IASB Conceptual Framework: what busy CPAs need to know

Tan Boon Seng explains why professional accountants in business should care about one of the most important documents concerning financial reporting

Professional accountants in business are generally familiar with applying accounting standards in the preparation of financial statements. The International Financial Reporting Standards – developed by the International Accounting Standards Board – is the most influential set of accounting standards, with or without modification by local standard setters, in use.

There are plans for convergence of the IFRS with the United States' Generally Accepted Accounting Principles developed by the Financial Accounting Standards Board and the IASB Conceptual Framework was an active convergence project for both standard setters.

Given that conceptual frameworks are originally and primarily designed to help set and develop standards but PAIBs are concerned mainly with applying standards for financial reporting, why should PAIBs care about the IASB Conceptual Framework? A historical preview is useful.

Historical background of FASB and IASB conceptual frameworks

Accounting standards and financial reporting precede any conceptual framework: the cart comes before the horse in a deductive way.

Standards were set in the absence of a conceptual framework based on notional principles – such as true and fair view, prudence, stewardship, conservatism and matching revenue and expense – instead of an integrated set of concepts reflecting the underlying economics as the frame of reference.

Decisions made about standard development and application relied on implicit personal "conceptual framework" of the decision makers. Nonetheless, standards are developed and applied.

The FASB Conceptual Framework project from 1973 to 1985 resulted in seven substantial concept statements published separately. The IASB equivalent – *Framework for the Preparation and Presentation of Financial Statements*, published in 1989 – has many similarities with the FASB version: both are incomplete in lacking a treatment of measurement, and both emphasize decision-making usefulness especially for capital investors (i.e. financial reporting) instead of legal and stewardship purposes (i.e. accounting).

In 2004, the FASB and IASB started a joint project on a conceptual framework (i.e. convergence) which was paused in late 2010, but reactivated as an IASB-only project in 2012. A discussion paper, *A Review of the Conceptual Framework for Financial Reporting*, was published in July 2013 with a comment deadline in January 2014.

Conceptual framework and quality of financial reporting

Having a conceptual framework improves the quality of financial reporting. A framework imposes discipline on standard setters to produce consistent decisions and, with a clear frame of reference, standard setters become accountable for their decisions.

For jurisdictions that have adopted IFRS, the revisions to IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* in 2003 mean that without an IFRS (or interpretation) that specifically applies to a transaction, judgment in developing and applying an accounting policy requires the PAIB to use the IASB Conceptual Framework as guidance for definitions, recognition criteria and measurement concepts for assets, liabilities, income, and expenses.

The conceptual framework also provides the set of commonly understood concepts for effective engagement between PAIBs and standard setters. The improved communication between standard setters and PAIBs, who apply accounting standards in financial reporting, contributes to improving the quality of standard setting and consequently financial reporting.

It is almost unavoidable that conflicts arise between the conceptual framework and new or existing standards. The value of the conceptual framework is its guidance on improving the quality of financial reporting as accounting standards evolve.

The conceptual framework is aspirational – the "conceptually correct" approach is not fully achieved at the standards level at any one time because of pragmatic compromises – and having the conceptual framework makes these compromises explicit.

