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Conceptual Framework for Financial Reporting (C/F)

Shakthi Karunananthan
CA Sri Lanka - Technical Division

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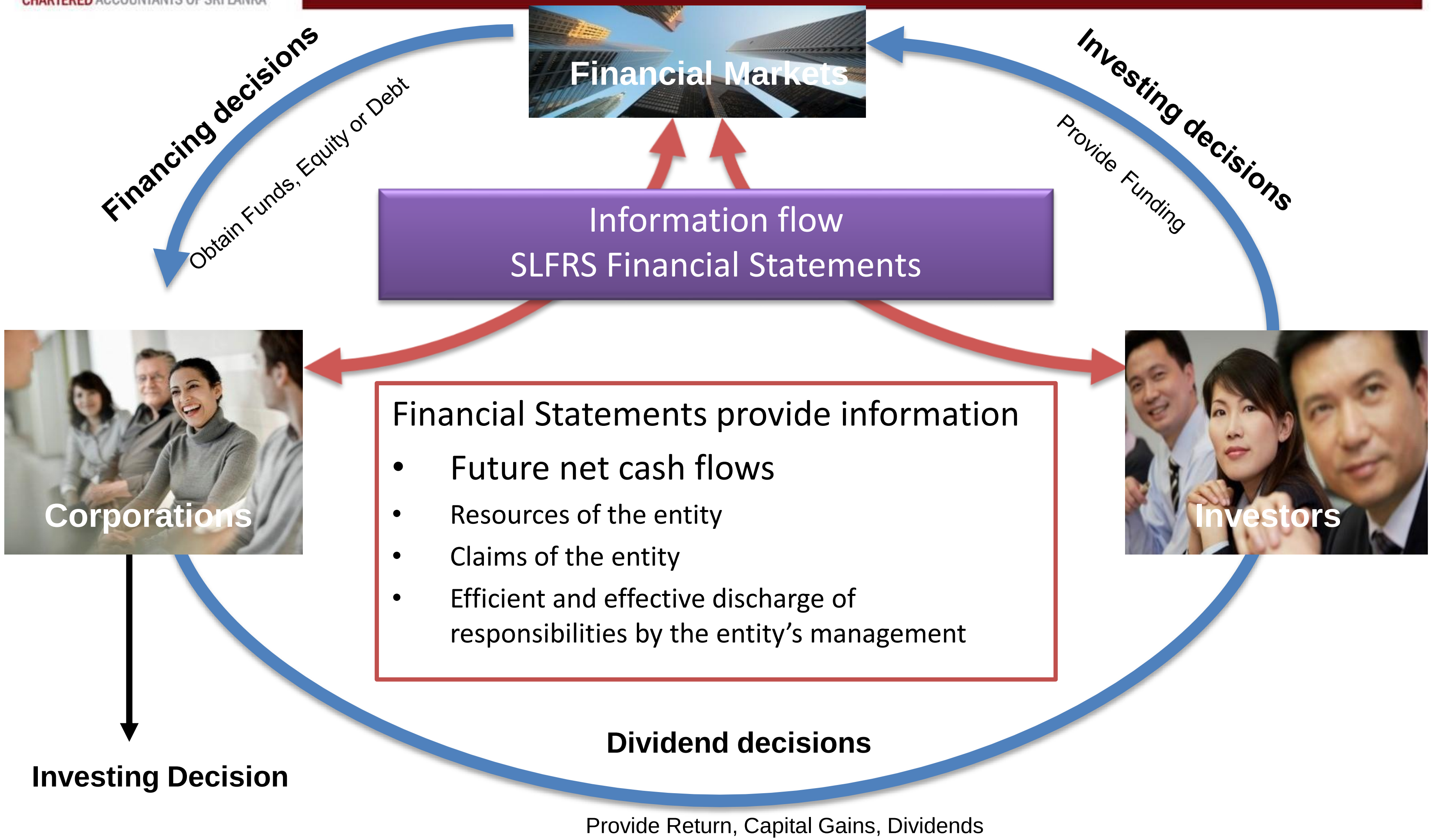
Existing Conceptual Framework for Financial Reporting

