Chapter 2

Conceptual Framework for Financial Reporting

Learning Objectives

- Purpose and status of the *Conceptual Framework for Financial Reporting*
- Objective of general purpose financial reporting
- Qualitative characteristics of useful financial information
- Underlying assumption – Going concern
- Recognition of the elements of financial statements
- Measurement of the elements of financial statements
- Concepts of capital and capital maintenance
- Concept of the reporting entity
- Significant judgments that are required in applying the concepts.

Important Role of the *Conceptual Framework*

- It assists the IASB in the process of developing new IFRS, improving existing IFRS, and promoting international harmonization of accounting standards, by providing a basis for reducing the number of alternative treatments permitted in IFRS;
- It assists national standard setting bodies in developing national standards;
- It assists preparers in applying IFRS, auditors in providing an opinion on whether the financial statements are in accordance with IFRS and users in interpreting the information presented in IFRS financial statements; and
- It provides others interested in IFRS with the IASB's approach to the formulation of IFRS.

IFRS HIERARCHY

- Using IFRS, entities are required to consider the *Conceptual Framework* when no standard or interpretation is specifically applicable.
- For example, in accordance with IAS 8, in the absence of an IFRS that specifically applies to a transaction, other event or condition, management should use its judgment and consider the following sources in descending order:
  - Requirements in IFRS dealing with similar and related issues; and
  - Definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses in the *Framework* (IAS 8, 11).

STATUS

- In 1989, the IASC, the IASB's predecessor, approved a 110 paragraph document called the *Conceptual Framework for the Preparation and Presentation of Financial Statements*.
- From October 2002, the IASB and the FASB have been working jointly on the development of the framework as part of the convergence process agreed to in a Memorandum of Understanding, known as the Norwalk Agreement.
- In September 2010, both the FASB and the IASB issued converged chapters dealing with the objectives of financial reporting and the qualitative characteristics of useful financial information.
- In 2010 the IASB and FASB suspended work on the Conceptual Framework project so that they could focus on those projects that arose from the financial crisis.
- However, in 2011, after conducting a public consultation during which many respondents identified the Conceptual Framework project as a priority project, the IASB decided to resume the project. As of late 2014, the project is an IASB-only project.
- In 2013, the IASB issued a Discussion Paper, A Review of the Conceptual Framework for Financial Reporting.
- In May 2015, the IASB published for public comment an Exposure Draft proposing a revised *Conceptual Framework for Financial Reporting*.

Eight Phases of the Conceptual Framework Project

Phase A	Objectives and Qualitative Characteristics
Phase B	Definitions of Elements, Recognition and Derecognition
Phase C	Measurement
Phase D	Reporting Entity Concept
Phase E	Boundaries of Financial Reporting, and Presentation and Disclosure
Phase F	Purpose and Status of the Conceptual Framework
Phase G	Application of the Conceptual Framework to Not-for-profit Entities
Phase H	Remaining Issues, if any

