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Conceptual Framework for Financial Reporting

Conceptual Framework

- **IASB published its *Framework for the Preparation and Presentation of Financial Statements* in 1989**
  - Not a standard in its own right
  - Does not override any specific IFRS pronouncement
  - Guides IASB when developing or amending standards
  - Guides preparers when developing an accounting policy to deal with an issue not covered by existing standards
- **IASB and FASB's convergence agenda included new common Conceptual Framework**
  - Due to pressure on resources the joint project was abandoned
  - Following its Agenda Consultation in 2012 the IASB added the project to its own agenda
    - Discussion Paper in 2013 and ED due in 2015

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Contents

- **Conceptual Framework from September 2010**
  - Chapter 1 – Objective of general purpose financial reporting (Part of FASB's Concepts Statement No. 8)
  - Chapter 2 – Reporting entity (to be added)
  - Chapter 3 – Qualitative characteristics of useful financial information (part of FASB's Concepts Statement No. 8)
  - Chapter 4 – Remaining text of 1989 Framework
    - Underlying assumption
    - Elements of financial statements – definition, recognition and measurement
    - Concepts of capital and capital maintenance

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Objective of Financial Reporting

- **Chapter 1 – 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 or hold equity and debt instruments; provide or settle loans and other forms of credit
  - Primary users of general purpose financial reports cannot require entity to report information directly to them; regulators can, so they are not primary users
- **Can't provide all the information needed by users**
- **Not designed to show the value of reporting entity**

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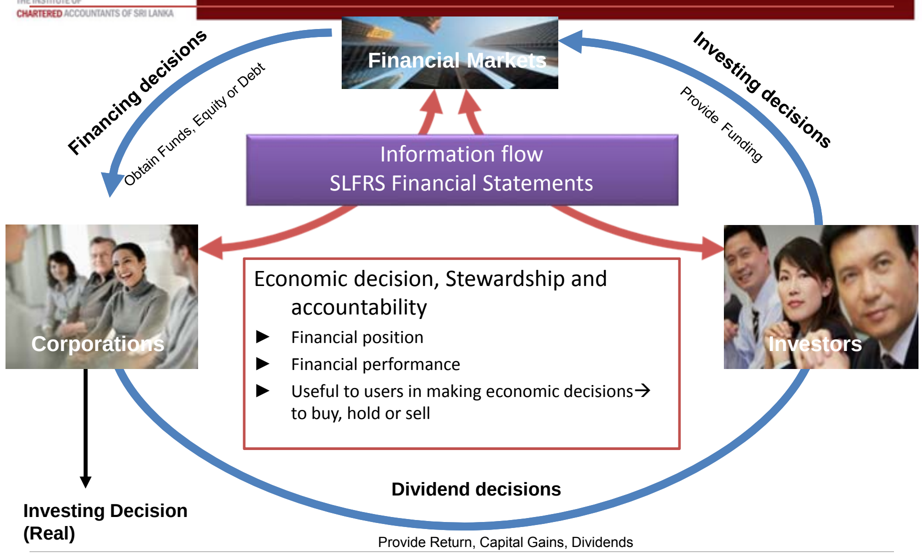
Where SLFRS fits in?



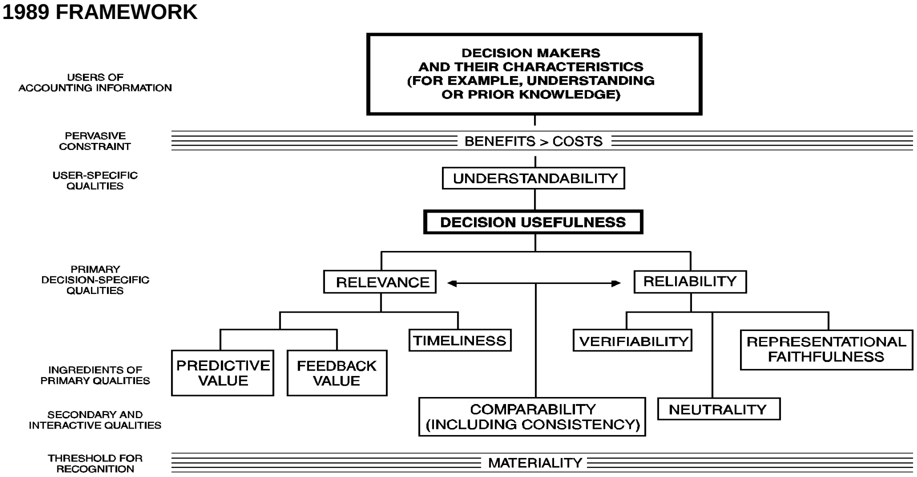
Qualitative Characteristics

- **Chapter 3 – Qualitative characteristics of useful financial information**
  - Financial reports provide information about entity's economic resources, claims against it and the effect of transactions and other events and conditions that change those resources and claims
  - Chapter 3 establishes two 'fundamental' qualitative characteristics of useful financial information – relevance and faithful representation
    - It lists four 'enhancing' characteristics – comparability, verifiability, timeliness and understandability