Purpose of Financial Statements



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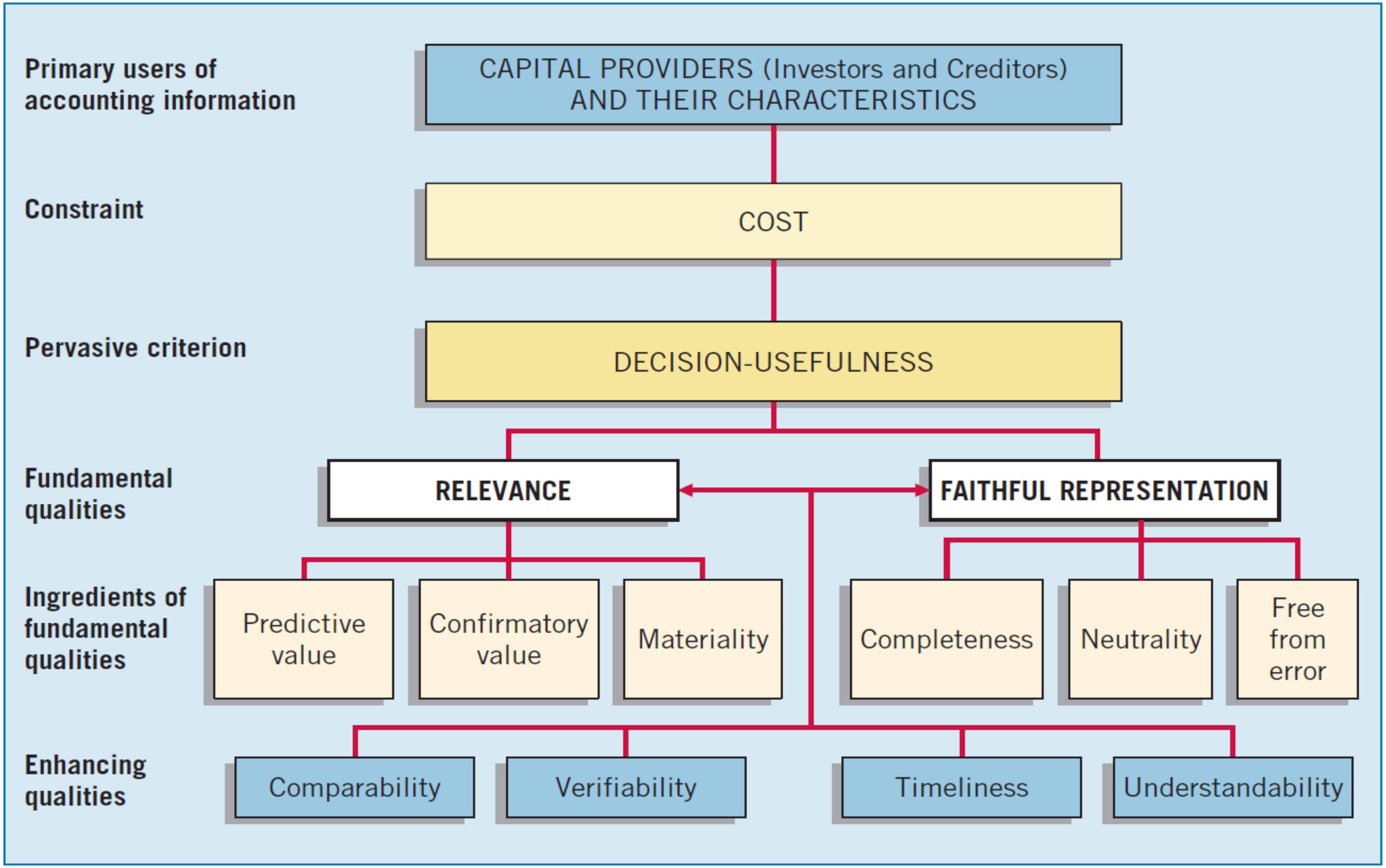
Contents

Conceptual Framework from 2010 to 2019

- 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

Hierarchy of Accounting Qualities



Background

- On March 29, 2018, the IASB published its revised Conceptual Framework for Financial Reporting.

