

## COMMENTARY

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### How the FASB Approaches a Standard-Setting Issue

#### INTRODUCTION

The mission of the Financial Accounting Standards Board is to establish and improve standards of financial accounting and reporting for the guidance and education of the public, including issuers auditors and users of financial information. To accomplish its mission, the FASB acts to:

- 1) Improve the usefulness of financial reporting by focusing on the primary characteristics of relevance and reliability and on the qualities of comparability and consistency;
- 2) Keep standards current to reflect changes in methods of doing business and changes in the economic environment;
- 3) Consider promptly any significant areas of deficiency in financial reporting that might be improved through the standard-setting process;
- 4) Promote the international comparability of accounting standards concurrent with improving the quality of financial reporting; and
- 5) Improve the common understanding of the nature and purposes of information contained in financial reports.

The FASB develops broad accounting concepts as well as standards for financial reporting. In addition, it provides guidance on implementation of standards. Since its inception in 1973, the FASB has issued 131 Statements of

Financial Accounting Standards and a series of concepts statements.

The series of concepts statements, which were issued between November 1978 and December 1985, include: FASB Concepts Statements No. 1, *Objectives of Financial Reporting by Business Enterprises*; No. 2, *Qualitative Characteristics of Accounting Information*; No. 4, *Objectives of Financial Reporting by Non-business Organizations*; No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*; and No. 6, *Elements of Financial Statements*.<sup>1</sup> Those statements set forth fundamentals on which financial accounting and reporting standards are based. In that regard, they are intended to establish the objectives and concepts that the FASB uses in fulfilling its primary function of developing standards of financial accounting and reporting.

In addition, the concepts statements are intended and expected to serve the public interest within the context of the role of

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<sup>1</sup> FASB Concepts Statement No. 3, *Elements of Financial Statements of Business Enterprises*, was superseded by Concepts Statement No. 6, which applies to both business enterprises and not-for-profit organizations.

This paper was prepared for discussion purposes for the December 1996 AAA/FASB Financial Reporting Issues Conference. The views expressed in this paper are those of the author. Official positions of the FASB are determined only after extensive due process and deliberation. Helpful comments on this paper were provided by Jim Leisenring, Tim Lucas and Reed Storey.

financial accounting and reporting in the economy. That role is to provide evenhanded financial and other information that, together with information from other sources, facilitates efficient functioning of capital and other markets, and otherwise assists in promoting efficient allocation of scarce resources in the economy.

The main purpose of this paper is to describe how the FASB approaches an issue as it performs its primary role as a standard setter. To aid in understanding that process, the paper will first review the objectives of financial reporting as described in Concepts Statement No. 1 and the qualitative characteristics of accounting information as described in Concepts Statement No. 2.

### **OBJECTIVES OF FINANCIAL REPORTING**

In developing standards, the Board must be aware of the objectives of financial reporting that are described in Concepts Statement No. 1. Those objectives stem primarily from the informational needs of external users who lack the authority to prescribe the information they want and, thus, must use the information that management communicates to them. The objectives begin with a broad focus on information that is useful in investment, credit and similar decisions. The focus is then narrowed to investors' and creditors' primary interests in the prospects of receiving cash from their investments in or loans to business enterprises. Since investors' and creditors' cash flows are related to enterprise cash flows, financial reporting should provide information to help investors, creditors and others assess the amounts, timing and uncertainty of prospective net cash inflows to the related enterprise. Finally, the objectives focus on information that accounting can provide that is useful in assessing the enterprise's cash flow prospects. According to Concepts Statement No. 1:

Financial reporting should provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit, and similar decisions. The information should be comprehensible to those who have a rea-

sonable understanding of business and economic activities and are willing to study the information with reasonable diligence. (para. 34)

Financial reporting should provide information to help present and potential investors and creditors and other users in assessing the amounts, timing, and uncertainty of prospective cash receipts from dividends or interest and the proceeds from the sale, redemption, or maturity of securities or loans. (para. 37)

Financial reporting should provide information about the economic resources of an enterprise, the claims to those resources (obligations of the enterprise to transfer resources to other entities and owners' equity), and the effects of transactions, events, and circumstances that change resources and claims to those resources. (para. 40)

Those objectives relate to general-purpose external financial reporting which is directed toward the common interest of various potential users. Although the objectives focus primarily on investment, credit and similar decisions, this does not mean that the objectives apply only to investors and creditors and exclude everyone else. To the contrary, information that satisfies the objectives should be useful to all who are interested in an enterprise's future capacity to pay or in how investors or creditors are faring.

The objectives are those of financial reporting rather than goals for investors, creditors or others who use the information or goals for the economy or society as a whole. The role of financial reporting in the economy is to provide information that is useful in making business and economic decisions, not to determine what those decisions should be.<sup>2</sup>

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<sup>2</sup> For example, saving and investing in productive resources (capital formation) are generally considered to be prerequisite to increasing the standard of living in an economy. To the extent that financial reporting provides information that helps identify relatively efficient and inefficient users of resources, aids in assessing relative returns and risks of investment opportunities, or otherwise assists in promoting efficient functioning of capital and other markets, it helps to create a favorable environment for capital formation decisions. However, investors, creditors and others make those decisions, and it is not a function of financial reporting to try to determine or influence the outcomes of those decisions.

