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COMMENTARY

Evaluating Concepts-Based vs. Rules-Based Approaches to Standard Setting

AAA Financial Accounting Standards Committee

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INTRODUCTION

In its new project on Codification and Simplification, the FASB indicates its intent to evaluate the feasibility of issuing concepts-based standards rather than issuing detailed, rule-based standards with exceptions and alternatives.[1] Related to this project, members of the FASB board and staff asked the Financial Accounting Standards Committee of the American Accounting Association (hereafter, the Committee) to provide comments on concepts-based standards and to recast two standards as concepts-based.[2] This article summarizes comments of the Committee on issues related to concepts-based vs. rules-based standards. Comments in this article reflect the views of the individuals on the Committee and not those of the American Accounting Association.

The Committee strongly supports the commitment by the FASB to evaluate the feasibility of concepts-based standards.[3] We believe that the economic substance, not

[1] The FASB approved the new project on Codification and Simplification on January 9, 2002. Members of the FASB board/staff and accounting practitioners also refer to concepts-based standards as principles-based or conceptual standards. Individuals sometimes refer to rules-based standards as bright line or cookbook standards.

[2] The Committee wrote two comment letters related to concepts-based standards. The first, "Response to FASB Invitation to Comment on the FASB Proposal for a New Agenda Project on Issues Related to the Recognition of Revenues and Liabilities," contains the Committee's comments on concepts-based standards as they relate to the FASB's proposed project on recognition of revenues and liabilities. The second, "Comments to the FASB on Conceptual Standards," presents the Committee's general comments on concepts-based standards, as well as the recasting of two standards as concepts-based (SFAS No. 87, Employers' Accounting for Pensions and SFAS No. 133, Accounting for Derivatives and Hedging Activities). Linda Vincent, Patti Fairfield, and Eli Bartov revised SFAS No. 87 and Cathy Schrand and Anne Beatty revised SFAS No. 133. The AAA web site (http://www.aaa-edu.org) contains both original comment letters.

[3] The Committee is neither first nor alone in advocating a return to concepts-based standard setting. For example, Ralph E. Walters (member, FASB) dissented to SFAS No. 66 (*Accounting for Sales of Real Estate*) in 1982 with the following comments:

> (Mr. Walters) believes that the accounting profession can serve its members by offering more specific guidance for applying standards in particular specialized areas, but such detailed and arbitrary guidelines should not be dignified as accounting standards. To do so debases accounting standards and inevitably will diminish the stature and effectiveness of the accounting profession, whose strength and purpose arise from applying broad accounting and reporting objectives and standards to specific circumstances with professional judgment and objectivity. That judgment is the hallmark of a true profession. (FASB 1982)

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the form, of any given transaction should guide financial reporting and standard setting, and that concepts-based standards represent the best approach for achieving this objective. Rules-based standards provide companies the opportunity to structure transactions to meet the requirements for particular accounting treatments, even if such treatments don't reflect the true economic substance of the transaction. We recognize, however, that the current plethora of detailed rules has been demand-driven, suggesting that companies may request more guidance than that provided by concepts-based standards. Additionally, a change from rules-based to concepts-based standards magnifies the importance of informed professional judgment and expertise for implementation of standards. Overall, however, we believe that concepts-based standards, if applied properly, better support the FASB's stated mission of "improving the usefulness of financial reporting by focusing on the primary characteristics of relevance and reliability...."

RULES-BASED VS. CONCEPTS-BASED STANDARDS

An Illustration of Rules-Based and Concepts-Based Standards

In order to make our discussion of concepts-based vs. rules-based standards more concrete, we characterize the accounting standard-setting process and its products as a continuum ranging from unequivocally rigid standards on one end to general definitions of economics-based concepts on the other end. An example of the extreme left (rigid) end of the continuum is:

> Annual depreciation expense for all fixed assets is to be 10 percent of the original cost of the asset until the asset is fully depreciated.

Such a rule leaves no room for judgment or disagreement about the amount of depreciation expense to be recognized. Comparability and consistency across firms and through time is virtually assured under such a rule. However, such a standard lacks relevance due its inability to reflect the underlying economics of the reporting entity, which differ across firms and through time.

At the opposite (right) end of the continuum is a provision or rule such as the following:

> Depreciation expense for the reporting period should reflect the decline in the economic value of the asset over the period.[4]

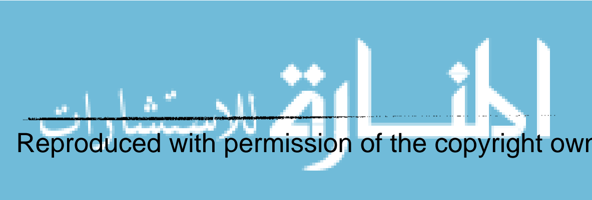
Such a standard requires the application of judgment and expertise by both managers and auditors. The goal is to record economic depreciation of the asset, something about which the manager arguably has more information than anyone else. Many might agree that such a rule reflects the underlying purpose of financial reporting, but argue that it is too costly to implement and would likely lead to results that are neither comparable across firms nor consistent through time.

