

## International Financial Reporting Standards



# Conceptual Framework

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# Conceptual Framework

- The Conceptual Framework sets out the concepts that underlie the preparation of financial statements
- The project will revise and update the existing framework
- Will cover
  - Purpose and status of the Conceptual Framework
  - Elements of financial statements
  - Recognition and derecognition
  - Measurement
  - Presentation and disclosure (including use of OCI)
  - Reporting entity
- We do not plan major revisions to:
  - Objective of financial reporting
  - Qualitative characteristics of useful financial information

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. (OB 2)

...they need information about:

- the resources of the entity
- claims against the entity
- how effectively and efficiently the entity's management, and governing body have discharged their responsibilities to use the entity's resources.

(OB4)

# Qualitative characteristics

- What type of information is useful in meeting the objective of financials statements?

## Fundamental qualitative characteristics

### Relevance

- Capable of making a difference to the decisions of users

### Faithful representation

- Complete
- Neutral
- Free from error

Cost constraint

# Reliability vs faithful representation

- Some have objected to replacing reliability with faithful representation:

Pre 2010 Framework	Post 2010 Framework
<p>To be useful information must be reliable.</p> <p>Information is reliable when it is:</p> <ul style="list-style-type: none"> <li>• Free from material error and bias</li> <li>• Can be depended upon to represent faithfully either what it purports to represent or can be reasonably expected to represent</li> </ul> <p>Other aspects of reliability</p> <ul style="list-style-type: none"> <li>• Substance over form</li> <li>• Neutrality</li> <li>• Prudence</li> <li>• Completeness</li> </ul>	<p>To be useful information must faithfully represent what it purports to represent</p> <p>To be a perfectly faithful representation a depiction would be:</p> <ul style="list-style-type: none"> <li>• Complete</li> <li>• Neutral</li> <li>• Free from error</li> </ul>

# Prudence vs neutrality

- Some have objected to the removal of the term prudence:

Pre 2010 Framework	Post 2010 Framework
<p>To be reliable the information in the financial statements must be neutral, that is, free from bias.</p> <p>Prudence is the exercise of a degree of caution in the exercise of judgements under conditions of uncertainty.</p> <p>Prudence does not allow the deliberate overstatement of liabilities or expenses or the deliberate understatement of assets or income.</p>	<p>A faithful representation should be neutral.</p> <p>A neutral depiction is without bias in the selection of financial information.</p>

## Enhancing qualitative characteristics

Comparability

Verifiability

Timeliness

Understandability

# Questions

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- Are there any other areas you would like to see addressed as part of the Conceptual Framework project?



# Asset and liability definitions

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# Existing definitions of assets and liabilities

Asset [of an entity]	Liability [of an entity]
• a <b>resource</b> controlled by the entity	• a <b>present</b> obligation of the entity
• as a result of <b>past events</b>	• arising from <b>past events</b>
• from which <b>future economic benefits</b> are <b>expected</b> to flow to the entity	• the settlement of which is <b>expected</b> to result in an outflow from the entity of resources embodying <b>economic benefits</b>

# Problems with existing definitions

- Risk of confusing:
  - the resource or obligation, with
  - the inflows or outflows of economic benefits that the resource or obligation may generate
- What does ‘expected’ mean?
- More guidance needed?
  - What is a resource?
  - What is an obligation?

# Possible improved definitions of assets and liabilities

<b>Asset [of an entity]</b>	<b>Liability [of an entity]</b>
<ul style="list-style-type: none"><li>• a <b>present economic resource</b> [controlled by the entity]</li></ul>	<ul style="list-style-type: none"><li>• a <b>present obligation</b> [of the entity] to transfer an <b>economic resource</b></li></ul>
<ul style="list-style-type: none"><li>• An economic resource = a [scarce] item that is <b>capable</b> of producing economic benefits</li></ul>	

- Treatment of conditional liabilities
- 3 possible approaches:
  - A: Obligations must be unconditional
  - B: In addition to unconditional obligations, obligations also exist if:
    - Obligation accumulates over time
    - Possibility of avoiding obligation is not realistic
  - C: Focus on past events
    - Obligation exists if, as a result of past events, an entity has an obligation to transfer resources to another party on more onerous terms

# Conditional liabilities

Example	Present Obligation A	Present Obligation B	Present Obligation C
Employee bonus with vesting conditions	x	✓	✓
Electricity supplier levy	x	✓	✓
Emissions trading scheme	x	x	✓
Variable lease payment	x	x	✓
Contingent consideration	x	x	✓

# Questions

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- Do you think that the reference to “expected” inflows and outflows could be removed from the definition of a liability?
- Which of the three approaches to conditional liabilities described in slide 13 do you prefer?

