The IASB conceptual framework

Introduction

A "conceptual framework" for financial reporting consists of a coherent set of fundament principles which underpin financial accounting and so provide a sound theoretical basis f the development of accounting standards. Amongst other things, a conceptual framewo should consider the objectives of financial statements, the elements from which the statements are built, the circumstances in which elements may be shown ("recognised") the financial statements and the ways in which elements are measured and presented.

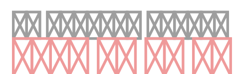
In the absence of a conceptual framework, accounting standards are more difficult develop since each standard must begin from scratch. It is also more likely that there w be inconsistencies and contradictions between one standard and another.

The IASB contribution to the development of a conceptual framework is its *Conceptu Framework for Financial Reporting*. Although devised by a standard-setting body, t IASB *Conceptual Framework* is not itself an accounting standard and does not overri the standards. If there is a conflict between the *Conceptual Framework* and an int national standard, then the standard prevails. But the *Conceptual Framework* identif certain concepts which, in the view of the IASB, underlie the preparation and presentat of financial statements. The purpose of this chapter is to explain these concepts.

Development of the Conceptual Framework

The IASB *Conceptual Framework* replaces the IASC *Framework for the Preparation Presentation of Financial Statements* which was issued in 1989. The first version of new *Conceptual Framework* was published in 2010 and contained revised material (agr with the US FASB) on the objectives of financial reporting and the qualitative charac istics of useful financial information. The completed version was issued in March 2018. the same time, some minor amendments were made to those international standards wh make explicit reference to the *Conceptual Framework*.

The completed version of the IASB *Conceptual Framework* took immediate effect the IASB itself, so that standards issued after March 2018 are based upon the princip expressed in that version. The minor amendments made to existing standards (see abo take effect as from 1 January 2020, though earlier application is permitted.



Objectives

By the end of this chapter, the reader should be able to:

- state the main purposes of the IASB *Conceptual Framework*
- state the objective of general purpose financial reporting and identify the primary users of financial reports
- state and explain the qualitative characteristics of useful financial information
- explain the "going concern" assumption which usually underlies the preparation of financial statements
- define each of the main elements of financial statements
- explain the criteria which determine whether or not an element should be recognised in the financial statements
- explain the measurement bases which are identified in the *Conceptual Framework* and the factors which should be considered when selecting a measurement basis
- distinguish between financial capital maintenance and physical capital maintenance.

Purpose and status of the IASB *Conceptual Framework*

The IASB *Conceptual Framework for Financial Reporting* states the objective of general purpose financial reporting and sets out the concepts that underlie the preparation of general purpose financial reports. The main purposes of the *Conceptual Framework* are:

(a) to assist the IASB in the development of international standards that are based on consistent concepts

(b) to assist the preparers of financial reports to develop consistent accounting policies (see Chapter 4) when no international standard applies to a particular transaction or event, or when an international standard permits a choice of accounting policy

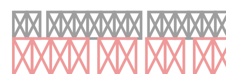
(c) to assist all parties to understand and interpret the international standards.

As stated above, the *Conceptual Framework* is not itself an international standard and does not override the standards. But the *Conceptual Framework* provides the foundation for standards which enhance the comparability and quality of financial information, providing the information needed to hold management to account and helping investors to identify opportunities and risks. The use of a single set of international standards based on the *Conceptual Framework* also reduces financial reporting costs.

Scope

The March 2018 version of the *Conceptual Framework* deals with the following matters:

(a) the objective of general purpose financial reporting



(b) the qualitative characteristics of useful financial information
(c) financial statements and the reporting entity
(d) the elements of financial statements
(e) recognition and derecognition of the elements of financial statements
(f) measurement of the elements of financial statements
(g) presentation and disclosure
(h) concepts of capital and capital maintenance.

Each of these is explained below.

Objective of general purpose financial reporting

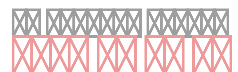
The *Conceptual Framework* states that the objective of general purpose financial reporting is "*to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity*". Such decisions may be concerned with buying, selling or holding equity in the entity (e.g. shares), providing credit to the entity (e.g. loans) or voting on the actions of the entity's management. Existing and potential investors, lenders and other creditors are referred to collectively as the "primary users" of general purpose financial reports. In more detail, the *Conceptual Framework* states that:

(a) Decisions by existing and potential investors depend upon the returns they expect to receive from an investment in the entity concerned (e.g. dividends or increases in the market value of the entity's shares). Decisions by lenders and other creditors also depend upon expected returns (e.g. loan interest and debt repayments). Therefore these "primary users" need information that will help them to assess the amount, timing (and degree of uncertainty) of future cash inflows to the entity. This includes information about the entity's economic resources, claims against the entity and changes in those resources and claims.