Benefits and Costs of Rules-Based vs. Concepts-Based Standards

Rules-Based Standards

Evidence abounds that detailed standards cannot meet the challenges of a complex and rapidly changing financial world, and that they frequently provide a benchmark for determining compliance in form but not in substance (Finnerty 1988). The Committee

[4] By using this example, the Committee is not taking a position about the appropriateness of using "decline in economic value" as a basis for depreciation; this is simply one concepts-based approach to depreciation that we use as an illustration.



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believes it is impracticable, if not impossible, for any standard-setting organization to anticipate and provide for every possible form and type of financial transaction and business relationship. Detailed standards are likely to be incomplete or even obsolete by the time they are published. In addition, such detailed standards provide self-interested managers the opportunity to manipulate the reported results under the guise of complying with the rules. In turn, auditors find it more difficult to thwart such manipulations of reported financial results when detailed rules serve as the managers' justification.

The Committee offers two examples of these problems associated with rules-based standards. The first example is accounting for leases. SFAS No. 13 is a rules-based standard with a list of four precise criteria, several of which contain numerical cut-off points, and the requirement that if any one of the criteria is met, a company must account for the lease as a capital lease. However, the application of these criteria has been controversial since the promulgation of the standard, with the subsequent issuance of hundreds of pages of documentation dealing with leases; for example, see the FASB's 450-page *Accounting for Leases—A Codification as of October 1, 1998*. Additionally, professional expertise, creative arrangements such as synthetic leases, and judgment have been applied to circumvent the accounting rules rather than to present financial statements that reflect the underlying economics of the transaction. For example, Pulliam (1988) reports that third-party guarantors of the residual values of leased assets developed contracts to avoid the "90 percent present value of minimum lease payments" threshold imposed by SFAS No. 13. Imhoff and Thomas (1988) find that the most common effect of SFAS No.13 was the substitution of operating leases for capital leases, presumably in order to avoid liability recognition.

The second example is pooling vs. purchase accounting for business combinations. APB No. 16 contained a list of 12 conditions necessary to qualify for pooling, an apparently bright line standard. However, even with these precise conditions, Michael Sutton, former Chief Accountant of the SEC, estimated that his staff spent 40 percent of their time fielding questions on whether specific transaction structures could qualify for pooling treatment (McGoldrick 1997). Lys and Vincent (1995) document an extreme case in which AT&T paid as much as $500 million in order to gain SEC approval of the pooling-of-interests method of accounting for its acquisition of NCR.[5]

In highlighting these problems, the Committee turns to the Internal Revenue Service (IRS) for analogy as to the effects of bright line rules. The IRS relies on the Internal Revenue Code (IRC), Treasury Regulations, rulings, and case law to establish whether taxpayers have violated the rules—a negative standard of conduct. There is general consensus among IRS constituents that tax rules have become fearsomely complex, detailed, cumbersome, and costly, as they attempt to restrict transaction structuring that accompanies such bright line rules. Thus, detailed tax regulations can facilitate a "form over substance" treatment of an item.[6] We believe the tax code and regulations provide a negative example for the FASB, and that accounting standard setters should provide guidelines for which there is a positive standard of conduct, relying on substance over form and reflecting underlying economics rather than compliance with an arbitrary standard.

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[5] The FASB recently eliminated the pooling-of-interests method of accounting for business combinations, substituting a required treatment (purchase accounting) and also providing for significant judgment in the application of the new standards for the treatment of acquisition goodwill.

[6] We note, however, that the U.S. Supreme Court has long held the doctrine that "in determining tax liability, taxing authorities must look through form to fact and substance" (*Tex-Penn Oil Co.*, 37-1 USTC ¶ 9194, 300 U.S. 481, 492-3).

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Concepts-Based Standards

The committee recognizes that the latitude inherent in concepts-based standards is a double-edged sword. Such latitude allows managers to choose accounting treatments that reflect their informed understanding of the underlying economics of transactions. This latitude, however, also permits managers to advocate reporting treatments that do not reflect the underlying economics of a transaction. Managers, audit committee members, and auditors must possess both expert judgment and a desire for unbiased reporting in order for conceptual standards to result in financial reporting that reflects underlying economics. Both the SEC and the Auditing Standards Board support this view with their focus on the quality, as opposed to simply the acceptability, of financial reporting, as well as their emphasis on the need for expert judgment and unbiased reporting (AICPA 1999; SEC 1999).