### QUALITATIVE CHARACTERISTICS OF ACCOUNTING INFORMATION

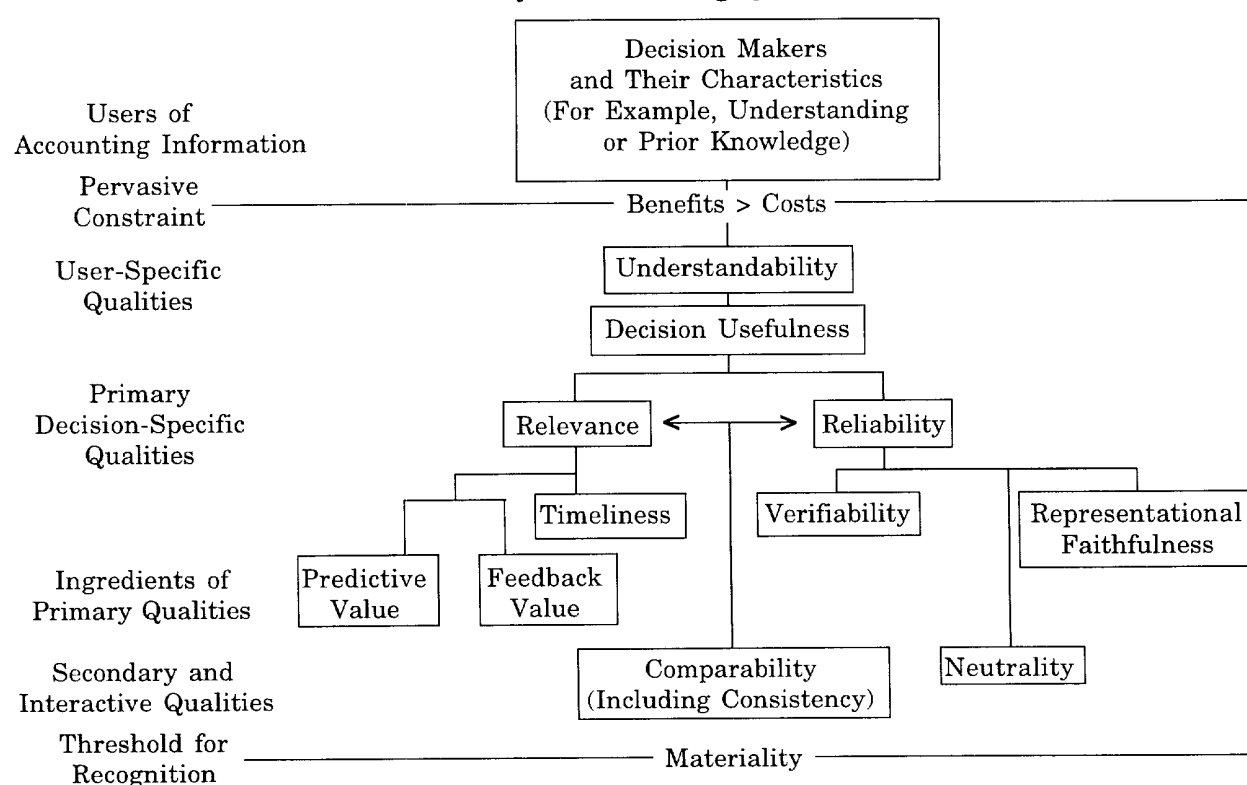
Concepts Statement No. 2 focuses on the qualities that make information useful in meeting the objectives of financial reporting. Information that is useful in meeting the objectives of financial reporting is primarily information about the elements of financial statements, which is the subject of Concepts Statement Nos. 3 and 6. That is why most financial accounting standards are about assets or liabilities (or both) and about the changes in assets and liabilities, called comprehensive income and its components (revenues, expenses, gains and losses). Figure 1 illustrates the hierarchy of qualitative characteristics of accounting information, which are briefly described below.

Relevance and reliability are the two primary qualities that make accounting informa-

tion useful for decision making. If either of those qualities is missing, the information will not be useful. To be relevant, information must be timely and it must have predictive value or feedback value or both. To be reliable, information must have representational faithfulness and it must be verifiable and neutral.

Representational faithfulness refers to correspondence or agreement between a measure or description and the phenomenon that it purports to represent. Verifiability refers to the ability, through consensus among measurers, to ensure that information represents what it purports to represent or that the chosen method of measurement has been used without error or bias. Finally, neutrality means that, in formulating or implementing standards, the primary concern should be the relevance and reliability of the information

**FIGURE 1**  
**Hierarchy of Accounting Qualities<sup>a</sup>**



<sup>a</sup>Source: FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*.

that results, not the effect that the new rule may have on a particular interest.

Comparability is a secondary quality that interacts with relevance and reliability. Information about an enterprise gains greatly in usefulness if it can be compared with similar information about other enterprises and with similar information about the same enterprise for some other period or some other point in time. Comparability between enterprises and consistency in the application of methods over time increases the informational value of comparisons of relative economic opportunities or performance. The significance of information, especially quantitative information, depends to a great extent on the user's ability to relate it to some benchmark.<sup>3</sup> Since the purpose of comparison is to detect and explain similarities and differences, in seeking comparability the Board must be careful not to develop accounting standards that disguise real differences or create false differences.

