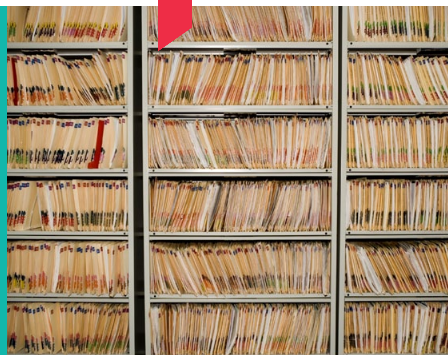
INTERNATIONAL FINANCIAL REPORTING BULLETIN 2010/24

CONCEPTUAL FRAMEWORK FOR FINANCIAL REPORTING 2010



STATUS
Final

EFFECTIVE DATE
n/a

ACCOUNTING IMPACT
Changes to the concepts underlying the preparation and presentation of financial statements

Background

The International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) have announced the completion of the first phase of their joint project to develop an improved conceptual framework for International Financial Reporting Standards (IFRSs) and US Generally Accepted Accounting Principles (US GAAP).

The IASB's Conceptual Framework project aims to update and refine the existing concepts to reflect the changes in markets, business practices and the economic environment that have occurred since the current IFRS Framework was published in 1989 (the 1989 Framework). Its overall objective is to create a sound foundation for future accounting standards that are principles-based, internally consistent and internationally converged. In order to achieve this last criterion the IASB and the US FASB (the boards) are undertaking the project jointly. The IASB has revised portions of its framework; the FASB has issued Concepts Statement 8 to replace Concepts Statements 1 and 2.

Both the IASB and the FASB are finalising the new framework as parts (chapters) are completed. It is therefore possible that later parts will include consequential amendments to earlier parts. The boards noted that the question of how to finalise the joint framework may need to be readdressed when the boards discuss the placement of the framework within the IASB and FASB hierarchies.

The boards are conducting the project in 8 phases. Phases A (now complete, and summarised in this Bulletin), B, C and D of the project are currently active:

A) Objective and qualitative characteristics: Chapters 1 and 3 of the new Conceptual Framework;

B) Definitions of elements, recognition and derecognition: Discussion Paper (DP) to be published in 2011;

C) Measurement: DP to be published in 2011; and

D) Reporting entity concept: Exposure Draft (ED) published in March 2010 (the comment deadline was 16 July 2010).

Phases not yet active, and to be considered in the future are:

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; and

H) Remaining issues, if any.

As each chapter is finalised, the relevant paragraphs in the 1989 Framework will be replaced. Completion of the conceptual framework project will result in a comprehensive single document 'The Conceptual Framework for Financial Reporting'.

The Conceptual Framework for Financial Reporting 2010 (the Conceptual Framework)

The updated version of the Conceptual Framework includes the first two chapters published as a result of the first phase of the conceptual framework project – Chapter 1 *The objective of financial reporting* and Chapter 3 *Qualitative characteristics of useful financial information*. Chapter 2, which has yet to be completed, will deal with the reporting entity concept and chapter 4 contains the remaining text of the 1989 Framework.

The Introduction has been carried forward from the 1989 Framework. This will be updated when the IASB considers the overall purpose of the Conceptual Framework. Until then, the existing purpose and the status of the 1989 Framework are retained.

It should be noted that the Conceptual Framework is not an IFRS and hence does not define accounting requirements for any particular measurement or disclosure issue. Nothing in the Conceptual Framework overrides any specific IFRS. It is acknowledged that it is possible, in a small number of cases, for there to be a conflict between the Conceptual Framework and an IFRS; in such circumstances, the requirements of the IFRS override those of the Conceptual Framework.

Summary of the main changes in comparison with the discussion paper

- The objective of financial reporting has been amended to clarify that its purpose is to help users to make decisions about providing resources to an entity.
- It has been clarified that financial reports are directed to meet the common information needs of those who provide resources to an entity but cannot compel the entity to provide information to enable them to make decisions about the entity.
- The qualitative characteristics are now categorised as either fundamental or enhancing characteristics. This clarifies how the qualitative characteristics relate to each other. There is one constraint upon providing useful information – cost.

Chapter 1: The objective of general purpose financial reporting

The first chapter of the Conceptual Framework deals with the objective of financial reporting. 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.'

General purpose financial reporting is directed at users who provide resources to an entity, but lack the ability to compel the entity to provide them with the information they need to be able to make related decisions. While regulators and members of the public other than investors, lenders and other creditors may also find the information useful, general purpose financial reports are not primarily directed at them.

General purpose financial statements are not designed to show the value of an entity. However, the information that they contain is intended to assist users of those financial statements to estimate that value.

Chapter 3: Qualitative characteristics of useful financial information

The chapter of the new Conceptual Framework on qualitative characteristics deals with the attributes that make financial information useful. They are:

- relevance and faithful representation – the fundamental qualitative characteristics
- comparability, timeliness, verifiability and understandability – the enhancing qualitative characteristics that distinguish more useful information from less useful information.

The application of these qualitative characteristics is balanced by a cost/benefit analysis, with cost being regarded as being a pervasive constraint on the reporting entity's ability to provide useful financial information.

The qualitative characteristics of useful financial information apply to financial information provided in financial statements, as well as to financial information provided in other ways, such as in forecasts. However, it is acknowledged that the application of the qualitative characteristics and cost constraints to financial information provided in those other ways may be different.

Fundamental qualitative characteristics

Relevance

Financial information is relevant if its use is capable of resulting in different decisions being made by its users. For these purposes, the focus is on whether the financial information has predictive and/or confimatory value. The focus is on capability of use, and not on whether the information is in fact used, or is also available from other sources.

