

RELEVANT TO ACCA QUALIFICATION PAPER F7 AND P2

### Studying Paper F7 or P2?

Performance objectives 10 and 11 are relevant to this exam

## The IASB's Conceptual Framework for Financial Reporting

I am from England, and here in the UK, unlike most countries, our system of government has no comprehensive written constitution. Many countries do have such constitutions and in these circumstances the laws of the land are shaped and influenced by the constitution. Now while the International Accounting Standards Board (IASB) is not a country it does have a sort of constitution, in the form of the Conceptual Framework for Financial Reporting (the Framework), that proves the definitive reference document for the development of accounting standards. The Framework can also be described as a theoretical base, a statement of principles, a philosophy and a map. By setting out the very basic theory of accounting the Framework points the way for the development of new accounting standards. It should be noted that the Framework is not an accounting standard, and where there is perceived to be a conflict between the Framework and the specific provisions of an accounting standard then the accounting standard prevails.

Before we look at the contents of the Framework, let us continue to put the Framework into context. It is true to say that the Framework:

- seeks to ensure that accounting standards have a consistent approach to problem solving and do not represent a series of ad hoc responses that address accounting problems on a piece meal basis
- assists the IASB in the development of coherent and consistent accounting standards
- is not a standard, but rather acts as a guide to the preparers of financial statements to enable them to resolve accounting issues that are not addressed directly in a standard
- is an incredibly important and influential document that helps users understand the purpose of, and limitations of, financial reporting
- used to be called the Framework for the Preparation and Presentation of Financial Statements
- is a current issue as it is being revised as a joint project with the IASB's American counterparts the Financial Accounting Standards Board .

### Overview of the contents of the Framework

The starting point of the Framework is to address the fundamental question of why financial statements are actually prepared. The basic answer to that is they are prepared 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.

In turn this means the Framework has to consider what is meant by useful information. In essence for information to be useful it must be considered both relevant, ie capable of making a difference in the decisions made by users and

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be faithful in its presentation, ie be complete, neutral and free from error. The usefulness of information is enhanced if it is also comparable, verifiable, timely, and understandable.

The Framework also considers the nature of the reporting entity and, in what reminds me of my school chemistry lessons, the basic elements from which financial statements are constructed. The Framework identifies three elements relating to the statement of financial position, being assets, liabilities and equity, and two relating to the income statement, being income and expenses. The definitions and recognition criteria of these elements are very important and these are considered in detail below.

### **The five elements**

An asset is defined as a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.

Assets are presented on the statement of financial position as being noncurrent or current. They can be intangible, ie without physical presence, eg goodwill. Examples of assets include property plant and equipment, financial assets and inventory.

While most assets will be both controlled and legally owned by the entity it should be noted that legal ownership is not a prerequisite for recognition, rather it is control that is the key issue. For example IAS 17, *Leases*, with regard to a lessee with a finance lease, is consistent with the Framework's definition of an asset. IAS 17 requires that where substantially all the risks and rewards of ownership have passed to the lessee it is regarded as a finance lease and the lessee should recognise an asset on the statement of financial position in respect of the benefits that it controls, even though the asset subject to the lease is not the legally owned by the lessee. So this reflects that the economic reality of a finance lease is a loan to buy an asset, and so the accounting is a faithful presentation.

A liability is defined as a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

Liabilities are also presented on the statement of financial position as being noncurrent or current. Examples of liabilities include trade payables, tax creditors and loans.

It should be noted that in order to recognise a liability there does not have to be an obligation that is due on demand but rather there has to be a present obligation. Thus for example IAS 37, *Provisions, Contingent Liabilities and*

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*Contingent Assets* is consistent with the Framework's approach when considering whether there is a liability for the future costs to decommission oil rigs. As soon as a company has erected an oil rig that it is required to dismantle at the end of the oil rig's life, it will have a present obligation in respect of the decommissioning costs. This liability will be recognised in full, as a non-current liability and measured at present value to reflect the time value of money. The past event that creates the present obligation is the original erection of the oil rig as once it is erected the company is responsible to incur the costs of decommissioning.

Equity is defined as the residual interest in the assets of the entity after deducting all its liabilities.

The effect of this definition is to acknowledge the supreme conceptual importance of indentifying, recognising and measuring assets and liabilities, as equity is conceptually regarded as a function of assets and liabilities, ie a balancing figure.

Equity includes the original capital introduced by the owners, ie share capital and share premium, the accumulated retained profits of the entity, ie retained earnings, unrealised asset gains in the form of revaluation reserves and, in group accounts, the equity interest in the subsidiaries not enjoyed by the parent company, ie the non-controlling interest (NCI). Slightly more exotically, equity can also include the equity element of convertible loan stock, equity settled share based payments, differences arising when there are increases or decreases in the NCI, group foreign exchange differences and contingently issuable shares. These would probably all be included in equity under the umbrella term of Other Components of Equity.