The conceptual Framework

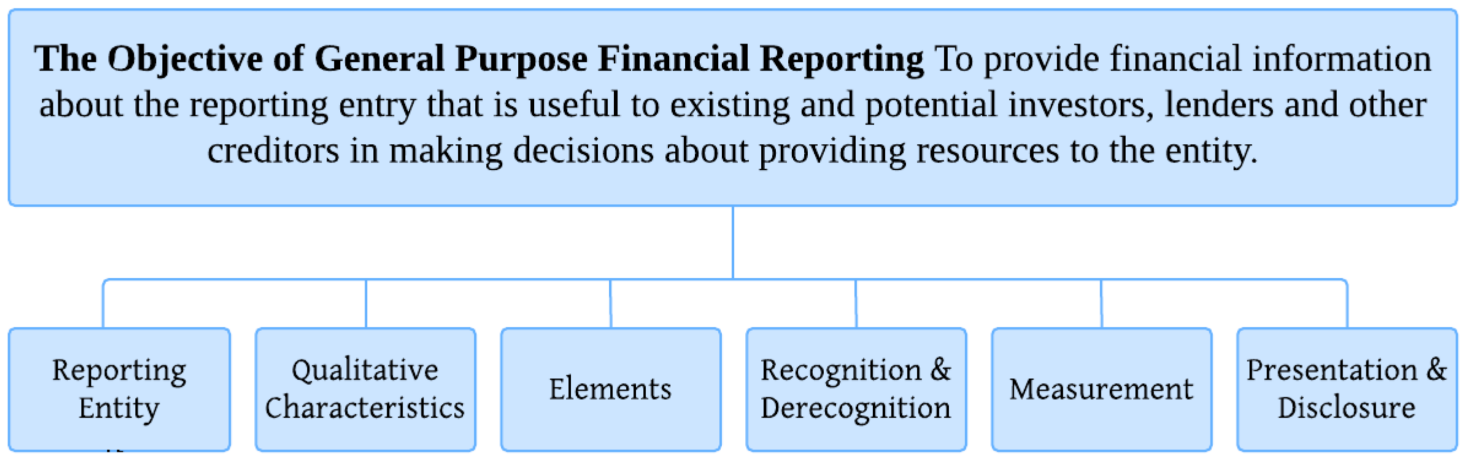
SCOPE

» It sets out the objective of general purpose financial reporting and the concepts underlying the preparation and presentation of financial statements for external reporting that flow from the objective.

» It covers:

- Objective of financial reporting;
- Qualitative characteristics of useful financial information;
- Definition, recognition and measurement of the elements from which financial statements are constructed; and
- Concepts of capital and capital maintenance.

Illustration 2-2. Components of the *Conceptual Framework*



Objective of General Purpose Financial Reporting

- Provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity (buy, sell, hold equity or debt instruments or provide/settle loans)
  - Who cannot require reporting entities to provide information directly to them (OB 5);
  - Who have a reasonable knowledge of business and economic activities and who review and analyze the information diligently (QC 32).

Objective of General Purpose Financial Reporting, *cont.*

- Primary users' expectations about their returns (e.g., dividends, interest and projected increase in market value) depend on **their assessment** of the amount, timing and uncertainty of (the prospects for) future net cash inflows to the entity.
- Information about a reporting entity's economic resources and claims can help users to determine the entity's financial strengths and weaknesses, liquidity, solvency, needs for additional financing and future cash flows.
- Information about changes in an entity's economic resources and claims that result from an entity's financial performance or other events, e.g., issuing debt or equity instruments, helps users to determine the entity's return on its economic resources and its prospects for future returns and cash flows.

Objective of General Purpose Financial Reporting, *cont.*

- To assess the prospects of future net cash inflows to an entity, primary users need information about:
  - the resources of the entity;
  - claims against the entity; and
  - how efficiently and effectively the entity's management and governing board have discharged their responsibilities to use the resources provided
    - (e.g., protecting the entity's resources from unfavorable effects of economic factors such as price or technological changes)(stewardship).

Objective of General Purpose Financial Reporting , *cont.*

- General purpose financial reports are not intended to present the value of a reporting entity (but may assist in making forecasts of an entity's future cash flows and profit or loss, as well as equity value).
- Financial reports (to a large extent) are based on estimates, judgments and models rather than exact depictions. Therefore, the *Conceptual Framework* establishes the concepts that underlie those estimates, judgments and models.

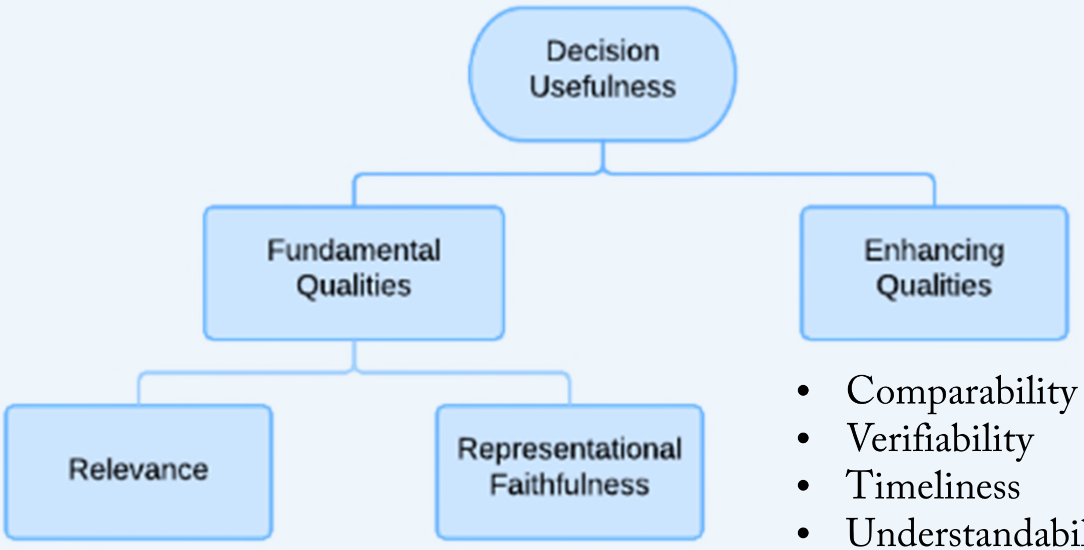
Objective of General Purpose Financial Reporting, cont.

