The Conceptual Framework for Financial Reporting

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This article is written for students of P1 Corporate Reporting and reflects the level of knowledge of the conceptual framework appropriate for this level.

Students of P2 will find the article useful as an introduction to the topic but should be aware that the application of the principles to more challenging transactions is likely to be expected at P2 level.

Introduction:

A conceptual framework in general is a statement of theoretical principles forming a frame of reference for a particular field of study. In the field of accounting it is a body of agreed principles designed to provide underpinning to the more detailed principles, rules and application guidance contained in accounting standards.

The IASB's Conceptual Framework was originally issued in 1989 and was revised in 2010. The latest revision, in 2018, represents the culmination of much discussion regarding its contents. The latest revision offers clarity on some matters, updates others, and provides new material to fill certain gaps left unanswered by previous versions.

Purpose of the Conceptual Framework:

- It assists the IASB in developing accounting standards that are based on consistent concepts;
- It assists preparers of financial statements in developing consistent accounting policies when no standard applies to a particular transaction or event or when a standard allows a choice of policy;
- It assists all parties understand and interpret the standards.

However, the framework does not override the provisions of any IFRS. If a conflict exists between a standard and the framework, the standard takes priority. Such conflict may be deliberate, as the IASB may deem a particular treatment appropriate even though it may not conform with the framework. A good example of this is the use (under IAS 20) of a deferred income liability for unamortised government grants where no obligation exists.

Contents of the Conceptual Framework:

The revised framework is laid out in 8 chapters. These are as follows:

1. The objective of financial reporting
2. Qualitative characteristics of useful financial information
3. Financial statements and the reporting entity
4. The elements of financial statements
5. Recognition and derecognition
6. Measurement
7. Presentation and disclosure
8. Concepts of capital and capital maintenance

Let us consider each of these chapters in detail, exploring its contribution to the regulatory framework of financial reporting.

Chapter 1 – The objective of financial reporting
The objective is to provide financial information that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity.

Such decisions involve
- buying, selling or holding equity and debt instruments;
- providing or settling loans or other forms of credit; or
- voting or otherwise influencing management's actions.

In making these decisions, users assess
- The economic resources of the entity, claims against those resources, and prospects for future net cash inflows to the entity, and
- Management's stewardship of the entity's economic resources.

This objective is very significant as it gives accountants a benchmark against which to judge the quality of their reports. Remember financial statements include numbers, formats and notes. There is always uncertainty regarding the extent and nature of disclosures financial statements should provide. Only some of this uncertainty is resolved by accounting standards. Knowing the overall purpose is to provide decision-useful information is of great value in making judgments about the nature and extent of information to be disclosed in the financial statements and accompanying notes.

This chapter emphasises the importance of the accrual concept of accounting. This is a fundamental assumption of our system that seeks to record transactions in the periods the transactions occur rather than when any resulting cash flows occur. This provides a better basis for assessing an entity's past and future performance.

Chapter 2 – Qualitative characteristics of useful financial information
A qualitative characteristic is an attribute that is not easily measurable. For example, how "nice" a person is. Assessing it requires judgment. A quantitative characteristic is measurable, often (though not always) with precision. For example, how "tall" a person is.

When it comes to financial information, data will naturally have quantitative characteristics, such as the amount of cash in a bank account, or the value of amounts receivable from customers. There are also qualitative (non-quantitative) characteristics which financial information should have if it is to be useful. This chapter identifies the most important qualitative characteristics useful information should have.

The conceptual framework recognises that cost is a valid constraint on the provision of useful information. If the benefit of providing the information does not exceed the cost of gathering and providing it, there is no requirement to provide it.

Qualitative characteristics are divided into "Fundamental" and "Enhancing".

Fundamental characteristics

These are characteristics that distinguish useful information from that which is non-useful. There are two such characteristics identified by the framework.

1. Relevance

   Information should have the ability to influence decisions. This means it should have either predictive value or confirmatory value. Materiality is an entity-specific aspect of relevance. Information is material if omitting it could influence decisions that users make about a specific reporting entity.

