

THE CONCEPTUAL FRAMEWORK FOR FINANCIAL REPORTING

1 INTRODUCTION

The Conceptual Framework sets out the concepts that underlie the preparation and presentation of financial statements for external users (Conceptual Framework, Section “Purpose and status”). The relationship between the Conceptual Framework and individual IFRSs can be described as follows.

- In the **absence of regulation**, management has to develop an accounting policy. That accounting policy has to be compatible with the Conceptual Framework if there are no requirements in IFRSs which deal with similar and related issues (IAS 8.11).
- In a limited number of cases, there may be a **conflict between the Conceptual Framework and the requirements of an IFRS**. In such cases, the requirements of the IFRS prevail over those of the Conceptual Framework (Conceptual Framework, Section “Purpose and status”).

2 THE OBJECTIVE OF GENERAL PURPOSE 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 (e.g. providing loans to the entity or buying equity instruments of the entity) (OB2).

Existing and potential investors, lenders, and other creditors are the **primary users** to whom general purpose financial reports are directed (OB5). They require useful information in order to be able to assess the future cash flows of the entity they are evaluating. Normally, general purpose financial reports are not primarily prepared for use by management, regulators or other members of the public, although they may also find those reports useful (OB9-OB10).

General purpose financial reports are not designed to show the value of a reporting entity. Instead, they help the primary users to estimate such value (OB7).

Changes in the reporting entity’s economic resources and claims against the entity result from that entity’s **financial performance** and from **other events or transactions** such as issuing debt or equity instruments. To properly assess the entity’s future cash flow prospects, users need to be able to distinguish between both of these changes (OB15).

Accrual accounting is applied when preparing the financial statements. Accrual accounting depicts the effects of transactions and other events and circumstances on the reporting entity’s economic resources and claims against the entity in the periods in which those effects occur, even if the resulting cash receipts and payments occur in a different period (OB17). However, the statement of cash flows is not prepared on an accrual basis (IAS 7).

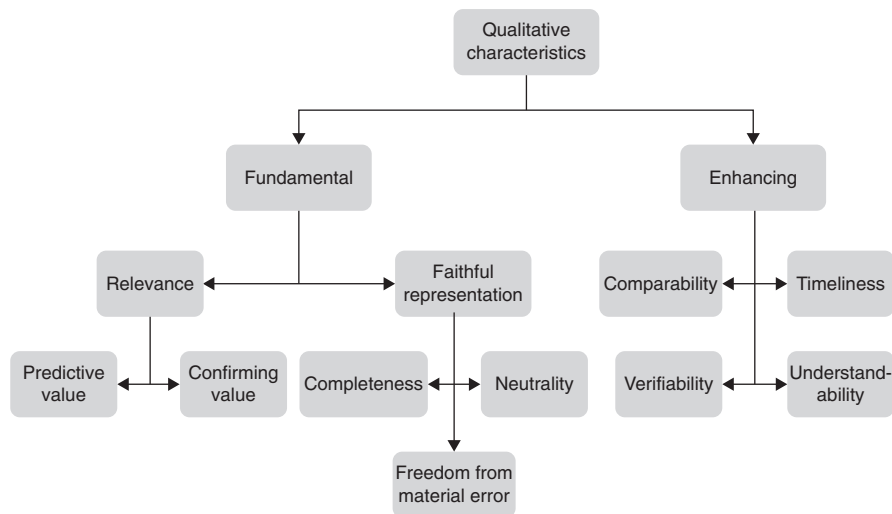
3 GOING CONCERN

The financial statements are normally prepared on the assumption that the entity is a going concern and will continue in operation for the foreseeable future. Thus, it is assumed that the entity has neither the intention nor the need to liquidate or curtail materially the scale of its operations. However, if such an intention or need exists, the financial statements may have to be prepared on a different basis and, if so, the basis used is disclosed (F.4.1).

