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Project: **Conceptual Framework**

Topic: **Cover note**

Purpose

1. The Conceptual Framework project is intended to strengthen the consistency of IFRSs, which is one of the Board's strategic objectives.

2. The purpose of this paper is to stimulate discussion about the next stages of the Conceptual Framework project. We particularly hope to stimulate debate about how financial statement elements are, or should be, defined and how the existing section on measurement might be strengthened. We would like to see the debate conducted by applying the concepts in the existing *Conceptual Framework* to determine whether an item is an asset and how one would measure it we hope to stimulate debate about how financial statement elements are or should be defined and the existing section on measurement might be strengthened.

3. Appendix A contains some background to assist you in responding to the questions.

During the session

4. Participants are asked to discuss the following questions in light of the examples given. These examples are based on some of the issues that the Board is considering in current projects.

5. In considering your response, please ignore the existing requirements in IFRSs except for the *Conceptual Framework*.

6. In addition to the guidance in the *Conceptual Framework* (see Appendix A), we have included after each example some additional things for you to consider when responding to the questions below.

Question 1
Are there one or more assets in the examples listed below? What are they?

Question 2
For each asset you identified, how should it be measured? Why?

Question 3
Did the *Conceptual Framework* (see Appendix A) help you to: (a) decide whether there was an asset in the examples; and (b) choose which measurement basis to apply? If the guidance in the existing *Conceptual Framework* did not help you, how should it be changed? Are there other concepts that you think the *Conceptual Framework* should include?

Examples

> Example 1
>
> Entity X produces solar energy panels. Entity X has been given emission credits by the national government that are worth CU5,000 so that solar energy panels can be sold at a discounted price to the public. Emission credits have an active market and many entities buy and sell those credits in the market.
>
> The emission credits are allocated to Entity X at the start of every third year. The only conditions to receiving those credits are that Entity X is continuing to operate and is continuing to sell solar energy panels at subsidised prices.

7. In answering question 1 for Entity X, one could consider the following issue:

    (a) Is the condition that requires Entity X to continue to operate a condition that prevents you from recognising the subsidy as an asset?

8. If you think that the credits are assets, consider the following when answering question 2:

    (a) Why do you think that your measurement basis would best satisfy the qualitative characteristics of useful financial information?

    (b) How would you apply the cost constraint on useful financial reporting? Would your answer be different if an active market for the emission credits has not yet developed in your country?

> Example 2
>
> Entity A has entered into a lease contract with Lessor B. Entity A will pay Lessor B a fixed payment of CU500 per month for the use of a machine for five years. The machine has an expected useful life of 10 years. The machine is used by Entity A to produce pencils. Lessor B bought the machine from a third party and it is in the leasing business to lease out new machines. Lessor B is also a dealer.
>
> The contract is non-cancellable. Entity A has an option to extend its right to use the machine for another three years for CU400 per month. Entity A and Lessor B view this lease payment to be less than market value. Lessor B has given this discount because Entity A has been a good, longstanding customer of Lessor B.

9. In answering question 1 from the standpoint of Entity A (the lessee) and/or Lessor B (the lessor), consider the following issues:

    (a) Can a physical asset be 'bifurcated' or 'separated' into different assets?

    (b) Is the option to extend the lease an asset in its own right? Is your response on whether the option is an asset different depending on whether you are answering from the perspective of Entity A (the lessee) or of Lessor B (the lessor)?

    (c) Would you combine the machine and the option to extend the lease as a single asset? Why?

10. In answering question 2, consider the following:

    (a) Why do you think that your measurement basis would best satisfy the qualitative characteristics of useful financial information?

    (b) How would you apply the cost constraint on useful financial reporting?

Appendix A *Background*

Objective of financial reporting

A1. The objective of general purpose financial reporting is 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. Those decisions involve buying, selling or holding equity and debt instruments, and providing or settling loans and other forms of credit (paragraph OB2 of the *Conceptual Framework*).

A2. Other aspects of the *Conceptual Framework* (a reporting entity concept, the qualitative characteristics of, and the constraint on, useful financial information, elements of financial statements, recognition, measurement, presentation and disclosure) flow logically from the objective.

A3. The primary users of financial reporting are the existing and potential investors, lenders and other creditors. The boards decided to focus on this group of external users because many of them are unable to require reporting entities to provide information directly to them and must rely on general purpose financial reports for much of the financial information that they need. Other types of users, eg regulators or management, have the ability to access additional financial information.

Financial information about the reporting entity's activities

A4. Information about a reporting entity's financial position (the entity's resources and claims against the entity) and financial performance during a period (changes in its economic resources and claims other than by obtaining additional resources directly from investors and creditors) is useful in assessing the entity's past and future ability to generate net cash inflows. That information indicates the extent to which the reporting entity has increased its available economic resources, and thus indicates its capacity for generating net cash inflows through its operations rather than by obtaining additional resources directly from investors and creditors (paragraphs OB12 and OB18 of the *Conceptual Framework*).

A5. Elements directly related to the measurement of financial position are assets, liabilities and equity (paragraph 4.4 of the *Conceptual Framework*).

