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FASB/IASB *Revisiting the Concepts*: a comment on Hicks and the concept of 'income' in the conceptual framework

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Preliminary note: The status of this FASB/IASB 'communications' paper (dated May 2005) on 'a new conceptual framework project'[1] is not entirely clear. It is written by FASB and IASB staff members (Halsey G. Bullen and Kimberley Crook) but does not carry any of the customary disclaimers as to the status of staff opinions relative to the Boards' need for extensive due processes etc., and it is billed without explanation on the Boards' websites. We therefore have to presume it is to be taken as an authoritative joint statement of how the two Boards currently intend to undertake the convergence of their existing conceptual frameworks, even though there has not apparently been any prior exposure for public comment.

Nor is any comment now invited. However, given the highly contestable nature of many of the arguments the paper contains, it would seem appropriate that the Boards do invite public comment before any decisions are taken to expend further resources on pursuing the line of approach for converging and revising their conceptual frameworks that is set forth in the paper. We ourselves may prepare a fuller comment in due course. However, here we focus principally on what appears to be—and is predicted in the paper to continue to be—the bedrock of the Boards' frameworks, namely the conceptual 'primacy of assets' (p.9) and especially its purported derivation from Professor Sir John Hicks's (1946) definition of 'income' (p.7; p.18).

Since other national standard setters, such as the UK's ASB, also have similar frameworks (referred to at p.3 of the paper), we are copying this comment to the ASB as well (as Richard Macve is also a member of the ASB's Academic Panel and Michael Bromwich is a former member of the ASC). Further discussion of the ASB's own *Statement of Principles*, which is also relevant to the arguments we make here and cites further relevant literature, may be found in Bromwich (2001).

We trust this comment will be made public in the normal way for comment letters sent to the respective Boards, and we shall be glad to see the Boards' response (whether joint or several) to this and others' comments in due course. We would of course be happy to amplify any of the points made here and to provide appropriate references to further reading if that would be helpful to Board members and staff.

[1] http://www.iasb.org/uploaded_files/documents/10_484_communications_paper.pdf

The bedrock?

'..a wise man, which built his house upon a rock……….a foolish man, which built his house upon the sand…and it fell; and great was the fall of it.' *Matthew*, 7: 24-27.

Starting with the overriding objective of usefulness in making economic decisions, and thereby of usefulness in assessing cash flow prospects, the Boards' frameworks focus on 'enterprise resources, claims to those resources, and changes in them' (p.3).[2]

This leads to definitions of the elements of financial statements, beginning with assets, which are (in FASB's version) characterized as 'probable future economic benefits obtained or controlled by a particular entity as the result of past transactions or other events'.[3] All other elements can be derived in terms of the definition of assets, which gives them 'conceptual primacy'[4] and leads to the 'asset/liability' view of income measurement, 'in which income is a measure of the increase in the net resources of the enterprise during a period, defined primarily in terms of increases in assets and decreases in liabilities' (p.7).[5]

It is at this point that the framework purports to be 'grounded in a theory prevalent in economics: that an entity's income can be objectively determined from the change in its wealth plus what it consumed during a period' and Hicks (1946, pp. 178-9) is cited. It is on this foundation that the 'conceptual primacy' of assets and the superiority of the 'asset/liability' view over the 'revenue and expense view' are purportedly based.

The Boards' attempt to ground their converged framework of accounting theory and principles on a sound economics foundation is to be welcomed. Unfortunately, that foundation will not support the particular structure the Boards wish to erect. The relevant passage from Hicks about the 'one supremely important property' (i.e. objectivity) of what Hicks labels 'Income No. 1 *ex post*' is quoted at p.18—but the quoted words are taken out of context.

