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The Conceptual Framework: Past, Present, and Future

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Abstract

In a broad sense, a conceptual framework can be seen as a structured theory of accounting. A conceptual framework is intended to set forth objectives and fundamental concepts that will be the basis for the development of accounting standards.

A complete, internally consistent, and logical conceptual framework assists the standard setters in developing new and improving existing standards based on underlying concepts. It also assists preparers in applying financial reporting standards, auditors in providing an opinion on whether the financial statements are in accordance with a given set of standards, and users in interpreting the information presented in the financial statements.

Moreover, such a well developed conceptual framework facilitates communication between national and international standard setting bodies.

In 2004, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) began a joint project to revise and converge their respective conceptual frameworks. The six-year long cooperation on that project resulted in convergence regarding the objective of general purpose financial reporting and the qualitative characteristics of useful financial information.

However, in late 2010 the Boards, preoccupied with other joint convergence projects, agreed to discontinue the joint efforts in order to work on their respective frameworks.

As the convergence process pursued by FASB and IASB moved the accounting standards into a less rule-based and more principles-based direction, the creation of a well-structured accounting theory has become of paramount importance.

No wonder that when questioned about the IASB agenda in 2011, many stakeholders identified the conceptual framework as a priority project.

Consequently, the IASB restarted its conceptual framework project in 2012, and independently developed an Exposure Draft of the *Conceptual Framework for Financial Reporting* in 2015. The final version of the revised conceptual framework was issued on March 29, 2018.

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Meanwhile, in January 2014, the FASB reactivated its conceptual framework project, focusing on concepts for presentation and measurement. The measurement portion of the project is still at the initial deliberations stage, but a limited Exposure Draft addressing issues of presentation, which would become Chapter 7 of Concepts Statement 8, was issued in 2016.

More recently the FASB expanded the conceptual framework project by starting initial deliberations of issues related to the elements of financial statements.

The recommendations to continue independent work on the respective conceptual framework projects received by both Boards, and the engagement of constituencies in the due process, indicate how important conceptual framework is not only to standard setters, but also to users of financial statements and other stakeholders.

The increasing use of framework-based teaching of accounting standards adds further urgency to this need.

INTRODUCTION

A conceptual framework is a logical system of interrelated objectives and basic concepts that prescribe the nature, function, and limits of financial reporting, which is expected to lead to development of consistent guidance, whether rules-based or principles-based. In the absence of such a framework, guidance would often be promulgated on an ad hoc basis, the result of which process would likely be inconsistent and incoherent, with obvious negative ramifications.

Furthermore, without a framework, standard-setting would be subject to the possibly divergent individual concepts held by the members of the standard-setting body. Agreement on issues would be more difficult to reach, as it would require the convergence of personal perspectives on financial reporting or that other compromises be made on a case-by-case basis.

As a result, different conclusions might be reached on similar or even identical issues addressed on different dates, making the standard setting very ineffective. For the users, this would mean inconsistent, more difficult to understand and, consequently, less useful financial reports.

Accounting standard setting by the Financial Accounting Standard Board (FASB) in the United States and by the International Accounting Standards Board (IASB) (collectively, the Boards) is guided by their respective conceptual frameworks.

The FASB's original conceptual framework was issued in a series of seven Statements of Financial Accounting Concepts (SFACs or Concept Statements) between 1978 and 2000.

The IASB inherited the International Accounting Standards Committee's (IASC's) *Framework for the Preparation and Presentation of Financial Statements* (the *Framework*) issued in 1989, which was partially derived from the FASB's Concept Statements.

The existing FASB and IASB frameworks differ in their authoritative status. Managers of entities preparing financial statements in accordance with International Financial Reporting Standards (IFRS) may be required to consider the IASB's *Framework* if no standard or interpretation specifically applies to a transaction, other event, or condition.

In a situation such as that, management should use its judgment in developing and applying accounting policy. In making the judgment, management should refer to, and consider the applicability of, first, the requirements in IFRS dealing with similar and related issues, and, second, the definitions, recognition criteria, and measurement concepts for assets, liabilities, income, and expenses in the *Framework* (IASB, IAS 8.10-11).