4 QUALITATIVE CHARACTERISTICS OF USEFUL FINANCIAL INFORMATION

4.1 Introduction

The objective of general purpose financial reporting (see Section 2) is a very broad concept. Consequently, the IASB provides guidance on how to make the judgments necessary to achieve that overall objective. The qualitative characteristics of useful financial information described subsequently identify the types of information that are likely to be most useful to the existing and potential investors, lenders, and other creditors for making decisions about the reporting entity on the basis of information in its financial report (QC1). The following chart represents an overview of the qualitative characteristics.¹



4.2 Fundamental Qualitative Characteristics

Financial information must be both relevant and faithfully represented if it is to be useful (QC4 and QC17).

¹ See KPMG, *Briefing Sheet, Conceptual Framework for Financial Reporting: Chapters 1 and 3, October 2010, Issue 213*.

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4.2.1 Relevance Financial information is relevant if it is **capable of making a difference** in the decisions made by users (QC6). Financial information is capable of making a difference in decisions if it has predictive value, confirmatory value, or both (QC7).

Predictive value means that the financial information can be used as an input to processes employed by users to predict future outcomes. Financial information need not be a prediction or forecast itself in order to have predictive value. Instead, financial information with predictive value is employed by users in making their own predictions (QC8). **Confirmatory value** means that the financial information provides feedback about (i.e. confirms or changes) previous evaluations (QC9).

The predictive value and confirmatory value are interrelated. Financial information that has predictive value often also has confirmatory value (QC10).

Financial information about a specific reporting entity is material if omitting it or misstating it could influence the decisions of users. In other words, **materiality** is an entity-specific aspect of relevance based on the magnitude or nature, or both, of the items to which the information relates in the context of an individual entity's financial report. Hence, the IASB cannot specify a uniform quantitative threshold for materiality or predetermine what could be material in a particular situation (QC11).

4.2.2 Faithful Representation A faithful representation of economic phenomena would have three characteristics. It would be complete, neutral, and free from error. The IASB intends to maximize those qualities to the extent possible (QC12).

A **complete** depiction includes all information necessary for a user to understand the economic phenomenon being depicted. That information includes the necessary numerical information, descriptions, and explanations (QC13).

A **neutral** depiction is without bias in the selection or presentation of information. A neutral depiction is not slanted, weighted, emphasized, de-emphasized or otherwise manipulated in order to increase the probability that the information will be received favorably or unfavorably by users (QC14).

Free from error means that there are no errors or omissions in the description of an economic phenomenon, and the process used to produce the reported information has been selected and applied with no errors in the process. Nevertheless, free from error does not mean perfectly accurate in all respects. For example, there is always some uncertainty when estimating an unobservable price or value (QC15).

Faithful representation **excludes prudence** because it was considered to be in conflict with neutrality (FBC3.19 and BC3.27–BC3.28).

In the Conceptual Framework, **substance over form** does not represent a separate component of faithful representation because it would be redundant. This is because representing a legal form that differs from the economic substance of the underlying economic phenomenon could not result in a faithful representation. Consequently, faithful representation implies that financial information represents the substance of an economic phenomenon rather than merely representing its legal form (FBC3.19 and BC3.26). This means that substance over form is

an important principle in IFRS. The following are examples for applying the principle of substance over form with regard to the issue of revenue recognition when selling goods.