The full sentence reads: (Hicks, 1946, p.178-9, our emphasis added): '*So long as we confine our attention to income from property, and leave out of account any increment or decrement in the value of prospects due to changes in people's own*

[2] As many commentators have observed, the more obvious primary focus would be on forecasts of future cash flows. We do not pursue that argument further here.
[3] This definition is contrasted with 'earlier efforts that included deferred debits among assets' (a result of the 'revenue and expense', or 'matching', approach to measuring income). However, a traditional professional textbook such as Cropper, 1930, p.94, for example, explains in relation to items of 'deferred revenue expenditure' that these 'must be carefully reviewed, and, as explained before, may be "held up" as an asset legitimately, if written off over a reasonable period. It is assumed in such cases that benefits will accrue in succeeding years from the expenditure, and so these years should bear their proportion of the burden'—i.e. 'deferred debits' must also represent 'probable future economic benefits' (which the paper—somewhat surprisingly—claims are 'phenomena observable in the real world' (p.6)).
[4] For fundamental scepticism about the effectiveness of any such attempts at 'necessary and sufficient' definitions see, e.g., Kitchen, 1954; Dopuch & Sunder, 1980.
[5] While the paper cites the authority of the SEC for its approach (p.8), it overlooks the criticism by a former SEC chief accountant (Schuetze, 1997) that the FASB's definitions do not exclude anything that anyone might reasonably want to include.

earning power (accumulation or decumulation of "Human Capital"), Income No. 1 *ex post* is not a subjective affair, like other kinds of income; it is almost completely objective'.

What does the omitted, but vitally important, qualifying clause 'so long as…….' imply? As has been explained by many leading academic accounting authors (e.g. Beaver, 1998), this concept of income is only fully determinable and objective where there are 'complete and perfect markets'—i.e. where every resource and claim on future cash flows has been 'commoditized' into fully exchangeable assets (what Hicks calls 'property') and where everyone faces the same prices. In the real world, markets are neither complete nor perfect, so there will, in the case of business enterprises, be a large element of the value of their future cash flow prospects that is not captured in the value of their net assets, however good the markets in which the value of those assets and liabilities may be measured.[6] This element of value depends *inter alia* on the skill with which management can exploit an enterprise's resources and its markets, and its business, social and political opportunities—what Hicks labels 'Human Capital'.

In general therefore an 'objective' version of Hicks's 'No.1 *ex post*' concept of the business income of a listed enterprise is more likely to be found in the measure of its 'shareholder return' (dividend plus/minus change in share price), i.e. the change in its 'capital value' at the stockmarket level, than in the change in the enterprise's net assets.[7] There is no justification for the paper's rendering (at p.18) of Hicks's 'capital value' as 'in accounting terms, its assets and liabilities'.[8]

Whatever the relation between asset/liability measures in accounting statements and Hicks's 'capital value', and whether or not 'Income No. 1 *ex post*' can be 'objective', there is however an even greater problem with the paper's reliance on Hicks's concept as the bedrock of its approach to the conceptual framework. In the same passage, in the next paragraph, Hicks goes on to say about this concept: '*Ex post* calculations....have no significance for conduct......... On the general principle of "bygones are bygones", it can have no relevance to present decisions.' This, given the FASB's/IASB's 'overriding objective' of 'decision usefulness', undermines the whole structure that the paper attempts to build. That structure is being built on sand.

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[6] The difference between net asset ('book') value and an enterprise's market value is its 'internal goodwill' which is not recognised in financial statements, except where an enterprise is taken over by another enterprise so that 'goodwill on acquisition' has to be recorded in respect of the subsidiary. (However, 'fresh start' accounting is due to be considered under Phase II of the IASB's Business Combinations project: http://www.iasb.org/uploaded_files/documents/16_10_buscom2-ps.pdf and this could, at least in principle, extend to recognition of the goodwill of both acquirer and acquiree.)

[7] In the cited work Hicks confines himself to the individual person who wishes to measure his or her income. He does not actually discuss firms there at all.

[8] There is of course an extensive academic literature exploring how far concepts and measures of asset and liability value that are consistent with (while not generally capturing all of) Hicks's underlying model of 'capital value' may be developed (including the literature on 'deprival' value, e.g. Baxter, 1984; Edey, 1974). Any such links require considerable further restrictive assumptions to handle *inter alia* what are identified in the paper (pp. 15-16) as the 'cross-cutting issues' of 'uncertainty', 'unit of account' and 'management intentions'. [We note that 'deprival value' is referred to at p.15, albeit without further explanation, but not at p.12, even though it does provide theoretical and practical 'guidance on how to choose between the [other] listed measurement attributes' mentioned there. This deprival value concept is developed in the ASB's own *Statement of Principles* (as 'value to the business') as it was in the UK's Sandilands Report (1975).]