FIGURE 1

1989 FRAMEWORK

A HIERARCHY OF ACCOUNTING QUALITIES



Fundamental Characteristics

- **Relevance**
  - Relevant financial information can make a difference to users' decisions. Might be predictive, confirmatory or both
  - Materiality is part of relevance
- **Faithful representation**
  - Complete, neutral and free from error
  - Acknowledges limitations on faithful representation
    - Uncertainties, estimates and assumptions

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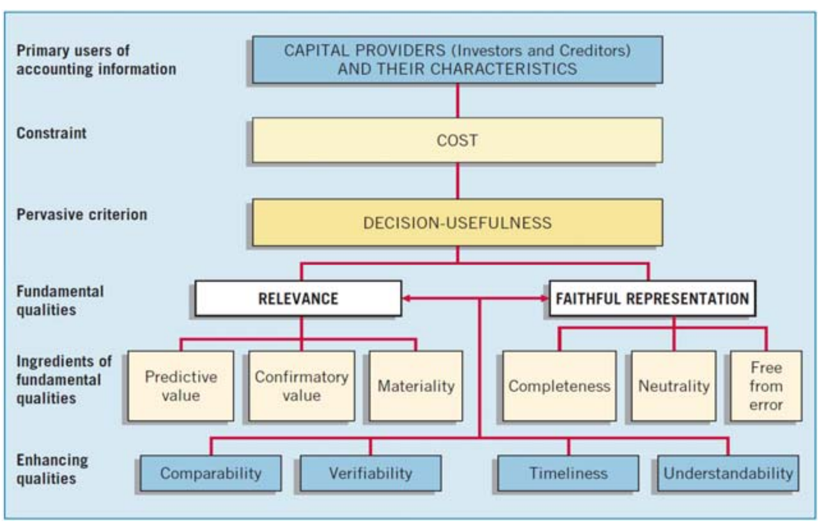
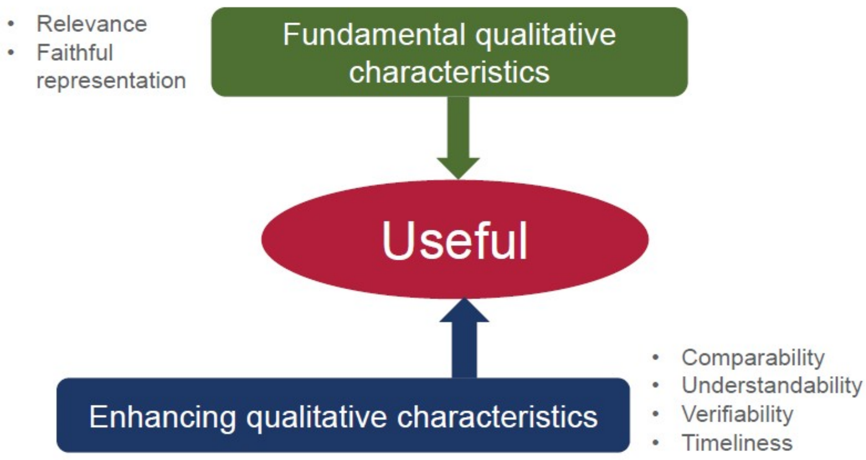
Hierarchy of Accounting Qualities



Qualitative characteristics



Fundamental qualitative characteristics

- *Relevance*: capable of making a difference in users' decisions
  – predictive value
  – confirmatory value
  – materiality (entity-specific)
- *Faithful representation*: faithfully represents the phenomena it purports to represent
  – completeness (depiction including numbers and words)
  – neutrality (unbiased)
  – free from error (ideally)

  Note: faithful representation replaces reliability

Enhancing Qualitative characteristics

- If financial information is to be useful, it **must** be relevant and faithfully represent what it purports to represent (ie fundamental qualities).
  - Financial information without both relevance and faithful representation is not useful, and it cannot be made useful by being more comparable, verifiable, timely or understandable.
- The usefulness of financial information is enhanced if it is comparable, verifiable, timely and understandable (ie enhancing qualities—less critical but still highly desirable)
  - Financial information that is relevant and faithfully represented may still be useful even if it does not have any of the enhancing qualitative characteristics