- Accrual accounting is an important basis for assessing the entity's economic resources and claims and changes in economic resources and claims during the period.
- Information about an entity's cash flows during a period also helps users in assessing the entity's ability to generate future net cash inflows.

Qualitative Characteristics of Useful Financial Information

- The qualitative characteristics of accounting information identify the types of information that are likely to be most useful to existing and potential investors, lenders, and other creditors in making decisions about the reporting entity on the basis of information in its financial reports (QC 1).
- If financial information is to be useful, it must be ***relevant*** and ***faithfully represent*** what it purports to represent (fundamental qualities).
- Financial information is enhanced if it is **comparable, verifiable, timely and understandable.**
- However, financial information cannot be useful without both relevance and faithful representation.
- The cost is a pervasive constraint on the entity's ability to provide useful financial information.

Illustration 2-3. Qualitative Characteristics of Useful Accounting Information



Enhancing Qualities:

- Comparability
- Verifiability
- Timeliness
- Understandability

Relevance:

- Predictive value
- Confirmatory value
- Materiality

Representational Faithfulness:

- Complete
- Neutral
- Free from error

Pervasive Constraint - Costs

Fundamental Qualitative Characteristic: Relevance

» **Relevance**: Capable of making a difference in the decisions made by users:
- Predictive value;
- Confirmatory value;
- Materiality.

» Financial information has predictive value if it can be used as an input in making predictions about the potential outcomes of past or current events. Information that has confirmatory value helps users to confirm or correct prior evaluations (predictions).

MATERIALITY

- »Information is material if omitting it or misstating it could influence decisions that users make on the basis of financial information about a specific reporting entity (QC 11).
- »Materiality is an element of relevance, because immaterial information does not affect users' decisions.
- »Materiality is entity-specific consideration and is based on the nature and relative size of the specific items to which the information relates.

Example 2.2. Predictive and confirmatory value

In its financial statements for the year 20X1, Bahia Entity (BE) provides its sales revenue and cost of goods sold in the amount of $800,000 and $600,000 respectively.

This financial information has predictive value because the total sales revenue and cost of goods sold for the current year can be used to predict these items as well as the amount of BE's earnings for future years. It also has confirmatory value because the total sales revenue and cost of goods sold for the current year can be compared to predictions that were made in prior years for the current year. Consequently, the results of those comparisons should help users to correct and improve the processes used to make predictions.

Example 2.3. Materiality

In 20X4, before Chengdu Entity's (CE) 20X3 financial statements were authorized for issue, the entity discovered an error in the calculation of interest expense. If the error had been corrected, CE would breach a borrowing covenant on a significant loan with a local bank.

This prior period error is material and must be corrected because it could influence the economic decisions of users made on the basis of 20X3 financial statements.

Fundamental Qualitative Characteristic: Faithful Representation

- **Faithful representation**: faithfully represents the phenomena that it purports to represent:
  - Completeness (it contains all information necessary for a user to understand the phenomenon being depicted);
  - Neutrality (without bias); and
  - Free from error (ideally).

- Faithful representation replaced 'reliability.'

Example 2.4. Faithful representation

Durban Entity (DE) acquired a building in 20X1 for $500,000. The building is held to earn rentals and for capital appreciation. DE chooses the fair value model to measure the building after initial recognition. The building is valued at $650,000 on December 31, 20X4, the amount provided by the valuation expert.

A representation of the fair value of investment property is faithful because DE disclosed significant assumptions that were used in determining the fair value of the building and a statement that the determination of fair value was supported by market evidence.

Enhancing Qualitative Characteristics

- **Comparability**: like things must look alike and different things must look different
- **Verifiability**: occurs when knowledgeable and independent observers could reach consensus, although not necessarily complete agreement
- **Timeliness**: have information available to decision-makers in time to be capable of influencing their decisions
- **Understandability**: classify, characterize and present information clearly and concisely.

