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IFRS News

Special Edition

A revised 'Conceptual Framework for Financial Reporting'

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The IASB has published a revised version of the 'Conceptual Framework for Financial Reporting' (the Conceptual Framework). This completes the IASB's long-running project to update and clarify its existing guidance and fill in the gaps in it.

This Special Edition of IFRS News explains the key features of the revised Conceptual Framework and provides practical insights into its application and impact.

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Introduction

The IASB has published a revised Conceptual Framework that clarifies and updates its existing guidance that was published in 1989 and updated in 2010. It also fills gaps in areas where there was no or only little guidance.

The Conceptual Framework describes the objective of, and the concepts for, general purpose financial reporting. Its purpose is to:

- assist the IASB in developing IFRS Standards that are based on consistent concepts
- assist preparers in developing accounting policies for transactions or events to which no Standard applies or when a Standard allows a choice of accounting policy
- help all other parties to understand and interpret the Standards.

The revised Conceptual Framework now contains a comprehensive set of concepts, making some major changes to the previous version. It now contains guidance on:

- measurement
- presentation and disclosure
- the reporting entity
- derecognition.

It further updates the definitions of assets and liabilities and the guidance on recognition as well as clarifying the concepts of measurement uncertainty, prudence, stewardship and substance over form.

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While the Conceptual Framework is not a Standard and will not override or change any existing Standards, it is fundamental that the IASB has a comprehensive and consistent framework which it can use as a basis for developing and revising IFRS Standards.

The revised Conceptual Framework provides much needed guidance on, for example, measurement and reporting financial performance; areas that have not been sufficiently covered in the past. It also updates existing chapters to tailor those to the needs of the IASB.

Although the Conceptual Framework is primarily for the use of the IASB, preparers will find it useful in developing accounting policies for events and transactions for which no Standard applies or when there is a choice of accounting policy.

Background

In 2004, the IASB and the US standard-setter, the Financial Accounting Standards Board (FASB), initiated a joint project to revise their conceptual frameworks. In 2010, they published revised chapters on the objective of financial reporting and the qualitative characteristics of useful financial information before suspending their joint work to focus on other projects.

However, IASB constituents asked the IASB during its 2011 public consultation on its work plan, to continue and finalise the Conceptual Framework project. Following this consultation, the IASB restarted the project in 2012 without the FASB.

One year later, in 2013, the IASB published a Discussion Paper, asking constituents for their preliminary views on the IASB's proposals. The Discussion Paper did not cover all aspects, as some chapters had just been published or consulted on[1].

The Exposure Draft that the IASB published in 2015 included all chapters that a revised version of the Conceptual Framework would contain. Contrary to its initial intention not to change the chapters on the objective of financial reporting and the qualitative characteristics of useful financial information, the Exposure Draft suggested small changes in response to concerns from constituents. The Exposure Draft also included a chapter on the reporting entity which was based on the proposals in the 2010 Exposure Draft.

Scope

The Conceptual Framework is mainly a tool to assist the IASB in developing and revising IFRS Standards that are based on consistent concepts.

It also applies directly to preparers who develop accounting policies based on the Conceptual Framework as permitted in paragraph 11(b) of IAS 8 'Accounting Policies, Changes in Accounting Estimates and Errors'. The intention behind the changes in the revised version of the Conceptual Framework is not however to significantly change those existing accounting policies (see 'Effective date and transition' on page 10).

Some sections of the Conceptual Framework are for the IASB's use only, for example that on the use of other comprehensive income (OCI).

The Conceptual Framework is mainly a tool to assist the IASB in developing and revising IFRS Standards that are based on consistent concepts.

[1] The chapters on the objective and the qualitative characteristics of useful information were published in 2010. Shortly before this, an Exposure Draft on the reporting entity was published.

Objective and qualitative characteristics

Although the IASB's intention was to leave the chapters on the objective of financial reporting and the qualitative characteristics of useful financial information unchanged, as they had only been issued in 2010, constituent's feedback on both the Discussion Paper and the Exposure Draft indicated a strong case for improving those chapters further.

