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The Conceptual Framework for Financial Reporting

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Introduction

- The Framework sets out the concepts that underlie the preparation and presentation of financial statements for external users. Its purpose is to:
  - Assist IASB in developing accounting standards and assist preparers of financial statements in applying IFRSs and in dealing with topics that have yet to form the subject of an IFRS
  - Assist users of financial statements in interpreting the information contained in financial statements prepared in conformity with IFRSs
  - Provide those who are interested in the work of IASB with information about its approach to the formulation of IFRSs
- The framework was first published in July 1989 and adopted in April 2001.

Introduction (Cont'd)

- In the absence of a Standard or an Interpretation that applies specifically to a transaction, management must use its judgement in developing and applying an accounting policy that results in information that is relevant and reliable.
  - In doing this, IAS 8 requires management to consider the definitions, recognition criteria, and measurement concepts for assets, liabilities, income, and expenses as contained in the IFRS Framework.

Scope

- The 1989 Framework consists of several sections or chapters, following on after a preface and introduction. These chapters are as follows:
  - The objective of financial statements
  - Underlying assumptions
  - The qualitative characteristics of financial statements
  - The elements of financial statements
  - Recognition of elements of financial statements
  - Measurements of the elements of the financial statements
  - Concepts of capital and capital maintenance

Improved Conceptual Framework for Financial Reporting

- In July 2006 IASB produced a discussion paper-preliminary views on an improved conceptual framework for financial reporting.
  - The paper covers the two chapters of the conceptual framework:
    - Chapter 1: The objective of financial reporting
    - Chapter 3: Qualitative characteristics of useful financial information
- The framework was first published in July 1989 and adopted in April 2001
- In September 2010 the IASB approved the *Conceptual Framework for Financial Reporting 2010* (the IFRS Framework), dealing with these two chapters and retained the remaining text of 1989 edition.

Objectives of General Purpose Financial Reporting

- To 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, which includes decisions about the accountability of the entity’s management

Users Of General Purpose Financial Reporting

The Conceptual framework groups these into **primary** and **other users**

- Primary users are present and potential investors, lenders and other creditors.
- Other parties include prudential and market regulators.

Users Information Needs

- Primary users use the information to make decisions about buying, selling or holding equity or debt instruments and providing or settling loans or other forms of credit.
- The primary users use the information to assess an entity's prospects for future net cash inflows and to judge how effective and efficient management has discharged their responsibilities of using the entity's existing resources.
- Other parties, including prudential and market regulators, may find general purpose financial reports useful, but the reports are not primarily directed to regulators or other parties

Economic Resources And Claims

- A reporting entity's economic resources and claims are reported in the statement of financial position

- Information about the nature and amounts assists users to assess an entity's
  - financial strengths and weaknesses;
  - liquidity and solvency, and
  - its need and ability to obtain financing.

- Information about the claims and payment requirements assists users to predict how future cash flows will be distributed among those with a claim on the reporting entity.

Changes In Economic Resources And Claims

- Changes in an entity's economic resources and claims are presented in the SOCI
- Changes in economic resources and claims result from performance and from other events or transactions such as issuing debt or equity instruments.
  - Users need to be able to distinguish between both of these changes
- Information about a reporting entity's financial performance during a period, representing changes in economic resources and claims other than those obtained directly from investors and creditors, is useful in assessing the entity's past and future ability to generate net cash inflows.
- Such information may also indicate the extent to which general economic events have changed the entity's ability to generate future cash inflows

Financial Performance Reflected By Past Cash Flows

- The changes in the entity's cash flows are presented in the statement of cash flows
- Information about a reporting entity's cash flows during the reporting period also assists users to assess the entity's ability to generate future net cash inflows.
- This information indicates how the entity obtains and spends cash, including information about its borrowing and repayment of debt, cash dividends to shareholders, etc

Changes In Economic Resources And Claims Not Resulting From Financial Performance

- The changes in an entity's economic resources and claims not resulting from financial performance is presented in the statement of changes in equity.

- Information about changes in an entity's economic resources and claims resulting from events and transactions other than financial performance, such as the issue of equity instruments or distributions of cash or other assets to shareholders is necessary to complete the picture of the total change in the entity's economic resources and claims

Qualitative Characteristics of Useful Financial Information

Qualitative characteristics are the attributes that make the information provided in financial statements useful to users.

They are:

- relevance and faithful representation- the **fundamental qualitative characteristics**

- comparability, timeliness, verifiability and understandability- the **enhancing qualitative characteristics** that distinguish more useful information from less useful information.