The FASB's Concepts Statements had a lower standing in the Generally Accepted Accounting Principles (GAAP) hierarchy, and entities were not required to consider those concepts in preparing financial statements, even in the absence of fact-specific guidance in the standards themselves.

In April 2005, when FASB issued and Exposure Draft of a Proposed Statement of Financial Accounting Standards entitled *The Hierarchy of Generally Accepted Accounting Principles*, the Board acknowledged that it had considered elevating the ranking of Concepts Statements, but decided not to make such an improvement to the existing GAAP hierarchy, as set forth in AICPA's Statement on Auditing Standards No. 69, *The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles* (SAS-69), at that time.

When FASB codified the accounting standards, only pronouncements from levels A-D of the GAAP hierarchy were included in the FASB Accounting Standards Codification®, the source of authoritative GAAP recognized by the FASB to be applied to nongovernmental entities, effective September 2009. The conceptual framework has not been codified and remains among the non-authoritative literature items.

Both the FASB and IASB frameworks have been criticized for various reasons. A few aspects of the frameworks are internally inconsistent and some others are unclear. Also, the two frameworks differ on some concepts.

Furthermore, some aspects of the frameworks are outdated and do not fully reflect accounting thought of the past three decades. Still other aspects of the FASB's framework that were originally planned were not ultimately completed (Bullen and Crook, 2005).

Because of the shortcomings mentioned above, the development of a better conceptual framework was considered one of the most critical aspects in the effort to converge U.S. GAAP and IFRS. Starting with the Norwalk Agreement in 2002, FASB and IASB in their joint effort tried to develop standards which would be more principles-based and less prescriptive in nature.

To provide the best foundation for developing principles-based and internationally converged accounting standards, the Boards undertook a joint project to develop a common conceptual framework that would be both complete and internally consistent.

The goals for this project, added to FASB and IASB agenda in 2004, included:

1. Updating and refining the existing concepts to reflect changes in markets, business practices, and the economic environment
2. Improving some parts of the existing frameworks, such as recognition and measurement
3. Filling gaps in the existing frameworks

This paper reflects on the importance of the conceptual framework for financial reporting, compares the FASB's Concepts Statements with the IASB's *Framework,* discusses the joint conceptual framework project and its accomplishments, and highlights the most recent independently proposed advances in FASB and IASB respective conceptual frameworks. Arguments for a more prominent role of the conceptual framework as a meta-theoretical structure for financial reporting are made.

THE PRE-CONVERGENCE FASB CONCEPTUAL FRAMEWORK

The FASB was the first accounting-standard setting body in the world that successfully developed a comprehensive conceptual framework. It presented its concepts in a series of separate Concept Statements. Seven pre-convergence FASB Concepts Statements are listed in Table 1.

The FASB *Conceptual Framework* is an evolutionary document based on many earlier attempts at the promulgation of concepts. For example, the objectives were rooted in the AICPA's 1973 Trueblood Committee Report and the qualitative characteristics and definitions of elements stem from *A Statement of Basic Accounting Theory* published by the American Accounting Association in 1966; and/or APB's Statement 4, *Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises* (Wolk, Dodd, and Rozycki, 2013, pp. 255–256).

The goal of this framework is to rationalize a basis for the development of financial reporting standards. It relies on three central features (Christensen and Demski, 2002):

- Information is being provided
- This information is conveyed using the language and algebra of valuation
- This information perspective can be well articulated with or by "qualitative characteristics" of that information

The FASB stressed the overriding importance of providing useful information, and viewed *relevance* and *reliability* as the characteristics that are essential for *usefulness*.

TABLE 1. Concept Statements Constituting Pre-Convergence FASB Conceptual Framework

Date Issued	Concept Number	Concept Statement Title
November 1978	SFAC No. 1	*Objectives of Financial Reporting by Business Enterprises*
May 1980	SFAC No. 2	*Qualitative Characteristics of Accounting Information*
December 1980	SFAC No. 3	*Elements of Financial Statements of Business Enterprises*
December 1980	SFAC No. 4	*Objectives of Financial Reporting by Nonbusiness Organizations*
December 1984	SFAC No. 5	*Recognition and Measurement in Financial Statements of Business Enterprises*
December 1985	SFAC No. 6	*Elements of Financial Statements—A Replacement of FASB Concepts Statement*
February 2000	SFAC No. 7	*Using Cash Flow Information and Present Value in Accounting Measurements*

THE PRE-CONVERGENCE IASB FRAMEWORK

The IASB also had a conceptual framework underlying its financial reporting standards and interpretations. The IASB *Framework* set out the concepts that underlie the preparation and presentation of financial statements for external users.