Decisions by the primary users will also depend upon their assessment of the entity's management and its "stewardship" of the entity's resources. Therefore information is needed about the efficiency and effectiveness with which the entity's management has used its resources.

(b) The primary users cannot require an entity to provide information directly to them and so they rely on general purpose financial reports for much of the information which they need. However, these financial reports cannot provide all of the required information and primary users will also need to consider information from other sources (e.g. general economic forecasts, industry outlooks etc.).

(c) General purpose financial reports are not designed to show the value of the reporting entity but may help primary users to estimate the entity's value.



(d) Individual primary users may have differing information needs. When developing international standards, the IASB seeks to ensure that financial reports prepared in accordance with those standards will provide information that meets the needs of the maximum number of primary users. However, there is nothing to prevent an entity from disclosing additional information that might be useful to a particular subset of primary users.

(e) Financial reports are based to some extent upon estimates, judgements and models and so cannot be exact. The *Conceptual Framework* establishes the concepts that underlie those estimates, judgements and models.

(f) In addition to the primary users, other parties might find general purpose financial reports useful, although these reports are not primarily intended for their benefit. The *Conceptual Framework* does not list these other parties but the IASC *Framework* issued in 1989 indicated that the users of financial reports might also include:

(i) employees and their representatives, who may use financial reports to help them assess the profitability and stability of an entity and so determine the entity's ability to provide employment opportunities, fair pay and retirement pensions

(ii) customers, who may use financial reports to help them assess whether the entity is likely to continue in business and so act as a reliable source of supply

(iii) governments and their agencies, who may use the information provided in financial reports to help determine taxation policies, regulate business and compile national statistics

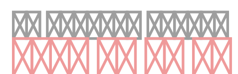
(iv) the public, who may wish to assess an entity's prosperity and developments in its range of activities, especially if that entity makes a substantial contribution to the local economy (e.g. by providing local employment or by its patronage of local suppliers).

The management of an entity is obviously interested in financial information about that entity. However, management is able to obtain financial information internally and so does not rely upon general purpose financial reports.

Information about an entity's resources and claims

General purpose financial reports should provide information about the *financial position* of the reporting entity (i.e. information about the entity's economic resources and claims against the entity). Financial reports should also provide information about transactions and other events that change the entity's financial position. Changes in financial position may result from the entity's *financial performance* (e.g. the making of a profit) or from other events such as share issues. Both of these types of information are useful when making decisions about providing resources to the entity. Note that:

(a) Information about an entity's financial position helps primary users to identify that entity's financial strengths and weaknesses and to assess its liquidity and solvency.



(b) Information about an entity's financial performance helps primary users to understand the return that the entity has made on the resources at its disposal and whether those resources have been managed efficiently and effectively (so helping users to assess the stewardship of management). Information about past financial performance may also be useful when predicting future returns on an entity's economic resources.

(c) Financial performance information is prepared on an "accrual accounting" basis. This means that transactions and other events are recognised in the periods in which they occur (not necessarily the periods in which cash is received or paid). This approach provides better financial performance information than information based solely on cash receipts and payments occurring during a reporting period.

However, information about cash flows during a period is also important, since it indicates how an entity generates and spends cash and helps users to assess the entity's ability to generate future net cash inflows.

(d) Finally, information about changes in an entity's financial position which have not resulted from its financial performance (e.g. changes caused by share issues) is also necessary since it gives users a complete understanding of how and why the entity's financial position has changed.

This section of the *Conceptual Framework* does not specify or name the financial statements in which each of the four classes of information listed above should be presented. However, financial statements are introduced in a later section under the heading "Financial statements and the reporting entity" (see below) and the four main financial statements are identified in international standard IAS1 (see Chapter 3).

Qualitative characteristics of financial information

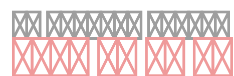
The *Conceptual Framework* identifies six "qualitative characteristics" of useful financial information. These characteristics indicate the types of information that are likely to be most useful to the primary users of financial reports. Two of the qualitative characteristics are stated to be "fundamental". These are:

- relevance
- faithful representation.