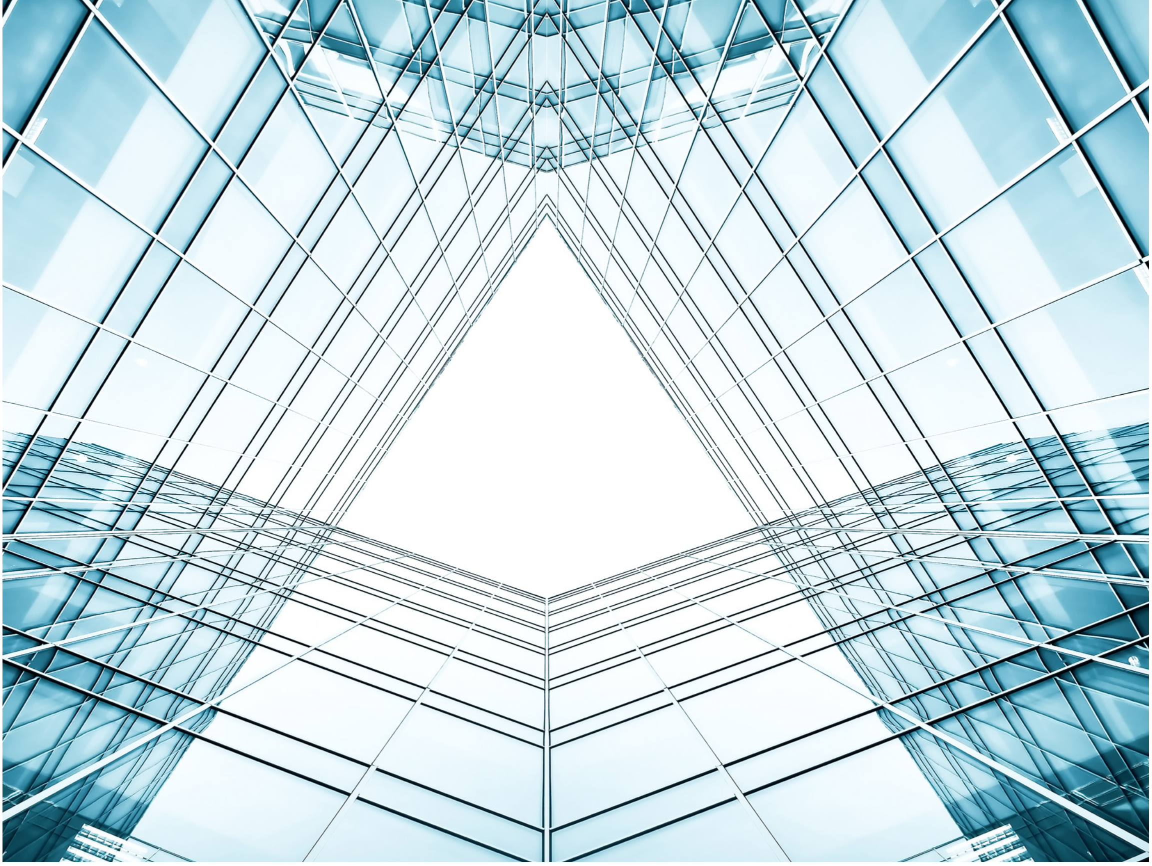
In the short run, PAIBs care only about applying the standards and the conceptual framework provides no direct guidance (except as in IAS 8). In the long run, the conceptual framework guides the journey for high-quality financial reporting.

Conceptual framework in a nutshell

The current version of the conceptual framework (2010) contains the following five key content elements:

i. Objective of financial reporting
ii. Qualitative characteristics of useful financial information
iii. Reporting entity
iv. Definition, recognition and measurement of the elements from which financial statements are constructed
v. Concepts of capital and capital maintenance

Interested readers can see *www.iasplus.com/en/standards/other/framework* for a useful summary for each element. As part



of the IASB due process, the issuance of the discussion paper in 2013 is to solicit early views on proposed changes. An exposure draft containing proposed changes is expected in the fourth quarter of this year and the revised conceptual framework is expected by end 2015.

The discussion paper examines in detail the following seven issues:

i. *Elements of financial statements:* The discussion paper clarifies the definitions of "assets" and "liabilities." The framework will no longer refer to expected inflows or outflows of economic benefits, but directly to the underlying resource or obligation. The notion of probability is removed from the definitions. It also defines income and expense, cash receipts and payments as well as contributions to, distributions of and transfers between classes of equity.

ii. *Additional guidance to support the asset and liability definitions:* The discussion paper tests the usefulness of the definitions in areas that have application problems in the past, especially the meaning of "present obligation" in connection with a liability.

iii. *Recognition and de-recognition:* The discussion paper introduces the concept of de-recognition into the framework.

iv. *Definition of equity and distinction between liabilities and equity instruments:* The discussion paper refines the definition of equity as residual interest and proposes a requirement to update the measure of the different classes of equity claims at the end of each reporting period in order to show dilution effects.

v. *Measurement:* The discussion paper describes the objectives of the different categories of measurement, how an appropriate measurement can be identified, and explains why one measurement across all items of the balance sheet is not appropriate.

vi. *Presentation and disclosure:* The discussion paper introduces the purpose of the primary financial statements and the notes to the financial statements and their relationship to the conceptual framework and addresses materiality and forward-looking information.

vii. *Presentation in the statement of comprehensive income – profit and loss and other comprehensive income:* The discussion paper distinguishes between profit and loss and other comprehensive income, and marking them by sub-totals. As a principle, all income and expense will be shown in profit and loss unless relating to the re-measurement of assets and liabilities, which would normally be shown in other comprehensive income with recycling generally permitted.

Interested readers can see *www.iasplus.com/en/news/2013/07/framework-dp* for a useful summary of the issues.

Conclusions

In the long run, PAIBs should care about the conceptual framework because it is instrumental to improve the quality of financial reporting. The conceptual framework is undergoing important and subtle changes which are hotly debated among the technically inclined, but that is beyond the scope of this short article.

A survey by the Institute of Singapore Chartered Accountants and Singapore Management University in the first quarter of 2014 suggests broad consensus among accountants in Singapore with respect to most of the proposed changes in the discussion paper.

The areas that generate the most disagreement among practitioners relate to the removal of economic benefits in the proposed asset definition, the proposal to remove the minimum probability threshold from the asset definition, and the use of fair value as a measurement basis for certain difficult to measure assets.

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