This *Framework*, derived from the FASB's Concept Statements, was approved by the International Accounting Standards Committee (IASC) in April 1989, and adopted by the IASB in April 2001. It was less developed than the FASB's Concepts Statements, often alluding in few words to fundamental concepts that need further explanation to provide a principles-based guidance for resolving financial reporting issues.

THE CONCEPTUAL FRAMEWORK CONVERGENCE PROJECT 2004–2010

A conceptual framework project was added to the FASB and IASB agendas in October 2004. This project was later described in the Memorandum of Understanding published in February 2006, which set forth a joint program of work for the Boards.

The objective of this joint project was to develop a common superior conceptual framework that both converges and improves upon the existing frameworks of the two Boards. It was determined that the common FASB-IASB framework was needed because:

1. The existing FASB and IASB frameworks are two or more decades old and in need of refinement, updating, completion, and convergence to guide both standard-setters to similar conclusions on accounting issues
2. It would help to eliminate existing differences between U.S. GAAP and IFRS and serve to develop principles-based standards

The Boards gave priority to issues that were believed likely to yield standard-setting benefits in the near term. The goal was the common framework, a single document (like the IASB's *Framework* rather than a series of Concepts Statements) and would include a summary and basis for conclusion.

The Boards decided to focus initially on business entities in the private sector. They intended to later consider the applicability of those concepts to financial reporting by not-for-profit entities in the private sector and business entities in the public sector.

The conceptual framework project was divided into phases A-H. Table 2 lists the phases with their status and outcomes.

THE SUCCESS STORY: PHASE A OF THE CONCEPTUAL FRAMEWORK PROJECT

In September 2010, both the FASB and the IASB issued converged chapters dealing with the objectives of financial reporting and with the qualitative characteristics of useful financial information.

More specifically, FASB issued Concept Statement No. 8 (SFAC 8), *Conceptual Framework for Financial Reporting:* Chapter 1, "The Objective of General

TABLE 2. Conceptual Framework Project Phases, Status, and Outcomes

Phase	Topic	Status	Outcome
A	Objectives and qualitative characteristics	Completed	Converged Chapters 1 and 3 of the FASB's SFAC No. 8 and Chapters 1 and 3 of the IASB's Conceptual Framework for Financial Reporting (2010)
B	Elements and recognition	Initiated	The Boards reconsidered definitions of the elements of the financial statements
C	Measurement	Initiated	Few tentative decisions reached by the Boards
D	Reporting entity	Worked on	Discussion Paper (2008) and Exposure Draft (2010)
E	Presentation and disclosure, including financial reporting boundaries	Never started	None
F	Framework purpose and status in GAAP hierarchy	Never started	None
G	Applicability to the not-for-profit sector	Never started	None
H	Remaining Issues	Never started	None

Purpose Financial Reporting," and Chapter 3, "Qualitative Characteristics of Useful Financial Information," which replaced SFAC 1 and SFAC 2, respectively.

At the same time the IASB issued Chapter 1, "The Objective of General Purpose Financial Reporting" and Chapter 3, "Qualitative Characteristics of Useful Financial Information," which replaced the Preface and Introduction as well as paragraphs 1 through 22 and 24 through 46 in the IASB's *Framework*. Chapters 1 and 3 are identical in FASB SFAC No. 8 and in the IASB's *Framework*.

According to Chapter 1, "The Objective of General Purpose Financial Reporting," "the objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and creditors ["primary users"] in making decisions about providing resources to the entity. Those decisions involve buying, selling, or holding equity and debt instruments, and providing or settling loans and other forms of credit" (FASB, 2010). Consequently, primary users need information to help them assess the prospects of future net cash inflows to an entity.

To assess an entity's prospects for future cash inflows, primary users need information about the resources of the entity, claims against the entity, and how efficiently and effectively the entity's management and governing board have discharged the responsibilities to use the entity's resources.

