

The Conceptual Framework for Financial Reporting

Framework Lecture Video 1

WHAT IS THE FRAMEWORK?

What is the Framework?

- Sets out the objectives & concepts
 - that underlie the preparation & presentation of
 - general purpose financial statements for external users. (*Framework par 1*)
- Provides a theoretical background or general frame of reference – used by standard setters (IASB) when setting new standards

What is the Framework? (Cont.)

- NOT an accounting standard.
- Does not override an IAS or IFRS standard.

Purpose of the Framework

- Assist _____ bodies;
- Assist _____ of financial statements;
- Assist _____;
- Assist other users of financial statements.

Improvement project

- IASB and FASB are jointly developing an improved Conceptual Framework.
- IASB replacing 1989 Framework.

Project Status

The boards (FASB & IASB) are jointly conducting the project in **8 phases**:

- A. Objectives and qualitative characteristics – **2010 Framework**
- B. Definitions of elements, recognition and de-recognition - **Active**
- C. Measurement - **Active**
- D. Reporting entity concept - **Active**
- E. Boundaries of financial reporting, and Presentation and Disclosure
- F. Purpose and status of the framework
- G. Application of the framework to not-for-profit entities
- H. Remaining Issues, if any

Framework Lecture Video 2

THE OBJECTIVE OF GENERAL PURPOSE FINANCIAL REPORTING

The Objective...

- The foundation of the Conceptual Framework
- Other aspects flow logically from the objective:
 - Qualitative characteristics;
 - Elements of financial statements;
 - Recognition
 - Presentation and disclosure

2010 Framework Objective (paragraph OB 2)

The objective of general purpose financial reporting is to provide financial information about

that is useful to

in making decisions about

Decisions?

(Par OB 2 cont.)

- Buying, selling or holding

AND

- Providing or settling loans (credit)

Contribution to debate

- New Framework (2010) has more focussed assumptions.
 1. Potential and present ***investors and creditors*** given primacy instead of a *wide range of users*.
 2. Investor needs = ***Resource allocation decision*** for investors resources, therefore tending towards fair value.
Created large debate over stewardship function.
- Both the old and new objective mention stewardship. (or its essence)

Estimates and judgements

- Financial reports based on estimates and judgements.
- Conceptual Framework establishes concepts that underlie those estimates and judgements.
- Not perfect, but IASB striving to improve.

Framework Lecture Video 3

QUALITATIVE CHARACTERISTICS

Introduction

- Qualitative characteristics of useful information:
 - Identify information that will be most useful
 - To investors (existing and potential) and lenders (and other creditors)
 - For making decisions based on financial reports

To be useful...

- For financial information to be useful, it must be (fundamental):
 - Relevant and
 - Faithfully represent what it purports to represent
- Usefulness is enhanced if it is (enhancing):
 - Comparable
 - Verifiable
 - Timely
 - Understandable

Qualitative characteristics

1989 FRAMEWORK

- *Relevance*
- *Reliability* →
- *Comparability*
- *Understandability*

2010 FRAMEWORK

FUNDAMENTAL

- *Relevance*
- *Reliability*

ENHANCING

- *Comparability*
- *Verifiability* (NEW)
- *Timeliness* (NEW)
- *Understandability*

Relevance

- Makes a difference in the decisions made by users.
- Information will make a difference in decision making if it has:

— ;

— ;

– Or both

Relevance: *Predictive and confirmatory value*

- Predictive value:
 - If the information can be used as an input for users making predictions.
- Confirmatory value:
 - Provides feedback about previous evaluations

Relevance: *Materiality*

Information is material if it's _____ **or**
_____ could influence decisions

- Entity specific
- Based on magnitude or nature, or both
- Context of an individual entity's financial report
- No quantitative threshold – professional judgement

Faithful representation

- Information must faithfully represent economic phenomena that it purports to represent.
- 3 characteristics for perfect faithful representation:
 1. C _____;
 2. N _____;
 3. F _____.
- Try and maximise these (perfection impossible)

Application

1. Identify *economic phenomenon* that has the *potential to be useful*;
2. Identify *type of information* about phenomenon that would be *most relevant*;
3. Determine if information is *available* and can be *faithfully represented*.

Enhancing - Comparability

- Information is more useful if it can be compared with similar information about:
 - Other entities
 - Same entity for another date
- NOT same as consistency
- NOT uniformity

Enhancing - verifiability

- Different knowledgeable and independent observers could reach consensus.
- Verification can be direct or indirect.
- Maybe not possible to verify some information until a future period
 - Necessary to disclose assumptions, methods, factors and circumstances.