Concepts-based standards have the potential to promote the financial reporting goals of the FASB in ways that rules-based standards cannot. First, as educators, we believe that individuals must possess a conceptual framework for financial information in order to use this information appropriately in decision making. Concepts-based standards reflect a more consistent application of the FASB's Conceptual Framework and enhance individuals' understanding of the framework. Thus, a concepts-based approach is consistent with the FASB's stated goal to "improve the common understanding of the nature and purposes of information contained in financial reports."

Second, we believe concepts-based standards are consistent with the stated goal of the FASB to promote convergence of accounting standards worldwide. The European Commission is reportedly (Guerrera and Norman 2002) proposing that the U.S. abandon GAAP in favor of the "more flexible IAS, which emphasizes 'substance over form' in auditors' inspection of the accounts." A concepts-based approach likely will lead to greater agreement in standard setting between the FASB and IASB and thus promote international harmonization.

REVIEW OF RELATED ACADEMIC RESEARCH

The academic accounting literature is somewhat limited with respect to direct research on the issue of concepts-based vs. rules-based standards for financial reporting. However, several studies shed light on issues related to the benefits and costs of these two approaches; we summarize a representative sample of these below. Some of this research relates to audits of financial statements rather than to the setting of standards. The Committee believes that the tension and potential conflict between auditors and their clients are inherently separable from, but not always distinctly different from, the tension and potential conflict between preparers and users of financial statements. Although auditing tensions should not dictate the form and content of accounting standards, we believe that inferences about standard setting can be drawn from the literature on auditing.

Preparers' Reaction to Concepts-Based and Rules-Based Standards

The primary responsibility for financial reports lies with management. Academic literature provides abundant evidence that managers, with or without the knowledge and/or consent of their auditors, both interpret rules and structure transactions to achieve desired accounting treatments. There is an extensive empirical/archival accounting literature (e.g., Watts and Zimmerman 1986) addressing the incentives of managers to make financial reporting choices and decisions in their own best interests. These studies do not provide a comparison of concepts-based and rules-based standards but rather document evidence of manipulation of financial reporting for both types of standards.

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A recent study specifically addresses the effects of bright line vs. conceptual standards using survey data gathered from 253 audit partners on their experience with 515 attempts at earnings management by their clients (Nelson et al. 2002). This study reports that managers are more likely to attempt earnings management with transaction structuring when precise standards govern the accounting—leases, equity vs. cost method, consolidations, and so forth—than when standards are more flexible. Correspondingly, auditors are more likely to permit earnings management attempts through transaction structuring to stand when governing rules are precise and the transaction structuring is consistent with the rules.

Nelson et al. (2002) find that when the standard provides no "bright line" for managers to use in transaction structuring, they are less likely to engage in costly transaction structuring. However, with such concepts-based standards, managers are more likely to justify earnings management attempts by convincing the auditor of their interpretation of the imprecise rules. Auditors are more likely to permit such earnings management attempts to stand when the accounting is governed by more flexible or subjective standards.

In related research, Cuccia et al. (1995) use experimental methods to examine reporting aggressiveness in the tax area. They study whether professional tax practitioners are more or less aggressive with vague, verbal standards than they are under more precise, quantitative or numerical standards. The authors find that tax practitioners are equally aggressive under both types of standards but that the form of their aggression varies. That is, with vaguely worded standards, the practitioners use the latitude inherent in the regulation to justify aggressive reporting. With numerical standards, they instead use the latitude available in assessing evidentiary support to justify an aggressive reporting position. The authors conclude that when practitioners have incentives to report aggressively, modifications to standards to make them more stringent and quantitative may prove ineffective in reducing the aggressiveness of the reporting. Although there are significant differences between tax preparers and auditors and their respective relations with their clients, these results likely have implications for the effects of financial accounting standards.

Costs Incurred to Structure Transactions

Dye (2002) examines transaction structuring by modeling analytically the manager's financial reporting process as one of classification manipulation. That is, for many standards, there is a generally preferred outcome, such as operating rather than capital lease treatment, and classification manipulation results in more firms attaining the preferred accounting treatment than would otherwise be the case under GAAP. He concludes that such manipulation reduces the effectiveness of rules in a standard to distinguish among true economic differences in transactions. Rather, classification manipulation leads to a *shadow standard* that simply demarks the boundary between those firms that are or are not willing to pay the cost needed to structure a transaction to secure the more favorable classification. In other words, Dye (2002) provides support for Nelson et al.'s (2002) conclusion that rigid standards will increase managers' ability to manipulate financial reporting outcomes opportunistically, and thus weaken the effectiveness of the standard.

Empirical research provides evidence that managers structure transactions to avoid balance sheet recognition. Examples include Bowman (1980) and Ely (1995) on leases and Shevlin (1987) on R&D limited partnerships. Engel et al. (1999) explore whether

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managers will incur costs in order to simply change balance sheet classification of a financial transaction as equity rather than debt. They find that firms incurred costs of as much as $43 million in order to classify a transaction as equity rather than debt.

