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Don's column: Revised conceptual framework for financial reporting (Part 1)

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DON’S COLUMN: REVISED CONCEPTUAL FRAMEWORK FOR FINANCIAL REPORTING (PART 1)

PEARL TAN

REDEFINING FOCUS AND BOUNDARIES

In March 2018, the International Accounting Standards Board (IASB) issued the revised Conceptual Framework for Financial Reporting (CF 2018) after five years of deliberation since the Discussion Paper was first issued. CF 2018 is immediately applicable to the IASB and International Financial Reporting Standards (IFRS) Interpretations Committee.

We need to understand that CF 2018, like the preceding conceptual framework, is not a standard and does not override standards. It guides the IASB in setting new standards and provides principles that assist all parties to understand and interpret standards. The framework also assists preparers in making informed judgements when no standard exists. In this respect, it takes effect for preparers with effect from 1 January 2020.

Although the International Accounting Standards Committee (predecessor of IASB) was formed in 1973, the first conceptual framework was issued only in 1989. The second framework issued in 2010 was a joint project with the Financial Accounting Standards Board of the United States and was largely similar to the 1989 version. The conceptual framework of 2018 has a bit more bite than the 2010 version, with significant changes.

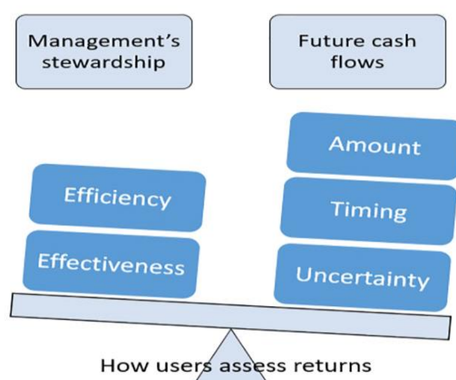
The purpose of this article, presented in two parts, is to highlight changes in the framework and to explain their implications for practice. The changes in the framework must first change accounting standards before they impact practice. However, it is useful to understand the developments in the framework to prepare us for future changes.

RETURN TO HISTORY: MANAGEMENT’S STEWARDSHIP OF ECONOMIC RESOURCES

Management's stewardship is given a more prominent focus in CF 2018. The stance is that users' expectations about returns would depend not simply on their assessment of future cash flows but also on their assessment of management's stewardship of the entity's economic resources (Figure 1). The focus on management's stewardship reminds reporting entities that the process of managing the resources are as important as the outcomes of the process (that is, future cash flows). CF 2018 introduces a new resource allocation decision – that of making decisions on the exercise of rights to vote on or influence management's actions[1].

Clearly, this is a very lofty reporting goal. To be able to assess management's stewardship in resource allocation, one must virtually be able to take a peek into the internal environment of an entity. Is this even possible or will the efforts for greater transparency result in more "boilerplate reporting"? It is not surprising that some of the more immediate projects on the IASB's plate relate to disclosures. Examples include the "Disclosure Initiative – Principles of Disclosure" and "Management Commentary".

Figure 1 Information needed for resource allocation decisions



CLARIFICATION: PRUDENCE IS NOT ASYMMETRIC

CF 2018 clarifies that to achieve faithful representation of financial information in conditions of uncertainty, caution must be exercised when making judgements. Caution should be exercised such that there should be neither overstatement nor understatement of assets, liabilities, income or expenses[2]. It is interesting to note that prudence was featured in the original conceptual framework in 1989, removed in 2010 and reinstated in 2018. However, the examples of prudence in the conceptual framework of 1989 were removed in the 2018 version, with emphasis given on the principle instead.

UPDATED DEFINITIONS OF AN ASSET AND A LIABILITY

One of the most significant changes in CF 2018 relates to the definition of an asset and a liability. The previous definitions have endured for almost 30 years. We are familiar with the three conditions of an asset or a liability – the occurrence of a past event that leads to the existence of present control or present obligation and the expectation of future benefits for an

asset and future outflow for a liability. The three dimensions of "past", "present" and "future" in an asset and a liability strike an intuitive chord with generations of accountants.