Concepts Statement No. 2 notes that the decision usefulness of accounting information is affected by characteristics of the decision maker. Thus, in the final analysis, each decision maker judges what accounting information is useful. That judgment is influenced by factors such as the specific decision being made, the method of decision making being used, the information already possessed or obtainable from other sources, and the decision maker's capacity (alone or with professional help) to process the information. Since optimal information for one user will not necessarily be optimal for another, in setting standards the Board must try to cater to different users while considering the burdens placed on those who have to provide the information.

### HOW THE FASB APPROACHES A STANDARD-SETTING ISSUE

The Board does not approach each standard-setting issue in an identical manner. However, certain major steps in the process form the foundation for almost every agenda project: (1) issue identification, (2) the agenda decision, (3) development of an agenda project, (4) prac-

tical considerations in developing a standard, and (5) post-issuance efforts.

### Issue Identification

The FASB is mostly reactive rather than proactive in its approach to identifying financial reporting issues that warrant agenda consideration. In general, the Board does not have a mechanism for identifying accounting problems "in need of fixing" unless those problems are brought to its attention through one or more of several sources that provide "candidates" for the Board's agenda: (1) Financial Accounting Standards Advisory Committee (FASAC), (2) Emerging Issues Task Force (EITF), (3) meetings of Board members and representatives of FASB constituents including the Securities and Exchange Commission (SEC) and the AICPA Accounting Standards Executive Committee (AcSEC), (4) letters from other organizations and individuals, (5) technical inquiries, (6) the business press, and (7) international standard-setting activity.<sup>4</sup> Those sources are discussed below.

### Financial Accounting Standards Advisory Committee

FASAC's primary function is to *advise* the Board on technical issues related to projects on the Board's agenda, possible agenda items, project priorities, procedural matters that may require the attention of the FASB, and other matters as requested by the chairman of the FASB. As part of that function, FASAC provides advice about the priorities of projects

<sup>3</sup> The difficulty in making financial comparisons between enterprises because of the use of different accounting methods has been accepted for many years as the principal reason for the development of accounting standards. Indeed, the only other possible reason for wanting accounting standards would be a belief that there was one right method among the available alternatives, and few people, if any, hold such a belief.

<sup>4</sup> Even though the sources are separately identified and discussed, it is important to realize that they are not mutually exclusive. For example, issues identified in the business press may also have come to the FASB's attention through the EITF, FASAC, the SEC, or technical inquiries. In other words, as an issue becomes pervasive, it is likely that it will be brought to the FASB's attention through several sources.

that are either before the Board or that could come before it. One of the ways in which FASAC carries out its primary function, is through an annual survey of its members of the projects and priorities of the FASB. Included in that survey are questions about possible projects the Board should consider adding to its agenda. For example, respondents are asked to score potential topics ranging from (1) the topic should be placed on the agenda now, even if some project currently on the active agenda would have to be deactivated, to (2) the Board should not be at all interested in adding this topic to the agenda. The survey also includes an open-ended request for suggested additional topics that should be included on the Board's agenda and for suggested re-examination of previously adopted standards.

FASAC meets with the Board at least four times a year in sessions which are open to public observation. Those meetings and the responses to the annual FASAC survey provide valuable perspectives and observations about the Board's process and direction. Both the Board and staff refer to guidance provided by FASAC as they deliberate issues related to projects on the FASB's agenda and as the Board makes decisions about projects to add to its agenda and how to allocate its resources.

### ***Emerging Issues Task Force***

The EITF was formed in 1984 in response to the recommendations of the FASB's task force on timely financial reporting guidance and the FASB invitation to comment on those recommendations. The make-up of EITF is designed to include persons in a position to be aware of emerging issues before they become widespread and before divergent practices regarding them become entrenched. Therefore, if the EITF can reach a consensus on an issue, that is usually an indication that Board action is not necessary (that is, the topic does not need to be added to the Board's technical agenda). On the other hand, if no consensus is possible and there is agreement that the problem is an important one, it may be an indication that the Board should undertake the development of a more careful resolution of the issues. In

general, the issues that the EITF reaches a consensus on must be resolved within the framework of existing generally accepted accounting principles. Therefore, if consensus cannot be reached, it might suggest that the issue is beyond the scope of current GAAP and, thus, might require a broader consideration by the Board in the form of an agenda project. For example, in 1984 through 1986 the EITF discussed the issue of impairment recognition and observed divergent practices, but was unable to reach a consensus. In November 1988, the Board undertook a project in that area which resulted in FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and Long-Lived Assets to Be Disposed Of*.

### ***Meetings of Board Members and Representatives of FASB Constituents***

The Board communicates with professional groups through organized liaison meetings. Such groups, to name a few, include the American Institute of Certified Public Accountants (AICPA) and its Accounting Standards Executive Committee (AcSEC), the Financial Executives Institute (FEI), the Association for Investment Management and Research (AIMR), Robert Morriss and Associates (RMA), the American Accounting Association (AAA), the Institute of Management Accountants (IMA), and the Mortgage Bankers Association (MBA). Often, those groups meet with the Board to discuss current projects or outstanding FASB documents, such as Exposure Drafts, but sometimes the groups bring to the Board's attention emerging problems that might need the Board's consideration. For example, the need for a project on accounting for removal costs, including costs of nuclear decommissioning was brought to the Board's attention by Edison Electric Institute. That project resulted in the February 1996 Exposure Draft, *Accounting for Certain Liabilities Related to Closure or Removal of Long-Lived Assets*.