The remaining four qualitative characteristics are described as "enhancing" since they further enhance the usefulness of financial information that is already relevant and faithfully represented. The enhancing characteristics are:

- comparability
- verifiability
- timeliness
- understandability.

Each of these characteristics is explained below.



Relevance

The first fundamental qualitative characteristic of useful financial information is that it should be relevant to users' decision-making needs (i.e. capable of making a difference to users' decisions). Irrelevant information is obviously not useful. In particular, information is relevant if it has predictive value or confirmatory value, as follows:

(a) Information has "predictive value" if can help users to predict future outcomes (e.g. future financial performance). In order to have predictive value, information does not have to take the form of an explicit forecast, since information on past transactions or events may be used as a basis for predictions about the future.

(b) Information has "confirmatory value" if it provides feedback which helps to confirm or refute previous predictions.

The relevance of financial information is affected not only by its nature but also by its level of materiality. Materiality is mainly concerned with the size or monetary amount of an item and information is said to be "material" if omitting, mis-stating or obscuring it could influence users' decisions. Information about an item which is so small as to be immaterial is not relevant to users' needs. The IASB cannot specify a generally applicable materiality threshold, since materiality is entity-specific, but IFRS Practice Statement 2 *Making Materiality Judgements* (see Chapter 3) provides guidance on this matter.

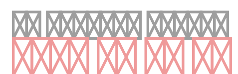
Faithful representation

The second fundamental qualitative characteristic of useful financial information is that it must faithfully represent the transactions and other events that it purports to represent. A perfectly faithful representation would be *complete*, *neutral* and *free from error*. The objective of the IASB is to maximise these qualities to as great an extent as possible.

(a) **Completeness**. Financial information is complete if it includes all of the information required in order that a user should understand the transactions and other events being represented, including all necessary descriptions and explanations.

(b) **Neutrality**. A neutral representation is one that is unbiased. Financial information is not neutral if it is manipulated in some way to achieve a predetermined result, with the aim of increasing the probability that the information will be received favourably (or unfavourably) by users.

The *Conceptual Framework* states that neutrality is supported by the application of prudence, where "prudence" is the exercise of caution when making judgements under conditions of uncertainty. Although prudence does not necessarily imply an asymmetric approach to financial reporting (e.g. a tendency to understate assets and income or to overstate liabilities and expenses) it is accepted that certain standards may adopt such an approach so as to provide users with information which is relevant to their needs and which gives a faithful representation.



(c) **Freedom from error.** Financial information does not have to be 100% accurate but it must be free from material error. Freedom from error implies that there are no errors or omissions in the description of the items being represented and that no errors have been made when selecting and applying the process used to produce the reported information. For instance, an estimate can be regarded as free from error as long as the amount is clearly described as being an estimate, the estimating process is fully explained and no errors are made when selecting or applying that process.

The *Conceptual Framework* makes it clear that the use of reasonable estimates is essential to the preparation of financial information and does not undermine the usefulness of that information, as long as the estimates are clearly explained.

Furthermore, financial information must represent the economic substance of transactions and other events. If the legal form of such transactions and events differs from their economic substance, providing information only about their legal form would not provide a faithful representation. This is the "substance over form" concept.

Finally, financial information must both be relevant and provide a faithful representation. A faithful representation of irrelevant information would not help users to make good decisions. Nor would an unfaithful representation of relevant information.

Enhancing qualitative characteristics

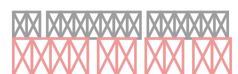
As stated above, the enhancing qualitative characteristics are comparability, verifiability, timeliness and understandability. These characteristics enhance the usefulness of financial information which is already both relevant and faithfully represented.

(a) **Comparability.** This characteristic enables users to compare financial information about an entity for a reporting period with similar information about other entities for the same period and with similar information about the same entity for other periods. Such comparisons will help users to make economic decisions.

Comparability is improved through consistency. Consistency refers to the use of the same accounting treatments for the same types of item, either from period to period by one reporting entity or in a single period across entities. The IASB takes the view that permitting alternative accounting treatments for an item diminishes consistency and so diminishes comparability. This is an argument in favour of the IASB's stated intention of reducing the number of choices of accounting treatment allowed by international standards or possibly eliminating choice altogether (see Chapter 1).