Many primary users cannot require that reporting entities provide information directly to them, and thus primary users must rely on general purpose financial statements for much of the financial information they need.

The Boards emphasized that general purpose financial statements are not designed to show the value of the reporting entity, are not designed for the sole use of management, and are not directed toward regulators or other parties that are not primary users.

Although the word *stewardship* does not appear in the statement on objectives, the Boards indicated that one purpose of financial reporting is to provide information that allows users to assess how efficiently and effectively management has been in using the reporting entity's resources.

Relevance remains as one of the two fundamental qualitative characteristics of useful information. *Reliability*, however, was replaced with *faithful representation* as the second fundamental quality.

Relevance influences user decisions, and is determined by predictive and confirmatory values. Furthermore, relevant information is constrained by entity-specific materiality and cost considerations. Information that is *faithfully represented* is complete, neutral, and free from error.

The FASB recommends this three-step process for applying the fundamental qualitative characteristics when reporting financial information:

1. Identification of an economic phenomenon that has the potential to be useful to users of the reporting entity's financial information
2. Identification of the type of information about the phenomenon that would be the most relevant if it is available and can be faithfully represented
3. Determination of whether that information is available and can be faithfully represented (if not, the process is repeated with the next most relevant type of information) (FASB, 2010, QC18, p. 19)

The converged framework groups comparability, verifiability, timeliness, and understandability as enhanced qualitative characteristics. This approach simplifies the framework and clarifies that these attributes serve to enhance the usefulness of financial information that is relevant and faithfully represented.

The Boards considered other concepts for inclusion in the framework, such as transparency and the true and fair view, but in the final analysis determined that they were not qualitative characteristics (Kaminski and Carpenter, 2011).

Other Work Completed Under the Joint Project Agenda

The FASB and the IASB also worked jointly on the reporting entity concept. Their effort resulted in publication of both, a Discussion Paper in 2008, and an Exposure Draft in 2010.

Some work on the definitions of the elements of the financial statements and on measurement was also completed. The pressure of the other projects, however, resulted in the Boards suspending further work on the joint *Conceptual Framework* project in November 2010.

POST-CONVERGENCE REVISIONS TO THE FASB AND IASB CONCEPTUAL FRAMEWORKS

Developments at FASB

FASB reactivated its conceptual framework project in January 2014. At the June 18, 2014 meeting, the FASB discussed how to proceed with the conceptual framework project. Discussion focused on Concept Statement No. 5, dealing with recognition, measurement, and certain aspects of presentation of information on the face of financial statements.

Consistent with the objective of financial reporting, the FASB concluded that the discussion of presentation could be developed further to enhance ability of investors and creditors to determine future cash flows.

The deliberations over the next several months regarding the presentation issues resulted in the Exposure Draft entitled *Conceptual Framework for Financial Reporting: Chapter 7: Presentation*. This proposed chapter of Concept Statement 8, issued August 11, 2016, deals with items that have been recognized in financial statements, and addresses issues such as the display of line items, totals, and subtotals.

The proposal is designed to provide the FASB with a framework for developing standards concerning summarization and communication of information in the financial statements in ways consistent with the objective of financial reporting.

Specifically, the FASB intended to provide a foundation for future standards that enhance financial statement users' ability to assess prospects for future cash flows by addressing the grouping of items and clarifying the relationships among an entity's assets, liabilities, and equity, and the effects of related changes of those assets and liabilities on comprehensive income and cash flows (FASB, 2016).

The FASB has discussed the feedback received from constituencies and will redeliberate the proposed chapter at a future meeting.

The FASB members have also discussed how to proceed with developing concepts related to measurement, including identifying appropriate types of measurements and determining which measurements to use in specific circumstances. The *Conceptual Framework: Measurement* project is still in the initial deliberations stage.

On September 24, 2015, the FASB issued two exposure drafts as part of its ongoing Disclosure Framework project. One proposal was issued to amend the FASB's discussion of materiality in the conceptual framework; the other was intended to update the codification to explain the application of materiality to the preparation of footnote disclosures.

The proposed amendment to Chapter 3 of FASB Concepts Statement No. 8 intended to clarify that materiality is fundamentally a legal concept. It acknowledged that different legal frameworks may have different definitions of materiality and that the FASB cannot prescribe a specific universal threshold.