The Board and staff frequently communicate on both a formal and an informal basis with the Securities and Exchange Commission (SEC) and its staff. Formally, the FASB

Chairman and Director of Research meet quarterly with the Chairman of the SEC and the Chief Accountant. Because the SEC staff examines financial statements included with filings of all public companies, it becomes aware of new problems early. If the SEC's Chief Accountant and staff members cannot resolve a problem using the existing authoritative literature, they may suggest to the FASB that it conduct a study of the issues.

### **Letters from Other Organizations and Individuals**

The FASB sometimes receives unsolicited letters from constituents, suggesting that the FASB add particular topics to its agenda, or revisit existing standards. Those letters are processed by the FASB staff according to a standard operating procedure and the replies are part of the FASB public record. Depending on the pervasiveness of the requests, some of the suggested topics are included as potential agenda topics on the annual FASAC survey.

### **Technical Inquiries**

The FASB staff responds to technical inquiries received from preparers, auditors and other constituents. Those inquiries are most often received by telephone, but some are received in writing. Although many of the inquiries can be handled on an *ad hoc* basis, repeated inquiries about specific issues may indicate that formal Board action is warranted. Although that action could be in the form of a Technical Bulletin or an Interpretation, it also could result in an issue to be considered for a formal agenda decision. Recently, the Board added a project to its agenda related to impairment issues in Statement No. 121 because the FASB staff received numerous technical inquiries dealing with the implementation of it.

### **Business Press**

Board members and staff monitor the newspapers and periodicals in the business press for stories about unusual transactions, events, or conditions that create financial accounting issues. More often than not, issues identified in the business press have been

brought to the Board's attention through other means such as technical inquiries or from constituent groups mentioned above (for example, the SEC). If the staff initially identifies an issue through the business press, they may make preliminary inquiries to determine the details and the potential for the occurrence of that issue in other settings. If it appears that the problem could be pervasive, the staff may bring the issue to the Board's attention as a potential for agenda consideration.

### **International Activity**

Of increasing importance is the influence of the issues being addressed by international standard setters on the issues considered by the FASB (and vice versa). In particular, the Board communicates both formally and informally with the United Kingdom Accounting Standards Board (ASB), the Australian Accounting Research Foundation (AARF), the Canadian Institute of Chartered Accountants (CICA), and the International Accounting Standards Committee (IASC). Those standard setters plus the FASB, have been dubbed the "G4+1 group," which is used to refer to the group of standard setters from the four key countries plus representatives of the IASC. The G4+1 group meets three to four times per year to discuss relevant accounting issues. The chairman along with the vice chairman or staff director of each of those organizations participates in those meetings. The G4 +1 has come to represent a valuable way to identify and study accounting issues that are of timely importance globally.

Recently, the FASB conducted two joint projects with international standard setters. One project, pursued concurrently with the IASC, resulted in two FASB Statements that were released in February 1997: Statement No. 128, *Earnings per Share*, and Statement No. 129, *Disclosure of Information about Capital Structure*. The other project, on segment disclosures, was conducted jointly with the CICA. In June 1997, it resulted in FASB Statement No. 131, *Disclosures about Segments of an Enterprise and Related Information*.

The Board recently added a project to its agenda to reconsider APB Opinion No. 16, *Business Combinations*, and No. 17, *Intangible Assets*. In determining whether to add that project to its agenda, the Board recognized that the United States has broader criteria for pooling-of-interests accounting than other countries. The U.S. criteria result in substantially more acquisitions being accounted for as poolings than other countries' criteria, which have virtually eliminated the use of the pooling-of-interests method. Furthermore, the U.S. has different accounting for goodwill than other countries. Although the Board has not decided to pursue this as a joint project with any other countries, it did receive a request from the CICA to participate in a joint project. In addition, the ASB has encouraged a joint multinational project to harmonize the accounting for business combinations and intangibles. Currently, the ASB and the IASC have active projects on their agendas relating to accounting for goodwill.

While other topics on the agenda might not result directly from international efforts, the Board is increasingly aware of related issues and standards in other countries. For example, in the comprehensive income project, the Board noted that the ASB has a requirement for a financial statement which reports a measurement analogous to comprehensive income. As another example, the Board held a roundtable discussion in October 1996 of its Special Report, "The FASB Project on Present Value Based Measurements: An Analysis of Deliberations and Techniques." International accounting standards setters actively participated in that discussion.

### The Agenda Decision

After receiving advice or suggestions about potential projects from the constituency, the Board must make its own decisions regarding its technical agenda.<sup>5</sup> Once an issue has been identified as being a candidate for the Board's agenda, the staff prepares an "agenda decision package" which is discussed at a public Board meeting. A large portion of the agenda decision package is developed around a list of fac-

tors that the Board uses to evaluate proposed agenda topics. Those factors include consideration of:

- 1) Pervasiveness of the problem: the extent to which an issue is troublesome to users, preparers, auditors, or others; the extent to which there is diversity of practice; and the likely duration of the problem (i.e., is it transitory or will it persist).
- 2) Alternative solutions: the extent to which one or more alternative solutions that will improve financial reporting in terms of relevance, reliability, and comparability are likely to be developed.
- 3) Technical feasibility: the extent to which a technically sound solution can be developed or whether the project under consideration should await completion of other projects.
- 4) Practical consequences: the extent to which an improved accounting solution is likely to be acceptable generally and the extent to which addressing a particular subject (or not addressing it) might cause others to act, (e.g., the SEC or Congress).<sup>6</sup>