(b) **Verifiability.** Financial information is said to be "verifiable" if independent, knowledgeable observers are able to agree that the information concerned provides a faithful representation. Verification may be direct or indirect.

Direct verification involves direct observation (e.g. counting cash). Indirect verification involves checking the inputs to a model and then recalculating the outputs of that model. For example, closing inventory measured by the FIFO cost formula (see Chapter 10) may be verified by checking inventory movements and costs during the reporting period and then using the FIFO formula to recalculate closing inventory.



(c) **Timeliness**. Financial information is timely if it is made available to users in time for it to be capable of influencing their economic decisions.

(d) **Understandability**. It is clearly desirable that the information provided in financial reports should be understandable by users. Incomprehensible information would have no value. The understandability of financial information is improved if it is classified and presented clearly and concisely. But omitting unavoidably complex information from financial reports on the grounds that it would be difficult to understand is not acceptable since this would make those reports incomplete.

The *Conceptual Framework* states that financial reports are prepared for users who "have a reasonable knowledge of business and economic activities and who review and analyse the information diligently". These are the users who should generally be able to understand financial reports. However, it is accepted that even well-informed users may sometimes need the help of an advisor to understand information about complex transactions and other events.

The cost constraint on useful financial reporting

The *Conceptual Framework* recognises that there are cost constraints on the information that can be provided in financial reports. Reporting financial information imposes costs and obviously these costs should be justified by the benefits of reporting that information. Although the costs of financial reporting are borne initially by the providers of financial reports, these costs are borne ultimately by users (e.g. shareholders) in the form of reduced returns (e.g. lower profits). Users may also bear the additional costs of analysing and interpreting the information provided in financial reports.

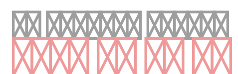
When developing an international standard, the IASB assesses whether the benefits of reporting the information required by that standard are likely to justify the costs incurred to provide and use it. This assessment is conducted in the light of information obtained from providers, users, auditors and others about the expected costs and benefits.

Financial statements and the reporting entity

The remaining sections of the *Conceptual Framework* discuss the information provided in general purpose financial statements, which are one form of general purpose financial reporting. 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 entity and in assessing management's stewardship of the entity's economic resources*". This information is provided in the following financial statements:

(a) a statement of financial position, which shows (or "recognises") the entity's assets, liabilities and equity (i.e. share capital and reserves for a company)

(b) a statement of financial performance, showing the entity's income and expenses



(c) other statements and notes which present information relating to matters such as the entity's cash flows, the contributions received from equity holders (and distributions made to them) and the methods, assumptions and judgements used in preparing the financial statements.

Financial statements are prepared for a specified period of time (a "reporting period") and should also provide comparative information for at least the preceding period. The financial statements do not typically provide forward-looking information, such as management forecasts. A reporting entity may be a single entity (e.g. a single company) or may comprise more than one entity. For instance, "consolidated" financial statements may be prepared for a group of companies (see Chapter 18).

Going concern assumption

The *Conceptual Framework* states that financial statements are normally prepared on the assumption that the reporting entity is a "going concern" and will continue in operation for the foreseeable future. It is assumed that the entity has neither the intention nor the need to close down or materially reduce the scale of its operations. This allows (for example) the net realisable value of inventories to be based upon their normal sale price and items such as property, plant and equipment to be depreciated over their normal useful lives.

However, if an entity is not a going concern, the financial statements will have to be prepared on a different basis and that basis should be disclosed.

Elements of financial statements

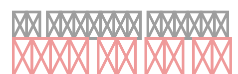
This section of the *Conceptual Framework* identifies the main elements of financial statements and offers a definition of each element. The most important definitions are those of "asset" and "liability" since each of the other elements is defined in terms of its relationship to an entity's assets or liabilities.

Elements relating to financial position

The elements directly related to the measurement of financial position are assets, liabilities and equity. These are defined as follows:

(a) Assets. An asset is "*a present economic resource controlled by the entity as a resul of past events*". An economic resource is "*a right that has the potential to produc economic benefits*". Note the following points with regard to this definition:

– Rights that have the potential to produce economic benefits include the right t receive cash (e.g. a trade receivable), the right to receive goods or services (e.g a prepayment), rights over physical objects (e.g. property, plant and equipmer or inventories) and the right to use intellectual property.

