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Don's column: Revised conceptual framework for financial reporting (Part 2)

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DON'S COLUMN: REVISED CONCEPTUAL FRAMEWORK FOR FINANCIAL REPORTING (PART 2)

PEARL TAN

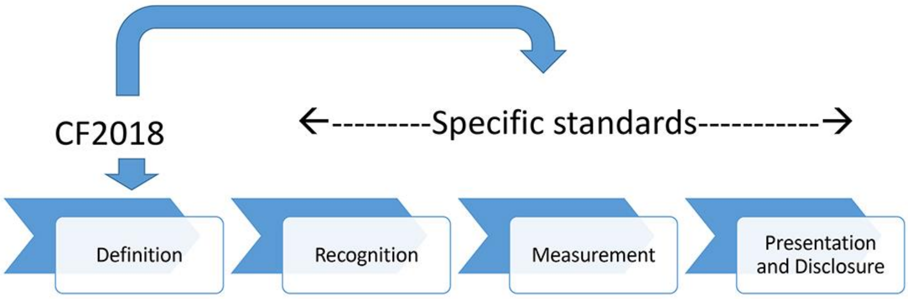
FRESH PERSPECTIVES IN RECOGNITION, MEASUREMENT AND DISCLOSURES

In the first article of this two-part series, published in the October issue of ***IS Chartered Accountant*** Journal, we saw how the Revised Conceptual Framework for Financial Reporting (CF 2018) redefines focus and boundaries by highlighting the importance of information on management stewardship, symmetric prudence and updated definitions for assets and liabilities. This second article explains how CF 2018 provides new and updated principles on recognition, measurement and disclosure in a manner that was not seen in earlier framework projects. The International Accounting Standards Board (IASB) presents the new content with consistent reference to the qualitative characteristics that form the overarching pillars of financial reporting – "relevance" and "faithful representation".

It is useful to refresh our understanding of these two qualitative attributes. Information is relevant if it is capable of making an impact on decisions of users[1]. Hence, it must have predictive and/or confirmatory value. The information must also faithfully represent the substance of the purported economic phenomenon. To achieve faithful representation, the information must be complete, neutral and free from error. These twin attributes of "relevance" and "faithful representation" are the motivating factors for bold moves in CF 2018.

As explained in the first article, the conceptual framework is not a standard and does not override any standard (Figure 1). However, the framework provides broad principles and concepts to assist the IASB in formulating standards. In the first article, we noted that the definitions of assets and liabilities have changed. However, an asset or liability, so defined, may not be recognised or measured if it fails to meet the criteria specified in the appropriate standard.

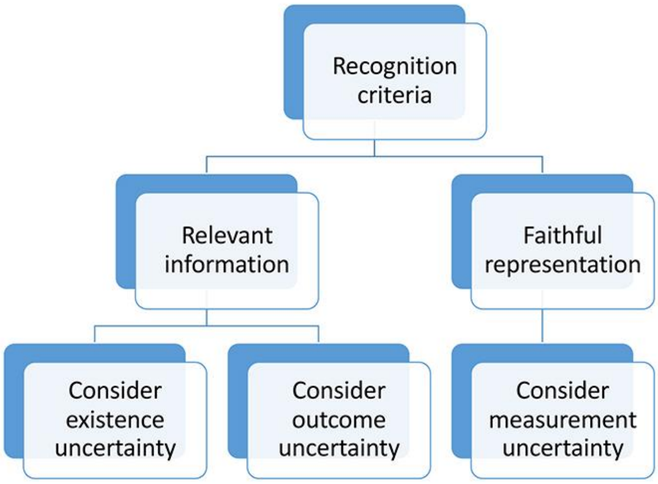
Figure 1 Interactions of the Framework with Specific Standards



UPDATED RECOGNITION CRITERIA

Under CF 2018, recognition is no longer dependent on filters or thresholds. This is a significant departure from the recognition criteria in the previous conceptual framework that requires the benefits or outflow to be “probable” and the cost or value to be measured with “reliability”. CF 2018 provides overarching principles instead (Figure 2 provides a pictorial summary). An item is to be recognised if it provides relevant information of an item and is a faithful representation of that item. CF 2018 also emphasises symmetry in recognition. Failure to recognise an asset or liability is as serious as inappropriate recognition. The new framework expects an asset or liability *not* to be recognised only in limited circumstances[2]. Hence, in principle, an asset or liability may be recognised if recognition provides relevant information even if the probability of an inflow or outflow of economic benefits is low[3]. CF 2018 also evaluates faithful representation through the combined effects of recognition on the financial statements and the presentation and disclosure of footnote information.