The paper goes on to say (on p.7) that a concept of income founded ultimately on the definition of 'assets' is necessary because, among the proponents of the alternative (the 'revenue and expense') view', 'none could meet the challenge' of defining 'income directly, without reference to assets or liabilities or recourse to highly subjective terminology like *proper matching*'.[9]

Hicks himself could 'meet the challenge'. Dissatisfied with his 'No. 1' version he had already offered 'Income No.2', defined as the amount that an entity can consume in a period and still expect to be able to consume the same amount in each ensuing period (1946, p.174).[10] In the case of a joint stock company this could translate as 'the maximum dividend the company could pay this period to its current equity shareholders and expect to be able to be able to pay them the same dividend in all future periods', which is equivalent to what financial analysts call its 'maintainable (or 'permanent') income'.[11] To be sure one can, under further restrictive assumptions, also derive definitions and measures of 'assets' and 'liabilities' that would be consistent with this concept, but they are to be derived from it, not it from them.[12]

Finally we may note that, given the conceptual tension between 'Income No.1' (expressed in terms of capital value) and 'Income No.2' (expressed in terms of maintainable income), there are also conceptual grounds for believing that the most relevant income concept for users and their economic decisions will vary with their individual circumstances and conditions (Paish, 1940). This insight can go a long way towards explaining why the underlying motivations of those who identify with the 'asset/liability' view and those who identify with the 'revenue/expense' (or 'matching') view are sometimes complementary, but are often seen as in opposition with regard to what is the most useful approach to measuring enterprise income in the context of individual standards. The 'new conceptual framework' project of FASB and IASB will not itself be able to eliminate either underlying economic motivation in favour of the other, so neither is it likely that it will be able to eliminate the 'revenue/expense' view in favour of the 'asset/liability' view. It is therefore truly important that the project 'revisits the concepts' in a much more fundamental way. Indeed, revisiting the concepts will help both the Boards and their constituents to

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[9] IASB Board member James Leisenring has frequently made the same assertion in his presentations on the conceptual framework. We do not pursue here the argument that the challenge itself is rigged. (For example, unless and until the Boards can find unambiguous valuation bases (e.g., by reference to current market prices) that are acceptable for all assets and liabilities, the 'asset/liability' approach itself will in practice continue to require the use of accounting procedures, such as inventory flow accounting and depreciation of non-financial fixed assets, which themselves include conventions for 'proper matching of costs and revenues', in order to arrive at the measures of assets and liabilities needed for the construction of statements of financial position/balance sheets.)

[10] When there is inflation, the expectation needs to be 'in real terms' (Hicks's 'Income No.3' (1946, p.174)).

[11] Within Hicks's framework of analysis, Income No. 2 is, as he notes (p.174), the same thing as Income No. 1 only when there is no expected (or actual) change in the rate of interest at which future cash flows are discounted to obtain the 'capital value'.

[12] It was this 'No.2' concept of income that underlay the proposals in the UK's Sandilands Report (1975) for 'current cost accounting'. Sandilands (1975: p.47, para.166) said: ' no accounting system can predict a company's future prospects. However, an accounting system can at least ensure that the profit figure reported is such that, if the profit for the year were fully distributed, it would not prejudice the ability of the company to continue to generate the same profit in future years if the revenues earned and costs incurred in future years were the same as in the year of account.'

understand why accounting practice *has* to be made up of conventions.[13] To rewrite a key sentence from p.1 of the paper: 'To be principles-based, standards have to be a collection of (socially) useful conventions, rooted in fundamental concepts.'

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[13] The paper refers to Storey & Storey (1998) as 'the definitive history of the FASB's conceptual framework project' (p.18). While no history can be 'definitive' it is at least important that it be independent and objective. Reed Storey was, as noted, himself a major player in the development of the project: stronger claimants for providing independent and more objective histories would be, e.g., Zeff (1999) and Macve (1997).

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