- The assessment of when to recognize revenue is based on the transfer of beneficial ownership and not on the transfer of legal title or the passing of possession (IAS 18.15). For example, when goods are sold under **retention of title**, the seller recognizes revenue when the significant risks and rewards of ownership have been transferred, the seller retains neither effective control nor continuing managerial involvement to the degree usually associated with ownership, and the general criteria (the revenue and the costs can be measured reliably and it is probable that the economic benefits will flow to the seller) are met (IAS 18.14). This means that revenue is recognized by the seller and the goods are recognized by the buyer when beneficial ownership is transferred.
- In an **agency relationship**, an agent may sell goods of the principal in his own name. The **agent** receives a commission from the principal as consideration. In the agent's statement of comprehensive income, the amounts collected by the agent on behalf of the principal do not represent revenue. Instead, **revenue** of the agent is the **amount of commission** (IAS 18.8). This procedure results from the application of the principle "substance over form." Moreover, the agent does not recognize the goods received from the principal in his statement of financial position because beneficial ownership is not transferred to the agent. The **principal** recognizes revenue and derecognizes the goods when he loses beneficial ownership as a result of the sale of the goods to a third party (IAS 18.IE2c and IAS 2.34).
- In an agency relationship in which an agent sells goods of his principal, the accounting treatment described above applies. However, in some cases **determining whether an entity is acting as a principal or as an agent** is not straightforward. That determination requires judgment and consideration of all relevant facts and circumstances. An entity is **acting as a principal** when it has exposure to the significant risks and rewards associated with the sale of the goods. Features that indicate that an entity is acting as a principal include (IAS 18.IE21):
 - The entity has the **primary responsibility** for fulfilling the order, for example by being responsible for the acceptability of the goods.
 - The entity has **inventory risk** before or after the customer order, during shipping or on return.
 - The entity has **latitude in establishing prices**, either directly or indirectly (e.g. by providing additional goods or services).
 - The entity **bears the customer's credit risk** for the amount receivable from the customer.

One feature indicating that an entity is **acting as an agent** is that the amount the entity earns is predetermined (being either a fixed fee per transaction or a stated percentage of the amount billed to the customer).

4.3 Enhancing Qualitative Characteristics

The enhancing qualitative characteristics enhance the usefulness of information that is relevant and faithfully represented. However, they cannot make information useful if that information is irrelevant or not faithfully represented. They may also help to determine which of two ways should be used to depict an economic phenomenon if both are considered equally relevant and faithfully represented (QC19 and QC33).

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Enhancing qualitative characteristics should be maximized to the extent possible. However, one enhancing qualitative characteristic may have to be diminished in order to maximize another qualitative characteristic (QC33–QC34).

4.3.1 Comparability Information about a reporting entity is more useful if it can be compared with similar information about the **same entity for another period** or another date and with similar information about **other entities** (QC20).

Consistency, although related to comparability, is not the same. Consistency refers to the use of the same methods for the same items, either in a single period across entities or from period to period, within the reporting entity. Comparability is the goal whereas consistency helps to achieve that goal (QC22).

The IASB also notes that permitting **alternative accounting methods** for the same economic phenomenon diminishes comparability (QC25).

4.3.2 Verifiability Verifiability means that different knowledgeable and independent observers could reach consensus although not necessarily complete agreement that a particular depiction constitutes a faithful representation (QC26).

Quantified information need not be a single point estimate in order to be verifiable. A range of possible amounts and the related probabilities can also be verified (QC26).

It may not be possible to verify some explanations and forward-looking information until a future period, if at all. To help users decide whether they want to use that information, it is normally necessary to disclose the underlying assumptions, the methods of compiling the information and other factors, and circumstances that support the information (QC28).

4.3.3 Timeliness Timeliness means having information available to decision-makers in time to be capable of influencing their decisions. Normally, the older the information is the less useful it is (QC29).

4.3.4 Understandability Information is made understandable by classifying, characterizing and presenting it clearly and concisely (QC30).

Financial reports are prepared for users who have a reasonable knowledge of business and economic activities and who review and analyze the financial information diligently. Sometimes even well-informed and diligent users may need to seek the aid of an adviser to understand information about complex phenomena (QC32).

5 THE COST CONSTRAINT ON USEFUL FINANCIAL REPORTING

Cost is a pervasive constraint on the information that can be provided by financial reporting. Reporting information imposes **costs** and it is important that those costs are justified by the **benefits** of reporting that information (QC35). Hence, when applying the cost constraint in developing an IFRS, the IASB assesses whether the benefits of reporting particular information are likely to justify the costs incurred to provide and use that information (QC38).