In response to the feedback, the IASB has reintroduced an explicit reference to the notion of prudence, a concept that was deleted from the 2010 Conceptual Framework. The revised Conceptual Framework describes prudence as the exercise of caution when making judgements under conditions of uncertainty. At the same time, it clarifies that prudence does not automatically imply a need for asymmetry.

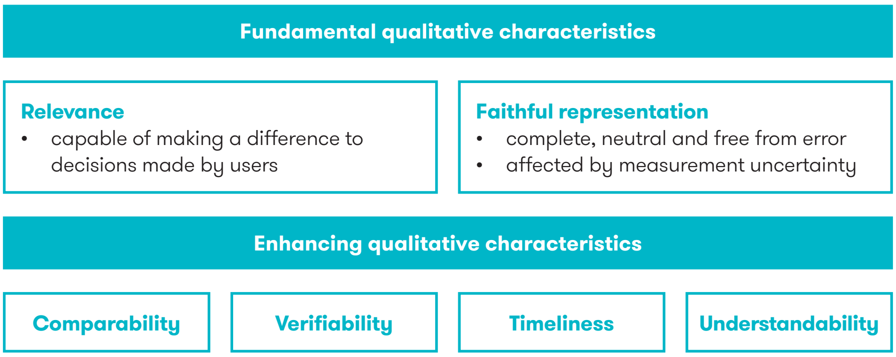
Furthermore, the Conceptual Framework now places more emphasis on the importance of providing information needed to assess management's stewardship and states explicitly that a faithful representation of a transaction or event reports its substance rather than merely its legal form.

Also, the revised Conceptual Framework clarifies that measurement uncertainty might have an influence on the faithful representation of an item. However, it does not necessarily mean that a high level of measurement uncertainty prevents an item from providing useful information.

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 relating to providing resources to the entity.

The qualitative characteristics of **useful financial information** are **relevance** and a **faithful representation** of the underlying transaction or event. The enhancing qualitative characteristics are comparability; verifiability; timeliness; and understandability.

Cost is a pervasive constraint on information that can be provided by financial reporting. It is however not amongst the enhancing qualitative characteristics.



Fundamental qualitative characteristics

Relevance
- capable of making a difference to decisions made by users

Faithful representation
- complete, neutral and free from error
- affected by measurement uncertainty

Enhancing qualitative characteristics

Comparability

Verifiability

Timeliness

Understandability

Financial statements and the reporting entity

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A reporting entity is described as an entity that is required, or chooses, to prepare financial statements. Those financial statements are prepared from the perspective of the reporting entity and are normally prepared on the assumption that the reporting entity is a going concern and will not enter liquidation or cease trading.

A reporting entity does not necessarily have to be a legal entity and can comprise more than one entity or a portion of an entity. Therefore, it is important to determine the boundaries of a reporting entity. The Conceptual Framework does this by stating that, when a reporting entity is not a legal entity or is not comprised of only legal entities connected by a parent-subsidiary relationship, the boundary is determined by the information needs of the financial statements' primary users. To achieve this:

- the boundary of a reporting entity does not include arbitrary or incomplete information
- the set of economic activities within the boundary of a reporting entity includes neutral information
- an explanation is provided as to how the boundary was determined and what constitutes the reporting entity.

The Conceptual Framework further sets out concepts on consolidated and unconsolidated financial statements. Whether an entity prepares consolidated or unconsolidated financial statements depends on whether one entity has control over another entity (a parent-subsidiary relationship). Should an entity consist of more than one entity without those entities being linked through a parent-subsidiary relationship, then its financial statements are combined financial statements. As IFRS Standards focus mainly on consolidated financial statements, it is no surprise that the Conceptual Framework does not provide guidance on when or how entities could prepare combined financial statements.

The objective of financial statements is to provide financial information about the reporting entity's assets, liabilities, equity, income and expenses that is useful to users of financial statements in assessing the prospects for future net cash inflows to the reporting entity and in assessing management's stewardship of the entity's economic resources.

The elements of the financial statements

The elements of financial statements are its basic 'building blocks'.

The revised Conceptual Framework introduces changes to the definitions of assets and liabilities. Although both definitions have worked well in the past, the revised definitions focus more on describing an asset as an economic resource and a liability as an obligation to transfer an economic resource rather than describing both in terms of an expected flow of benefits. The change is significant as the notion of an 'expected' flow of benefits had previously been interpreted by some as a probability threshold.