The proposed clarification of the definition was intended to resolve a longstanding inconsistency between the conceptual framework and the Security and Exchange Commission's guidance relating to materiality. The proposal was criticized for applying the Supreme Court's definition of materiality, because the decision regarding what constitutes a material disclosure would shift from preparers and auditors to lawyers. Consequently, the definition of materiality has not been amended in Chapter 3 of the Concept Statement No. 8.

At the meeting on May 3, 2017, the FASB decided to add to its technical agenda a project on elements of financial statements defined in FASB Concepts Statement No. 6, *Elements of Financial Statements*.

Developments at IASB

The international stakeholders, during a public consultation of the IASB agenda in 2011, encouraged the Board to independently complete revisions to the existing *Conceptual Framework*.

The deficiencies of the existing framework were perceived to include limited guidance on measurement and on presentation and disclosure, as well as an unclear role for uncertainty in recognition and measurement decisions. It was also noted that existing guidance on when assets and liabilities should be recognized was outdated.

In response, the IASB restarted its conceptual framework project in 2012 and decided to execute it in a single phase.

The first step in the due process was publication of a Discussion Paper entitled *A Review of the Conceptual Framework for Financial Reporting*, published in July 2013 (IASB, 2013). As the title suggests, the IASB decided to build on the existing conceptual framework rather than reconsider all the fundamental concepts.

This decision was met with support from stakeholders, as expressed in 221 comment letters. The IASB members and staff conducted over 150 outreach meetings to further gauge the response to the changes proposed in the Discussion Paper.

The IASB received support for revised definitions of an asset and of a liability focusing more on the resource or obligation than on the flows that might result from them. The mixed measurement approach was supported as well, but was criticized for including too much standard-level details.

The sections discussing the distinction between liabilities and equity, and presentation of profit or loss and other comprehensive income (OCI) were also perceived as being areas of concern.

Finally, although the IASB made the conscious decision to not reconsider chapters of the existing conceptual framework issued jointly with the FASB in 2010, some respondents who expressed unhappiness with the outcome of the joint project urged the IASB to reconsider such notions as stewardship, prudence, reliability, and substance over form.

After the extensive due process, including ten public meetings in 2014 and 2015, the IASB published the Exposure Draft *Conceptual Framework for Financial Reporting* accompanied by the Exposure Draft *Conceptual Framework for Financial Reporting: Basis for Conclusions,* in May 2015.[1]

The customary 150-day comment period for this Exposure Draft was extended, at the request of stakeholders, by another month, to the end of November 2015.

The new document covered the whole conceptual framework, including chapters on objectives of financial reporting and qualitative characteristics of useful information based on the chapters issued in 2010, but with proposed changes to some of the aspects of those chapters.

It also included a chapter on the reporting entity that was developed, based on the Discussion Paper and Exposure Draft developed jointly with the FASB, after taking into consideration the feedback received on those documents.

The IASB received 233 comment letters and conducted more than 80 outreach meetings in the wake of the Exposure Draft. The revisions to the conceptual framework have been enthusiastically received, and the Exposure Draft has been praised as a significant improvement over the Discussion Paper.

It received a strong support for reintroducing an explicit reference to the notion of prudence, for giving more prominence to the role of the financial in-

[1]The third document published by IASB on the same day, May 28, 2015 was Exposure Draft Updating References to the Conceptual Framework, Proposed Amendments to IFRS 2, IFRS 3, IFRS 4, IFRS 6, IAS 1, IAS 8, IAS 34, SIC-27 and SIC-32. All three Exposure Drafts on the Conceptual Framework had the same original due date for comment letters; that is, October 26, 2015.

formation in assessing management's stewardship of the entity's resources, and for the new definitions of an asset and liability, including additional guidance on uncertain liabilities.

Some respondents were still unhappy with the way measurement and the distinction between profit or loss and OCI were handled in the Exposure Draft. Despite the IASB removing a significant number of paragraphs containing a detailed standard-level discussion, a few respondents still perceived the Exposure Draft as an inappropriate mixture of concepts and rules. Some criticized its approach as a justification of existing practice rather than development of fundamental concepts.

Key changes to the conceptual framework since the proposals in the Discussion Paper and the up-to-date tentative decisions about the revised conceptual framework are summarized in Table 3, based on the information from the IASB website.