Enhancing - Timeliness

- Information being available to decision makers in time to be able to influence their decisions.
- The older the information, the less useful it is.

Enhancing - Understandability

- Classifying, characterising and presenting information clearly and concisely
 - *Makes it understandable*
- Reasonable knowledge and diligence assumption

Cost constraint

- Cost is a pervasive constraint
- Reporting financial information imposes costs

Costs must be justified by the
benefits of reporting

Framework Lecture Video 4

UNDERLYING ASSUMPTIONS

Overview

- ***Accrual basis*** (2010 Framework)
 - Refer “*Changes in economic resources and claims ;
Financial performance reflected by accrual
accounting*” ~ paragraph OB17 (2010 Framework)
- ***Going Concern*** (1989 Framework)
 - Refer “*Underlying assumption*” ~ paragraph 4.1 (1989 Framework)

Accrual Basis

- Effects of transactions & other events are recognised when they ***occur*** (NOT when cash flows!).
- ***Recorded*** in accounting records and reported in AFS of the ***periods to which they relate***.
- ***Take note:***
 - *Always note the reporting date (year end)*
 - *Compare transaction date (when recognition criteria etc met) with reporting date – don't recognise in wrong period!*

Going Concern

- Financial statements normally prepared on the assumption that entity is, and will continue to operate as a going concern into the foreseeable future.
- Entity not expected to liquidate in next 12 months
 - if expected to liquidate, then DON'T prepare on going concern basis, but rather use liquidation basis.

Framework Lecture Video 5

ELEMENTS : DEFINITION

Elements

Financial Position

Think accounting equation:

- *This is a measure of financial **POSITION** at a specific date.*

Elements

Financial Performance

- Remember:
 - *This is a measure of financial **PERFORMANCE** over a period.*

(Profit is closed out (accumulated) every year in retained earnings / accumulated profit = equity account.)

Financial position

- Asset:
 - Resource controlled by entity;
 - Resulting from past event;
 - Expected inflow of future economic benefits
- Liability:
 - Present obligation
 - Resulting from past event
 - Expected outflow of economic resources to settle
- Equity:
 - Residual interest, ie
 - Assets - Liabilities

Financial performance

- Income:
 - Increase in assets; or
 - Decrease in liabilities
- Expenses:
 - Increase in liabilities; or
 - Decrease in assets

Asset definition

1. Resource controlled by entity;
 - Control access to the FEB
2. Resulting from past event;
 - Look for entitling event.
3. Expected inflow of future economic benefits (FEB)
 - FEB = potential to contribute (directly / indirectly) to cash flows.
 - Time value of money!

Asset: Future economic benefits

- FEB may flow to entity in a number of ways:
 - Used in the production of goods / services to be sold;
 - Exchanged for other assets;
 - Used to settle a liability;
 - Distributed to the owners of the entity.

Liability definition

1. Present obligation;
 - Legal obligation – contract or statutory obligation
 - Constructive obligation – valid expectation
2. Resulting from past event;
 - Look for obligating event – avoidance test
3. Settlement expected to result in outflow of resources embodying economic benefits (FOF)
 - Time value of money!

Liability: Present obligation vs Future Commitment

- ***Present obligation*** = consequence of failing to honour obligation will result in outflow of resources (no right to avoid settlement)
- ***Future commitment*** eg – decision to acquire assets in future, NOT a present obligation.

Liability: Settlement (FOF)

Settlement of a liability may occur in the following ways:

- Payment of cash;
- Transfer of other assets;
- Provision of services;
- Replacement of that obligation with another obligation;
- Conversion of the obligation to equity
- Other means eg creditor waiving / forfeiting its rights

Additional Notes

- Time value of money:



- NB underlying substance and economic reality
NOT merely legal form

Equity definition

- Residual interest in assets after deduction liabilities.
- **EQUITY =**

Income

- Increases in economic benefits during the period
- in the form of inflows / enhancements of assets
- or decreases of liabilities
- that result in increases in equity,
- other than those relating to contributions from equity participants.

Income notes

- Encompasses both revenue and gains
- Revenue – ordinary business activities
- Gains – increases in economic benefits (same in nature, but not from ordinary activities)
 - Eg gains from sale of non-current assets
 - Includes unrealised gains (eg revaluations and fair value gains)

Expenses

- Decreases in economic benefits during the period
- in the form of outflows or depletions of assets
- or incurrences of liabilities
- that result in the decrease in equity,
- other than those relating to distributions to equity participants.