- The revised Conceptual Framework includes:

  Chapter 1 :- The Objective of Financial Reporting

  Chapter 2 :- Qualitative characteristics of useful financial information

  Chapter 3 :- Financial statements and the reporting entity

  Chapter 4 :- The elements of financial statements

  Chapter 5 :- Recognition and derecognition

  Chapter 6 :- Measurement

  Chapter 7 :- Presentation and disclosure

  Chapter 8 :- Concepts of capital and capital maintenance

- The amendments are **effective for annual periods beginning on or after January 1, 2020 in Sri Lanka.**

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Amendments to the Conceptual Framework for Financial Reporting

Why Revised C/F

Previous Conceptual Framework
Issued in 1989 and partially revised in 2010

Priority

Updating

Filling Gaps

Clarifying

Revised Conceptual Framework
Issued in 2018 and will be effective in 2020

Background

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Main Changes

New Changes

Measurement	•Concepts on measurement, including factors to be considered when selecting a measurement basis
Presentation and Disclosure	•Concepts on presentation and disclosure, including when to classify income and expenses in other comprehensive income
Derecognition	•Guidance on when assets and liabilities are removed from financial statements

Main Changes

Updated

Definitions	• Definitions of an asset and a liability
Recognition	• criteria for including assets and liabilities in financial statements

Clarified

- Prudence
- Stewardship
- Measurement Uncertainty
- Substance over Form

Chapter 1- The Objective of Financial Reporting

Key changes

The Board reintroduced **stewardship** and clarified the resulting information need.

Stewardship

- Users of financial reports need information to help them assess management's stewardship. The *Conceptual Framework* explicitly discusses this need as well as the need for information that helps users assess the prospects for future net cash inflows to the entity.
- Existing and potential investors, lenders and other creditors need information to help them make those assessments.

Chapter 2 – Qualitative Characteristics of Useful Financial Information

Fundamental qualitative characteristics

Relevance

- information is relevant if it is capable of making a difference to the decisions made by users
- financial information is capable of making a difference in decisions if it has predictive value or confirmatory value

Faithful representation

- information must faithfully represent the substance of what it purports to represent
- a faithful representation is, to the maximum extent possible, complete, neutral and free from error
- a faithful representation is affected by level of measurement uncertainty

Enhancing qualitative characteristics

Comparability | Verifiability | Timeliness | Understandability

- these four qualitative characteristics enhance the usefulness of information
- but they cannot make non-useful information useful

Cost constraint

- the benefit of providing the information needs to justify the cost of providing and using the information

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Chapter 2 – Qualitative Characteristics of Useful Financial Information

Key changes

Reintroduced the concept of prudence and defined the concept of measurement uncertainty in assessing the usefulness of financial information.

Prudence

Neutrality is supported by the exercise of prudence. Prudence is the exercise of caution when making judgements under conditions of uncertainty. Prudence does not allow for overstatement or understatement of assets, liabilities, income or expenses.

Measurement uncertainty

Measurement uncertainty <u>does not prevent</u> information from being useful. However, in some cases the most relevant information may have such a high level of measurement uncertainty that the most useful information is information that is slightly less relevant but is subject to lower measurement uncertainty

Predictive Value

Information has predictive value if it can be used in making decisions about the eventual outcomes of past or current events.

Chapter 3 – F/Ss and Reporting Entity

Reporting entity	• an entity that is required, or chooses, to prepare financial statements • not necessarily a legal entity—could be a portion of an entity or comprise more than one entity
Financial statements	a particular form of financial reports that provide information about the reporting entity's assets, liabilities, equity, income and expenses

Consolidated financial statements	Unconsolidated financial statements	Combined financial statements
provide information about assets, liabilities, equity, income and expenses of both the parent and its subsidiaries as a single reporting entity	provide information about assets, liabilities, equity, income and expenses of the parent only	provide information about assets, liabilities, equity, income and expenses of two or more entities that are not all linked by a parent-subsidiary relationship

Chapter 3 – F/Ss and Reporting Entity

Key changes

- This chapter is newly introduced (Scope and Objectives of F/S).

Boundary of a reporting entity

- Determining the appropriate boundary of a reporting entity can be difficult if, for example, the entity is not a legal entity. In such cases, the boundary is determined by considering the information needs of the users of the entity's financial statements. Those users need information that is **relevant** and that **faithfully represents** what it purports to represent. A reporting entity does not comprise an arbitrary or incomplete collection of assets, liabilities, equity, income and expenses.

Boundary of a reporting entity

- Its Financial Statements provide relevant information to existing and potential investors, lenders and other creditors.

- Financial Statement should describe the set of economic activities within the reporting entity.