# Recognition and derecognition

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- When should an entity recognise an asset or liability?
- Existing recognition criteria:
  - Meets **definition**
  - **Probable** that future economic benefits will flow to/from the entity
  - Cost or value can be **measured reliably** (complete, neutral and free from error)

# Problems with existing criteria

- Does reference to probability refer to:
  - Existence uncertainty (element uncertainty):
    - does the resource or obligation exist?
    - Example: litigation. The entity may not know whether it already has an obligation. The court decision may ultimately confirm whether the entity had an obligation.
  - Outcome uncertainty:
    - How likely is it that the resource (or obligation) will produce inflows of economic benefits (or outflows of economic resources)?
    - Example: option. The holder has a resource, but does not know whether it will ultimately exercise the option.

# Possible approaches to uncertainty

- Existence uncertainty:
  - Which threshold? (probable? virtually certain?)
  - Same threshold for assets and for liabilities
  - Same threshold for gains and for losses?
- Outcome uncertainty:
  - No specific probability threshold
  - But, in some cases, the Board may conclude that recognition does not:
    - provide relevant information
    - pass a cost/benefit test

# Recognition: possible approach

- A statement of financial position [balance sheet] is a summary listing of assets and liabilities.
- A more complete listing is likely to provide more useful information for assessing:
  - the amount, timing and uncertainty of future cash flows
  - how effectively and efficiently management is using the entity's resources
- But there may be cases when an entity should not recognise some asset or liability:
  - If recognition does not provide relevant information?
  - Cost/benefit

- Nothing in existing framework
- Is derecognition the mirror image of recognition or does history matter?
- Mirror image
  - Derecognise an asset or liability when it is no longer an asset or liability of the entity
- History matters = stickiness
  - Keep recognising an asset or liability in some cases even if it is no longer an asset or liability of the entity

# Example

Entity A transfers an asset with a carrying amount of CU70 to Entity B for its fair value (CU100). At the same time, Entity A agrees to repurchase that asset for CU100 in 1 year.

(For simplicity, ignore time value of money)

## *Balance sheet*

### Mirror image

Cash 100

Repo 0

Gain 30

### History matters

Asset 70

Cash 100

Liability 100

However, if entity A had never owned the asset but entered into a forward purchase contract with entity B, it would simply recognise the forward contract

Derecognition is the mirror image of recognition but if entity still exposed to rights or obligations associated with components of the asset or liability consider how best to portray the change in those rights and obligations.

- Reasons why mirror image is default
  - Consistent with recognition criteria
  - Same accounting treatment, irrespective of sequence
- Continued recognition
  - Standards-level issue
  - Consider both the financial position and the transaction

- How should uncertainty about the existence of an asset or liability be dealt with in the Conceptual Framework?
  - Should we include a probability threshold (virtually certain/probable)?
  - Should the treatment of assets and liabilities be the same?
- Do you agree that, in general, derecognition should be the mirror of recognition?
- When, if ever, should an entity continue to recognise an asset (liability) that it no longer controls (is obligated by)?



# Liability-equity boundary

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- Existing definition: the residual interest in the assets of the entity after deducting all its liabilities
- Problem: to distinguish liabilities from equity instruments, standards use complex criteria that:
  - conflict with the conceptual definitions
  - are difficult to understand and apply
- Possible approach:
  - Use conceptual definition of a liability:
    - to show obligation to transfer economic resources
  - remeasure equity claims through statement of changes in equity:
    - to show wealth transfers between equity holders

# Example

Entity A agrees to pay CU1,000 for legal services received on 1 January 20X1. Its contract requires it to pay on 31 December 20X2 by issuing shares whose fair value in 31 December 20X2 is CU1,210, representing principal of CU1,000 plus interest at a market rate of 10%.