Auditors and Concepts-Based vs. Rules-Based Standards

One of the auditor's roles is to monitor management's impulses to act opportunistically in financial reporting. Several academic studies offer indirect support for rules-based standards by documenting that rigid GAAP provides auditors with the justification needed to perform this monitoring function. For example, in an experiment using 54 audit partners as participants, Trompeter (1994) finds evidence that auditors are less able to resist client pressure for aggressive reporting when there is a wider range of acceptable accounting alternatives. Knapp (1987) reports that audit committees are more likely to support an auditor in a dispute with management when the issue is covered by technical standards. Magee and Tseng (1990) model the links between audit pricing, auditor independence, and the characteristics of accounting standards. They find that when accounting standards are specific, threats by the client to "opinion shop" in the case of a dispute are less effective because it is likely that all auditors will take the same position on an issue. This is supported by the idea that flexible standards accompany greater conflict and more negotiation efforts between auditor and client (Gibbins et al. 2001).

Studies find that other factors also affect auditor-client negotiations over GAAP. For example, Trompeter (1994) finds that the compensation structure of the auditing firm affects the auditor's ability to resist client pressures. Nelson et al. (2002) report that the size of the client and the size of the earnings management influence the auditor's decision whether to waive enforcement when earnings management is apparent. Based on an experiment using experienced auditors, Hackenbrack and Nelson (1996) conclude that the auditor's incentives determined by the level of audit risk influence significantly the interpretation of the applicable accounting standard. They find that when engagement risk is moderate, auditors prefer the aggressive reporting method and aggressively apply the relevant financial accounting standard. When engagement risk is high, the auditors prefer the conservative reporting method and conservatively apply the relevant professional standard.

Effectiveness of Concepts-Based Standards

Hronsky and Houghton (2001) provide some evidence on the effectiveness of concepts-based standards. Specifically, they examine whether changes in the wording of a conceptual standard results in different accounting treatments. They test classification of items as extraordinary using the change in the definition in Australia's standard on extraordinary items and 40 experienced auditors as experimental participants. Regulators changed the definition in order to remove the flexibility inherent in the old definition and thus "limit the inconsistencies and alleged opportunism observed in practice." The authors find significant differences in classification of items based on the new rules, from which they infer the importance of definitions and interpretations in decision making. The authors conclude that at least one important party in the financial reporting process (auditors) perceived the change in the regulated definition as having a different meaning from the old definition. Additionally, results suggest that there was a systematic relation between the perceived meaning and the subsequent classification decision outcome, in the direction intended by the regulators. This study provides evidence that precision in the wording of conceptual standards may in fact mitigate "aggressive" reporting.

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Conclusions

Overall, results of the academic literature indicate that the two different approaches to accounting standards alter neither the incentives nor the ability of management to report opportunistically; only the nature and characteristics of opportunistic reporting vary depending on the nature of the standard. This research provides some evidence that the rigid ("bright line") or flexible nature of the governing accounting standard is important, but generally less important than incentives faced by both managers and auditors. Finally, the literature provides some evidence that precision in the wording of concepts-based standards has some effect on financial reporting decisions.

IMPLEMENTATION OF CONCEPTS-BASED STANDARDS

FASB members and staff asked the Committee to undertake the task of recasting two standards, SFAS No. 87 and SFAS No. 133, as concepts-based standards. We present our recasting of SFAS No. 87 in the Appendix; see the AAA web site (http://www.aaa-edu.org) for the recasting of SFAS No. 133. In completing this task, the Committee both enumerated desirable characteristics of concepts-based standards and provided insight on implementation issues. We discuss these two issues in turn.

Characteristics of Concepts-Based Standards

The Committee first determined characteristics that a concepts-based standard should possess. Our list of characteristics is as follows.

1) In a concepts-based standard, the economic substance, not the form, of a given transaction should guide its financial reporting. The FASB's Conceptual Framework defines the classification and measurement of economic transactions and, accordingly, should serve as the foundation for financial reporting that reflects the economic substance of a transaction.
2) A concepts-based standard should include a description of the particular transaction that is the subject of the standard. This description should include the underlying economics of the transaction in order to provide a common, explicit understanding of these economics.[7]
3) A concepts-based standard should include a general discussion of the mapping between the economics of a transaction and the financial statements, using the Conceptual Framework to guide classification and measurement issues associated with this mapping.
4) A concepts-based standard may include implementation guidance, most likely in the form of examples that illustrate application of the standard's general principles to typical transactions covered by the standard. In these implementation examples, it may be necessary to make choices that are based on practicality rather than explicitly on the concepts. We believe this is acceptable, but should be noted as such in the discussion of the example.
5) In a concepts-based standard, the Board should be careful when creating "names" for concepts, even if they enhance the readability of the standard. The names may already have connotations for readers that differ from the concept that the Board has in mind. If it is unavoidable to use such names, the Board should articulate their definitions.