Comparability

- Comparability enables users to identify and understand similarities in, and differences among, items (QC 33).
- Comparability of financial information is one of the most important reasons for the development of financial reporting standards. Consistency is related to comparability and refers to the use of the same methods for the same item either from period to period within a reporting entity or in a single period across entities.
- Comparability should not be confused with uniformity in the use of the same accounting method by different firms. It should be seen as a process that results in a systematic choice between accounting methods by an entity dependent upon the nature and its operating environment but otherwise independent of the location in which the entity operates.

Example 2.7 Comparability

Gdansk Entity (GE) is preparing its statement of financial position for the period ended December 31, 20X3. GE is also required to present a statement of financial position for the previous period to enhance comparability. This allows users to identify and understand similarities in, and differences among, account balances from year to year.

Cost Constraint

- »Reporting financial information imposes costs, and those costs need to be justified by the benefits of providing that information.
- »The cost constraint means that the benefits of reporting particular information should exceed the costs incurred to provide and use the information.
- »The process of evaluating benefits and costs is based on judgment because the costs and especially benefits are not always measurable.

Example 2.11 Cost Constraint

A furniture manufacturing entity, when assigning costs to inventory and cost of goods sold, classifies the cost of items such as screws, clips and glue as indirect costs (included in manufacturing overhead) of producing different types of furniture. As a result of this classification, the cost of manufacturing overhead items is allocated to different types of furniture based on the selected allocation basis rather than traced directly to products, because it is not economically feasible to do so (the costs would exceed benefits).

Although managers prefer to make decisions on the basis of direct costs rather than indirect costs, the estimated benefits of directly assigning some materials may be less than the estimated cost to do the assigning.

The Framework (1989)

Going Concern Assumption

- In most cases, an entity prepares its financial statements on a going concern assumption – that the entity has neither the intention nor the need to liquidate its operations (or curtail materially the scale of its operations) but will continue in operation for the foreseeable future.

- Consequently, unless there is evidence to the contrary, it is assumed that an entity will have a long enough life to be able to fulfill its objectives and commitments.

Elements of Financial Statements

- The *Conceptual Framework* defines five (5) financial statement elements.
- Three relate to the measurement of financial position: **Assets, Liabilities**, and **Equity**.
- Two relate to the measurement of performance (profit): **Income** and **Expenses**.

Current Definitions

Asset	*Liability*
• A resource controlled by the entity... • As a result of past events… • From which future economic benefits are expected to flow to the entity.	• A preset obligation of the entity… • Arising from past events… • The settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

Problems with Current Definitions (Conceptual Framework Project)

- What does 'expected' mean and how does it relate to 'probable' in the recognition criteria?
- What is a resource?
- What is an obligation?

Proposed Definitions (Conceptual Framework Project)

Asset	*Liability*
A present economic resource controlled by an entity as a result of past events.	A present obligation of the entity to transfer an economic resource as a result of past events.

An economic resource is a right or other source of value, that is **capable** of producing economic benefits.

Example 2.12. Definition of an asset

Global Entity (GE) has a receivable from XYZ Company originating from a sale that took place on December 15, 20x1. The receivable is still outstanding as of December 31, 20x1, the reporting date. GE also expects to receive a large sum of money from the Environmental Protection Agency (EPA) upon completion of its environmentally friendly production facility. Installation is expected to be completed by late January 20x2.

The receivable meets the definition of an asset because it will produce additional cash inflows, it belongs to GE, and it exists as of the date of the financial statements.

Because the EPA is not obligated to pay anything unless the facility is completed, these future cash inflows are not a "present" economic resource and, thus, do not meet the definition of an *asset*.

Example 2.13. Definition of a liability

Berlin Entity (BE) has a bank loan in the amount of $1,000,000, payable semi-annually for the next 10 years. Also, in a board meeting, BE decides it will donate $5,000,000 to a local charity. The payment is expected to be made in two months, but BE can choose not to make the donation at any time.

The loan meets the definition of a liability because it requires an outflow of economic resources, the entity is required to bear the obligation, and the obligation exists as of the date of the financial statements. The expected future donation does not constitute a liability because the payment is not required of BE at the date of financial statements.

EQUITY

- Equity is the residual interest in the assets of the entity after deducting all its liabilities.