## Existing Treatment

- The promise to deliver a variable number of own shares is treated as a liability
- The effect on the statement of financial position, profit or loss and statement of changes in equity is shown on the following slides

# Existing approach

## Statement of financial position

	1 Jan 20X1	31 Dec 20X1	31 Dec 20X2
Liability	-1000	-1100	0
Net assets	<u>-1000</u>	<u>-1100</u>	<u>0</u>

## Equity

Share capital	0	0	1210
Retained earnings	-1000	-1100	-1210
	<u>-1000</u>	<u>-1100</u>	<u>0</u>

## Statement of comprehensive income

	31 Dec 20X1	31 Dec 20X2
Legal expenses	-1000	0
Interest expense	<u>-100</u>	<u>-110</u>
Loss	<u>-1100</u>	<u>-110</u>

# Existing approach

## Statement of changes in equity

	Share capital	Retained earnings	Total current shareholders
Opening 1Jan 20X1	0	0	0
Loss for X1	0	-1100	-1100
31 December 20X1	0	-1100	-1100
Loss for X2	0	-110	-110
New shares issued	1210	0	1210
31 December 20X2	1210	-1210	0

# Example

Entity A agrees to pay CU1,000 for legal services received on 1 January 20X1. Its contract requires it to pay on 31 December 20X2 by issuing shares whose fair value in 31 December 20X2 is CU1,210, representing principal of CU1,000 plus interest at a market rate of 10%.

## Possible Treatment

- The promise to deliver a variable number of own shares is not treated as a liability (the entity has no obligation to transfer economic benefits)
- The wealth transfer between existing and future shareholders is shown in the statement of changes in equity
- The effect on the statement of financial position, income statement and statement of changes in equity is shown on the following slides

# Possible approach

## Statement of financial position

	1 Jan 20X1	31 Dec 20X1	31 Dec 20X2
Liability	<u>0</u>	<u>0</u>	<u>0</u>
Net assets	<u><u>0</u></u>	<u><u>0</u></u>	<u><u>0</u></u>
Retained earnings	-1000	-1100	0
Future shareholders	<u>1000</u>	<u>1100</u>	<u>0</u>
	<u><u>0</u></u>	<u><u>0</u></u>	<u><u>0</u></u>

## Statement of comprehensive income

	31 Dec 20X1	31 Dec 20X2
Legal expenses	-1000	0
Interest expense	<u>0</u>	<u>0</u>
Loss	<u><u>-1000</u></u>	<u><u>0</u></u>

# Possible approach

## Statement of changes in equity

	Share capital	Retained earnings	Total current shareholders	Future shareholders	Total
Opening 1 Jan 20X1	0	0	0	0	0
Loss for X1	0	-1000	<b>-1000</b>	0	<b>-1000</b>
Wealth transfer	0	-100	<b>-100</b>	100	<b>0</b>
	0	-1100	<b>-1100</b>	100	<b>-1000</b>
Obligation to issue new shares	0	0	0	1000	<b>1000</b>
31 December 20X1	0	-1100	<b>-1100</b>	1100	<b>0</b>
Loss for X2	0	0	0	0	0
Wealth transfer	0	-110	<b>-110</b>	110	<b>0</b>
	0	-110	<b>-110</b>	110	<b>0</b>
New shares issued	1210	0	<b>1210</b>	-1210	<b>0</b>
31 December 20X2	1210	-1210	<b>0</b>	0	<b>0</b>



# Questions

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- Would an expanded statement of changes in equity that includes remeasurement of some classes of equity provide useful information?

# Measurement

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## *Principle 1*

- Objective of measurement is to represent faithfully the most relevant information about:
  - Economic resources
  - Claims
  - How efficiently management have used resources

## *Principle 2*

- Consider the effect of a measure on both the balance sheet and the statement of comprehensive income

## *Principle 3*

- Consider cost/benefit

# One measurement basis or many?

- A mixed measurement model allows us:
  - to pick the most relevant measure for what we are trying to represent
  - consider cost/benefit

A single measurement basis is unlikely to provide the most relevant information in all circumstances

# Selecting a measurement method

- Relevant measurement method depends on the way the:
  - Value of an asset will be realised
  - Obligation will be fulfilled

## Realising an asset

Using

Selling

Holding for collection

Charging others for right to use

## Fulfilling an obligation

Settling according to terms

Performing services

Settling by negotiation

Transferring

- Do you agree that a single measurement basis is unlikely to provide the most relevant information in all circumstances?
- To you agree that the most relevant measurement method is likely to depend upon how:
  - the asset is realised;
  - the obligation will be fulfilled?

# Other areas and timetable

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- Reporting entity:
  - Already published DP and ED
  - not likely to develop further before 2013 DP
  - 2013 DP will continue a summary of work to date
- For the IASB meeting in March 2013:
  - Other comprehensive income
  - Other aspects of presentation
  - Disclosure



# What is the timetable?