Relevance

- Relevant financial information is capable of making a difference in the decisions made by users. Financial information is capable of making a difference in decisions if it has predictive value, confirmatory value, or both. The predictive value and confirmatory value of financial information are interrelated

- *Materiality* is an entity-specific aspect of relevance based on the nature or magnitude (or both) of the items to which the information relates in the context of an individual entity's financial report

- Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements

Faithful Representation

- General purpose financial reports represent economic phenomena in words and numbers, To be useful, financial information must not only be relevant, it must also represent faithfully the phenomena it purports to represent.
- This fundamental characteristic seeks to maximise the underlying characteristics of completeness, neutrality and freedom from error.
- Information must be both relevant and faithfully represented if it is to be useful

Comparability

- Information about a reporting entity is more useful if it can be compared with a similar information about other entities and with similar information about the same entity for another period or another date.
- Comparability enables users to identify and understand similarities in, and differences among, items

Verifiability

- Verifiability helps to assure users that information represents faithfully the economic phenomena it purports to represent.

- Verifiability means that different knowledgeable and independent observers could reach consensus, although not necessarily complete agreement, that a particular depiction is a faithful representation

Timeliness

- Timeliness means that information is available to decision-makers in time to be capable of influencing their decisions

Understandability

- Classifying, characterising and presenting information clearly and concisely makes it understandable.
- While some phenomena are inherently complex and cannot be made easy to understand, to exclude such information would make financial reports incomplete and potentially misleading.
- Financial reports are prepared for users who have a reasonable knowledge of business and economic activities and who review and analyse the information with diligence

Information Irrelevance And Faithful Representation

- Enhancing qualitative characteristics (either individually or collectively) render information useful if that information is irrelevant or not represented faithfully

Cost Constraint On Useful Financial Reporting

- Cost is a pervasive constraint on the reporting entity's ability to provide useful information in general purpose financial reporting.
- Reporting such information imposes costs and those costs should be justified by the benefits of reporting that information.
- The IASB assesses costs and benefits in relation to financial reporting generally, and not solely in relation to individual reporting entities.
- The IASB will consider whether different sizes of entities and other factors justify different reporting requirements in certain situations.

Constraints on Relevant and Reliable Information

- Timeliness
  - If there is undue delay in the reporting of information it may lose its relevance. Management may need to balance the relative merits of timely reporting and the provision of reliable information
- Balance between benefit and cost
  - The benefits derived from information should exceed the cost of providing it
- Balance between qualitative characteristics
  - In practice a balancing, or trade-off, between qualitative characteristics is often necessary. Generally the aim is to achieve an appropriate balance among the characteristics in order to meet the objective of financial statements

Discussion Paper: The Reporting Entity

- The conceptual framework describes rather than precisely define a reporting entity as a circumscribed area of business activity of interest to present and potential equity investors, lenders and other capital providers.
  - Examples of reporting entities are:
    - Sole trader
    - Corporation
    - Trust
    - Partnership
    - Associations, and
    - Group

The Parent Entity Financial Reporting

- Two issues considered here are:
  - The parent company approach to consolidated financial statements.
  - Whether parent only financial statements and consolidated financial statements meet the objective of financial reporting and whether both are needed.
- IASB preliminary conclusion is:
  - That consolidated financial statements should be presented from the perspective of group reporting entity not, the parent company shareholders
  - That the consolidated financial statements meet the objective of financial reporting, but that parent only financial statements maybe presented provided they are included in the same financial report as consolidated financial statements.

Pending Work on The Improved Conceptual Framework

- Discussions on the other parts of the framework listed below are pending:
  - Purpose and status (see introduction)
  - Underlying assumptions
  - The elements of financial statements (see attached)
  - Recognition of elements of financial statements
  - Measurements of the elements of the financial statements
  - Concepts of capital and capital maintenance
  - Application to not for profit entities

Underlying Assumptions

- Going concern
  - The financial statements are normally prepared on the assumption that an entity is a going concern and will continue in operation for the foreseeable future
  - In order to meet their objectives, financial statements are prepared on the accrual basis of accounting since this basis of accounting can only be used when an entity is a going concern.

Elements of Financial Statements

- Financial statements portray the financial effects of transactions and other events by grouping them into broad classes according to their economic characteristics
- These broad classes are termed the elements of financial statements
- Elements directly related to the measurement of financial position in the balance sheet are assets, liabilities and equity
- The elements directly related to the measurement of performance in the income statement are income and expenses
- The statement of changes in financial position usually reflects income statement elements and changes in balance sheet elements

Financial Position

- 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 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
  - Is the residual interest in the assets of the entity after deducting all its liabilities

Assets

- The future economic benefit embodied in an asset is the potential to contribute, directly or indirectly, to the flow of cash and cash equivalents to the entity
- The future economic benefits embodied in an asset may flow to the entity in a number of ways:
  - Used singly or in combination with other assets in the production of goods or services to be sold by the entity
  - Exchanged for other assets
  - Used to settle a liability
  - Distributed to the owners of the entity