[7] Storey and Storey (1998, 86) highlight the importance of having "common premises" when developing conceptual statements in their FASB monograph, *The Framework of Financial Accounting Concepts and Standards*. As they state, "If experience is the frame of reference, no one can be sure of the starting point, if one exists at all, because everyone's experience is different."

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6) Concepts-based standards should include disclosure requirements related to a description of the economics of the transaction being reported, the assumptions made in the reporting, and any supporting information that will facilitate understanding both the economics and the reporting.

Issues Associated with a Conceptual Approach to Standard Setting

The Committee found the task of recasting current standards as concepts-based standards to be both engaging and challenging. In this section, we summarize issues that arose during our process of revising the standards.

As noted previously, approaches to standards setting can be depicted as a continuum, with purely rules-based standards on one end and purely concepts-based standards on the other. One primary issue the Committee encountered was where on this continuum to place the revised standards. That is, to what extent should concepts-based standards represent "ideal" standards that reflect the underlying economics of the transaction in a "pure" fashion? Given the academic orientation of most of the Committee's members, our natural inclination is to advocate that conceptual standards reflect the economics as purely as possible.

We encountered several issues when taking an economics-based approach for rewriting the two standards. First, we encountered the issue that the reporting for one transaction depends on the reporting for other transactions, such as assets and liabilities. In rewriting standards, problems arise due to the fact that not all of a firm's economic assets and liabilities are recorded. For assets and liabilities that are recorded, not all are recorded at fair value. Such recognition and measurement issues for assets and liabilities lead to problems with writing economic-based conceptual standards. For example, if all of a firm's assets and liabilities were recorded at fair values, there would be no need to distinguish between derivatives that were used to hedge vs. not used to hedge, between fair value and cash flow hedges, between separate and embedded derivatives, or even between derivatives that are used for hedging and other "instruments" that can act as hedges. One should simply record all derivatives at fair value with changes in fair value recorded in income. Our point here is not necessarily an endorsement of fair value accounting, rather, it is simply to point out the issues associated with reflecting "true economics" in rewriting standards as conceptual standards.

A second issue is that many rules in the current standards appear to arise from the practicality of dealing with constituents' concerns, rather than arising from the underlying economics of the transaction. The transition rules and corridor approach to recognizing unrealized gains and losses in SFAS No. 87 are examples of such rules. A question arises as to the extent to which conceptual standards should include such concessions to practicality. That is, to what extent should conceptual standards initially include practical considerations and gradually move to reflect the underlying economics vs. imposing an immediate change to an economics-based standard? We do not have an answer to this question, but raise it as an issue that needs to be considered. The Committee's approach to revising SFAS No. 87 more closely reflected the immediate transition to economics-based standards, without regard to practical concerns of constituents.

A third observation relates to the effect of a conceptual approach on the need for standards related to specific transactions. It is possible that some individual standards will be straightforward applications of the concepts in the FASB's Conceptual Framework. For example, accounting for pensions may require only a relatively straightforward application of the definition of liabilities and expenses. In effect, one view is that the accounting for pensions already exists in the Conceptual Framework and thus a

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concepts-based standard on pensions will add little. Here a concepts-based pension standard need only define pensions in terms of elements of the Conceptual Framework and provide illustrations of applying the framework. On a related point, a move to concepts-based standards allows for some combination of current standards. For example, SFAS No. 87 on pensions and SFAS No. 106 on other post-retirement benefits potentially could be combined into a single conceptual standard.

Finally, all of these observations raise the issue of whether the FASB should take a *piecemeal* or a *one-shot, comprehensive* approach to rewriting standards as concepts-based rather than rules-based. In a piecemeal approach, the FASB writes all new standards as concepts-based standards. All past rules are rewritten one by one. Such an approach may be necessary due to practical considerations. However, the Committee raises two issues related to this approach. First, the order in which the recasting of old standards is done is important in order to avoid having to go back and re-recast a standard due to issues that arise in recasting another standard. Second, it may be necessary to undertake a comprehensive re-thinking of the Conceptual Framework before undertaking revision of individual standards. For example, in the extreme, if a concepts-based approach is intended to reflect purely the economics of transactions, the idea of what constitutes assets, liabilities, and equity of the firm and the measurement basis for these elements needs to be reconsidered.

The Committee realizes that the FASB constantly reconsiders such issues. However, we believe a more comprehensive re-thinking of the Conceptual Framework may be needed prior to undertaking revision of current standards. One approach to accomplishing this goal would be to have a separate project on conceptual standard setting that is distinct from the process of setting current standards.