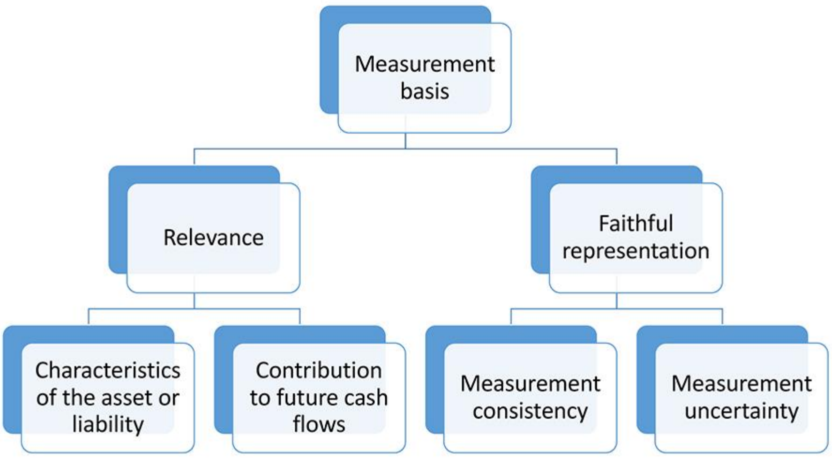
Figure 2 Recognition Criteria



NEW MEASUREMENT CONCEPTS

As with recognition criteria, the IASB provides substantially more new content on measurement in CF 2018. These concepts will guide the IASB in its future standard-setting activity. Figure 3 presents a pictorial summary of the measurement concepts. The guiding principles for measurement fall back on the fundamental qualitative characteristics of relevance and faithful representation. Although relevance and faithful representation have been the hallmarks of financial reporting, previous iterations of the conceptual framework did not feature them explicitly in the selection of a measurement basis.

Figure 3 Measurement Concepts



A situational approach is applied affirming a mixed measurement model of the IFRSs. The answer to the question, "Which measurement basis applies?" is answered by, "It all depends…" Relevant information is determined by the characteristics of the asset or liability and the contribution of the asset or liability to future cash flows. Critical questions asked to establish relevance include the following:

- What is the variability of cash flows of the asset or liability?
- Is the value of the asset or liability sensitive to market factors or other risks?
- What is the nature of the entity's business activities?
- Do economic resources produce cash flows directly or indirectly?

One underlying principle is that the greater the exposure to cash flow or fair value variability, the greater the relevance of fair value information. Another principle relates to the business activities of the entity, that is, the economic context relating to the use of the asset. For example, this principle is applied in IFRS 9: Financial Instruments, where the measurement basis for a debt instrument depends on the business model for holding that asset. Another principle of relevance is the nature of the asset's interdependencies with other assets, which is determined in part by the entity's business activities. The greater the interdependencies, the more relevant is the use of historical cost or current cost information[4]. CF 2018 recognises that no one single factor would determine the measurement basis. The relative weights given to each factor would depend on "facts and circumstances"[5].

Articulating principles of measurement for accounting is always a challenging process. The economic environment that firms operate in are complex and dynamic, making the determination of measurement models difficult. Principles can be derived using a deductive approach or an inductive approach. In a deductive approach, the principles are derived by logic and a process of reasoning in a top-down approach that is independent of practice. An inductive approach, on the other hand, are generalisations from actual practice in a bottom-up approach. The measurement concepts, while new to CF 2018, appear to be distilled from existing measurement standards. Given that standards preceded the framework, the implicit inductive approach is somewhat expected. The IASB also indicated that they consulted the guidance in IFRS 9: Financial Instruments in developing the measurement criteria in CF 2018[6]. Hence, it is not surprising that the measurement criteria ratify the mixed measurement models of existing accounting standards and do not change the status quo.

As with earlier framework projects, CF 2018 recognises the tension or trade-off between relevance and faithful representation. CF 2018 invokes the "efficient and effective process" of identifying the measurement basis that would provide the most relevant information first and then tests it for faithful representation[7] rather than the other way. In addition, CF 2018 provides factors to consider that are specific to initial measurement, situations when more than one measurement basis may be needed and the measurement of equity and cash flow-based measurement techniques.

NEW PRESENTATION AND DISCLOSURE CONCEPTS

This is a new component in the conceptual framework. One of the key contributions of this segment is the provision of principles governing the decisions on the items that are presented as "other comprehensive income" (OCI). CF 2018 affirms that the statement of profit or loss is the primary source of information about the entity's financial performance. Hence, income and expense items should be reflected in net income. However, CF 2018 recognises that in "exceptional circumstances", some income or expense items provide more relevant information or more faithful representation of the entity's performance when presented in OCI. The decision as to which item is better presented as OCI is solely under the purview of the IASB which evaluates the decision on the basis of the qualitative characteristics of relevance and faithful representation. Likewise, the IASB applies the qualitative characteristics of financial reporting to decide on reclassification (recycling) of OCI to net income. If there is no clear basis for identifying the period or amount of reclassification, the norm is not to reclassify the OCI to net income. The statement of profit or loss and OCI is described in CF 2018 as the statement of financial performance. However, the framework does not specify whether this statement comprises one or two statements.

CONCLUSION

CF 2018 emphasises the importance of "relevance" and "faithful representation" in recognition, measurement, presentation and disclosures. The framework removes the triggers and thresholds for recognition. If the information on an asset or liability is relevant and is a faithful representation of the economic phenomenon relating to that asset or liability, it should be recognised even though the probability of an outcome is low. CF 2018 provides new concepts for determining measurement basis, albeit ratifying the underlying principles in existing measurement standards. For the first time in its history, the IASB has arrived at a documented stance on whether and how OCI should be identified. Although broad in nature, the principles governing OCI would compel future standards to explain how an OCI classification would contribute to the fundamental qualitative characteristics of financial reporting.

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[1] Conceptual Framework for Financial Reporting – March 2018, International Accounting Standards Board, paragraph 2.6

[2] Ibid, Paragraph 5.22

[3] Ibid, Paragraph 5.17

[4] Ibid, Paragraph 6.55

[5] Ibid, Paragraph 6.44

[6] Basis of Conclusions, Conceptual Framework for Financial Reporting – March 2018, IASB, paragraph BC6.42

[7] Conceptual Framework for Financial Reporting – March 2018, IASB, Paragraph 6.46