2. Faithful representation

   Information should faithfully represent the substance of what it purports to represent. This is more than just the absence of untruthful information. It is possible to be truthful and still not be faithful to reality. Yet this does not mean information needs to be perfectly accurate. Information often depends on estimates and the accuracy of these estimates sometimes cannot be determined. However, the information would still be considered faithful if the uncertainties are managed honestly, and any material uncertainty disclosed. To be faithful, information should be:
   - Complete (no material information omitted);
   - Neutral (cautious but unbiased estimates are used wherever necessary);
   - Free from material error;
   - Prepared on the basis of substance over form.

Enhancing characteristics

Enhancing characteristics distinguish between more useful and less useful information. The following four characteristics are deemed by the framework to enhance the usefulness of information.

1. Comparability

   Information can be compared across different companies and different periods. This requires consistency of formats, for example.

2. Verifiability

   Different knowledgeable observers could agree that information has been prepared faithfully.

3. Timeliness

   Information is made available to decision makers in time to be able to influence their decisions.

4. Understandability

   It should be clear what the information means. It should be as clear and concise as possible. Achieving this can clearly depend on users' abilities. We normally assume reasonable financial literacy on the part of users. Note that the understandability characteristic must not be achieved by omitting valuable, albeit complex, information. Also, the inclusion of irrelevant detail violates this characteristic. There has been a tendency in recent years for reporting entities to include vast quantities of disclosure, much of it of questionable value to users. This might be out of fear of omitting required information, but is can have the effect of obscuring the truly valuable information and rendering the report less likely to be read and understood.

Chapter 3 – Financial statements and the reporting entity
This chapter is new in the 2018 conceptual framework. Its objective is to describe the objective and scope of financial statements and to provide a description of the reporting entity.

Financial statements are a particular form of report that provide information about (1) the income and expenses, (2) cash flows, and (3) the assets, liabilities and equity of an entity. They are required to be prepared in accordance with the formats and guidelines set out in IAS 1.

The going concern concept is applied unless evidence exists to suggest this is not appropriate. This involves an assumption that the entity will continue in business for the foreseeable future with no need or intention to enter liquidation or cease trading. If this assumption is not valid, the financial statements may need to be prepared on a different basis. If so, this should be disclosed and described.

The reporting entity is defined by this chapter as an entity that chooses or is required to prepare financial statements. Financial statements may be for a single entity, part of an entity, or indeed for several entities combined. It need not be a legal entity.

If the boundaries of a reporting entity are unclear, the framework requires that the boundary is determined by considering the information needs of the users.

Bear in mind that local legislation and stock exchange rules will have an impact in determining the boundaries of a reporting entity. The conceptual framework does not generally justify disobeying such laws.

Chapter 4 – The elements of financial statements
This chapter is updated significantly from the 2010 version of the conceptual framework. The main differences arise in the definitions of assets and liabilities, most importantly through the exclusion of the probable future inflow (in the case of assets) and outflow (in the case of liabilities) of economic benefits from the definitions.

According to the framework, there are five elements of financial statements. These are:
- Asset
- Liability
- Equity
- Income (or gain)
- Expense (or loss)

Each element is defined precisely, and this definition is considered when deciding how to account for transactions. Many standards expand upon these definitions and offer more detailed guidance on their implementation. For example, IAS 37 (liabilities) and IAS 16 (assets).

The definitions are as follows:
Asset
Definition: 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.

This definition clarifies that it is the resource that is the asset, not the probability of future economic benefit. For example, consider a plot of land that has a 10% probability of producing a rich gold mine and a 90% probability of turning out worthless. This cannot be said to have a probable future economic benefit. Yet it is an asset, nonetheless. The valuation of the land will reflect the amount and likelihood of future economic benefit. Yet it is the land that is the asset. The asset and its value are two separate concepts.

Liability
Definition: 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.

Similarly, to assets, it is the obligation that is the liability, not the economic resources that may be required to be transferred. Again, the liability and its valuation are two separate concepts.

Equity is defined as assets less liabilities.

Income is defined as increases in assets or decreases in liabilities that result in an increase to equity, other than those relating to contributions from holders of equity claims.

Expenses are defined decreases in assets or increases in liabilities that result in a decrease to equity, other than those relating to distributions to holders of equity claims.

Substance over form
The chapter makes it clear that contractual rights and obligations must be reported in accordance with their substance. Sometimes this is clear from the legal form of a contract, but sometimes the form and substance differ. This could be due to deliberate attempts to misrepresent reality, or due to the complex nature of some business arrangements.

