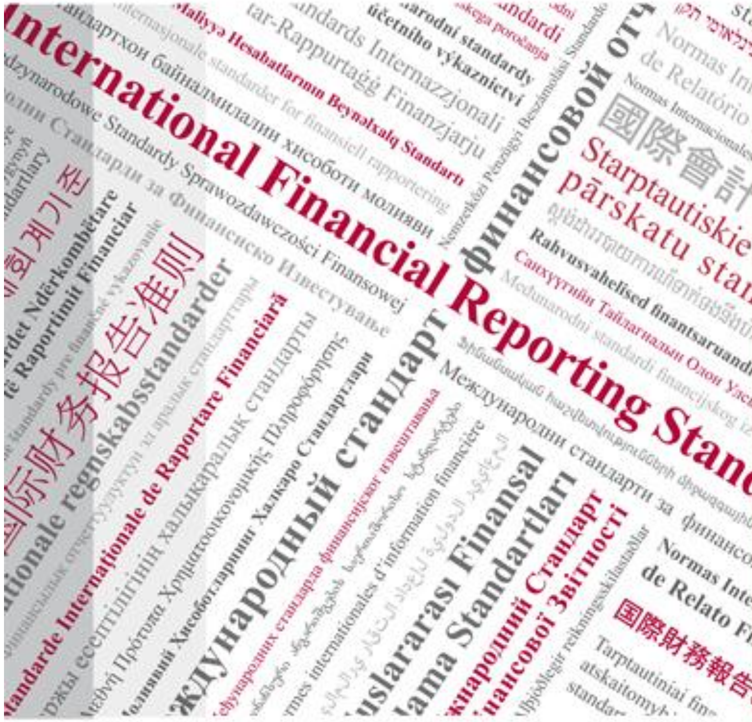
International Financial Reporting Standards



Conceptual Framework

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Agenda

- Background
- Asset and liability definitions
- Recognition and derecognition
- Liability-equity boundary
- Measurement
- Other areas and timetable

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

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Objective

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)

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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
To be useful information must be reliable. Information is reliable when it is: • Free from material error and bias • Can be depended upon to represent faithfully either what it purports to represent or can be reasonably expected to represent Other aspects of reliability • Substance over form • Neutrality • Prudence • Completeness	To be useful information must faithfully represent what it purports to represent To be a perfectly faithful representation a depiction would be: • Complete • Neutral • Free from error

Prudence vs neutrality

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

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

Qualitative characteristics contd.

Enhancing qualitative characteristics			
Comparability	Verifiability	Timeliness	Understandability

Existing definitions of assets and liabilities

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

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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

Asset [of an entity]	Liability [of an entity]
• a **present economic resource** [controlled by the entity]	• a **present** obligation [of the entity] to transfer an **economic resource**
• An economic resource = a [scarce] item that is **capable** of producing economic benefits	

Problems with existing definition

- 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	✘	✓	✓
Electricity supplier levy	✘	✓	✓
Emissions trading scheme	✘	✘	✓
Variable lease payment	✘	✘	✓
Contingent consideration	✘	✘	✓

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Problems with existing definition

- Treatment of constructive obligations

A *constructive obligation* is an obligation that derives from an entity's actions where:
(a) by an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities; and
(b) as a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities. (IAS 37)

- Example:
  – Environmental obligations of an entity that, although operating in a country with no environmental legislation, has a record of honouring its widely-published policy of cleaning up all contamination it causes

Constructive obligations

- Problems:
  - Difficult to identify
  - Difficult to define line between economic compulsion and constructive obligations
- Possible approaches:
  - Provide additional guidance on definition of constructive obligations
  - Restrict obligations to enforceable obligations

Recognition

- 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)

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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 [see next slide]

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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

Derecognition

- 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			History matters		
Cash	100		Asset	70	
Repo	0		Cash	100	
	Gain	30		Liability	100

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

Proposals for derecognition

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

Definition of equity

- 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	-1000	-1100	0
Equity			
Share capital	0	0	1210
Retained earnings	-1000	-1100	-1210
	-1000	-1100	0

Statement of comprehensive income

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

Existing approach

Statement of changes in equity

	Share capital	Retained earnings	Total current shareholders
Opening 1 Jan 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

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Possible approach

Statement of financial position

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

Statement of comprehensive income

	31 Dec 20X1	31 Dec 20X2
Legal expenses	-1000	0
Interest expense	0	0
Loss	-1000	0

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	**-1000**	0	**-1000**
Wealth transfer	0	-100	**-100**	100	**0**
	0	-1100	**-1100**	100	**-1000**
Obligation to issue new shares	0	0	**0**	1000	**1000**
31 December 20X1	0	-1100	**-1100**	1100	**0**
Loss for X2	0	0	**0**	0	**0**
Wealth transfer	0	-110	**-110**	110	**0**
	0	-110	**-110**	110	**0**
New shares issued	1210	0	**1210**	-1210	**0**
31 December 20X2	1210	-1210	**0**	0	**0**

Proposed principles of measurement

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

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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

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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

Other areas

- 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?

Feb - Apr 2013
Board discussions

Jul 2013
Issue DP
4-month comment period

Aug 2014
Issue ED
4-month comment period

Final by September 2015

Where to go for more information

- Project page on the IFRS website:
  - http://www.ifrs.org/Current-Projects/IASB-Projects/Conceptual-Framework/Pages/Conceptual-Framework-Summary.aspx
- Contacts:
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