Frame the question

In part one of a two-part series, Tom Clendon explains what the the revised conceptual framework is and why it is important

The framework for financial reporting was revised in 2018. As the framework is an important and topical issue it is regularly examined, and in the first of two articles I'll explain how the revised framework will affect students in their upcoming exams.

What is the framework?

Firstly, let's remind ourselves why we have a framework. After all, there are plenty of accounting standards in place to give clear instruction on how to deal with the various accounting transactions.

The conceptual framework for financial reporting (the framework) is a set of principles, not rules, issued by the International Accounting Standards Board (IASB). The framework is designed to assist:

- The IASB in developing International Financial Reporting Standards (accounting standards).
- Preparers develop consistent accounting policies.
- In the understanding and interpretation of standards, where there is no applicable accounting standard in place.

For the avoidance of doubt, the framework is not an accounting standard and does not override the requirements of any particular accounting standard.

The framework has been variously described as a base, or foundation, on which accounting standards can be built; and a constitution that will influence the revision of existing accounting standards and the development of new accounting standards. To that extent the framework can also be regarded as a map that indicates the future of financial reporting.

So, the framework is accounting theory and rather abstract. It is, though, an important issue, and now also a topical one because, in March 2018, the IASB reissued it.

Why did the IASB revise the framework?

The previous framework was criticised for being out of date and not addressing certain key topics. For example, it did not give any conceptual guidance as to whether gains or losses should be recognised in the statement of profit or loss or in other comprehensive income. As a result of this vacuum we currently have an inconsistent, ad hoc rules-based approach as to where gains and losses are recognised.

This has led to other comprehensive income rather acting as a dumping ground for odd gains and losses allegedly not deemed suitable for the statement of profit or loss. This is clearly unsatisfactory.

So how has the framework changed?

Prudence returns!

Believe it or not, the age-old tradition of expecting accountants to be prudent was not explicitly set out in the previous version of the framework. Prudence as a concept has now, rightfully, been reinstated.

For information to be useful, so the framework argues, it must be relevant and faithfully represent the substance of financial information; and for information to be a faithful representation it has to be neutral. The revised framework reintroduces the concept of prudence as the IASB believes that prudence supports the neutrality of information. Prudence is defined as "the exercise of caution when making judgements under conditions of uncertainty."

A new definition of an asset

It has been long established that there are five elements in the financial statements: assets, liabilities, equity, income and expenses. The revised framework puts the definition of assets and liabilities centre stage and has taken the opportunity to tinker with their definitions.

Let's look at the previous and the revised definitions to see what has changed!

> **Previous 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.
> **The new definition of an asset**
> 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.

An asset continues to be regarded as a resource that is controlled and results in future economic benefits; namely, an asset is not defined by reference to legal title, but the new definition clarifies that the potential economic benefits no longer need to be expected and they do not need to be certain. Arguably this could result in more assets being identified.

A new definition of a liability

Again, let's look at the previous and the revised definitions to see what has changed!

> **Previous 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.
> **The new definition of a liability**
> 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.

Both the original and revised definitions concur that a liability does not have to be legally enforceable, but the revised framework has introduced the concept of "no practical ability to avoid". The new definition also clarifies that a liability is the obligation to transfer an economic resource, and not the ultimate outflow of economic benefits. As with the revised definition of an asset, the outflow no longer needs to be expected.

Recognition criteria for assets and liabilities

The revised framework states that recognition of an asset or liability in the financial statements is only appropriate if it results in relevant information and is a faithful representation of the element. This is different from the previous framework, which articulated its recognition criteria on the basis of a probable flow of the economic benefits that could be determined reliably.

Next month

In the April issue of PQ we'll look at how the revised framework deals with the measurement of assets and liabilities, plus more about the statement of other comprehensive income. PQ

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