Chapter 5 – Recognition and derecognition
Recognition of an element simply means including it in the financial statements. Derecognition means removing an element from the financial statements. This chapter of the conceptual framework gives guidance on when to include and remove elements from the financial statements.

These criteria mainly refer to assets and liabilities, as equity, expenses and gains are the consequences of movements in the carrying values of assets and liabilities (as per the definitions provided by chapter 4). It is often the case that the decision to recognise or derecognise an asset or liability automatically triggers the recognition of a gain or loss through the operation of the double entry system.

The criteria for recognition and derecognition are based on the qualitative characteristics discussed in chapter 2, particularly the fundamental ones.

Recognition
Recognition is defined as the process of capturing for inclusion in the financial statements an item that meets the definition of an asset, liability, equity, income or expense. It is possible that an item that meets the definition in chapter 4 fails to meet recognition criteria and may not be recognised as a result.

Recognition is appropriate if it results in both relevant information about an element and a faithful representation of those items (the fundamental qualitative characteristics of useful financial information). Remember the overall purpose of our endeavour is to provide useful information to aid the decisions of the providers of resources to the entity (as per chapter 1). Useful information is deemed to possess these two fundamental characteristics. Hence it is appropriate that recognition should depend on the information provided being relevant and faithfully representing reality.

Recognition might not happen on the basis of relevance if there is an existence uncertainty or a low probability of economic benefits being received by the entity. For example, a customer owes the entity €10,000 but is in liquidation, and it is considered unlikely that the debt will be recovered. No trade receivable would be recognised by the entity.

Recognition might not happen on the basis of faithful representation if there was a measurement uncertainty. An example of this is the issue of internally generated intangibles. Existence might not be in question, but recognition might not happen due to an inability to measure the asset's cost or value reliably.

Derecognition

Derecognition is defined as the removal of an element from the financial statements.

For an asset, derecognition normally occurs when the entity loses control of a recognised asset. The most common example of this is the sale of an asset. Another example is the payment to the entity of a receivable by the debtor.

For a liability, derecognition occurs when the entity no longer has a present obligation for the liability. This could be due to discharge, when the entity performs the obligation associated with the liability, or due to changing circumstances rendering the liability void.

For both assets and liabilities, partial derecognition is required when appropriate, for example when a liability is partially discharged.

Chapter 6 – Measurement

This chapter describes the amount at which to recognise an element, once the decision has been made to recognise it. Previous versions of the conceptual framework provided little guidance on measurement beyond identifying various possible bases. The 2018 framework not only describes measurement bases but discusses the factors to be considered when selecting a particular base.

There are several possible measurement bases used in the preparation of financial statements.

Historic cost bases are derived from the original transaction value of an element. For example, the purchase cost of an asset. Depreciated historic cost is the cost of an asset as depreciated for usage in accordance with accounting standards. Amortised cost for financial assets is an example of a historical cost measurement base.

Current value bases try to reflect conditions that exist at the measurement date. Examples include:

- Fair value, defined as 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, is a measure of the present value of future cash flows discounted at an appropriate discount rate. This is useful when cash flows are reasonably predictable.
- Current cost is defined as the price that would be paid for an equivalent element at the measurement date. Note this is not the same as fair value, as fair value is an exit (selling) price, whereas current cost is an entry (buying) price.

All of the above are acceptable in certain circumstances.

The framework sets out in considerable detail the factors to be considered when choosing a measurement base. These again centre around relevance and faithful representation. The logic of this is similar to that of recognition and derecognition decisions. We are obliged to provide useful information. The key characteristics that define useful information are relevance and faithful representation.

The relevance of information provided by a measurement base is affected by the characteristics of the element and its contribution to future cash flows. For example, if an element's future cash flows are very much determined by market forces, a market value measurement base is more likely to be appropriate. If future cash flows are independent of market forces, historic cost bases are more likely to be appropriate.

In terms of faithful representation, if an element is subject to measurement inconsistency or measurement uncertainty, the measurement base producing the inconsistency or uncertainty is less likely to be appropriate. For example, unquoted equity investments are difficult to measure at fair value, as no ready market value exists. This uncertainty does not preclude the use of fair value, as methods may exist to mitigate the uncertainty. If, however, the uncertainty it too high, then the appropriateness of using the base could be questioned.