Chapter 4 – The Elements of F/Ss

Previous definition of an asset	Revised definition of an asset
A resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity	A present economic resource controlled by the entity as a result of past events An economic resource is a right that has the potential to produce economic benefits

Main changes in the definition of an asset

- separate definition of an economic resource—to clarify that an asset is the economic resource, not the ultimate inflow of economic benefits
- deletion of 'expected flow'—it does not need to be certain, or even likely, that economic benefits will arise
- a low probability of economic benefits might affect recognition decisions and the measurement of the asset

Previous definition of a liability	Revised definition of a 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	A present obligation of the entity to transfer an economic resource as a result of past events An obligation is a duty or responsibility that the entity has no practical ability to avoid

Main changes in the definition of a liability

- separate definition of an economic resource—to clarify that a liability is the obligation to transfer the economic resource, not the ultimate outflow of economic benefits
- deletion of 'expected flow'—with the same implications as set out above for an asset
- introduction of the 'no practical ability to avoid' criterion to the definition of obligation

Chapter 4 – The Elements of F/Ss

Unit of account

the right(s) or obligation(s), or group of rights and obligations, to which recognition criteria and measurement concepts are applied

Selecting the unit of account

Relevance

- a unit of account is selected to provide relevant information about the asset or liability and any related income and expenses

Faithful representation

- a unit of account is selected to provide a faithful represention of the substance of the transaction or other event from which the asset, liability and any related income or expenses have arisen

Revised definition of income

Increases in assets, or decreases in liabilities, that result in increases in equity, other than those relating to contributions from holders of equity claims

Revised definition of expenses

Decreases in assets, or increases in liabilities, that result in decreases in equity, other than those relating to distributions to holders of equity claims

Chapter 4 – The Elements of F/Ss

Element	Previous Definition	Revised Definition
Asset	A resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.	A present economic resource controlled by the entity as a result of past events. An economic resource is a right that has the potential to produce economic benefits.
Liabilities	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.	A present obligation of the entity to transfer an economic resource as a result of past events. An obligation is a duty of responsibility that the entity has no practical ability to avoid.

Chapter 4 – The Elements of F/Ss

Element	Previous Definition	Revised Definition
An Economic Resource	Not defined.	An economic resource is a right that has the **potential to produce economic benefits**
Equity	Residual interest in the assets of the entity after deducting all its liabilities	No Change
Income	Increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decrease of liabilities that result in increase in equity, other than those relating to contributions from equity participants.	Increases in assets, or decreases in liabilities, that result in increases in equity, other than those relating to contributions from holders of equity claims
Expenses	Decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrence of liabilities that result in decrease in equity, other	Decreases in assets, or increases in liabilities, that result in decreases in equity, other than those relating to distributions to holders of equity claims

Questions – Asset?? Liability??

1. Saman & Co has purchased a patent for $ 50,000. This patent gives the Saman & Co the sole authority to use the particular process which in turn will save $ 5,000 per year for the next five years.

2. Ratnayake Automobile (Pvt) Limited paid Mr. Dump $ 10,000 to set up a car repair shop, on condition that priority treatment is given to cars from the Company's fleet.

3. ABC Electrics provides a warranty with every eclectic equipment's sold.

Chapter 4 – The Elements of F/Ss

Answers

Saman & Co

Past Event – Yes
Right to produce Economic Benefits – Yes
Asset - ✓

Ratnayake Automobiles

Past Event – Yes
Right to produce Economic Benefits – No. as no control over the car repair shop and difficult to argue
Asset - ✗

ABC Electrics

Present Obligation – Yes
Practical ability to avoid – No
Liability- ✓

Chapter 5 – Recognition & Derecognition

Recognition	The process of capturing for inclusion in the statement of financial position or the statement(s) of financial performance an item that meets the definition of an asset, a liability, equity, income or expenses

Recognition is appropriate if it results in both relevant information about assets, liabilities, equity, income and expenses and a faithful representation of those items, because the aim is to provide information that is useful to investors, lenders and other creditors

Recognition criteria

Relevance

- whether recognition of an item results in relevant information may be affected by, for example:

  - low probability of a flow of economic benefits
  - existence uncertainty

Faithful representation

- whether recognition of an item results in a faithful representation may be affected by, for example:

  - measurement uncertainty
  - recognition inconsistency (accounting mismatch)
  - presentation and disclosure

Cost constraint

Cost constrains recognition decisions, just as it constrains other financial reporting decisions

Chapter 5 – Recognition & Derecognition

Derecognition	The removal of all or part of a recognised asset or liability from an entity's statement of financial position

Derecognition normally occurs

For an asset	For a liability
when the entity loses control of all or part of the recognised asset	when the entity no longer has a present obligation for all or part of the recognised liability

Derecognition aims to faithfully represent both

- any assets and liabilities retained after the transaction that led to the derecognition
- the change in the entity's assets and liabilities as a result of that transaction

Chapter 5 – Recognition & Derecognition

Key changes

- The previous recognition criteria were that an entity should recognise an item that met the definition of an element if it was probable that economic benefits would flow to the entity and if the item had a cost or value that could be determined reliably.

