Comments on FASB Exposure Draft
Proposed Statement of Financial Accounting Concepts No. 8

Financial Reporting Policy Committee of the
Financial Accounting and Reporting Section of the
American Accounting Association

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Introduction

The Financial Accounting and Reporting Section (FARS) of the American Accounting Association (AAA) has charged the Financial Reporting Policy Committee (the Committee) to evaluate official standard-setting releases (e.g., invitations to comment, discussion papers, exposure drafts, and accounting standard updates) related to financial accounting and reporting and to provide timely, substantive, and constructive written feedback that is grounded in relevant academic research. The Committee's feedback is to be based on relevant research findings and our understanding of the Conceptual Framework. We are pleased to provide feedback on *Proposed Statement of Financial Accounting Concepts No. 8*. These comments reflect the views of the individuals on the Committee and do not represent an official position of either FARS or the AAA.

Questions and Comments

Question 1: *The Board expects that most assets that met the definition of an asset in FASB Concepts Statement No. 6, Elements of Financial Statements, will continue to qualify as assets under the definition of an asset in this proposed chapter. Do you agree that the definition of an asset in this proposed chapter is consistent with the Board's assertion? If not, please provide examples.*

The Committee acknowledges that application of the proposed definition could result in changes to the population of items considered assets as a result of (a) shifting the focus from future economic benefits to present rights and (b) removing *control* as an explicit criterion. Potentially affected items include non-exclusive rights[1] such as the right to access a public good, specialized knowledge such as legally unprotected trade secrets, and goodwill. In the first two cases, the issue turns on non-exclusivity, and in the third case the issue turns on the existence of a right to a benefit. Please see also the response to Question 3.

With respect to a right to access a public good such as a public road, the Committee acknowledges that access to the road will be limited to those who pay for a vehicle license;

[1] The Committee agrees with the reasoning in paragraph E25 that access can be shared by contract. A contract that specifies shared rights as described in paragraph E25 confers exclusive rights to the specified share of the overall benefits.

however, an entity with a right to access the public road has a non-exclusive right to an economic benefit deriving from operating a vehicle on the road because the entity cannot typically control others' access to the road. Thus, to avoid including non-exclusive rights such as rights to access public goods as assets of an entity requires the inclusion of *control* in the asset definition.

The Committee acknowledges that an entity possessing specialized knowledge or legally unprotected trade secrets has rights to receive economic benefits flowing from that knowledge and those secrets. The issue is whether the entity can control others' access to those benefits. We suggest the definition include *control* explicitly instead of adding a sentence asserting that the combination of *present right* with *economic benefit* means the entity can control others' access to the benefit. The ambiguity arises in cases of non-exclusive rights. In the specific cases of specialized knowledge and legally unprotected trade secrets, we suggest the Board clarify the definition of *present right* to specify whether the right is relatively narrow as in legal or contractual rights or relatively broad as in the right to use or transfer the item.

With regard to goodwill recognized in a business combination, the Committee believes goodwill, a residual amount, cannot be described as a present right to an economic benefit. We are unable to describe with any specificity the nature of the economic benefit embodied in goodwill.

Question 2: *In particular, respondents are asked to focus on internally generated intangible assets. Is the definition of an asset in this proposed chapter helpful in resolving issues of identifying intangible assets?*

The Committee agrees that the discussion of intangible assets in the Exposure Draft, particularly paragraphs E34 and E36, provides more direction than exists in FASB Concepts Statement No. 6. We do not believe the proposed definition of an asset and associated discussion resolve two important issues in identifying intangible assets.

Internally-developed intangible assets may be non-contractual until and unless the entity obtains legal protection, for example, a patent. The non-contractual nature of the item impedes objective analysis to determine whether the entity has a present right to benefits that might flow from the item. The Committee acknowledges the paragraph E36 discussion of separability as an indicator of a present right and does not believe this indicator is either necessary or sufficient to identify the existence of an asset. For example, the ability to exchange next period's estimated sales revenues for cash does not mean those future estimated revenues qualify as an asset of the entity.

The proposed definition of an asset does not specify the point at which the entity's (internal) costs incurred for the purpose of developing intangible assets qualify as an asset. The Committee acknowledges that an entity's research and development (R&D) spending is intended to create rights to economic benefits and those benefits can be statistically associated with that R&D spending (e.g., Lev and Sougiannis 1996). The conclusion is that there must exist a point at which research and development costs qualify as an asset, but the Exposure Draft does not provide guidance with respect to identifying this point. We agree that paragraph E35 of the Exposure Draft clearly expresses this difficulty but does not explain how to resolve it.