CONCLUDING COMMENTS

In closing, the Committee believes consideration of a concepts-based approach to standard setting should be given priority. As indicated, the Committee's experience suggests that this process will not be easy and that many issues will need to be resolved, but we believe undertaking such a project will improve standard setting. We recognize, consistent with evidence in accounting research, that the implementation and enforcement of concepts-based accounting standards may be daunting because they necessarily rely on the joint efforts of management, the board of directors, and the auditors to apply professional expertise and judgment to achieve unbiased financial reporting. However, the tensions between and among the companies, their auditors, investors, and regulators are not specific to the nature of the standards as concepts-based or rules-based. Standards, in whatever form, cannot solve these conflicts. We believe that issues of incentives and monitoring should be addressed separately and should not determine the nature of accounting standards.

With concepts-based standards, the importance of professional judgment and the desire for unbiased reporting is paramount. However, as noted by Mason and Gibbins (1991), professional judgment is important in all cases. In discussing the issue of professional judgment, they quote from the *Introduction to Accounting Recommendations* to the CICA Handbook: "no rule of general application can be phrased to suit all circumstances...that may arise, nor is there any substitute for the exercise of professional judgment in the determination of what constitutes fair presentation or good practice in a particular case." The Committee encourages the FASB to provide explicit references to the importance of professional judgment in interpreting and implementing concepts-based standards in the preparation of financial reports.

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APPENDIX
A Conceptual Approach for SFAS No. 87, Employers' Accounting for Pensions

Overview and Background Comments

There are two main economic aspects to the accounting for pensions. The first is to recognize the current period pension expense and the second is to recognize the total unfunded obligation for pension benefits as of the end of the reporting period.

In reformulating SFAS No. 87 from a rules-based to conceptual standard, we focused on capturing economic substance over form and maintaining consistency with the FASB's Conceptual Framework. We believe that the principles underlying SFAS No. 87, as written, generally are consistent with the Conceptual Framework.

However, the detailed rules provided in SFAS No. 87 (e.g., corridor amortization and recognizing a minimum liability amount) are not appropriate to a conceptual standard. Many of these rules appear to be compromises aimed at maintaining certain desired characteristics of the financial statements unrelated to the economic substance of the transactions. The impetus for other detailed rules appears to be the Board's concern regarding transition accounting at the time of the issuance of the standard. We do not consider transition accounting to be a pertinent concern in a concepts-based standard and so we eliminate the rules related to transition accounting. We expect that any cumulative effect of an accounting change will be reported as such in the year of transition.

We shortened SFAS No. 87 substantially and rewrote it with minimal detailed implementation guidance because we believe that there is a reasonably common and accepted definition of pensions benefits, unlike other transactions such as derivatives. Additionally, the goals of the FASB with respect to pension reporting are quite straightforward and consistent with the Conceptual Framework. We do, however, retain most of the disclosure requirements of SFAS No. 87. We consider these disclosures to be of primary importance to investors in understanding the accounting for pensions. We conclude that a shortened and simplified standard accomplishes the financial reporting goals for pensions.

We believe that under a conceptual approach to standard setting, the standard should encompass all post-employment benefits and not just those related to pensions. We do not perceive an economic or philosophical difference between pension benefits and, for example, health care benefits. However, because of the purpose of this exercise, we felt that the focus should remain on SFAS No. 87 as written, so we did not include other post-employment benefits in the reconstituted standard.

We also note that certain inconsistencies arise in converting an existing standard such as SFAS No. 87 into a conceptual standard due to the connections between the subject standard and other existing standards. For example, SFAS No. 87 refers to SFAS No. 34 on Capitalization of Interest Costs, among others. We do not address such specific relations, recognizing that if all standards are rewritten as conceptual, such inconsistencies should disappear.

We rely on the Conceptual Framework for the definition of both an asset and a liability in determining whether the pension plan assets and the unfunded pension obligation should be carried on the statement of financial position. The change in the net pension asset or liability should be reported in income.

The first section of the existing standard, the Summary, states that SFAS No. 87 retains three fundamental aspects of past pension accounting: delaying recognition of

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certain events, reporting net cost, and offsetting liabilities and assets. We retain only the third of these reporting approaches. We eliminate the delayed recognition of prior service cost and gains and losses on pension assets—the Committee believes that the underlying economics requires that recognition should be contemporaneous. Second, because one of the main objectives of the standard is to report the current period's pension cost, the Committee believes that the compensation (service) component of the cost should be separately reported and not offset against the financial components of the pension cost—therefore we eliminated the reporting of "net cost." We believe that the components of the cost that relate to financing issues—specifically interest expense on the pension liability and gains and losses on the pension asset—should be reported separately from the compensation component. We agree with SFAS No. 87 that offsetting pension assets and liabilities is appropriate—the assets contributed by the employer to the pension plan discharge a portion of the obligation and so we retained the offsetting provision for assets and liabilities.

