The conceptual framework

- Conceptual framework and GAAP
- The IASB's Conceptual Framework
- The objective of general purpose financial reporting
- Underlying assumption
- Qualitative characteristics of financial information
- The elements of financial statements
- Recognition and measurement of the elements of financial statements
- Fair presentation and compliance with IFRS

Conceptual Framework

What is a conceptual framework?

- The Conceptual Framework sets out the fundamental concepts for financial reporting that guide the Board in developing IFRS Standards.
- It helps to ensure that the Standards are conceptually consistent and that similar transactions are treated the same way, to provide useful information for investors, lenders, and other creditors. The Conceptual Framework also assists companies in developing accounting policies when no IFRS Standard applies to a particular transaction, and more broadly, helps stakeholders understand and interpret the Standards
- These provide a basis for developing new accounting standards and a platform to evaluate those already in existence.

Conceptual Framework and GAAP 2

Advantages of a conceptual framework

- Having a consistent conceptual base should avoid contradictions and inconsistencies in basic concepts and so produce standardized consistent accounting practices.
- The development of standards is less subject to political pressure.
- A consistent statement of financial position-driven or profit or loss-driven approach is used.

Conceptual Framework

Some Critics to conceptual Framework

- Financial statements have many users all with differing needs:
  - A single framework cannot satisfy the needs of all users.
  - There may be a need for a variety of accounting standards, each produced for a different purpose with different conceptual bases.
- Having a conceptual framework may not make it any easier to prepare accounting standards.

The IASB's Conceptual Framework 2

- Currently comprises four chapters:
  - Chapters 1–3 are from the new *Conceptual Framework for Financial Reporting*.
  - Chapter 4 consists of the parts of the former 1989 Framework which will be updated in Phase 2 of the project.

The IASB's Conceptual Framework 2018

- Chapter 1
  - The objective or the general purpose financial reporting
- Chapter 2
  - The reporting entity (still to be issued)
- Chapter 3
  - Qualitative characteristics of useful financial information

The IASB's Conceptual Framework -1989

- Chapter 4
  - Remaining text of the 1989 Framework
  - Underlying assumption
  - The elements of financial statements
  - Recognition of the elements of financial statements
  - Measurement of the elements of financial statements
  - Concepts of capital and capital maintenance

The scope of Conceptual Framework

The Framework addresses the following:

- The objective or general purpose of the financial reporting
- The qualitative characteristics of useful financial information
- Financial statements and the reporting entity (still ED)
- The elements of the Financial Statements
- Recognition and derecognition
- Measurement
- Faithfull Presentation and disclosures and compliance with IFRS 1

Scope of the Conceptual Framework

Chapter 1: The objective of general purpose financial reporting

- To provide 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
- Such decisions are likely to include:
  - Decisions to buy, hold or sell equity investments
  - Assessment of management stewardship and accountability
  - Assessment of the entity's ability to pay employees
  - Assessment of the security of amounts lent to the entity

Scope of the Conceptual Framework

Chapter 1: The objective of general purpose financial reporting (continued)

- The information required therefore relates to:
  - The economic resources of the entity
  - The claims against the entity
  - Changes in the entity's economic resources and claims
- This information should be prepared on an **accruals basis**

Underlying assumption

Underlying assumption

- Going concern:
  - The financial statements are normally prepared on the assumption that the entity is a going concern and will continue to trade for the foreseeable future.
- It is assumed that the entity has neither the intention not the need to liquidate the business or curtail major operations.
- If it did the financial statements would be prepared on a **different basis** and this basis would be **disclosed**.

Scope of the Conceptual Framework

Chapter 3: Qualitative characteristics of useful financial information

- These describe the attributes that information needs to have in order for it to be most useful for existing and potential investors, lenders and other creditors for making decisions about the reporting entity.
- They are divided into two categories:
  - Fundamental qualitative characteristics
  - Enhancing qualitative characteristics

Qualitative characteristics of financial information 2

Fundamental qualitative characteristics

Relevance

Relevant financial information is capable of making a difference in the decisions made by users, ie if it has:

- Predictive value, and/or
- Confirmatory value.