	New 2018 definition	Previous definition
Asset	A present economic resource controlled by the entity as a result of past events. An economic resource is defined as a right that has the potential to produce economic benefits.	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.
Liability	A present obligation of the entity to transfer an economic resource as a result of past events.	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.

Since income and expenses are defined as changes in an entity's assets and liabilities, these definitions have been updated slightly to reflect the wording in the updated asset and liability definitions.

The IASB has previously stated that the now superseded definitions have worked well in the past. Therefore, it is not surprising that no changes have been made to Standards that use the 'old' definition of a liability like for example IAS 37 'Provisions, Contingent Liabilities and Contingent Assets' or IFRIC 21 'Levies'. Although the Conceptual Framework and IAS 37 and IFRIC 21 are now to some extent inconsistent, the requirements in a Standard or Interpretation will always prevail.

The Conceptual Framework further defines equity as a residual after deducting an entity's liabilities from its assets. However, the IASB has already expressed their intention to update this definition when it concludes its separate project on 'Financial Instruments with Characteristics of Equity'.

Recognition and derecognition

Recognition

The recognition criteria are based on the qualitative characteristics of useful financial information.

For an item to be recognised in the statement of financial position, it needs to meet the definition of an asset, a liability or equity. Likewise, for an item to be recognised in the statement of financial performance, it needs to meet the definition of income or expenses.

In addition to meeting the definition of an element, items are only recognised when their recognition provides users of financial statements with information about the items that is both relevant and faithfully represented (ie meets the qualitative characteristics of useful information).

Derecognition

Derecognition has not been previously covered by the Conceptual Framework. The newly introduced concept aims to faithfully represent both:

- any assets and liabilities retained after the transaction or other event that led to the derecognition (including any asset or liability acquired, incurred or created as part of the transaction or other event)
- the change in the entity's assets and liabilities as a result of that transaction or other event.

The first of these two aims can be viewed as representative of a control approach while the second represents more of a risks-and-rewards approach. The IASB views both aims as valid. Accordingly, in the 2018 Conceptual Framework the Board did not specify the use of the control approach or the risks-and-rewards approach.

Measurement

Similar to the concepts on financial statements and the reporting entity, the previous Conceptual Framework did not provide much in the way of guidance on measurement.

Measurement is described as quantifying, in monetary terms, elements that are recognised in financial statements. Measuring those elements requires the selection of a measurement basis, which can be either a historical cost measure or a current value. The Conceptual Framework does not favour one basis over the other but notes that under some circumstances one may provide more useful information than the other.

Historical cost would typically reflect the cost of acquiring or creating an asset or taking on a liability, with both measures being adjusted for transaction costs. Over time, historical cost is further adjusted to reflect for example the consumption of an asset or the fulfilment of part or all of a liability. It is described as an entry value[2].

Historical cost can provide relevant information about assets and liabilities and the price of the transaction that gave rise to each. One example of historical cost would be amortised cost.

Measurement bases

Measurement bases	Historical cost	Current value		
	Eg amortised cost	Fair value	Value in use/ fulfilment value	Current cost
Cost is…	…the cost of transaction that gave rise to the asset/liability	…the price that would be received/paid to sell/transfer the asset/liability	…the present value of cash flows and other economic benefits from the asset/ liability	…the cost of an equivalent asset/ liability
Transaction costs considered?	Yes	No	No	Yes
Updated for…	…eg consumption/ fulfilment	…changes since previous measurement date	…changes since previous measurement date	…changes since previous measurement date
Entry or exit value?	Entry	Exit	Exit	Entry

A **current value measurement basis** on the other hand reflects conditions at the measurement date and not the price of the transaction that gave rise to the asset or liability. Current value measurement bases have different characteristics. **Fair value** for example reflects a price that would be received or paid for selling an asset or transferring a liability from the perspective of market participants. **Value in use** (for assets) and **fulfilment value** (for liabilities) on the other hand reflect the present value of future cash flows which are based on entity-specific assumptions.

