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The Conceptual Framework for Financial Reporting

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Framework Lecture Video 1

WHAT IS THE FRAMEWORK?

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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

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What is the Framework? (Cont.)

- NOT an accounting standard.

- Does not override an IAS or IFRS standard.

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Purpose of the Framework

- Assist ______________________________ bodies;
- Assist _______________ of financial statements;
- Assist ____________________________________;
- Assist other users of financial statements.

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Improvement project

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

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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

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Framework Lecture Video 2

THE OBJECTIVE OF GENERAL PURPOSE FINANCIAL REPORTING

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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

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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

____

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Decisions?

(Par OB 2 cont.)

- Buying, selling or holding

AND

- Providing or settling loans (credit)

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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)

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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.

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Framework Lecture Video 3

QUALITATIVE CHARACTERISTICS

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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

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To be useful…

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

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Qualitative characteristics

1989 FRAMEWORK	2010 FRAMEWORK
	FUNDAMENTAL
▪ *Relevance*	▪ ______________________.
▪ ***Reliability*** →	▪ ______________________.
	ENHANCING
▪ *Comparability*	▪ Comparability
	▪ Verifiability (NEW)
	▪ Timeliness (NEW)
▪ *Understandability*	▪ Understandability

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Relevance

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

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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

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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

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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)

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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***.

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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

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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.

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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.

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Enhancing - Understandability

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

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Cost constraint

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

Costs must be justified by the

benefits of reporting

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Framework Lecture Video 4

UNDERLYING ASSUMPTIONS

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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)

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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!*

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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.

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Framework Lecture Video 5

ELEMENTS : DEFINITION

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<u>Elements</u>

Financial Position

Think accounting equation:

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

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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.)

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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

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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!

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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.

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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!

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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.

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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

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Additional Notes

- Time value of money:

- NB underlying substance and economic reality

  NOT merely legal form

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Equity definition

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

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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.

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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)

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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.

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ELEMENTS : RECOGNITION CRITERIA

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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.

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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

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Framework Lecture Video 7

ELEMENTS : MEASUREMENT

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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.

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Measurement bases:

Some of the measurement bases noted include:

a) Historical cost (most common)

b) Current cost

c) Realisable (settlement) value

d) Present value

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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.

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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.

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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.

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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

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Framework Lecture Video 8

CAPITAL MAINTENANCE CONCEPTS

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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?

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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.

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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.

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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.*

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Capital Maintenance (cont)

- The framework refers to two different concepts of capital maintenance:

1. Financial capital maintenance;

2. Physical capital maintenance.

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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.

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Framework Lecture Video 9

FRAMEWORK SUMMARY

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Important

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

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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

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Qualitative Characteristics

FUNDAMENTAL

- Relevance
- ***Faithful representation***

ENHANCING

- Comparability
- Verifiability
- Timeliness
- Understandability

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Definition of elements

Financial position

- Asset:
  - Resource controlled by entity;
  - Resulting from past event;
  - Expected inflow of future economic benefits
- Liability:
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Financial performance

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Recognition criteria

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