(a) An asset is 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.

(b) A liability is 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.

(c) Equity is the residual interest in the assets of the entity after deducting all of its liabilities.

What is an asset?
(Paragraphs 4.8–4.14 of the *Conceptual Framework*)

A6. 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 potential may be a productive one that is part of the operating activities of the entity. It may also take the form of convertibility into cash or cash equivalents or a capability to reduce cash outflows, such as when an alternative manufacturing process lowers the costs of production.

A7. An entity usually employs its assets to produce goods or services that are capable of satisfying the wants or needs of customers; because these goods or services can satisfy these wants or needs, customers are prepared to pay for them and hence contribute to the cash flow of the entity. Cash itself renders a service to the entity because of its command over other resources.

A8. The future economic benefits embodied in an asset may flow to the entity in a number of ways. For example, an asset may be:

(a) used singly or in combination with other assets in the production of goods or services to be sold by the entity;

(b) exchanged for other assets;

(c) used to settle a liability; or

(d) distributed to the owners of the entity.

A9. Many assets, for example, property, plant and equipment, have a physical form. However, physical form is not essential to the existence of an asset; hence patents and copyrights, for example, are assets if future economic benefits are expected to flow from them to the entity and if they are controlled by the entity.

A10. Many assets, for example, receivables and property, are associated with legal rights, including the right of ownership. In determining the existence of an asset, the right of ownership is not essential; thus, for example, property held on a lease is an asset if the entity controls the benefits which are expected to flow from the property. Although the capacity of an entity to control benefits is usually the result of legal rights, an item may nonetheless satisfy the definition of an asset even when there is no legal control. For example, know-how obtained from a development activity may meet the definition of an asset when, by keeping that know-how secret, an entity controls the benefits that are expected to flow from it.

A11. The assets of an entity result from past transactions or other past events. Entities normally obtain assets by purchasing or producing them, but other transactions or events may generate assets; examples include property received by an entity from government as part of a programme to encourage economic growth in an area and the discovery of mineral deposits. Transactions or events expected to occur in the future do not in themselves give rise to assets; hence, for example, an intention to purchase inventory does not, of itself, meet the definition of an asset.

A12. There is a close association between incurring expenditure and generating assets but the two do not necessarily coincide. Hence, when an entity incurs expenditure, this may provide evidence that future economic benefits were sought but is not conclusive proof that an item satisfying the definition of an asset has been obtained. Similarly the absence of a related expenditure does not preclude an item from satisfying the definition of an asset and thus becoming a candidate for recognition in the balance sheet; for example, items that have been donated to the entity may satisfy the definition of an asset.

Qualitative Characteristics of useful financial information (Chapter 3 of the *Conceptual Framework*)

A13. The qualitative characteristics of useful information identify the types of information that are likely to be most useful to users for making decisions.

A14. If financial information is to be useful, it must be relevant and faithfully represent what it purports to represent. The usefulness of financial information is enhanced if it is comparable, verifiable, timely and understandable.

A15. 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. Materiality is an entity-specific aspect of relevance.

A16. Financial reports represent economic phenomena in words and numbers. Financial information is faithfully represented if it represents the economic phenomena in words and numbers that it purports to represent. To be a perfectly faithful representation, a depiction would have three characteristics. It would be complete, neutral and free from error. Of course, perfection is seldom, if ever, achievable. The Board’s objective is to maximise those qualities to the extent possible.

A17. A faithful representation, by itself, does not necessarily result in useful information. For example, an estimate of the amount of an asset’s carrying amount should be adjusted to reflect an impairment in the asset’s value. However, if the level of uncertainty in the estimate is sufficiently large, that estimate is not particularly useful. In other words, the relevance of the asset being faithfully represented is questionable. If there is no alternative representation that is more faithful, that estimate may provide the best available information.

Measurement of the elements of financial statements (Paragraph 4.54–4.56 of the *Conceptual Framework*)

A18. Measurement is the process of determining the monetary amounts at which the elements of financial statements are to be recognised and carried in the statement of financial position and statement of comprehensive income.

A19. Descriptions of some measurement bases described in the *Conceptual Framework* are below:

(a) *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 the proceeds received in exchange for the obligation, or in some circumstances (for example, income taxes), at the amounts of cash or cash equivalents expected to be paid to satisfy the liability in the normal course of business.

(b) *Current cost*. Assets are carried at the amount of cash or cash equivalents that would have to be paid if the same or an equivalent asset was acquired currently. Liabilities are carried at the undiscounted amount of cash or cash equivalents that would be required to settle the obligation currently.

(c) *Realisable (settlement) value*. Assets are carried at the amount of cash or cash equivalents that could currently be obtained by selling the asset in an orderly disposal. Liabilities are carried at their settlement values; that is, the undiscounted amounts of cash or cash equivalents expected to be paid to satisfy the liabilities in the normal course of business.

(d) *Present Value.* Assets are carried at the present discounted value of the future net cash inflows that the item is expected to generate in the normal course of business. Liabilities are carried at the present discounted value of the future net cash outflows that are expected to be required to settle the liabilities in the normal course of business.