Fair value, value in use and fulfilment value are described as exit values, whereas **current cost** is – like historical cost – an entry value. Unlike fair value, value in use and fulfilment value, current cost takes into account transaction costs that would be incurred at the date the asset or liability is measured, based on the cost that an equivalent asset or liability would have.

The Conceptual Framework further explains which factors should be considered when selecting a measurement basis and what information is provided by a particular measurement basis.

[2] An entry value is described as reflecting prices in the market in which the entity would acquire the asset or would incur the liability.

Presentation and disclosure

The 2018 Conceptual Framework introduces a new chapter, setting out high level concepts about how information should be presented and disclosed. It also includes material on how to report financial performance.

The Conceptual Framework does not specify whether the statement of financial performance should contain one single statement with a separate section of profit or loss or contain two separate statements. It does however describe the statement of profit or loss as the primary source of information about an entity's financial performance. The Conceptual Framework therefore presumes that all income and expenses would normally be included in that statement unless the IASB has reason to decide that excluding certain income and expenses and instead including them in the statement of other comprehensive income provides more relevant and/or more faithfully represented information. This discretion applies only to the IASB – preparers of financial statements will not be able to choose to exclude items from profit or loss when using the Conceptual Framework to develop accounting policies. Furthermore, the IASB will only be able to do this for income and expenses arising from changes in assets and liabilities that are measured using current values.

The assumption that all income and expenses are (eventually) included in the statement of profit or loss means that income and expenses included in other comprehensive income will normally be reclassified ('recycled') to profit or loss in a future period. Only in exceptional circumstances may the IASB decide that such income and expenses will not be reclassified to profit or loss, for example, if there is no clear basis for recycling.

Concepts of capital and capital maintenance

The chapter on capital and capital maintenance has been carried forward largely unchanged from the existing Conceptual Framework and only editorial changes have been made.

Effective date and transition

Consequential amendments and effects on preparers

Alongside the revised Conceptual Framework, the IASB has published 'Amendments to References to the Conceptual Framework in IFRS Standards'. This publication updates nearly all of the references to previous versions of the Conceptual Framework with references to the 2018 version. The IASB is confident that the updated references will have no impact on preparers of financial statements and reminds them that the Conceptual Framework is not a Standard and does not change or override requirements of any existing Standards.

However, some references have not been updated in order to allow preparers to continue applying the 2010 Conceptual Framework. In particular, IFRS 3 'Business Combinations' states that in a business combination, identifiable assets acquired, and liabilities assumed, must meet the definitions of assets and liabilities in the Conceptual Framework. To avoid unintended consequences, preparers are therefore required to apply the definitions of assets and liabilities from the 2010 Conceptual Framework when accounting for business combinations under IFRS 3. The IASB plans to explore in due course how those references can be updated without having any effect on preparers of financial statements.

Also, preparers will continue to use the 2010 definitions of assets and liabilities when accounting for regulatory account balances. This is because the IASB is planning to replace its interim Standard IFRS 14 'Regulatory Deferral Accounts' with a more comprehensive Standard in the near future. Continuing to use the 2010 definitions means preparers will not have to change their accounting for rate-regulated assets and liabilities twice within a short period of time.

Effective date and transition

The Conceptual Framework is not a Standard and will not change or override any existing Standards. It does not therefore have an effective date. It is primarily a tool for the IASB to help them develop Standards based on consistent concepts. Over the last few years, the IASB has already started applying some of the new or revised concepts when developing or revising Standards.

However, entities that develop accounting policies using the Conceptual Framework, or that are in any other way affected by the amendments to IFRS Standards, will have to apply the changes from 1 January 2020.

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Practical insight – next steps

Although the Conceptual Framework does not immediately change existing Standards, there are nevertheless some actions that entities may wish to consider:

- if an entity develops accounting policies by reference to IAS 8, it should assess whether the changes to the Conceptual Framework will have an effect
- if they will have an effect, then the entity will need to review the accounting policies and apply the changes from 1 January 2020 or earlier.

We hope you find the information in this Special Edition newsletter helpful in giving you an overview of the revised Conceptual Framework. If you would like to discuss any of the points raised, please speak to your usual Grant Thornton contact or visit **www.grantthornton.global/locations** to find your local member firm.

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