The key difference between CF 2018 and the earlier framework relates to the "future" dimension. The requirement for expected future benefits or expected future outflows in the previous framework implies the ability to measure the probability and the amount of those benefits and outflows. CF 2018 removes the expectation of future benefits or future outflows from the definition statements.

CF 2018 introduces a new concept – "economic resource". Under CF 2018, an entity has an asset if it controls a present economic resource as a result of past events[3]. An economic resource has two important attributes – (a) it is a right, and (b) has the potential to produce economic benefits. However, it is not necessary for the future benefits to be certain or even likely[4]. It is only necessary for the right to exist, and in at least one scenario, be able to produce economic benefits solely for the entity.

What was the reason for the change? The incorporation of recognition and measurement criteria at an early stage clouds the identification process. For example, an out-of-the-money option has no future benefit to the investor and no future outflow to the writer, but technically, it is an asset to the investor and a liability to the writer. In at least one situation (when the option is "in-the-money"), the right leads to future benefits. With the revised definition of an asset, the focus is on the capability that generates the benefits rather than the benefits themselves. The low probability of the benefits or the difficulty of measuring the benefits is a recognition and measurement issue and should not be evaluated at the point of identifying if an asset exists. We have to answer "what" first before proceeding to the "when", "where" and "how much" questions.

With respect to a liability, CF 2018 states that the reporting entity must have a present obligation to transfer an economic resource as a result of past events[5]. The existence of a present obligation is the first criterion; it typically arises from contracts, legislation or is a constructive obligation, and is such that the entity has no practical ability to avoid a transfer. The second criterion is that there must be a transfer of an economic resource. As with an asset, the transfer only needs to be potential and does not need to be certain or even likely. For example, an acquisition contract may require the seller to refund cash to the buyer in certain pre-specified conditions, resulting in a liability for the seller even if the probability is low. In another example, a company may be a defendant in a legal case that is pending judgement. In this situation, there is uncertainty about the existence of the obligation[6] and is not a liability. Hence, while outcome uncertainty is not relevant to the definition of a liability (asset), there should not be existence uncertainty of the obligation (right).

Hence, CF 2018 takes great effort in separating the definition of an asset and a liability from their recognition and measurement. The IASB also highlights that disclosure of unrecognised assets and liabilities may provide useful information to stakeholders. Users of financial statements are better off with the information in the footnotes about these assets and liabilities than none at all.

The updated definitions have a significant impact in extending our understanding of what an asset and liability is. For example, executory contracts with their contractual rights and obligations (often interdependent) fall within the definition of assets and liabilities. However, whether an asset or liability should be recognised depends on the recognition and

measurement criteria of specific standards. The second article in this two-part series will explain how CF 2018 impacts recognition and measurement criteria.

BOUNDARIES OF REPORTING ENTITY

CF 2018 also includes a new chapter on the reporting entity where it explains the differences in three statements – consolidated financial statements, unconsolidated financial statements and combined financial statements. CF 2018 reinforces the stand in IFRS 10: Consolidated Financial Statements that unconsolidated financial statements typically are not sufficient to meet the information needs of the stakeholders of the parent.

CONCLUSION

CF 2018 includes interesting new components. In particular, the definitions of assets and liabilities have been changed to focus on the existence of rights and obligations rather than their outcomes. There is a strong intentionality in the framework to separate definition from recognition and measurement criteria. There is also a strong underlying tone to avert asymmetric prudence or a bias towards conservatism. Disclosures also feature prominently in the new framework as a means to enhance better communication to stakeholders. With a renewed focus on management stewardship, CF 2018 points the way towards eliciting richer and more complex information that stakeholders need in their resource allocation decisions.

The second article in this two-part series will explain how CF 2018 impacts recognition and measurement criteria.

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[1] Conceptual Framework for Financial Reporting – March 2018, International Accounting Standards Board, paragraph 1.2

[2] Ibid, Paragraph 2.16

[3] Ibid, Paragraph 4.3

[4] Ibid, Paragraph 4.14

[5] Ibid, Paragraph 4.26

[6] Ibid, Paragraph 4.35