We note that there are many techniques used by actuaries to determine the total amount of the employer's pension obligation. We do not believe that it is appropriate for a conceptual standard to specify the form of the computation or the techniques and assumptions to be applied. The standard requires disclosure of the techniques and assumptions used by the actuary to determine the gross pension obligation and the components of periodic pension expense (income).

The revised statement for SFAS No. 87 consists of the following six sections:

A. Objective of Statement
B. Scope and Definitions
C. Disclosure Requirements
D. Glossary of Terms
E. Appendix (optional)

The outline of the reconstituted standard is provided below in tabular format with the conceptual standard's antecedent from the original SFAS No. 87 pronouncement shown in the first column.

Because the revised standard is quite short, the entire standard is presented below in standard typeface (with the exception of the glossary terms). Editorial comments by the Committee are shown in *italics*.

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Statement 87 (paragraph #s)	**Suggested Text/*Comments***
Summary (6)	**A. Objective of Statement** The objective of this statement is to provide standards for the recognition and disclosure of the employer's compensation cost for pension benefits for the reporting period and of the employer's related liability for employees' pension benefits as of the end of the reporting period. Pension benefits constitute one element of employee compensation and, as with other forms of compensation, the cost of that compensation is to be accrued and recognized as an expense in the period incurred.
(35)	For pension costs that have been accrued but not funded, a corresponding liability for the unfunded obligation is to be recognized on the balance sheet. An employer with an overfunded pension obligation has an asset for the amount overfunded. Absent convincing evidence to the contrary, the terms of the plan that define the benefits an employee will receive (the plan's benefit formula) provide the most relevant and reliable indication of how pension costs and obligations are incurred.
(10–14, 39)	The Board recognizes that computation of the current period's pension expense and of the end of period pension obligation requires the use of estimates as well as the prediction of events over which the employer has little or no control. Actuarial assumptions include discount rates and probability of payment. The necessity of making and incorporating such estimates and predictions does not diminish the importance of recognizing the cost and obligation in order to reflect on the financial statements of the firm, the economic implications and consequences for the employer of providing pension benefits for employees.
Introduction (1–5)	*History of pension accounting, not appropriate for inclusion in body of standard, perhaps relegate to an appendix—or eliminate.*
Scope (7, 8, 9)	**B. Scope and Definitions** Pension plans in the U.S. are governed by many laws and regulations. Generally these require that pension plans be funded by the employer and that the assets funding the pensions be transferred to the pension trustee. Pension plans take many forms. Frequently, pension benefits provide for periodic payment to retired employees or to their survivors, but they may also include lump sum payments or other types of benefits. All such plans are included within the scope of this standard. Statutory funding requirements should have no effect on the recognition of the cost and liability associated with pensions.

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	Likewise, an employer's obligation to provide pension benefits may take a variety of forms and may be financed in different ways. This Statement applies to any arrangement that is similar in economic substance to a pension plan regardless of the particular terms of the plan or the form of financing. This Statement applies to a written plan as well as to a plan whose existence may be implied from a well-established but perhaps unwritten practice of paying postretirement benefits.
(12)	**Pension benefits.** Pension benefits are part of the compensation paid to an employee for services. Generally, but not always, the amount of benefit to be paid depends on a number of future events (including, for example, the employee's years of service, the employee's compensation, how long the employee and any survivor lives) that are incorporated into the computation of the benefit. The total amount of the promised benefit can only be estimated.
(16, 21, 24)	**Pension (service) cost.** This is the current period cost of the employer of providing pension benefits to employees for the services rendered during the period. The actuarial present value of these benefits is generally determined by the terms of the plan. This cost may include several additional components, including but not limited to: the impact of plan amendments, including retroactive enhancements; and changes in actuarial assumptions related to employees (e.g., age at retirement, years of retirement).
(22)	**Pension (financing) cost.** The current period financing cost of the pension plans includes the interest cost on the gross liability net of the change in the fair market value of the plan assets, adjusted for contributions and disbursements.
(36)	**Net Pension obligation (asset).** The accumulated liability of the employer for the employees' pension benefits less the fair value of plan assets.
(15–53)	*These paragraphs provide both detailed definitions of terms, including components of periodic net pension cost and measures of the accumulated pension obligation, and detailed rules as to the accounting for the cost and the liability. Some of these terms are not consistent with the Conceptual Framework. In addition, the Committee finds that several of the terms together with the required accounting treatment are inconsistent with the underlying economics of providing pension benefits for employees. The Committee points specifically, as examples of uneconomic treatment, to the provisions in (25) for amortization of the cost of retroactive benefits, to (29) on nonrecognition of gain or loss, to (32) for required amortization of an unrecognized gain or loss when that gain or loss exceeds a 10 percent threshold, to (36) for the minimum liability computation, and to (37) for the recognition of an intangible asset to offset the minimum liability in (36).* *We eliminate both the detailed terminology and the detailed reporting rules.*