Enhancing Characteristics

- **Comparability**
  - Enables users to identify similarities and differences – over time and between entities
  - Consistent application of accounting methods helps
- **Verifiability**
  - Where knowledgeable and independent observers can decide whether a particular depiction of an event or transaction is a faithful representation
- **Timeliness – necessary for ability to influence decisions**
- **Understandability**
  - Classify, characterise and present information clearly and concisely

Constraint on Useful Financial Reporting

- **Cost is a pervasive constraint**
  - Costs of providing information should be justified by benefits
  - Costs fall on both providers and users
- **Benefits include enabling individuals to make more informed decisions and the more efficient functioning of markets in general**
- **IASB applies the cost constraint in developing standards**
  - Problem is that different parties assess the balance between costs and benefits differently – IASB must decide on balance for financial reporting generally

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Chapter 4 – Underlying Assumption

- **Going concern**
  - Normally the statements reflect an assumption that an entity will continue in operation for the foreseeable future
    - i.e. neither intend nor need to liquidate or significantly curtail scale of operations
  - If not a going concern, must prepare statements on a different basis (e.g. break up) and disclose

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Summary

- Reporting financial information that is relevant and faithfully represents what it purports to represent helps users to make decisions with more confidence (ie financial information must possess the fundamental qualitative characteristics).
- SLFRS requirements must be cost-beneficial
  - Applying the enhancing qualitative characteristics is an iterative process that does not follow a prescribed order. Sometimes, one enhancing qualitative characteristic may have to be diminished to maximise another qualitative characteristic.

Chapter 4 – Elements of Financial Statements: Financial Position

- **Asset**
  - Resource controlled by the entity
  - As a result of past events
  - From which future economic benefits are expected to flow to the entity
- **Liability**
  - A present 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
- **Equity**
  - A residual interest in the assets of the entity after deducting all its liabilities

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Chapter 4 – Elements of Financial Statements: Performance

- **Income**
  - Increases in economic benefits
  - In form of inflows or enhancements of assets or decreases of liabilities
  - Result in increases in equity, other than those relating to contributions from equity participants
- **Expenses**
  - Decreases in economic benefits during the accounting period
  - In form of outflows or depletions of assets or incurrences of liabilities
  - Result in decreases in equity, other than those relating to distributions to equity participants
- **Capital maintenance adjustments**
  - Revaluation or restatement of assets and liabilities gives rise to increases or decreases in equity

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Chapter 4 – Recognition of the Elements

- **Recognition is the process of incorporating an item in the balance sheet or income statement**
- **An item that meets the definition of an element shall be recognised if:**
  - **a) It is probable that any future economic benefit associated with an item will flow to or from the entity, and**
  - **b) The item has a cost or value that can be measured with reliability**

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Chapter 4 – Recognition of the Elements

- An **asset** is recognised when it is probable that the **future economic benefits will flow to the entity** and the asset has a cost or value that can be **measured reliably**
- A **liability** is recognised when it is probable that an **outflow of economic benefits** will result from the settlement of a present obligation and the amount can be **measured reliably**

Chapter 4 – Recognition of the Elements

- **Income** is recognised when an **increase in future economic benefits** related to an increase in an asset or a decrease of a liability has arisen that can be **measured reliably**
- **Expenses** are recognised when a **decrease in future economic benefits** related to a decrease in an asset or an increase of a liability has arisen that can be **measured reliably**

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Chapter 4 – Measurement

- **Measurement is the process of determining the monetary amounts at which the elements of the financial statements are to be recognised and carried in the statement of financial position**
  - Must choose measurement basis
- **Describes different bases that can be used:**
  - Historical cost
  - Current cost
  - Realisable (settlement) value
  - Present value
- **But little guidance and bypassed by standards**
  - IFRSs specify different bases or combinations of bases
    - Discussion Paper on *Conceptual Framework* considers three measurement categories – cost-based, current market prices including fair value and other cash-flow-based measurements

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Measurement concepts

- Measurement is the process of determining monetary amounts at which elements are recognised and carried. (CF.4.54)
- To a large extent, financial reports are based on estimates, judgements and models rather than exact depictions. The *Framework* establishes the concepts that underlie those estimates, judgements and models (CF.OB11)
- SLASC guided by objective and qualitative characteristics when specifying measurements

Measurement

The objective of measurement is to faithfully represent relevant information about:

- the resources of the entity and claims against the entity, and changes to those resources and claims
- how efficiently and effectively the entity's management and governing board have discharged their responsibilities to use the entity's resources.

