

Proprietary theory and entity theory

1. This appendix contains a brief outline of the proprietary theory, the entity theory, and the mixed model we use today. It is not a full analysis of the two theories, nor does it discuss all issues arising from the application of either or both of the two theories. Furthermore, there are other theories in accounting literature not mentioned here. The purpose of this appendix is to simply give an overview of the two theories and some of the issues arising from their application.

Proprietary theory

2. The proprietary theory places the proprietors in the central position of financial reporting and the accounting equation. Assets represent resources owned by the proprietors; liabilities are debts or obligations of the proprietors; and revenues and expenses represent changes in proprietorship.
3. The proprietary theory is also viewed as a wealth concept: proprietorship is the net value of the business to its proprietors. Net income accrues directly to the proprietors and thus represents an increase in their wealth. Hence, some regard the proprietary theory as “balance sheet orientated”, and consistent with the use of current values rather than historical costs.

4. The accounting equation under the proprietary theory is therefore:

$$\text{Assets} - \text{Liabilities} = \text{Proprietorship (or Equity)}.$$

5. Under the proprietary theory, liabilities and proprietors' equity are fundamentally different in concept. The following comments of Sprague (1907), made while rejecting the notion that the proprietors' interest should be treated as part of an entity's liabilities, illustrates the proprietary theory's view of equity:

Surely The Business does not stand in the same relation to its proprietors or its capitalists as to its “other” liabilities. It would seem more appropriate to say that it is “owned by” than “owes” the proprietors. (page 57)

6. The proprietary theory views the entity's liabilities as being obligations, while the proprietors' equity is not in any sense an obligation. An obligation requires the entity to transfer resources, such as money, goods or services, from the entity to another party *outside the entity* at some time in the future. Because the entity is not viewed as existing

separately from the proprietors, the proprietors are not “outside” the entity. Hence, proprietors’ equity is not an obligation of the entity.

Entity Theory

7. The entity theory stresses the importance of the entity as an organisation separate from the proprietors. This separate existence is supported by legislation, in the case of companies. However, the entity theory is not only applicable to companies.
8. Under the entity theory, the fundamental accounting equation is:

$$\text{Assets} = \text{Liabilities}$$

or

$$\text{Assets} = \text{Equities}$$

9. In other words, there is only one category of financial interests, which some call “liabilities” and others call “equities”. Assets represent rights accruing to the entity, while creditors and shareholders have equities in the entity. Under the entity theory, there is no conceptual distinction between the various parties who have a financial interest in the entity; they are all “equity holders”. That is, the interests of both creditors and shareholders form part of the total “equities” or “liabilities”, irrespective of any differences in the rights and conditions attached to the various financial interests. Shareholders’ equity is thus considered to be the obligation or liability of the entity to its shareholders, in the same manner as the claims of creditors represent obligations or liabilities.
10. Some regard the entity theory as “income statement orientated”, and more consistent with the use of historical costs rather than current values. Because of the separation between the entity and the owners, who are outside the entity, a stewardship role for accounting is given prominence. The use of historical cost, and the matching of costs against realised revenues, is regarded as less open to management manipulation than current values. Arguably, it is therefore better suited to monitoring managerial stewardship. Also, because the entity is the centre of attention, rather than the proprietors, proprietors’ net worth is not regarded as particularly important.

The mixed model we have today

11. Many years ago, before companies existed, most businesses were owned and operated by sole traders or partnerships. Accounting (such as it was back then!) was based on the proprietary theory. However, once companies came into existence—particularly large,

listed companies for which shares regularly changed hands, and whose shareholders had limited liability and little, if any, involvement in the day-to-day running of the company—proprietary theory did not fit very well, particularly the notion that the entity does not exist separately from the proprietors.

12. However, these changes did not result in the abandonment of the proprietary theory in favour of the entity theory. Instead, a mixed model developed, which is essentially the same as in the IASB and FASB frameworks today. For example, consistent with the proprietary theory, a fundamental distinction between liabilities and equity still exists; liabilities are still defined in terms of present obligations to transfer resources to other parties; equity is still intended to represent the owners' interests; and equity interests are still regarded as imposing no obligation on the entity to transfer resources.
13. However, the entity is now regarded as existing separately from the owners, which is consistent with entity theory, not proprietary theory. Accordingly, owners' interests are no longer automatically excluded from liabilities, as they were under the proprietary theory. Instead, the reason why owners' interests are excluded from liabilities is that the entity is not obliged to transfer resources to owners until some formal act, such as the declaration of a dividend.
14. Therefore, when classifying a particular financial interest as a liability or equity, the key question was no longer 'is the interest holder an owner?' Instead, the key question became 'is the entity compelled to transfer resources to the interest holder?'