If the Board adds a project to its agenda, it must decide what type of pronouncement will ultimately result from the project. For example, the recently added project on business combinations and purchased intangibles is expected to result in a Statement of Financial Accounting Standards. However, another recently added project that will address the accounting for stock-based compensation under APB Opinion No. 25, *Accounting for Stock Issued to*

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<sup>5</sup> One of the Financial Accounting Standards Advisory Council's primary functions is to *advise* the Board on possible agenda items. In performing that function, FASAC meets with the Board at least four times a year in sessions which are open to public observation. In addition, FASAC conducts an annual survey of its members about the projects and priorities of the FASB. Those meetings and the responses to the annual FASAC survey provide valuable perspectives and observations to the Board as it makes decisions about projects to add to its agenda.

<sup>6</sup> Another part of the agenda decision package usually involves the anticipated scope of the proposed project. Although the Board does not normally "lock" itself into a predefined scope at the agenda-decision phase, the Board may use a predefined, preliminary scope to make the agenda decision.

*Employees*, is expected to result in an FASB Interpretation that provides implementation guidance on Opinion No. 25.

Not all projects suggested for the Board's agenda are added. In general, before adding a project to its agenda, the Board must believe that a technically sound solution to the accounting issue can be developed. Moreover, many proposed projects are considered but are not undertaken because the perceived improvement in financial reporting does not justify the expected cost. Recognizing that any accounting pronouncement will impose some costs, the Board considers undertaking a project only if evidence from constituents suggests that a significant and pervasive problem exists and that the benefit expected to be gained from changing existing accounting is likely to justify the expected cost of a change.

### **Development of an Agenda Project**

Many factors influence each of the projects undertaken at the FASB. While no two projects progress in the same manner or at the same pace, ultimately, all of the FASB pronouncements are the result of a series of tentative conclusions reached on the individual issues that are discussed and voted on during the weekly Board meetings. Because of the number and complexity of the issues typically addressed at each meeting, substantial advance preparation must be done, both by the Board members and the staff, to use productively the several hours a week that are devoted to public meetings. The most significant part of the advance preparation is the development by the staff of a memorandum<sup>7</sup> that describes the issues to be discussed. The memorandum explores the conceptual and practical implications of a variety of alternative solutions to an issue and includes a recommendation by the staff about which alternative the Board should accept.

Staff memorandums may cover various types of information. In any one project, the collection of staff memos most likely includes a description and analysis of:

- 1) Authoritative accounting pronouncements
- 2) Current practice and other related issues

- 3) Relevant literature
- 4) Underlying conceptual issues

The staff memorandums become the foundation for the Board's deliberations and ultimately form a major source for the basis for conclusions section of final FASB Statements. Therefore, the information included in them provides a practical way to examine how the FASB approaches an agenda project.

### **Authoritative Accounting Pronouncements**

In addition to FASB Statements, FASB Technical Bulletins, and FASB Interpretations, relevant authoritative accounting pronouncements include Accounting Research Bulletins, APB Opinions, EITF Abstracts, AcSEC documents, and SEC guidance. If the objective of a project is to interpret, clarify or supersede previously issued pronouncements, they obviously must be addressed and analyzed. However, often there are relevant pronouncements that can be analogized to issues within a particular project. For example, the project on postretirement benefits was directly related to the project on pensions. Furthermore, the Board usually identifies and analyzes relevant international accounting pronouncements that relate to FASB agenda projects.

### **Current Practice and Other Related Issues**

A description of current practice and an understanding of other related issues can be based on a review of annual reports, as well as published surveys. However, more often the Board and staff become educated about current practice and other issues in a project through liaison meetings with outside constituents. Much of the education occurs in the early stages of a project while the Board and staff are still refining the issues and deciding on the appropriate scope.<sup>8</sup> For example, in the early stages of

<sup>7</sup> The FASB uses the term *memorandum* to refer to an internal, informal communication between the Board and staff.

<sup>8</sup> That is not to say that education about current practice does not continue throughout a project. For example, as the derivatives and hedging project progressed (even through the Exposure Draft), the Board and staff were continually updated about developments in current practice.

the project on nuclear decommissioning costs, the Board invited a number of experts on related issues to share their knowledge in a half-day meeting open to the public.

More formally, on major agenda projects an official FASB task force is formed to assist in identifying problems and issues with respect to a project already underway or being considered. Task force members are expected to represent or hold a range of diverse views on a project's major issues. In addition, the task force provides a mechanism for communication between the FASB and its constituents and provides a means for the FASB to learn of potential implementation problems at an early date. Although a task force may be appointed for any purpose, a task force for a major agenda project generally will be involved in:

- 1) Advising and consulting on the definition of the problem and the scope of the project
- 2) Advising and consulting on the preparation of documents raising and defining appropriate financial accounting and reporting issues
- 3) Advising and consulting on the preparation of documents addressing appropriate financial accounting and reporting issues
- 4) Advising on other matters on which the Board may seek guidance

### **Relevant Literature**

The Board and staff actively seek articles and studies related to issues that are being addressed. In the early stages of a project, relevant research may be used to support the agenda decision. During the course of a project, relevant research is used to inform Board and staff members about issues and often is used to support or refute alternatives. As a project progresses, relevant research tends to become available from a variety of sources.