6 THE ELEMENTS OF FINANCIAL STATEMENTS

6.1 Definitions

The elements directly related to the measurement of **financial position** are defined as follows in the Conceptual Framework (F.4.4):

- An **asset** is a resource which is controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.
- A **liability** is a present obligation of the entity that arises from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.
- **Equity** is the residual interest in the assets of the entity after deducting all its liabilities.

Assets and liabilities (as defined above) are not always recognized in the statement of financial position. This is because recognition in the statement of financial position requires that the recognition criteria (see Section 6.2) are met (F.4.5).

Furthermore, the elements of **performance** are defined in the Conceptual Framework as follows (F.4.25):

- **Income** encompasses increases in economic benefits during the period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.
- **Expenses** are decreases in economic benefits during the period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants.

Income and expenses (as defined above) are not always recognized in the statement of comprehensive income. This is because recognition in the statement of comprehensive income requires that the recognition criteria (see Section 6.2) are met (F.4.26).

Income encompasses both **gains** (e.g. from the disposal of non-current assets) and **revenue** (e.g. from the sale of merchandise). Similarly, expenses encompass **losses** as well as **other expenses** (F.4.29–4.35).

6.2 Recognition

Recognition is the process of incorporating an element (see Section 6.1) in the statement of financial position or in the statement of comprehensive income (F.4.37).

An **asset** is recognized in the statement of financial position when it is probable that the future economic benefits associated with the asset will flow to the entity and the asset has a cost or value that can be measured reliably (F.4.44).

A **liability** is recognized in the statement of financial position when it is probable that an outflow of resources which embody economic benefits will result from the settlement of a present obligation and the amount at which the settlement will take place can be measured reliably (F.4.46).

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The so-called **matching principle** applies to the recognition of income and expenses in the statement of comprehensive income. Expenses are recognized in the statement of comprehensive income on the basis of a direct association between the costs incurred and the earning of specific items of income. This means that expenses and income that result directly and jointly from the same transactions or other events are recognized simultaneously or combined. For example, the costs of goods sold are recognized at the same time as the income derived from the sale of the goods. However, the application of the matching principle does not allow the recognition of items in the statement of financial position that do not meet the definition of assets or liabilities (F.4.50).

6.3 Measurement

The measurement of the items recognized in the statement of financial position items is defined in the individual standards. The description of different types of measurement in F.4.55 is of no importance in practice.

7 EXAMPLES WITH SOLUTIONS**Example 1*****Relevance: Predictive value and confirmatory value***

Entity E discloses revenue information for 01 in its financial statements as at Dec 31, 01.

Required

Assess whether E's revenue information is relevant within the meaning of the Conceptual Framework.

Hints for solution

In particular Section 4.2.1.

Solution

Predictive value means that the financial information can be used as an input to processes employed by users to predict future outcomes. Financial information need not be a prediction or forecast itself in order to have predictive value. Instead, financial information with predictive value is employed by users in making their own predictions. E's revenue information for the current period (01) can be used as the basis for predicting revenues in future periods. Consequently, it has predictive value (QC8 and QC10).

Confirmatory value means that the financial information provides feedback about (i.e. confirms or changes) previous evaluations (QC9). E's revenue information for the current period (01) can be compared with revenue predictions for 01 that were made in past periods. Hence, it also has confirmatory value (QC9–QC10).

Financial information is **relevant** if it has predictive value, confirmatory value or both (QC6–QC7). Since E's revenue information has predictive value as well as confirmatory value, it is relevant within the meaning of the Conceptual Framework.

Example 2***Substance over form – retention of title***

On Dec 31, 01, wholesaler W delivers merchandise under retention of title to retailer R. On that date, the significant risks and rewards of ownership are transferred. W retains neither effective control nor continuing managerial involvement to the degree usually associated with ownership. The carrying amount of the merchandise in W's statement of financial position is CU 4. They are sold for CU 5.

Required

Prepare all necessary entries in the financial statements as at Dec 31, 01 of (a) W and (b) R.

Hints for solution

In particular Section 4.2.2.