Question 3: *The Board's definition of an asset in this proposed chapter does not include the term control. However, this proposed chapter explains why and how control is interrelated to the definition of an asset. Is this discussion sufficient or is the term control necessary to include in the definition of an asset? If the term control is necessary to include, please explain how its inclusion would change the population of items that would meet the definition of an asset in this proposed chapter.*

As indicated in the response to Question 1, the Committee believes *control* tightens the definition of an asset. Paragraphs E16 and E17 define an asset as "a present right of an entity to an economic benefit" and identify two characteristics of an asset—(1) a present right, and (2) the right is to an economic benefit. Paragraph E17 asserts that the combination of (1) and (2) allows an entity to control others' access to an economic benefit. Along similar lines, paragraph BC4.17 claims that the issue of control is addressed by inclusion of the term *present right*.

The Committee does not agree that control is either implied by the combination of (1) and (2) or encompassed by the term *present right*. As discussed in the response to Question 1, the proposed definition of an asset implies an entity could recognize as an asset its non-exclusive right to access a public good such as a road. We agree that paragraph E20 clarifies that this is not the Board's intention. Given that an entity's control is central to determining whether an asset of that entity exists, we believe *control* should be included in the definition. This conclusion is consistent with the reasoning in paragraphs BC4.41 and BC4.42.

The Committee considered whether the phrase *of an entity* in paragraph E16 implies control. For example, if non-exclusive access to a public road is a present right, can that access be interpreted as a present right *of an entity*? If not, then the phrase *of an entity* might be sufficient to imply control. We conclude that non-exclusive access to a public good can be a present right of an entity regardless of whether the entity controls the access of others.

The Committee understands from paragraph BC4.16 that including the word *control* in the definition of an asset has been problematic in the context of FASB Concepts Statement No. 6. The examples provided in BC4.16 suggest the misunderstanding or misapplication of *control* was due to its application to the outcome of having an asset, that is, control over the existence and amount of the future economic benefits as opposed to control over the right to those benefits if they occur. Given that the proposed definition of an asset is centered on rights to benefits and not the benefits themselves, we believe including the word *control* in the definition of an asset will not give rise to misunderstanding or misapplication.

Further, the Committee notes that *control* is not inherently problematic, as it has been applied successfully in other contexts, such as in determining the satisfaction of performance obligations under ASC 606 or in determining when to recognize or de-recognize inventory under ASC 330. If there are contexts in which the term *control* has been applied unsuccessfully, we suggest it is preferable to clarify the term in those contexts.

Finally, Question 3 asks how including the term *control* would change the population of items that meet the definition of an asset. As previously explained, the Committee believes including *control* eliminates the possibility of recording non-exclusive rights as assets. Beyond this reason,

however, there is also value in including *control* in the definition if doing so provides clarity and reduces confusion.

Question 4: *The Board decided that an obligation to transfer either assets or, in certain limited circumstances, an entity's own shares would meet the definition of a liability. Is the discussion in this proposed chapter of the limited circumstances in which the entity's own shares would meet the definition of a liability sufficiently clear?*

The Committee believes the above-referenced discussion is clear. However, we see a conceptual issue with the content of the discussion.

The Exposure Draft indicates that obligations to be satisfied by a variable number of an entity's own shares with a determinable or defined amount meet the definition of a liability, while obligations to be satisfied by a fixed number of an entity's own shares do not. The latter approach results in equity recognition of, for example, obligations under stock option-based compensation plans at the option grant date and the expected value of contingently issuable shares in business combinations. In the case of assets, the Exposure Draft emphasizes distinguishing the present right from the outcome of those rights (i.e., the future benefits) but takes a different approach in the case of liabilities. The proposed definition instead treats some but not all future equity-like benefits as a present ownership stake, even though an obligation to transfer either a variable number or a fixed number of shares is a present obligation that will result in a future issuance of equity. The Committee regards the proposed distinguishing characteristic of fixed versus variable number of shares as more of a practical expedient to avoid including all share-settled obligations as liabilities.