- The revised recognition criteria refer explicitly to the qualitative characteristics of useful information.

Chapter 6 - Measurement

Historical cost measurement bases

- historical cost provides information derived, at least in part, from the price of the transaction or other event that gave rise to the item being measured
- historical cost of assets is reduced if they become impaired and historical cost of liabilities is increased if they become onerous
- one way to apply a historical cost measurement basis to financial assets and financial liabilities is to measure them at amortised cost

Current value measurement bases

- current value provides information updated to reflect conditions at the measurement date
- current value measurement bases include:

fair value	• the price that would be received to sell an asset, or paid to transfer a liability, in an orderly transaction between market participants at the measurement date • reflects market participants' current expectations about the amount, timing and uncertainty of future cash flows
value in use (for assets) fulfilment value (for liabilities)	• reflects entity-specific current expectations about the amount, timing and uncertainty of future cash flows
current cost	• reflects the current amount that would be: ▪ paid to acquire an equivalent asset ▪ received to take on an equivalent liability

Chapter 6 - Measurement

Factors to consider in selecting a measurement basis

Relevance

Relevance of information provided by a measurement basis is affected by:

characteristics of the asset or liability

- the variability of cash flows
- sensitivity of the value to market factors or other risks
- for example, amortised cost cannot provide relevant information about a deriviative

contribution to future cash flows

- whether cash flows are produced directly or indirectly in combination with other economic resources
- the nature of the entity's business activities
- for example, if assets are used in combination to produce goods or services, historical cost can provide relevant information about margins achieved in a period

Faithful representation

Whether a measurement basis can provide a faithful representation is affected by:

measurement inconsistency

- if financial statements contain measurement inconsistencies (accounting mismatch), those financial statements may not faithfully represent some aspects of the entity's financial position and financial performance

measurement uncertainty

- does not necessarily prevent the use of a measurement basis that provides relevant information
- but if too high might make it necessary to consider selecting a different measurement basis

Cost constraint

Cost constrains the selection of a measurement basis, just as it constrains other financial reporting decisions

Chapter 6 – Measurement Bases

Historical Cost	• The Price paid for an asset or for the event which gave rise to the liability. This price will be constant.
Current Value	• The price paid for an asset or the liability value will be updated to reflect any changes since it was acquired or incurred.
Fair Value	• The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.
Value in Use	• Present Value of the cash flows, or other economic benefits, that an entity expects to derive form the use of an asset and its ultimate disposal.
Current Cost	• Current cost, like historical cost, is an entry value. It reflects prices in the market in which the entity would acquire asset or incur the liability.

Chapter 7 – Presentation & Disclosure

The statement of profit or loss

- The statement of profit or loss is the primary source of information about an entity's financial performance for the reporting period
- Profit or loss could be a section of a single statement of financial performance or a separate statement
- The statement(s) of financial performance include(s) a total (subtotal) for profit or loss
- In principle, all income and expenses are classified and included in the statement of profit or loss

Other comprehensive income

- In exceptional circumstances, the Board may decide to exclude from the statement of profit or loss income or expenses arising from a change in current value of an asset or liability and include those income and expenses in other comprehensive income
- The Board may make such a decision when doing so would result in the statement of profit or loss providing more relevant information or a more faithful representation

Recycling

- In principle, income and expenses included in other comprehensive income in one period are recycled to the statement of profit or loss in a future period when doing so results in the statement of profit or loss providing more relevant information or a more faithful representation
- When recycling does not result in the statement of profit or loss providing more relevant information or a more faithful representation, the Board may decide income and expenses included in other comprehensive income are not to be subsequently recycled

Chapter 8 – Capital & Capital Maintenance

- No changes and will be continued under the new C/F.

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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Transition to the New C/F

- The revised concepts will guide the Board when it develops or revises Standards.
- However, changes to the Conceptual Framework **will not automatically** lead to changes in existing Standards.
- Changes to the Conceptual Framework will have no immediate effect on the financial statements of most reporting entities.
- Preparers of financial statements could be directly affected by the changes only if they need to use the Conceptual Framework to **develop an accounting policy when no Standard applies to a particular transaction or other event or when a Standard allows a choice of accounting policy.**

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THANK YOU