The IASB finalized an update to the *Conceptual Framework for Financial Reporting* to provide a more complete, clear, and updated set of concepts to use when it develops or revises IFRS standards. The revised *Conceptual Framework* was published on March 29, 2018 (IASB, 2018).

TABLE 3. Exposure Draft *Conceptual Framework for Financial Reporting:* Proposed Key Changes and Tentative Decisions on the Proposals

Section	Proposed Key Changes in the Exposure Draft	Tentative Decisions Since the Exposure Draft
The objective of financial reporting	Give more prominence, within the overall objective of financial reporting, to the importance of providing information needed to assess management's stewardship of the entity's resources.	The IASB will clarify further the link between the objective of financial reporting and management's stewardship of the entity's resources.
The qualitative characteristics of useful financial information	Reintroduce an explicit reference to prudence—the exercise of caution when making judgments under conditions of uncertainty. State explicitly that a faithful representation means the substance of an economic phenomenon instead of merely its legal form.	The IASB will clarify that prudence does not imply the need for asymmetry; the explicit reference to the notion of prudence is introduced to acknowledge the possibility that assets (income) might be treated differently from liabilities (expenses) if that provides useful information.
Measurement	Focus on describing the different measurement bases and a discussion on the factors to consider when selecting a measurement basis. Remove a detailed discussion of the implications of the measurement decisions for particular types of assets and liabilities.	The IASB will explain more clearly how various factors, such as the characteristic of an asset or a liability, affect the selection of a measurement basis.
Presentation and disclosure	Focus on the communication role of the financial statements. Remove a discussion of the distinction between primary financial statements and notes and remove standard-level details.	
Presentation in profit or loss and OCI	Emphasize the role of profit or loss as the primary source of information about an entity's performance for the period. Propose a high-level guidance to the board on the use of OCI and on recycling of OCI items into profit or loss. Remove discussion of the categories of items that can be included in OCI.	The IASB will replace the rebuttable presumption about the use of the statement of profit or loss with a principle that income and expenses should be included in the statement of profit or loss, unless the relevance or faithful representation of the information would be enhanced by including in OCI the income or expenses arising from a change in the current value of an asset or a liability. Also, the IASB will replace recycling with a principle that income and expenses included in OCI and recognized previously in the equity should be reclassified to profit or loss when doing so would enhance the relevance or faithful representation of the information in the statement of profit or loss for that period.

CONCLUDING REMARKS

Standards, to be principles-based, must be rooted in fundamental concepts. The conceptual framework is an attempt to provide a meta-theoretical structure for financial reporting (Wolk, Dodd, and Rozycki, 2013, p. 225).

The two most important financial reporting standard-setting bodies in the world, the FASB and the IASB, have concluded that they need a framework to provide direction and structure to their work in developing requirements for financial reporting. Many other national standard setters that have also developed conceptual frameworks to help guide their decisions on financial reporting issues share that conclusion.

Standard setters cannot fulfill their missions without a sound and unified conceptual underpinning that serves to guide and provide discipline to principles-based standard setting. Both the FASB and the IASB use their respective conceptual frameworks to establish the standards on which U.S. GAAP or IFRS financial reporting is based.

Although the FASB's and the IASB's respective original conceptual frameworks were not dramatically different, the Boards achieved only limited success in converging them. After a six-year-long process, only the objective of financial reporting and qualitative characteristics of useful information were fully converged.

Some work on reporting entity, measurement, and elements of financial statements had also been conducted and is now carried forward to the independent conceptual framework projects.

The IASB has just issued a revised version of its conceptual framework, while FASB has only begun the more substantive and impactful deliberations. Success of both projects is extremely important for the future of not only accounting standard setting, but also accounting education.

Teaching U.S. GAAP and IFRS should be grounded in the conceptual framework, with explicit delineation of how the concepts in the framework are related to individual standards being taught. Such framework-based teaching provides students with an enduring base for using judgment in addressing financial reporting issues.

Under this pedagogical approach, students would gain not only better understanding of accounting standards, but also an opportunity to exercise judgment consistent with the conceptual framework, necessary in applying principles-based accounting standards in practice (Burton and Jermakowicz, 2015, pp. 17–19).

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