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(54)	**C. Disclosure Requirements** This standard requires the employer to provide disclosures necessary for understanding the source and amounts of the reported pension cost and pension obligation. The underlying assumptions used in the computations are integral to such an understanding. These disclosures must include but are not limited to: a. A description of the plan including employee groups covered, type of benefit formula, funding policy, and the nature and effect of significant matters affecting comparability of information for all periods presented. b. Actuarial present value of benefits attributed by the plan's benefit formula to services rendered by employees during the reporting period including the key assumptions behind the computation (the service cost component). c. Assumptions and computations supporting the financing cost component of pension cost. d. Actuarial present value of all benefits attributed by the plan's benefit formula to employee service rendered prior to the current reporting period. e. Actuarial present value of all vested pension benefits as of the reporting date. f. Description of the plan assets as of the reporting date including the types of assets held and their fair market value. g. Schedule reconciling the change in the fair market value of plan assets from the previous reporting date, including, but not limited to the following: i) actual return on plan assets ii) employer's contribution during the period iii) benefits paid to employees during the period iv) realized gains and losses on plan assets during the period v) unrealized gains and losses on plan assets during the period h. Amount of pension cost deductible for federal income tax purposes. i. Key actuarial assumptions. j. Effect of changes in actuarial assumptions on the current period pension cost and the end of the period pension liability. k. Expected impact of statutory funding requirements on liquidity and financial position.
(55–75)	*We exclude these paragraphs because they provide detailed rules for employers with two or more plans, for annuity contracts and other life insurance company contracts, for defined contribution plans, for multiple employer plans, etc., all of which we believe are covered conceptually in the above paragraphs.*

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(76–77)	**Transition Rules.** *As indicated, we exclude transition rules. The cumulative effect of the accounting change would be shown as such in the income statement of the year of change.*
Appendix B	*Contains detailed implementation guidance using examples. Eliminate.*
Appendix D	**D. Glossary** (*Eliminate most terms. Retain the following. The actual definitions are provided below. Some of the definitions are taken directly from SFAS No. 87 and some are modifications.*) Actual return on plan assets Actuarial funding method Actuarial present value Assumptions Benefits Interest cost Pension benefit formula Plan assets Service Service cost Vested benefit obligation Vested benefits
Appendix C	**E. Appendix** *History of U.S. pension accounting. Not part of a conceptual standard. Retain or eliminate.*

GLOSSARY

This appendix contains definitions of certain terms used in accounting for pensions.

Actual return on plan assets. The difference between the fair value of plan assets at the end of the period and the fair value at the beginning of the period, adjusted for contributions and payments of benefits during the period.

Actuarial funding method. Any of several techniques that actuaries use in determining the amounts and incidence of employer contributions to provide for pension benefits.

Actuarial present value. The value, as of a specified date, of an amount or series of amounts payable or receivable thereafter, with each amount adjusted to reflect (a) the time value of money (through discounts for interest) and (b) the probability of payment (by means of decrements for events such as death, disability, withdrawal, or retirement) between the specified date and the expected date of payment.

Actuarial assumptions. Estimates of the occurrence of future events affecting pension costs, such as mortality, withdrawal, disablement and retirement, changes in compensation and national pension benefits, and discount rates to reflect the time value of money.

Benefits. Payments to which participants may be entitled under a pension plan, including pension benefits, death benefits, and benefits due on termination of employment.

Interest cost. The accrual of interest on the total pension liability over the reporting period.

Pension benefit formula. The basis for determining payments to which participants may be entitled under a pension plan. Pension benefit formulas usually refer to the employee's service or compensation or both.

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Plan assets. Assets—usually stocks, bonds, and other investments—that have been segregated and restricted (usually in a trust) to provide benefits. Plan assets include amounts contributed by the employer (and by employees for a contributory plan) and amounts earned from investing the contributions, less benefits paid.

Service. Employment taken into consideration under a pension plan. Years of employment before the inception of a plan constitute an employee's past service; years thereafter are classified in relation to the particular actuarial valuation being made or discussed. Years of employment (including past service) prior to the date of a particular valuation constitute prior service; years of employment following the date of the valuation constitute future service; a year of employment adjacent to the date of valuation, or in which such date falls, constitutes current service.

Service cost. The actuarial present value of benefits attributed by the pension benefit formula to services rendered by employees during that period.

Vested benefit obligation. The actuarial present value of vested benefits.

Vested benefits. Benefits for which the employee's right to receive a present or future pension benefit is no longer contingent on remaining in the service of the employer. (Other conditions, such as inadequacy of the pension fund, may prevent the employee from receiving the vested benefit.)

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