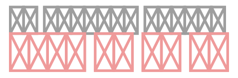


- There is no requirement for an item to be legally owned by the entity in order that it should be an asset, merely that the item should be controlled by the entity. This means that certain leased items may be classed as assets (see Chapter 9). This is an application of the principle of substance over form.
- An asset can arise only as the result of a past event. Expected future transactions (e.g. the intention to buy an item) do not give rise to assets at the present time.
- An item cannot be classed as an asset unless it is has the potential of generating future economic benefits for the entity. But if this potential is low, it is possible that the item might not be shown or "recognised" in the entity's statement of financial position (see later in this chapter).

(b) **Liabilities**. A liability is "*a present obligation of the entity to transfer an economic resource as a result of past events*". Note that:

- An essential characteristic of a liability is that the entity must be under an obligation. This means that the entity must have a duty or responsibility to transfer economic resources to another party. However, there is no requirement that the obligation should be legally enforceable, even though this would normally be the case. For instance, if it is an entity's policy to rectify faults in its products even after the warranty period has expired, the amounts expected to be expended in relation to goods already sold are obligations of the entity, even though they are not legally enforceable. Such obligations are known as "constructive obligations" (see Chapter 12).
- A further characteristic of a liability is that the obligation must be a *present* obligation, not a future commitment. For instance, a decision by management to buy an asset in the future does not give rise to a present obligation to pay for the asset, since the decision could be reversed. A present obligation is one that the entity cannot practically avoid.
- A liability can arise only as the result of a past event. A present obligation exists as a result of past events only if the entity has already obtained economic benefits (e.g. by receiving goods or services) and, in consequence, is now under an obligation to transfer economic resources (e.g. by making a payment).
- An obligation cannot be classed as a liability unless it is has the potential of requiring the entity to transfer economic resources to another party. But if this potential is low, it is possible that the obligation might not be recognised in the entity's statement of financial position (see later in this chapter).

(c) **Equity**. Equity is "*the residual interest in the assets of the entity after deducting all its liabilities*". This is of course an expression of the well-known accounting equation (assets = liabilities + capital). However, the IASB favours the term "equity" rather than "capital". In the case of a company, equity will usually consist of share capital, retained earnings and other reserves.



Elements relating to financial performance

The elements directly related to the measurement of financial performance are income and expenses. These are defined as follows:

(a) **Income**. Income is "*increases in assets, or decreases in liabilities, that result in increases in equity, other than those relating to contributions from holders of equity claims*". Note that:

- The term "income" encompasses both revenue which arises in the course of an entity's ordinary activities and also gains (e.g. gains arising on the disposal or revaluation of long-term assets).
- Income is defined in terms of an increase in net assets but does not include increases caused by contributions from equity holders (e.g. share issues).

(b) **Expenses**. Expenses are "*decreases in assets, or increases in liabilities, that result in decreases in equity, other than those relating to distributions to holders of equity claims*". Note that:

- The term "expenses" encompasses both expenses which arise in the course of an entity's ordinary activities and also losses (e.g. losses arising on the disposal or revaluation of long-term assets).
- Expenses are defined in terms of a decrease in net assets but do not include decreases caused by distributions to equity holders (e.g. dividends).

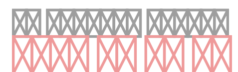
The fact that income and expenses are defined in terms of increases or decreases in net assets means that profits (or losses) are also defined in these terms.

Recognition of the elements of financial statements

Recognition is defined as "*the process of capturing for inclusion in the statement of financial position or the statement(s) of financial performance an item that meets the definition of one of the elements of financial statements*". Recognition involves the depiction of the item in words and by a monetary amount and "*including that amount in one or more totals in that statement*". Items which are merely disclosed in the notes that accompany the financial statements have not been recognised.

The *Conceptual Framework* states that an asset or liability should be recognised only if the recognition of that asset or liability (and any resulting income, expenses or changes in equity) would provide users of the financial statements with useful information. In other words, the information provided must be relevant to user needs and must offer a faithful representation. Whether recognising an asset or liability provides useful information (at a cost that does not outweigh benefits) is a matter of judgement and depends upon the facts of the case. Recognition might not provide useful information if (for example):

(a) there is uncertainty as to whether the asset or liability exists, or



(b) the probability of an inflow or outflow of economic benefits is low, or

(c) there is a very high level of "measurement uncertainty", so it is impossible to obtain a reasonable estimate of the monetary amount of the asset or liability concerned.

