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Michael Crooch Talks about the Conceptual Framework

In July, the FASB and the IASB took a significant step forward in their joint project to update and converge their existing conceptual frameworks. The milestone took the form of a Preliminary Views (PV) document, in which the Boards defined what they believe to be the objective of financial reporting and the qualitative characteristics of decision-useful financial information.

The definitions comprised the first two chapters of that draft framework, which, upon completion, will improve the foundation and concepts that underlie financial reporting around the world and serve as a more effective guide for the Boards to develop global financial reporting standards.

The FASB Report *sat down with G. Michael Crooch, FASB Board collaborator on the conceptual framework project, to discuss the significance of the framework and the progress made through the PV.*

TFR: Mr. Crooch, thanks for joining us today. Can we start by talking about why the conceptual framework project is an important one?

MC: Sure. Let me begin by starting at the very top. It's important that readers understand that a conceptual framework is basically a foundation. In this case, that foundation serves as a guide to standard setters as they establish the principles and concepts that underpin financial accounting and reporting standards.

One of the issues the FASB currently faces is that our existing conceptual framework has not been updated in a number of years. So, while it remains a valuable tool, there are areas that have become out-of-date given the complex and shifting nature of financial reporting. That's why it's so important to develop an updated framework that will serve as a better, more effective guide for us in developing improved and simplified standards for our constituents.

The IASB is faced with very similar issues on their framework. So, as we move toward international convergence, it makes sense for us to work together to develop a common framework that provides greater consistency in global standard setting and guides the Boards to similar conclusions that result in converged standards that produce more useful financial reports.

TFR: Given that, what significance does the recent PV have on the conceptual framework project?

MC: It's very significant, actually. First off, this PV is the first deliverable since the announcement of our recent Memorandum of Understanding (MOU) with the IASB. As many people know, the MOU laid out our joint work program, so we're already starting to deliver on that.

Technically speaking, the common goal of the Boards and our constituents is for standards to be based on consistent principles rooted in fundamental concepts, rather than a collection of conventions and rules.

In order to achieve this, we need to affirm even the most basic building blocks of financial reporting, from which all other concepts will flow. That's what this PV is geared to do. In this case, we're asking constituents if they agree with our description of what financial information is intended to do.

While the ideas set out in the PV are some of the most fundamental in accounting, there often can be very different views among constituents on what they really mean. This may sound insignificant, but if definitions are inconsistent, they may ultimately impact the way people are analyzing transactions. That can be a real problem.

We believe it's important to get constituent input on these issues. That's why we're asking them to join in the debate.

TFR: Let's talk more specifically about the PV. What are the Boards saying technically through this document?

MC: Let's look at the objective of financial reporting first.

The Boards are taking a preliminary view that sets forth a single overarching objective of general purpose external financial reporting for business entities. In doing so, we are saying that this objective is to provide information that is useful to present and potential investors and creditors and others in making investment, credit, and similar resource allocation decisions.

In simpler terms, we are saying that general purpose financial statements and reporting should continue to be directed at the information needs of that wide group of primary users.

TFR: So then, what information should financial reporting be providing to investors, creditors, and other users?

MC: Once again, practically speaking, we believe that the objective of financial reporting is to provide information that helps users make their assessments about the amounts, timing, and uncertainty surrounding an entity's cash flow prospects.

In order to meet that goal, financial reporting needs to provide useful information about an entity's economic resources and claims to them including financial position, information about the effects of transactions and other events, and circumstances that can change an entity's economic resources and the claims to them.

The PV conveys the Board's view that financial reporting needs to provide information about an entity's financial performance during a period measured by accrual accounting, as well as by cash flows, management explanations, and any other information that would allow users to better understand the information provided and make decisions based upon it.

Incidentally, this information also is helpful in assessing how well management has discharged its stewardship responsibility.

TFR: Stewardship seems to be a very big buzzword these days. What is it and are you addressing it in the PV?

MC: There seem to be many different views on what stewardship actually is and whether or not it requires unique information. In my view, it is financial reporting that has a role in providing information useful in assessing how well management has fulfilled its responsibilities for the use of an entity's resources. In fact, some people argue that reporting on management's stewardship is the objective of financial reporting.

We think that while providing an accounting for the safekeeping and effective and profitable use of an entity's resources is very important, providing information for assessing stewardship is a somewhat narrow aspect of the broad objective of financial reporting. Therefore, this PV does not emphasize it as a predominant objective. Instead, we believe that when we address the decision-making needs of investors, creditors, and others we also meet the information needs of those who place significance on stewardship.

TFR: The objective of financial reporting and the information needs of investors, creditors, and others seem similar to the existing framework. Is that so?

MC: Yes. As part of our effort to improve on the existing framework, the PV provides further clarifications, but the basic objective of financial reporting is much the same.

TFR: Let's talk about the qualitative characteristics of decision-useful financial information for a minute. What does that mean exactly?

MC: Basically, we are saying that good financial information has some important qualities embedded in it.

In our view, there are four major factors involved. There is **relevance,** i.e., this information is relevant to decision making.

The second major factor is **faithful representation,** which, incidentally, replaces the term *reliability* in the existing frameworks—and by this we mean that information should be complete, verifiable, and neutral.

The third major factor is **comparability (including consistency),** which would enable users to identify similarities in and differences between two sets of economic phenomena. In other words, we want to make sure this information allows users to compare apples to apples instead of apples to oranges.

The last major factor is **understandability.** We believe that people who have a reasonable knowledge of business and economic activities or financial accounting should be able to comprehend the meaning of this information. That said, we also believe that relevant financial information should not be excluded solely because it may be complex or difficult for some users to understand.

TFR: How is that different from the previous framework?

MC: Other than some re-labeling, those qualities of information are pretty much the same as those in the existing frameworks. However, there is a shift in emphasis. Rather than looking at them as a hierarchy of qualities in which one quality might be traded off for another, the Boards will consider them as a sequence of desired qualities that begins with relevance and strives to maximize each of the qualities of information. That consideration begins with relevance because if information is not relevant there is no need to strive for the other qualities.

TFR: What are you asking from constituents?

MC: We are eager to find out whether or not constituents agree with these preliminary views. Obviously, their input is essential to our process, and we will consider these views as we work toward publishing a formal exposure draft of these chapters, hopefully sometime in 2007.

TFR: Do you have any closing thoughts?

MC: Just that this is a very important document that will help us develop a more appropriate framework for today's global environment—one that empowers improvement, simplification, and convergence of standards that will lead to better and more useful financial reports.

Editor's Note: For a further analysis on the issues presented through the FASB and IASB PV, or to obtain a copy of the PV, please visit the FASB website (www.fasb.org).