Cost constraints must be taken into account. As stated previously, the benefits of improved information must outweigh the cost of acquiring that information. For example, the calculation of forecast future cash flows might involve expensive analysis, the cost of which might outweigh the information value of using the present value valuation method. If so, this base could validly be excluded from consideration.

Chapter 7 – Presentation and disclosure

This chapter did not appear in the 2010 version of the conceptual framework. It deals primarily with the classification of elements, setting out the following core principles:

- The focus should be on presentation and disclosure objectives and principles rather than rules;
- Elements should be classified in a manner that groups similar items and separates dissimilar items;
- Information should be aggregated in a manner that it is not obscured by unnecessary detail or excessive aggregation.

One important area of focus is the classification of income and expense elements as profit or loss (P/L) or as other comprehensive income (OCI). This has been a significant gap in regulatory guidance up to now. Each standard has its own rules for classification of income and expenses, and these are not always consistent with each other. For example, IAS 16 requires a revaluation gains and losses (if recognised) to be accounted for under a complex combination of P/L and OCI. The treatment of revaluation gains and losses on investment properties is very different (P/L), while gains and losses on the remeasurement of equity instruments follow a completely different model again (based on entity election).

This is a very important distinction as "profit for the year" is a crucially important line item, forming the basis for the earnings per share calculation. Earnings per share is a very widely used headline performance measure.

The conceptual framework suggests that the primary source of information about an entity's performance is the statement of profit or loss. All income and expenses should normally be included here.

However, the framework suggests that the IASB may deem it appropriate in exceptional circumstances to exclude certain gains and losses from P/L and include those in OCI. The reason for this should be the provision of more relevant information or more faithful representation of the entity's performance for the period.

Chapter 8 – Concepts of capital and capital maintenance
This chapter is unchanged since the 1989 version of the framework, and in reality does not assume major significance unless inflation is a feature of the financial background. In receipt years inflation has been very low although this may not always be the case.
The chapter identifies two concepts of capital. These are

- Financial capital; and
- Physical capital.

Financial capital is based on invested money or purchasing power. Currently, financial statements assume the monetary unit is stable, hence comparisons across periods are valid on the basis of unadjusted monetary amounts. This effectively assumes zero inflation, which is normally not the case. However, in periods of low inflation, and over short time horizons, the error produced by such comparisons is immaterial. Over longer time horizons, or in periods of high inflation, an adjustment becomes necessary before comparisons can be considered valid.

For an illustration of the above point, consider an entity with a single asset, a plot of land. This cost €20 million in 2000 and was sold for €22 million in 2020. Hence the gain recorded in the financial statements would be €2 million. This would be recorded over the period (through OCI) if the fair value model of IAS 16 had been followed, or entirely in 2020 (through profit or loss) if the cost model was adopted. If we assume inflation was 50% cumulatively over the 20 years, we can see that the entity has lost value despite showing an accounting profit. It needed to sell the land for €30 million in order to maintain its financial capital. Hence under this concept, a loss of €8 million would be recorded.

Physical capital is based on the productive capacity of the entity. Monetary value is secondary. If an entity has increased its value in monetary terms, but the productive capacity of its assets remained the same, it would not be considered to have earned a profit under this concept. Again, an adjustment would be calculated to eliminate the movement in net assets not caused by movements in productive capacity.

The adoption of either concept is again driven by the needs of the users of financial statements. The relevance of the information presented and the need to represent reality faithfully are the two factors that determine the choice.

In reality, as long as inflation remains subdued, neither of the above is likely to become an issue for most entities.

Conclusion
The revised conceptual framework is a much-improved document compared to the 2010 version. Several gaps in the guidance provided have been addressed, and some weaknesses remedied. It does appear that many chapters afford a level of discretion to management that will be difficult to regulate. In particular, the emphasis on the requirement to present the most relevant information that most faithfully represents reality would seem to require a level of judgment, the reasonableness of which could be difficult for an auditor to verify. It remains to be seen how these principles are adopted into future accounting standards.

The reader is referred to the source document for further detail. This is available here: http://eifrs.ifrs.org/eifrs/bnstandards/en/framework.pdf (account registration required free of charge).