Question 5: *Other than as described in Question 4, to allow certain share-settled instruments to be liabilities, the Board expects the liabilities that met the definition of a liability in Concepts Statement 6 will continue to qualify as liabilities under the definition of a liability in this proposed chapter. Do you agree that the definition of a liability in this proposed chapter is consistent with the Board's assertion? If not, please provide examples.*

The Committee agrees that the proposed liability definition is consistent with the intent that those items which met the definition of a liability under Concepts Statement No. 6 would continue to meet the definition proposed in the Exposure Draft. Academic research supports this assertion. Cade et al. (2019) find that individuals' assessments as to whether liabilities exist are largely invariant to changes in the liability definition.

Question 6: *In practice, the more challenging applications of the definition of a liability in Concepts Statement 6 were related to business risks, constructive obligations, and stand-ready obligations. Is the discussion of those three areas in this proposed chapter adequate to understand and apply the definition of a liability?*

The Committee agrees that the Exposure Draft's discussion of business risks, constructive obligations, and stand-ready obligations is adequate for understanding conceptual distinctions among the items. We do not, however, agree that the discussion is sufficient to apply the definition of a liability to these arrangements because of their fact-intensive and context-specific

nature. For example, Garavaglia et al. (2020) indicate that financial statement users view an entity's obligations as comprising "a broader range of situations than would be encompassed by a strict legal standard" (p. 5). Botosan et al. (2005) note that practitioners may "gravitate to the threshold associated with a legal obligation and…be less consistent in judging the obligating event associated with equitable and constructive obligations." Specific guidance may be necessary to expand the scope of reported liabilities beyond legal obligations.

Question 7: *The Board suggested that integration with presentation principles would be helpful in distinguishing between the components of comprehensive income. To facilitate this distinction, paragraph E92 of this proposed chapter references presentation principles. Is distinguishing revenues from gains and expenses from losses essential as a matter of elements, or should those distinctions be exclusively a matter for presentation concepts? Please explain.*

The Committee believes assets and liabilities should be defined as elements[2], equity and changes in equity can be defined based on assets and liabilities, and all other distinctions among financial statement components are best handled through presentation guidance. See Figure 1 below.

Following the basic accounting equation, equity is the difference between assets and liabilities. Change in equity encompasses the remaining seven elements defined in the Exposure Draft: investments by owners, distributions to owners, comprehensive income, revenues, expenses, gains, and losses. The Committee believes that distinguishing among various components of equity and the change in equity through presentation guidance as opposed to elements definitions has the following advantages:

1. Presentation guidance can be flexible and principles-based. For example, presentation guidance might consider both the nature of a potential expense or loss, and also characteristics of the potential expense or loss such as frequency or persistence.

2. Some of the concerns about element definitions relate to their implications for presentation outcomes such as inclusion/exclusion in certain subtotals or gross vs. net presentation. Distinguishing components of the change in equity through presentation guidance allows for a more comprehensive approach toward financial statement presentation of these components that includes not only the nature of these components (as definitions do) but also presentation outcomes.

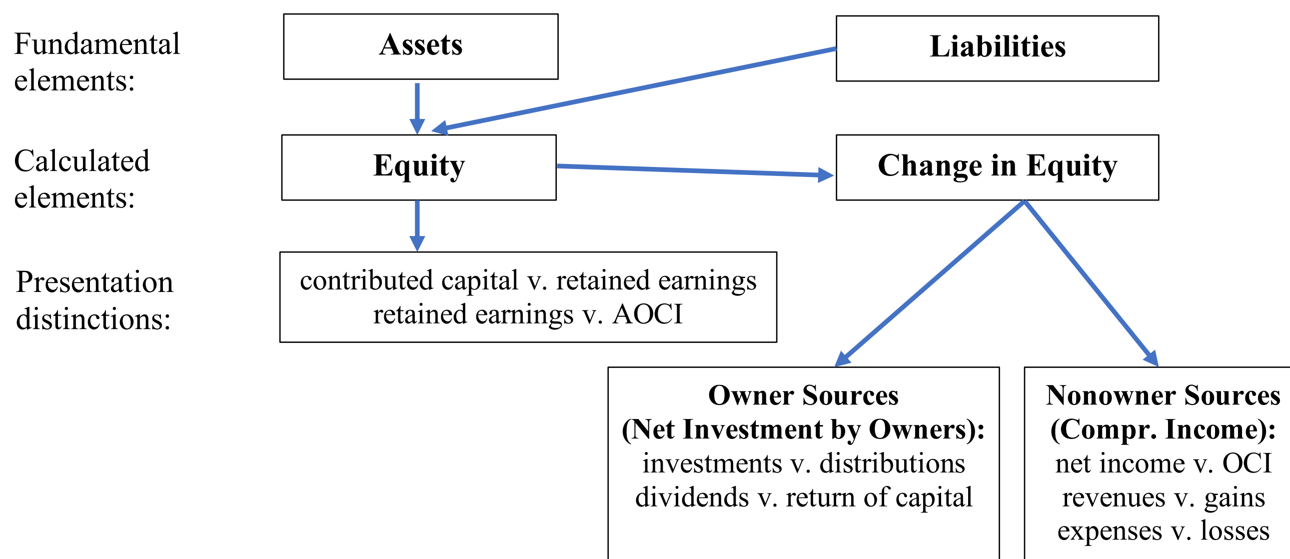
3. Defining two elements, not ten, allows the other components of financial reports to be defined and discussed entirely in terms of the two defined elements. Paragraphs BC4.47 through 55 discuss some of the issues related to the proposed definitions for equity, comprehensive income, revenues, expenses, gains, and losses.