- It is simply the difference between assets and liabilities.

$$Equity = Assets - Liabilities$$

Example 2.14. Definition of equity

In 20X1, its first year of operation, Malaga Entity (ME) issues 10,000 no-par shares for cash at $10 per share. ME reported a profit of $200,000 and paid dividends of $50,000. At December 31, 20X1, total assets are $620,000 (including revaluation of building $20,000) and liabilities $350,000.

At December 31, 20X1, ME reported total equity of $270,000 which is the difference between total assets ($620,000) minus total liabilities ($350,000). ME separately reported share capital of $100,000, retained earnings of $150,000 and revaluation reserve of $20,000.

Income

» Income is increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.

» Important components of the definition of income are:

- an increase in assets, a decrease in liabilities, or a combination of both;
- that increase or decrease must result in an increase in equity; and
- the increase in equity must result from something besides the contributions of equity participants.

Expenses

» Expenses are decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants.

» Important components of the definition of an expense are:

- a decrease in assets, an increase in liabilities, or a combination of both;
- that increase or decrease must result in a decrease in equity; and
- the decrease in equity must result from something besides distributions to equity participants.

Capital Maintenance Adjustments

- The revaluation or restatement of assets and liabilities that gives rise to increases or decreases in equity and meets the definition of income and expenses is not included in the income statement under certain concepts of capital maintenance.
- Instead these items are presented in equity as capital maintenance adjustments or revaluation reserves.

Recognition

- Recognition is the process of incorporating in the financial statements an item that meets the definition of an element and satisfies the criteria for recognition (unless results do not provide useful information or costs exceed benefits).
- The two criteria for recognition in the financial statements of an item that meets the definition of an element are:
  1. **Probability of future economic benefit** - it is probable than any future economic benefit associated with the item will flow to or from the entity; and
  2. **Reliability of measurement** - the item has a cost of value that can be measured with reliability.

Measurement

- Measurement is the process of determining the monetary amounts at which the elements of the financial statements are to be recognized and carried in the balance sheet and income statements. This involves the selection of the particular basis of measurement.
- There are various measurement models available in IFRS.
- The *Framework* currently lists four measurement bases to be used in financial statements.

Concepts of Capital and Capital Maintenance

- The *Framework* distinguishes between a financial concept of capital and a physical concept of capital. Each concept of capital leads to a different basis for measuring assets and determining profit.
- Most entities use a financial concept of capital in preparing their financial statements.
- Under a financial concept of capital (invested money or invested purchasing power) capital is identified with the net assets or equity of the entity.
- Under a physical concept of capital, such as operating capability, capital is defined in terms of physical productive capacity of the entity (e.g., units of output per day).

Three Features of a Reporting Entity (Conceptual Framework Project)

- Economic activities of an entity are being conducted, have been conducted, or will be conducted.
- Those economic activities can be objectively distinguished from those of other entities and from the economic environment in which the entity exists.
- Financial information about the economic activities of that entity has the potential to be useful in making decisions about providing resources to the entity and in assessing whether the management and the governing Board have made efficient and effective use of the resources provided.

Significant Estimates and Judgments

- Examples of significant judgments that may be required in applying the concepts in the *Conceptual Framework* include:
  - Applying the materiality concept;
  - Assessing the probability of future economic benefit flows; and
  - Developing an accounting policy for a transaction, or other event or condition, if IFRS does not specifically address this transaction, or other event or condition.

Key Differences between IFRS and U.S. GAAP

- Authoritative status of frameworks. The frameworks of the FASB and IASB currently differ in terms of their authoritative status. Currently, the Concept Statements of the FASB are nonauthoritative (ASC 105-10-05), not yet a part of the U.S. GAAP hierarchy; however, the FASB has announced that it is likely to increase the authoritative status of its framework. The IASB *Conceptual Framework* is a third level to be followed in the IFRS hierarchy.
- Definition differences. The frameworks have different definitions for assets, liabilities and probable.

FUTURE DEVELOPMENTS

- On May 28, 2015, the IASB published for public comment an Exposure Draft proposing a revised *Conceptual Framework for Financial Reporting*.
- The Exposure Draft clarifies some aspects of the existing *Conceptual Framework* and addresses the following areas that are either not covered, or not covered in enough detail, in the existing *Conceptual Framework*:
  - measurement;
  - financial performance (including the use of other comprehensive income);
  - presentation and disclosure;
  - derecognition; and
  - the reporting entity.