An item which qualifies as an element but fails to satisfy the recognition criteria may instead warrant disclosure in the notes.

Derecognition

Derecognition is defined as "*the removal of all or part of a recognised asset or liability from an entity's statement of financial position*". Derecognition should occur when the item concerned no longer meets the definition of an asset or liability. For an asset, this is normally when the entity loses control of that asset. For a liability, this is normally when the entity no longer has a present obligation for that liability.

Measurement of the elements of financial statements

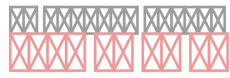
Measurement is the process of determining the monetary amount at which an element is to be shown in the financial statements. The *Conceptual Framework* identifies a number of different measurement bases which could be used in principle. These are:

(a) **Historical cost**. Assets are measured at the amount paid to acquire them. Unlike current value (see below), historical cost does not reflect changes in values since the asset was acquired. But the historical cost of an asset will normally be updated over time to reflect matters such as the consumption of all or part of the economic benefits provided by the asset (i.e. depreciation) or events that cause all or part of the asset's historical cost to be irrecoverable (i.e. impairment (see Chapter 7)).

Liabilities are normally measured at the amount of the consideration received in exchange for taking on the obligation concerned. However, in cases where there is no such consideration (e.g. tax liabilities) it may be necessary to measure a liability at the amount expected to be paid to satisfy the obligation.

(b) **Current value**. The current value basis measures assets and liabilities using information which has been updated to reflect conditions at the measurement date. The current value of an asset or liability is not in any way related to the original price of the transaction or other event that gave rise to that asset or liability. Current value measurement bases include:

(i) **Fair value**. Fair value is defined as "*the price that would be received to sell an asset, or paid to transfer a liability, in an orderly transaction between market participants at the measurement date*". Fair value may be determined directly by observing prices in an active market. But if no such market exists, it may be necessary to measure fair value indirectly by using appropriate measurement techniques (see Chapter 5 Appendix).



(ii) **Value in use.** The "value in use" of an asset is the present value† of the net cash flows (or other economic benefits) that the entity expects to derive from use of the asset and from its eventual disposal. Similarly, the "fulfilment value" of a liability is the present value of the cash (or other economic benefits) that the entity expects to be required to transfer in order to fulfil the liability.

Note that the fair value of an asset or liability may differ from its value in use (or its fulfilment value) because the former reflects the expectations of market participants, whilst the latter reflects entity-specific expectations.

(iii) **Current cost.** The current cost of an asset is the amount that would have to be paid to acquire an equivalent asset at the measurement date (i.e. replacement cost). The current cost of a liability is the amount that would be received for taking on an equivalent liability at the measurement date.

† *Readers who are not familiar with the concepts of discounting and present value are referred to the appendix at the end of this chapter in which these concepts are explained.*

Selection of measurement basis

The *Conceptual Framework* does not prescribe the use of any particular measurement basis and states that a consideration of the qualitative characteristics of useful financial information (and the cost constraint) may result in the selection of different measurement bases for different assets, liabilities, income and expenses. The factors which should be considered when choosing a measurement basis include:

(a) **Relevance.** The degree to which a measurement basis provides relevant information is affected by the characteristics of the asset or liability to which it is applied and the way in which that asset or liability is expected to contribute to the entity's future cash flows. For instance, if the value of an asset is sensitive to market factors, use of the historical cost basis will not provide relevant information if the asset is held primarily for sale (so that changes in value are particularly important). Similarly, the use of a current value basis in relation to such an asset may not provide relevant information if the entity concerned holds the asset solely for use and has no intention of selling it.

(b) **Faithful representation.** The degree to which a measurement basis can provide a faithful representation is affected by the level of uncertainty involved. For instance, use of the fair value basis when measuring an asset will usually provide an uncertain measurement if there is no active market for that type of asset. Although measurement uncertainty does not necessarily preclude the use of a measurement basis that provides relevant information, too high a level of uncertainty may make it necessary to consider alternative measurement bases.

A further factor to consider is "measurement inconsistency". This arises if different measurement bases are used for related assets and liabilities, so that the financial statements do not faithfully represent certain aspects of the entity's financial position and performance. In this case, a more faithful representation may be achieved by using the same measurement basis for all of the assets and liabilities concerned.