The FASB subscribes to over 250 journals, newsletters and newspapers, which are routinely routed to Board and staff members. Articles related to a particular topic are often earmarked and routed to appropriate staff. In addition, the FASB maintains an inventory of academic research papers (both published and unpublished) that are readily available to the Board and staff.

Sometimes, the FASB coordinates research work or cooperates with researchers in studies that are conducted on topics already added to or being considered for the agenda. For example, the Board and staff are cooperating with a committee of the Accounting, Behavior and Organization Section of the AAA that is working on a project related to joint-venture accounting. The results of that study will be useful to the Board as it examines issues related to accounting for unconsolidated entities.

### **Underlying Conceptual Issues**

In addition to identifying and analyzing authoritative accounting pronouncements, current practice, other issues and relevant research, the underlying conceptual issues in each project must be identified, analyzed and addressed. In doing that, the Board and staff rely heavily on the FASB Concepts Statements. Because conceptual issues are usually subjective, often a major portion of the staff's memorandums, and hence the Board's deliberations, are focused on resolving them. In particular, at the core of many of the issues in any major agenda project is the identification and analysis of underlying issues of recognition and measurement of assets or liabilities and often of revenues, expenses, gains or losses. Concepts Statement Nos. 5 and 6 provide most of the guidance used by the Board in deliberating those types of issues.

**Recognition.** Concepts Statement No. 5 defines recognition as the process of formally incorporating an item into the financial statements of an entity as an asset, liability, revenue, expense, or the like (para. 6). Recognition attempts to represent or depict in financial statements the effects on an entity of real-world economic things and events. The amount of a recognized item is included in the financial statement totals.<sup>9</sup>

In deliberating issues involving recognition, the Board ultimately must agree on the existence of a recognition event, which is an

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<sup>9</sup> In other words, recognition does not include disclosure in notes to the financial statements or disclosure parenthetically on the face of the financial statements.

economic event that triggers recognition or derecognition of assets, liabilities or equity, or changes in them in the financial statements of a particular entity. An economic event is a happening of consequence to an entity—one that affects the entity's real-world assets or liabilities, or both. It may be an internal event that occurs within an entity (such as using raw materials in production), it may be an external event (such as a transaction with another entity), or it may be a combination. Furthermore, an economic event may be initiated by the entity (such as a purchase of merchandise), or it may be partially or wholly beyond the entity's control (such as an interest-rate change).

**Fundamental recognition criteria.** Before the Board considers an item for recognition in the financial statements, it must determine if the item meets the fundamental recognition criteria that are included in Concepts Statement No. 5, para. 63. Those criteria are:

- 1) *Relevance*—The information about it is capable of making a difference in user decisions.
- 2) *Reliability*—The information is representationally faithful, verifiable and neutral.
- 3) *Definitions*—The item meets the definition of an element of financial statements.
- 4) *Measurability*—It has a relevant attribute measurable with sufficient reliability.

As discussed earlier, to be relevant, information about an item must have feedback value or predictive value (or both) for users, and must be timely. Information is relevant if it has the capacity to make a difference in investors', creditors', or other users' decisions.<sup>10</sup> To be reliable, information about an item must be representationally faithful, verifiable and neutral. Reliable information should be useful to investors, creditors and others in making decisions. Although Concepts Statement No. 5 lists relevance and reliability as criteria for recognition, they are more appropriately viewed as qualitative characteristics of accounting information as characterized by Concepts Statement No. 2. That is because if an

item meets the definition of an asset or liability or change in an asset or liability, it is by definition relevant to investment credit and similar decisions. Furthermore, if an item meets the recognition criteria of measurability, there is a strong presumption that it meets the qualitative characteristic of reliability.

Beyond relevance and reliability, before recognition of an item can occur, it must meet the definition of one of the financial statement elements that are included in FASB Concepts Statement No. 6, *Elements of Financial Statements*. In short, a resource must meet the definition of an asset, and an obligation must meet the definition of a liability. A change in equity must meet the definition of comprehensive income to be classified as a revenue, expense, gain or loss.<sup>11</sup> The definition criteria can be viewed as a screening device for recognition. However, meeting the definition of an element is a necessary but not a sufficient condition for recognition, because an item must also be measurable before it can be formally incorporated into the financial statements.

Measurability means that an asset, liability or change in equity must have a relevant attribute that can be quantified in monetary units with sufficient reliability.<sup>12</sup> Often, measurement decisions (especially the attribute to be measured) depend on *when* changes in existing assets and liabilities are to be recognized. For example, the Board's decision to

<sup>10</sup> Relevance should be evaluated in the context of (1) the principal objective of financial reporting: providing information that is useful in making rational investment, credit and similar decisions, and (2) a full set of financial statements—with consideration of how recognition of a particular item contributes to the aggregate decision usefulness.

<sup>11</sup> Comprehensive income is defined as the change in equity of a business enterprise during a period from transactions and other events and circumstances from nonowner sources. It includes all changes in equity during a period except those resulting from investments by owners and distributions to owners (Concepts Statement No. 6, para. 70).