“...liabilities...involve *nondiscretionary* future sacrifices of assets that must be satisfied on demand, at a specified or determinable date, or on the occurrence of a specified event....distributions to owners are *discretionary*...Generally, an enterprise is *not obligated* to transfer assets to owners except in the event of the enterprise's liquidation unless the enterprise acts formally to distribute assets to owners, for example, by declaring a dividend...” (FASB SFAC6 54 and 61, emphasis added)
15. However, more recently, the notion that financial interests to be classified as equity should have the characteristics associated with owners' interests has been re-introduced, (eg SFAS 150 *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*).
16. Under the modified version of proprietary theory used today, a fundamental distinction between liabilities and equity remains, as does the accounting equation:

Assets - Liabilities = Owners' Equity

17. Some authors went as far as combining the first two elements on the left side of the equation. Hatfield (1909) and Canning (1929) presented the accounting equation in this way, by taking that view that liabilities are negative assets. For example:

“In the matter of valuation, liabilities do not differ from assets except in characteristic direction of flow. Those writers who urge consideration of liabilities as negative assets express a view more fruitfully suggestive than do those who habitually associate liabilities and net proprietorship in their discussion.” (Canning 1929, p. 50-51)
18. This statement is consistent with the IASB and FASB frameworks, not only in their respective definitions of liabilities, which are essentially the negative of the definition of assets, but because the amount of equity is dependent upon the measurement of assets and liabilities.
19. Another example of the use of a mixed model relates to the boundaries of the reporting entity and the basis of consolidation. Under the proprietary perspective, the boundary of the reporting entity is defined by the proprietors' ownership of resources. Hence, other entities are consolidated on the basis of ownership interests rather than control, in particular, the parent company's ownership interests. Proportionate consolidation is appropriate if the parent company does not own 100% of the other company.⁵² In contrast, under the entity perspective, the boundary of the reporting entity is defined by the entity's control over resources. Hence, other entities are consolidated based on control rather than ownership interests. Full consolidation is appropriate.⁵³
20. Until recently, group accounts were prepared using both perspectives. For example, assets and liabilities were fully consolidated, while equity was proportionately consolidated, with minority interests making up the balance. The recent change to include minority interests in equity has moved the preparation of group accounts closer to the entity perspective.

Concluding comments

21. The above discussion noted that we currently use a mixed model. Some argue that a mixed model is confusing. Furthermore, it could result in inconsistencies in the framework, because of difficulties in reconciling the two perspectives.

⁵² Under the proprietary theory, the shareholders own the company's assets. If the subsidiary company has any shareholders other than the parent company, then clearly the shareholders of the parent company do not own all of the assets of the subsidiary company, only their share of those assets.

⁵³ If the parent entity controls the subsidiary entity, then it also controls the subsidiary's assets.

22. However, some argue that a mixed model has the capacity to yield more information than adopting one perspective or the other. Furthermore, it could be argued that adopting either a pure proprietary perspective or a pure entity perspective would be problematic.⁵⁴ It also might be difficult to apply internationally. For example, the proprietary theory is regarded as more consistent with the “shareholder” corporate governance model that operates in some countries (eg Australia, Canada, UK and US), whereas the entity theory is more consistent with the “stakeholder” corporate government model that operates on other countries (eg France, Germany and Japan).⁵⁵
23. Hence, one of the issues for the Boards to consider is whether we should continue using a mixed model. If so, there is the related issue of how to accommodate both perspectives in a single framework. If not, there is the related issue of deciding which model is preferable.

⁵⁴ For example, a pure proprietary perspective would be difficult to reconcile with the fact that companies have a separate legal existence. It would also be difficult to apply to the non-business sector. A pure entity perspective would mean the elimination of the distinction between liabilities and equity. Arguably, that would be contrary to users’ information needs and would have significant implications if all financial interests are measured at fair value.

⁵⁵ It could be argued that the enterprise theory, which is an extension of the entity theory, is more consistent with a “stakeholder” corporate governance model. Under the enterprise theory, the firm is considered a social institution operated for the benefit of many interested groups, including not only the firm’s finance providers, such as shareholders, but also employees, customers, the government and general public.