Income is defined as the increases in economic benefits during the accounting 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.

Most income is revenue generated from the normal activities of the business in selling goods and services, and as such is recognised in the Income section of the Statement of Comprehensive Income, however certain types of income are required by specific standards to be recognised directly to equity, ie reserves, for example certain revaluation gains on assets. In these circumstances the income (gain) is then also reported in the Other Comprehensive Income section of the Statement of Comprehensive Income.

The reference to 'other than those relating to contributions from equity participants' means that when the entity issues shares to equity shareholders,

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while this clearly increases the asset of cash, it is a transaction with equity participants and so does not represent income for the entity.

Again note how the definition of income is linked into assets and liabilities. This is often referred to as 'the balance sheet approach' (the former name for the statement of financial position).

Expenses are defined as decreases in economic benefits during the accounting 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.

The reference to 'other than those relating to distributions to equity participants' refers to the payment of dividends to equity shareholders. Such dividends are not an expense and so are not recognised anywhere in the Statement of Comprehensive Income. Rather they represent an appropriation of profit that is as reported as a deduction from Retained Earnings in the Statement of Changes in Equity.

Examples of expenses include depreciation, impairment of assets and purchases. As with income most expenses are recognised in the Income Statement section of the Statement of Comprehensive Income, but in certain circumstances expenses (losses) are required by specific standards to be recognised directly in equity and reported in the Other Comprehensive Income Section of the Statement of Comprehensive Income. An example of this is an impairment loss, on a previously revalued asset, that does not exceed the balance of its Revaluation Reserve.

### **The recognition criteria for elements**

The Framework also lays out the formal recognition criteria that have to be met to enable elements to be recognised in the financial statements. The recognition criteria that have to be met are that

- that an item that meets the definition of an element and
- it is probable that any future economic benefit associated with the item will flow to or from the entity and
- the item's cost or value can be measured with reliability.

### **Measurement issues for elements**

Finally the issue of whether assets and liabilities should be measured at cost or value is considered by the Framework. To use cost should be reliable as the cost is generally known, though cost is not necessary very relevant for the users as it is past orientated. To use a valuation method is generally regarded as relevant to the users as it up to date, but value does have the drawback of not always being reliable. This conflict creates a dilemma that is not satisfactorily resolved as the Framework is indecisive and acknowledges that

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there are various measurement methods that can be used. The failure to be prescriptive at this basic level results in many accounting standards sitting on the fence how they wish to measure assets. For example IAS 40, *Investment Properties* and IAS 16, *Property, Plant and Equipment* both allow the preparer the choice to formulate their own accounting policy on measurement.

### **Applying the Framework**

A company is about to enter into a three-year lease to rent a building. The lease cannot be cancelled and there is no certainty of renewal. The landlord retains responsibility for maintaining the premises in good repair. The directors are aware that in accordance with IAS 17 that technically the lease is classified as an operating lease, and that accordingly the correct accounting treatment is to simply expense the income statement with the rentals payable.

#### *Required*

Explain how such a lease can be regarded as creating an asset and liability per the Framework.

#### *Solution – lease*

Given that it is reasonable to assume that the expected life of the premises will vastly exceed three years and that the landlord (lessor) is responsible for the maintenance, on the basis of the information given, the risks and rewards of ownership have not passed. As such IAS 17 prescribes that the lessee charges the rentals payable to the income statement. No asset or liability is recognised, although the notes to the financial statements will disclose the existence of the future rental payments.

However, instead of considering IAS 17 let us consider how the Framework could approach the issue. To recognise a liability per the Framework requires that there is a past event that gives rise to a present obligation. It can be argued that the signing of the lease is a sufficient past event as to create a present obligation to pay the rentals for the whole period of the lease. On the same basis, while substantially all the risks and rewards of ownership have not passed, the lessee does control the use of the building for three years and has the benefits that brings. Accordingly, when considering the Framework, a radically different potential treatment arises for this lease. On entering the lease a liability is recognised, measured at the present value of the future cash flow obligations to reflect the time value of money. In turn an asset would also be accounted for. After the initial recognition of the liability, a finance cost is charged against profit in respect of unwinding the discount on the liability. The annual cash rental payments are accounted for as a reduction in the liability. The asset is systematically written off against profit over the three years of the agreement (depreciation).

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There is, at present, a conflict between IAS 17 and the Framework. The IASB is currently reviewing IAS 17 because the current accounting treatment of lessees not recognising the future operating lease rentals as liabilities arguably amounts to off balance sheet financing. The Framework's definition of a liability is at the heart of proposals to revise IAS 17 to ensure that the statement of financial position faithfully and completely represents all an entity's liabilities. Accordingly this conflict should soon be resolved.

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