<sup>12</sup> The concepts statements use the term *attribute* to refer to the traits or aspects of an item to be quantified or measured. Five different attributes are used in present practice—historical cost (historical proceeds), current cost, current market value, net realizable (settlement) value, and present (or discounted) value of future cash flows.

recognize fair value changes on debt and equity securities during the period they are owned necessitated measuring those assets at fair value rather than at historical cost.

**Recognition and uncertainty.** Ideally, an entity should recognize all existing assets and liabilities, and it should recognize revenues, expenses, and other changes in assets and liabilities when the transactions and other events that change the assets and liabilities occur. However, recognition falls short of that ideal because of uncertainty and its effect on business and economic activities and their depiction and measurement. Uncertainty about economic and business activities is pervasive and may make it difficult or impossible to record the effects of transactions and other events when they occur. Furthermore, it may be difficult to determine which event affected the asset or liability or change therein. Therefore, recognition considerations stemming from uncertainty may result either in nonrecognition or in postponing recognition of some assets or liabilities or changes in them until their existence becomes more probable or their measures become more reliable.

There are two major kinds of uncertainties that the Board must consider: *element uncertainty* and *measurement uncertainty*. The former refers to uncertainty about whether an asset or liability exists or an event has occurred that affects an asset or liability. The latter refers to the uncertainty involved in ascertaining the magnitude of the asset or liability or change therein. If both uncertainties can be adequately overcome, items can be recognized as assets and liabilities as soon as they are known to exist, and events can be recognized as revenues, expenses and so forth as soon as they are known to have occurred.

The critical recognition questions that the Board continually faces typically involve *relative uncertainty*—the degree of uncertainty in a particular situation—and whether that uncertainty is too great (or the cost of sufficiently reducing it too high) to justify accounting recognition. For example, determining whether an item meets the definition of a financial

statement element sometimes requires assessments of probabilities. However, degrees of probability are not part of the definitions and therefore become matters between the definitions and the steps needed to apply them.<sup>13</sup> Therefore, the Board sometimes finds itself deliberating the application of a definition because of, for example, the degree of probability of a future economic benefit. In cases in which relative uncertainty results in nonrecognition or postponement of recognition, the Board often resorts to requiring disclosure.

**Disclosure vs. recognition.** Sometimes the Board finds itself between a rock and a hard place because of uncertainties related to financial statement items that are candidates for recognition. As deliberations progress, disagreements between individual Board members or between the Board and its constituents may arise about whether an item should be recognized in financial statements. Usually arguments against recognition are based either on measurement uncertainty or element uncertainty, or both. In situations in which the Board cannot agree to recognize an item in the financial statements, it often chooses disclosure over providing no information at all. Some have characterized those situations as resulting in a conscientious decision by the Board to choose disclosure as a substitute for recognition. However, they are more appropriately characterized as being situations in which the Board decided that the relative uncertainty was too great to warrant recognition in financial statements.<sup>14</sup>

That is, the FASB generally does not view disclosure as a substitute for recognition. That view is stated clearly in Concepts Statement No. 5:

<sup>13</sup> Concepts Statement No. 6, para. 47 indicates that degrees of probability are matters of recognition that are beyond the scope of the Statement.

<sup>14</sup> An exception is the stock compensation project. The Board agreed that stock options should be recognized as expenses in financial statements (i.e., recognition criteria were met). However, for political reasons, the Board decided to permit entities to either disclose or recognize those options.

Disclosure of information about the items in financial statements and their measures that may be provided by notes or parenthetically on the face of financial statements, by supplementary information, or by other means of financial reporting is not a substitute for recognition in financial statements for items that meet recognition criteria. (para. 9)

**Purpose of disclosure.** While almost all agenda projects result in requiring a certain amount of disclosure in addition to recognition, some projects' major objective is to develop a "disclosure-only" standard. While the Board has not codified a general disclosure framework, its most recent official thinking on the purposes of disclosure is contained in the basis for conclusions of FASB Statement No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk*. In that Statement, the Board specified four major purposes for disclosure:

- 1) To describe recognized items and to provide relevant measures of those items other than the measure in the financial statements
- 2) To describe unrecognized items and to provide a useful measure of those items
- 3) To provide information to help investors and creditors assess risks and potentials of both recognized and unrecognized items
- 4) To provide important information in the interim while other accounting issues are being studied in more depth

The Board recently considered adding a project to its agenda to undertake a comprehensive study of "disclosure effectiveness." A project such as that could result in an overall framework for disclosures that would include objective criteria for the Board to use in evaluating disclosure requirements in existing and future standards. In July 1995, the Board issued a Prospectus, "Disclosure Effectiveness," that discussed disclosure-related issues, such as cost-effectiveness and purported information overload. The Prospectus also encouraged further research and discussion on improving effectiveness of financial reporting.

In response to FASAC's suggestion that an inductive approach to disclosure effectiveness be taken, in October 1996 the Board added a project to its agenda to evaluate pension disclosure requirements that resulted in the June 30, 1997 FASB Exposure Draft, *Employers' Disclosures about Pensions and Other Postretirement Benefits*.