Solution***General aspects***

Irrespective of the retention of title, beneficial ownership is transferred from W to R on Dec 31, 01. This is because the significant risks and rewards of ownership have been transferred and W retains neither effective control nor continuing managerial involvement to the degree usually associated with ownership. Moreover, it can be assumed that the criterion "probability of the inflow of economic benefits" is met because there are no indications to the contrary. In addition, it is obvious that the revenue and the costs can be measured reliably (IAS 18.14).

(a) W's perspective

On Dec 31, 01, W loses beneficial ownership. Therefore, the criteria for revenue recognition are met. The carrying amount of the merchandise sold has to be recognized as an expense in the period in which the related revenue is recognized, i.e. in 01 (IAS 2.34):

Dec 31, 01	Dr	Cash	5	
	Cr	Revenue		5
Dec 31, 01	Dr	Cost of sales	4	
	Cr	Merchandise		4

(b) R's perspective

R recognizes the merchandise in its statement of financial position when obtaining beneficial ownership:

Dec 31, 01	Dr	Merchandise	5	
	Cr	Cash		5

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Example 3***Determining whether the entity is acting as a principal or as an agent***

Entity E operates an internet business. E's customers pay via credit card. After a credit card check, the order is automatically sent to producer P who immediately sends the goods to the final customer.

E is responsible for any defects of P's products to the final customers. However, E and P have stipulated that all claims of final customers are forwarded to and resolved by P at P's cost.

E receives commission of 10% of the amount billed to the final customer for each sale. The selling prices and the conditions of sales are determined by P alone.

On Dec 07, 01, E sells goods to the final customer in the amount of CU 50. All payments are carried out on the same day.

Required

Assess whether E is acting as a principal or as an agent and prepare all necessary entries in E's financial statements as at Dec 31, 01.

Hints for solution

In particular Section 4.2.2.

Solution

E considers the following criteria when assessing whether it acts as a principal or as an agent (IAS 18.IE21):

- E is responsible for any defects of P's products to the final customers. However, E and P have stipulated that all claims of final customers are forwarded to and resolved by P at P's cost. This means that, in fact (i.e. when applying the principle "substance over form"), E does not have any obligations with regard to defective goods.
- E has no inventory risk, i.e. no risk of a decline in value of the goods.
- The selling prices and the conditions of the sales are determined by P alone. Hence, E has no latitude in establishing prices.
- The amount that E earns is predetermined, being a stated percentage of the amount billed to the final customer.
- Since the final customers have to pay via credit card, E does not bear the customers' credit risk.

According to the characteristics of E's business, E is acting as an agent. Consequently, E's revenue is the amount of commission:

Dec 07, 01	Dr	Cash	5	
	Cr	Revenue		5

Example 4***Is recognition of an intangible asset in the statement of financial position appropriate?***

In Jun 01, entity E spent CU 100 for employee training. E's management believes that its employees will make a more competent impression on E's clients as a result of the training which will then increase E's revenue.

Required

Assess whether the expenses for employee training have to be recognized as an intangible asset in E's statement of financial position. In doing so, also discuss the impact of the matching principle (F.4.50).

Hints for solution

In particular Sections 6.1 and 6.2.

Solution

Considering the matching principle (F.4.50) would suggest the following procedure: the expense of CU 100 is at first recognized as an intangible asset in E's statement of financial position. It affects profit or loss in the same periods in which the related increases in revenue occur. According to that procedure, the increases in revenue would be recognized in profit or loss in the same periods as the training costs that are necessary for creating the higher revenue.

However, the application of the matching principle does not allow the recognition of items in the statement of financial position that do not meet the definition of assets or liabilities (F.4.50), or of items that are assets but do not meet the recognition criteria.

Consequently, the procedure described above (capitalization of the training costs initially and subsequent recognition in profit or loss when the related increases in revenue occur) cannot be applied because the training costs do not represent an intangible asset that meets the recognition criteria (IAS 38.69b). Consequently, they are recognized in profit or loss in Jun 01.