4. Focusing on two fundamental elements avoids certain inconsistencies in the set of ten defined elements. For example, why are changes in equity resulting from transactions with

[2] The Committee recognizes that the Exposure Draft uses the word *element* in a general sense as "building blocks with which financial statements are constructed" (Paragraph E6). A stricter definition would preclude an element from being comprised of two others—the removal of Oxygen from Hydrogen does not create a third element. In this stricter sense, there are only two financial statement elements—assets and liabilities—rather than ten.

owners represented by two elements (i.e., investments by owners and distributions to owners) when changes in equity not resulting from transactions with owners are represented by one element (i.e., comprehensive income)? Why are revenues, expenses, gains, and losses considered elements when other comprehensive income is not defined as an element?

Figure 1: Summary of Proposed Elements and Presentation Distinctions



Question 8: *As described in Question 7, this proposed chapter seeks to distinguish between revenues, expenses, gains, and losses. Do the definitions of and other explanatory language related to revenues, expenses, gains, and losses make the distinction between these elements sufficiently clear?*

As described in our response to Question 7, the Committee believes distinctions among revenues, gains, expenses, and losses should be addressed with presentation guidance. We have identified three issues with the proposed definitions.

1. The definitions of revenues and expenses are vague. For example, could a company report revenue from "delivering or producing goods" if the particular good was a one-time event not related to the company's usual product lines or customers? What exactly are the "other activities" included in the revenue and expense definitions?

2. The definitions of revenues and gains (and of expenses and losses) are inconsistent. Why are revenues defined as "inflows or other enhancements of assets … or settlements of … liabilities (or a combination of both)" when gains are defined as "increases in equity (net assets)"? Is there a meaningful difference between these two descriptions of increases in net assets?

3. The definitions of revenues and expenses do not align with other principles. For example, expenses relate to "delivering or producing goods, rendering services, or carrying out other activities." Should this align with the notion of "ordinary course of business" as used in the definition of inventory? For example, the sale of an asset in the ordinary course of business will lead to revenue and an expense (i.e., cost of goods sold), but the sale of that same asset not in the ordinary course of business will lead to a gain or loss.

Question 9: *The Board has concluded that, other than when exceptions are specifically noted in this proposed chapter, the elements described in this proposed chapter would apply to not-for-profit organizations. Do you agree with this conclusion?*

The Committee agrees with this conclusion.

Question 10: *This proposed chapter was developed on the basis of Concepts Statement 6, though several paragraphs have been removed or adapted. Are any of the paragraphs from Concepts Statement 6 that have been removed in drafting this proposed chapter necessary to keep? If so, why?*

The Committee is not aware of any necessary paragraphs that have been removed.

Question 11: *"Appendix A: Accrual Accounting and Related Concepts," includes discussion of several concepts that are used in this proposed chapter and in other chapters of the Conceptual Framework. Is this material helpful in a chapter discussing the elements of financial statements?*

The Committee believes this material is helpful, but that it does not fit in this particular chapter of the Conceptual Framework.

References

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