Framework Lecture Video 6

ELEMENTS : RECOGNITION CRITERIA

Recognition of elements

- Refers to the inclusion of an item in the financial statements.
- Some items are included in the notes, but are not *recognised* on the face of the financial statements
 - Eg contingent assets & liabilities.

Recognition criteria

- First meet the definition of one of the elements!
- Then 2 recognition criteria:
 1. Is **PROBABLE** that any **FUTURE ECONOMIC BENEFITS** associated with the item will flow to or from the entity.
 2. The item must have a **COST OR VALUE** that can be **MEASURED** with **RELIABILITY**

Framework Lecture Video 7

ELEMENTS : MEASUREMENT

Measurement ?

- Process of determining monetary amounts at which the elements of financial statements are to be recognised and carried.
- Involves selection of measurement bases.
- Framework does NOT prescribe a measurement bases.

Measurement bases:

Some of the measurement bases noted include:

- a) Historical cost (most common)
- b) Current cost
- c) Realisable (settlement) value
- d) Present value

a) Historical cost

- Assets recorded at the amount of
 - cash paid, or
 - fair value of consideration given
- Liabilities are recorded at
 - Amount of proceeds received in exchange for the obligation, or
 - At the amounts of cash expected to be paid to satisfy the liability in the normal course of business.

b) Current cost

- **Assets**
 - The amount of cash to be paid to acquire the same or an equivalent asset.
- **Liabilities**
 - Undiscounted amount of cash that would be required to settle the obligation currently.

c) Realisable (settlement) value

- **Assets**
 - Amount of cash that could currently be obtained by selling the asset in an orderly transaction.
- **Liabilities**
 - Their settlement values: the undiscounted amount of cash expected to be paid to satisfy the liabilities in the normal course of business.

d) Present value

- Assets
 - Present discounted value of the future net cash inflows that the item is expected to generate
- Liabilities
 - Carried at the present discounted value of the future cash outflows that are expected to be required to settle the liabilities

Framework Lecture Video 8

CAPITAL MAINTENANCE CONCEPTS

Capital Maintenance

- The issue – how does an entity define the concept of *CAPITAL* that it seeks to maintain?
- Companies should only pay dividends out of profits in order to maintain a companies capital and therefore protect providers of capital (shareholders and providers of finance).
- So how do we define profit and do we take into account the effect of changing prices?

Capital Maintenance (cont)

Lets look at an example.....

- Co. A commences business on 1 Jan 2010 with R100 001 share capital.
- Co. A purchases 20 000 units of inventory at R5 each on 1 Jan 2010, total cost of R100 000.
- Co. A sold all inventory during 2010 for a total of R120 000 in cash.
- Therefore, a profit of R20 000 for 2010 is earned.
- If R20 000 dividend paid, then capital (equity) would be unchanged for the year.

Capital Maintenance (cont)

- Now lets assume that the company wishes to purchase another 20 000 units on 1 Jan 2011 (the second year).
- What happens, prices go up (inflation) – and now the inventory will cost R5,40.
- Therefore with the same capital of R100 000, the company can only purchase 18 518 units of inventory.

Capital Maintenance (cont)

- Therefore by distributing the full R20 000 in dividend, the company's ability to purchase goods / services has been eroded.
- Should the profit of R20 000 not be recorded as
 - R120 000 – R108 000 (20 000 units x R5.4) = R12 000 ?
- *IAS 2 still sticks to measuring inventory at lower of cost or net realisable value, but many other assets are now measured at fair value / current cost / replacement value for this reason.*

Capital Maintenance (cont)

- The framework refers to two different concepts of capital maintenance:
 1. Financial capital maintenance;
 2. Physical capital maintenance.

Financial capital maintenance

- Financial capital maintenance:
 - Profit is only earned if the financial (monetary) amount of net assets at the end of the period exceeds the financial net assets at the beginning of the period.
- Physical capital maintenance:
 - Profit is only earned if the physical productive capacity of the entity at the end of the period exceeds the physical productive capacity at the beginning of the year.

Framework Lecture Video 9

FRAMEWORK SUMMARY

Important

- Objective
- Qualitative characteristics
- Accrual basis and going concern
- Elements definition
- Recognition criteria

Objective

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

Qualitative Characteristics

FUNDAMENTAL

- Relevance
- ***Faithful representation***

ENHANCING

- Comparability
- Verifiability
- Timeliness
- Understandability

Definition of elements

Financial position

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