A single measurement basis may not provide the most relevant information

Number of different measurements used should be smallest number necessary

Asset

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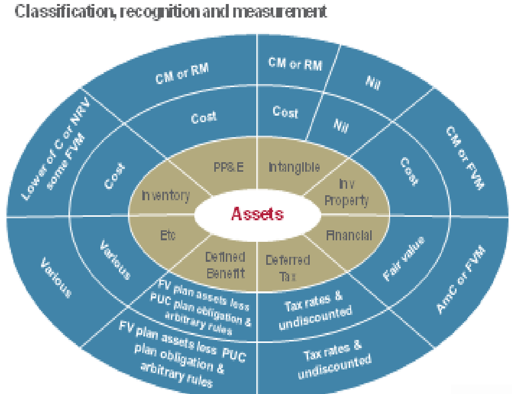
Classification, recognition and measurement



IFRS

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Liability

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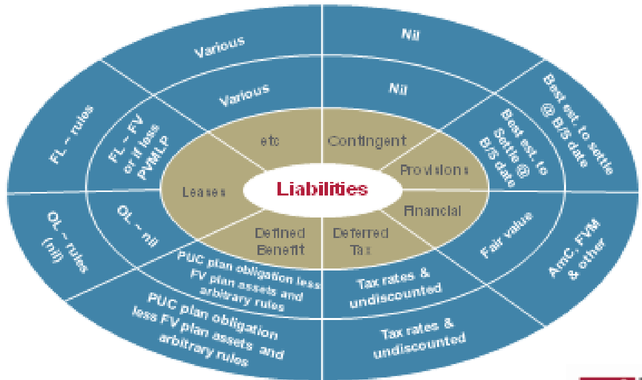
Classification, recognition and measurement



IFRS

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Measurement

Consider information produced in both:
- the statement of financial position (SFP); and
- the statement(s) of profit or loss and other comprehensive income (OCI)

Most relevant measure depends on:
- How an asset contributes to future cash flows (eg use, sell)
- How the entity will fulfil or settle a liability

Consider cost-benefit

Chapter 4 – Concepts of Capital Maintenance

- **Capital maintenance**
  - How an entity defines the capital that it seeks to maintain
- **Financial capital maintenance**
  - Profit is earned only if the financial amount of net assets at the end of the period exceeds the financial amount of net assets at the beginning of the period, after excluding any distributions to, and contributions from owners, during the period
  - Can be measured in nominal units or units of constant purchasing power
- **Physical capital maintenance**
  - Profit is earned only if the physical productive capacity of the entity at the end of the period exceeds the physical productive capacity at the beginning of the period
  - Requires current cost basis of measurement

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Common 'conceptual' misunderstandings

The *Framework* does **not**...	Clarification—the *Framework* Includes
include a matching concept	accrual basis of accounting—recognise elements when satisfy definition and recognition criteria
include prudence/conservatism concept	neutrality concept
include an element other comprehensive income (or a concept for OCI)	only the following elements—asset, liability, equity, income and expense
mention management intent or business model	

Common 'conceptual' misunderstandings continued

Misunderstanding	Clarification
Uniformity = comparability	Comparability is achieved when like things are accounted for in the same way. Comparability is not achieve when accounting rules require unlike things be accounted for in the same way

Common 'conceptual' misunderstandings continued

Misunderstanding	Clarification
There is a clear concept for the historical cost of an item	The *Framework* provides only a vague description—assets are recorded at the amount of cash or cash equivalents paid **or** the fair value of the consideration given to acquire them at the time of their acquisition. **What is cost** when: - advance/deferred payment? - purchased option exercised? - contingent purchase price?

Common 'conceptual' misunderstandings continued

Misunderstanding	Clarification
Principles are necessarily less rigorous than rules	Rules are the tools of financial engineers
There are few judgements and estimates in cost-based measurements	Inventory, eg allocate joint costs and production overheads PPE, eg costs to dismantle/restore site, useful life, residual value, depreciation method Provisions, eg uncertain timing and amount of expected future cash flows

Way forward

- After deliberation on the Comments for the Exposure Draft issued recently, revised Conceptual Framework will be issued by IASB.
- Target period is early 2017

THANK YOU

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