Liabilities

- An essential characteristic of a liability is that the entity has a present obligation
- Obligations may be legally enforceable or statutory requirement
- Obligations also arise, however, from normal business practice, custom and a desire to maintain good business relations or act in an equitable manner
- There is a distinction between a present obligation and a future commitment

Liabilities

- The settlement of a present obligation usually involves the entity giving up resources embodying economic benefits in order to satisfy the claim of the other party
- They may be settled by:
  - Payment of cash
  - Transfer of other assets
  - Provision of services
  - Replacement of that obligation with another obligation
  - Conversion of the obligation to equity

Proposed Working Definition

Asset

- An **asset** of an entity is a present economic resource to which the entity has a right or other access that others do not have

- **Present** means that on the date of the financial statements both the economic resource exists and the entity has the right or other access that others do not have

- An **economic resource** is something that is scarce and capable of producing cash inflows or reducing cash outflows, directly or indirectly, alone or together with other economic resources. Economic resources that arise from contracts and other binding arrangements are unconditional promises and other abilities to require provision of economic resources, including through risk protection.

- A **right or other access that others do not have** enables the entity to use the economic resource and its use by others can be precluded or limited. A right or other access that others do not have is enforceable by legal or equivalent means.

Proposed Working Definition

Liability

- A **liability** of an entity is a present economic obligation for which the entity is the obligor.
- **Present** means that on the date of the financial statements both the economic obligation exists and the entity is the obligor.
- An **economic obligation** is an unconditional promise or other requirement to provide or forgo economic resources, including through risk protection.
- An entity is the **obligor** if the entity is required to bear the economic obligation and its requirement to bear the economic obligation is enforceable by legal or equivalent means

Performance

- Profit is frequently used as a measure of performance or as the basis for other measures, such as return on investment or earnings per share.
- The elements directly related to the measurement of profit are income and expenses. The recognition and measurement of income and expenses, and hence profit, depends in part on:
  - The concepts of capital
  - Capital maintenance used by the entity

Income and Expenses

Income

- 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

Expenses

- 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.

Income

The definition of income encompasses both revenue and gains.

- Revenue arises in the course of the ordinary activities of an entity and is referred to by a variety of different names including sales, fees, interest, dividends, royalties and rent
- Gains represent other items that meet the definition of income and may, or may not, arise in the course of the ordinary activities of an entity. Gains represent increases in economic benefits and as such are no different in nature from revenue

Expenses

- The definition of expenses encompasses losses as well as those expenses that arise in the course of the ordinary activities of the entity e.g.
  - Cost of sales
  - Wages
  - Depreciation
- Losses represent other items that meet the definition of expenses and may, or may not, arise in the course of the ordinary activities of the entity
  - Losses represent decreases in economic benefits and as such they are no different in nature from other expenses

Capital Maintenance Adjustments

- The revaluation or restatement of assets and liabilities gives rise to increases or decreases in equity
- While these increases or decreases meet the definition of income and expenses, they are not included in the income statement under certain concepts of capital maintenance
- Instead these items are included in equity as capital maintenance adjustments or revaluation reserves

Recognition Of The Elements Of Financial Statements

- 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
- An item that meets the definition of an element should be recognised if:
  - It is probable that any future economic benefit associated with the item will flow to or from the entity
  - The item has a cost or value that can be measured with reliability.

Measurement of the Elements of Financial Statements

- 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 balance sheet and income statement
- Bases of measurement include:
  - Historical cost
  - Current cost
  - Realisable (settlement) value
  - Present value

Measurement of the Elements of Financial Statements

- Historical cost is commonly adopted by entities in preparing their financial statements

- This is usually combined with other measurement bases. For example:
  - Inventories are usually carried at the lower of cost and net realisable value
  - Marketable securities may be carried at market value
  - Pension liabilities are carried at their present value
- Furthermore, some entities use the current cost basis as a response to the inability of the historical cost accounting model to deal with the effects of changing prices of non-monetary assets

Concepts of Capital

- A financial concept of capital is adopted by most entities in preparing their financial statements
- Under a financial concept of capital, capital is synonymous with the net assets or equity of the entity
- Under a physical concept of capital, capital is regarded as the productive capacity of the entity based on, for example, units of output per day
- The selection of the appropriate concept of capital by an entity should be based on the needs of the users of its financial statements

Concepts of Capital Maintenance

- Financial capital maintenance
  - Profit is earned only if the financial (or money) amount of the net assets at the end of the period exceeds the financial (or money) amount of net assets at the beginning of the period, after excluding any distributions to, and contributions from, owners during the period
  - Financial capital maintenance can be measured in either nominal monetary units or units of constant purchasing power.

Physical Capital Maintenance

- Profit is earned only if the physical productive capacity (or operating capability) of the entity (or the resources or funds needed to achieve that capacity) at the end of the period exceeds the physical productive capacity at the beginning of the period;
  - After excluding any distributions to; and
  - Contributions from, owners during the period

THANK YOU