Materiality

Information is material if omitting it or misstating it could influence decisions that users make on the basis of financial information.

Faithful representation

To be useful, financial information must faithfully represent the phenomena it purports to represent.

A perfect faithful representation would be:

- Complete
- Neutral
- Free from error

Qualitative characteristics of financial information 3

Enhancing qualitative characteristics

Comparability

Information is more useful if it can be compared with similar information about:

- Other entities, and
- Other periods.

Consistency helps achieve comparability.

Verifiability

Assures users that information faithfully represents the economic phenomena it purports to represent

Verification can be direct or indirect

Timeliness

Having information available to decision-makers in time to be capable of influencing their decisions

Understandability

Classifying, characterising and presenting information clearly and concisely

Scope of the conceptual Framework

The elements of financial statements

- An item can only be recognised in the financial statements if it can be defined as one of the following elements.
  - Asset
  - Liability
  - Equity
  - Income
  - Expense

The elements of financial statements 2

ASSET	A resource controlled by an entity as a result of past events and 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 of resources embodying economic benefits
EQUITY	The residual interest in the assets of an entity after deducting its liabilities

The elements of financial statements 3

INCOME	Increases in economic benefits during the period other than contributions from equity participants
EXPENSE	Decreases in economic benefits during the period other than distributions to equity participants

Scope of conceptual Framework - Recognition and measurement 1

Recognition of the elements of financial statements

- Recognition is the process of recording or showing an item in the financial statements.
- An item can only be recognised in the financial statements when it satisfies the recognition criteria.

Recognition and measurement 2

Recognition of the elements of financial statements

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

Case study: Footballers 1

Are transfer fees paid for footballers an asset?

Case study: Footballers 2

Are the recognition criteria satisfied?

- Firstly, is there an asset?
  - Control
  - Past event
  - Expected generation of future economic benefit

Case study: Footballers 3

Asset?

- Control: the football club has purchased the right to use the player for match fixtures/training and merchandising (player rights)
- Past event: the transaction to purchase the player
- Future economic benefits

Case study: Footballers 4

What are the future economic benefits?

Case study: Footballers 5

- Asset?
  - Yes, an intangible asset
- Secondly, is there probable future economic benefit?
  - Yes as discussed above
- Thirdly, can the amount be measured with reliability?
  - Fee paid → yes

- Capitalise the transfer fee paid as an intangible non-current asset

Recognition and measurement 3

Measurement of the elements of financial statements

- 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 and the statement of profit or loss
- There are four choices available:
  - Historical cost
  - Realisable value
  - Current cost
  - Present value

Recognition and measurement 4

Measurement basis	Definition
Historical cost	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. Liabilities are recorded at the amount of proceeds received in exchange for the obligation.
Realisable value	The amount of cash or cash equivalents that could currently be obtained by selling an asset in an orderly disposal.

Recognition and measurement 5

Measurement basis	Definition
Current cost	Assets are recorded at the amount of cash or cash equivalents that would have to be paid if the same or an equivalent asset was acquired at the current time. Liabilities are carried at the undiscounted amount of cash or cash equivalents that would be required to settle the obligation at the current time.
Present value	A current estimate of the present discounted value of the future net cash flows in the normal course of business.

Scope of Conceptual Framework Fair presentation and compliance with IFRS 1

- Financial statements should present fairly the financial position, financial performance and cash flows of an entity.
- It is presumed that this fair presentation will be achieved where an entity complies with both the *Conceptual Framework* and IFRSs.
- Fair presentation also requires an entity to:
  - Select and apply appropriate accounting policies
  - Present information in a manner that provides relevance information and which is a faithful representation
  - Provide additional disclosures where further information is required to enable users to understand the impact of transactions

Past exam questions

Nature of question	Exam details
Discuss the meaning of understandability and comparability and the role of consistency when preparing financial statements	Q4 (a) Dec 2012
Use specific examples to show how IFRS disclosure can assist the predictive nature of historic financial statements	Q4 (a) June 2011
Note that past exam questions were all under the **previous exam format**.	Under new format some topics will be examined by **MCQ**