Predictive value arises from the use of financial information, which does not itself need to be a forecast, as a means to predict future outcomes. Confirmatory value of financial information arises from the confirmation of, or change from, previous evaluations. It is noted that some information could have both predictive and confirmatory value, such as revenue information for the current year which could be used both as a prediction for future years and as confirmation of whether prior year forecasts were accurate.

For the purposes of relevance, reference is made to materiality. Information is considered to be material if either its omission or misstatement could influence decisions taken about a specific reporting entity on the basis of its reported financial information. This means that materiality will be determined for each individual entity, taking into account both quantitative and qualitative aspects.

Faithful representation

'Faithful representation' represents a change from the previous equivalent term 'reliability'. The change has been made because of the variations in interpretation of what 'reliable' means. The Board noted in its Feedback Statement that, when a 'reliable' criterion is used, the emphasis users place on freedom from error can be greater than the overall faithful presentation of transactions and events, while some also associate reliability with precision. The intention is that faithful representation will capture all of the different qualities that are required, including reliability.

Financial reports present underlying economic transactions and events in both numerical and narrative form. To be useful, the financial information contained in these reports needs to both be relevant and be a faithful representation of the underlying transactions and events. To the extent possible, the aim is to maximise completeness, neutrality and freedom from error.

Completeness of information will often require both numerical and narrative information. This might include information about the depreciated cost and fair value of an asset, together with a description of associated facts and circumstances such as the nature of the asset and its location. Neutral information is considered to be free from emphasis (or lack of emphasis) or other manipulation designed to change how well or badly it will be received by its users. Freedom from error does not mean perfectly accurate, and it is acknowledged that financial statements contain estimates (for example, for the calculation of fair value, and for provisions). The focus is instead on the clarity of information presented, including disclosure of the nature and limitations of the estimation process, and the derivation of an estimate through the use of a process which itself is free from error.

Applying the fundamental qualitative characteristics

Information must be both relevant and faithfully represented if it is to be useful. An example is given of a process under which those fundamental characteristics could be applied. This would first be to identify economic transactions and events that have the potential to be useful to users of financial information. The reporting entity would then identify the most relevant available information (subject to cost constraints) that can be faithfully represented.

Enhancing qualitative characteristics

The Conceptual Framework identifies comparability, verifiability, timeliness and understandability as qualitative characteristics that enhance the usefulness of information that is relevant and faithfully represented. It is noted that these characteristics may also help determine which of two ways should be used to depict certain economic transactions and events if they are otherwise considered to be equally good. Generally speaking, enhancing qualitative characteristics are desirable but they are not always necessarily required.

Comparability

Comparability enables users of financial information to understand similarities and differences among items included in information presented by two or more entities. This can assist in decisions about whether to sell or hold an investment, or in determining the appropriate choice among different potential investments.

It is noted that while transactions and events can be presented in different ways, comparability is reduced if choices of accounting method are permitted.

Verifiability

Verifiability means that different knowledgeable and independent observers could reach consensus, although not necessarily complete agreement, that a particular depiction is a faithful representation. It assists in giving users assurance that financial information appropriately represents the underlying transactions and events. It is noted that quantified information does not need to have a single value, and that a range of possible amounts and probabilities of outcome can exist.

Verification can be direct, where a quantity or amount can be verified directly (such as an amount of inventory), or indirect where data is checked through reference to a model, formula or other technique. Some information, such as forecasts, may not be capable of being verified until a future period, in which case it will normally be necessary to disclose the underlying assumptions and other relevant information about how the forecast has been obtained.

Timeliness

Financial information is timely if it is available in time to be capable of influencing decisions taken by users. Generally, the older the information is, the less useful it is. However, some information may continue to be timely long after the end of a reporting period because, for example, some users may need to identify and assess trends

Understandability

Classifying, characterising and presenting information clearly and concisely makes it understandable.

It is noted that certain transactions and events are inherently complex and that it may not be possible to make them easy to understand. However, while their exclusion might make a financial report easier to understand, it would also make the reports incomplete and potentially misleading. It is noted that even well informed users of financial information may need to obtain specialist advice to interpret and use certain complex aspects of information in a financial report.

Applying the enhancing qualitative characteristics

The inclusion of enhancing qualitative characteristics should be maximised to the extent possible, but it is not essential. In contrast, it is necessary for information presented to meet the fundamental characteristics of relevance and faithful representation, as enhancing qualitative characteristics by themselves cannot make information useful if that information is irrelevant or not faithfully represented.

The cost constraint on useful financial reporting

Cost is a pervasive constraint on the information that can be provided by financial reporting. Reporting financial information imposes costs, and it is important that those costs are justified by the benefits of reporting that information.

Although it is the preparers of financial information who directly incur the costs associated with the preparation of financial information, these costs are ultimately borne by the users of that information in the form of reduced returns. It is therefore important that unnecessary information is not provided to avoid associated costs, and that all necessary information is included to avoid users incurring additional expense in obtaining the information themselves.

Chapter 4: The 1989 Framework: The remaining text

The remaining text of the 1989 Framework has not been amended to reflect changes made by IAS 1 Presentation of Financial Statements (as revised in 2007). This text will be updated when the Board has considered the elements of financial statements and their measurement bases.

Chapter 4 is comprised of the underlying assumption (going concern), the elements of financial statements, recognition of the elements of financial statements, the measurement of the elements of financial statements, and the concepts of capital and capital maintenance

Next steps

The IASB is currently debating the draft chapter on the reporting entity (the comment period in respect of the related exposure draft closed in July 2010). When that chapter is completed the Board will release a further update of the Conceptual Framework. The Board is also working to develop discussion papers for potential chapters addressing the elements and measurement (Phases B and C).

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