**Display-only projects.** Occasionally, the Board undertakes an agenda project with the objective of *displaying* useful information in financial statements. In those projects, the conceptual questions do not center around recognition and measurement because the items that are the subject of display are already recognized in the financial statements. Agenda projects of that type can result in a new primary financial statement or in the rearrangement of information in an already existing financial statement. For example, the agenda project that resulted in FASB Statement No. 95, *Statement of Cash Flows*, can be characterized as involving the display, rather than the recognition, of financial statement information. More recently, the Board undertook a project to address display of comprehensive income in a statement of financial performance. That project, which in June 1997 resulted in FASB Statement No. 130, *Reporting Comprehensive Income*, implements the definition of comprehensive income in Concepts Statement No. 6. Both the reporting of cash flows and of comprehensive income are conceptually grounded in Concepts Statement No. 5, which states that "A full set of financial statements for a period should show:...(c)omprehensive income for the period [and] cash flows during the period."

### **Practical Considerations in Developing a Standard**

In achieving the objectives of financial reporting, the Board must constantly be aware of the practicality of the standards that it develops. That means that the Board must continuously anticipate application of the standard in practice by assessing whether its requirements will be operational.<sup>15</sup> Often the Board is faced

<sup>15</sup> Operability relates to the general application of the requirements of the standard as well as the enforceability (auditability) of a standard.

with compromising a conceptually sound alternative for one that is more practical. In addition, standard setting is an evolutionary process. Therefore, a purely conceptual approach to a standard-setting issue might evolve over time. In the interim, more practical approaches are better than nothing. For example, in FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, the Board compromised on the conceptual approach of recognizing all debt and equity securities at fair value on the balance sheet and all changes in fair value in the income statement, for the more practical approach of recognizing some debt and equity securities at fair value on the balance sheet and some changes in fair value in the income statement and some changes in equity.

Even though the Board considers the practicality and operability of various alternatives during its deliberations leading to a proposed standard, it learns more about those considerations from comment letters and public hearing testimony. In addition, the Board may determine that a field test is necessary to determine the practicality of a proposed standard. Following analysis of comment letters, public hearing testimony, and field tests, the Board must redeliberate the issues to determine if any evidence has been uncovered that indicates that a previous position should be changed. Often those redeliberations entail balancing the Board's earlier conceptual position with practical considerations uncovered from evidence gained in the Board's analyses of constituent responses and field test results.

### Post-Issuance Efforts

Although the Board is not directly involved in researching the capital-market effects or economic consequences of its final pronouncements, it does have several ways to monitor the consequences of its standards, including their overall acceptance and understandability. In addition, the Board may determine how entities are implementing the requirements of a standard by examining financial information resulting from it.

One way the Board and staff can monitor the consequences of a pronouncement is to be aware of and examine the nature of technical

inquiries related to it. Those inquiries may indicate that implementation guidance is needed, which could lead the Board to issue an informal question-and-answer document capturing the nature of technical inquiries or to issue implementation guidance in the form of a Special Report. For example, Special Reports have been issued providing implementation guidance on FASB Statement No. 109, *Accounting for Income Taxes*, and No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*. Finally, if a minor problem is associated with the interpretation of a pronouncement, the Board might issue a Technical Bulletin or an Interpretation.

Occasionally, the Board may receive both informal and formal requests to reconsider certain provisions of a pronouncement. Based on those requests, the Board may determine that it needs to alter a standard or reconsider its decisions. For example, the Board received several requests to reconsider the requirements of Statement No. 95 as they related to banks. Those requests resulted in the development of FASB Statement No. 104, *Statement of Cash Flows—Net Reporting of Certain Cash Receipts and Cash Payments and Classification of Cash Flows from Hedging Transactions*. The uproar over the requirements of FASB Statement No. 96, *Accounting for Income Taxes*, resulted in three deferrals of its effective date and, ultimately, in its supersession by Statement No. 109.

The need for EITF activity also provides a way for the Board to monitor pronouncements. If that activity results directly from the issuance of a new standard, it may indicate that the guidance provided in the standard is incomplete or that the guidance is being analogized to similar transactions not covered by the standard. Other EITF activity (not resulting directly from a new standard) may indicate the existence of new transactions that require an interpretation of existing GAAP.

Finally, the Board may request the staff to undertake a study to determine how entities have implemented a standard. Recently, the FASB staff completed a project on the implementation of FASB Statement No. 119,

*Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments.* That study was published as a FASB Special Report so that it could be available to preparers, auditors and others in understanding and applying the standard. Additionally, staff members, at their own discretion, may undertake a study related to implementation or effects of a standard that they have been involved in developing. Those studies, which are sometimes published in business journals, can be quite revealing and may supply feedback to the Board about projects that have been completed.

### **SUMMARY AND CONCLUSIONS**

This paper focused on the approach that the FASB uses to address a standard-setting issue (i.e., agenda project). It described that approach as consisting of several major steps including issue identification, the agenda decision, development of an agenda project, practical considerations, and post-issuance efforts.

Although no two agenda projects have ever progressed in an identical manner, one com-

mon thread among agenda projects is the Board's use of the framework provided by the FASB Concepts Statements. Those Statements outline the objectives of financial reporting and the qualitative characteristics of accounting information. In addition, they provide conceptual criteria for determining, recognizing and measuring financial statement elements. The Board must constantly weigh those conceptual criteria against practical considerations discovered during the standard-setting process.

The role of financial reporting is to provide information that is useful in making business and economic decisions. However, decision usefulness of accounting information depends on the characteristics of the decision maker who must judge what information is useful to the particular decision being made. Since optimal information for one decision maker will not necessarily be optimal for another, in setting standards the Board must try to cater to the varying needs of different decision makers while considering the burdens placed on the information providers.