Overview of IASB exposure draft on the proposed changes to the existing Conceptual Framework

The Conceptual Framework for Financial Reporting sets out the concepts that underlie the preparation and presentation of financial statements. Although the existing *Conceptual Framework* has helped the International Accounting Standards Board when developing and revising International Financial Reporting Standards, the IASB has identified a number of problems with the existing *Conceptual Framework*.

In order to improve financial reporting by providing a more complete, clear and updated set of concepts, the IASB published a discussion paper, *A Review of the Conceptual Framework for Financial Reporting*, in July 2013. In light of responses received on the discussion paper, the IASB published an exposure draft in May, which sets out proposals for a revised *Conceptual Framework*. Compared to the existing *Conceptual Framework*, the exposure draft does the following:

a. Addresses the following areas that are either not covered, or not covered in any detail, in the existing *Conceptual Framework*:
   - Measurement;
   - Financial performance (including the use of other comprehensive income);
   - Presentation and disclosure;
   - Derecognition; and
   - The reporting entity.
b. Clarifies some aspects of the existing *Conceptual Framework*; and
c. Updates parts of the existing *Conceptual Framework* that are out of date. For example, this exposure draft clarifies the role of probability in the definitions of assets and liabilities.

Objective of general purpose financial reporting and the qualitative characteristics of useful financial information

When the IASB restarted work on the *Conceptual Framework*, it decided not to reconsider fundamentally the chapters that deal with the objective of general purpose financial reporting and the qualitative characteristics of useful financial information. However, many respondents to the discussion paper stated that the IASB should reconsider one or more aspects of these chapters. In response to these comments, the IASB now proposes:

a. To give more prominence to the importance of providing information needed to assess management's stewardship of the entity's resources within the discussion of the objective of financial reporting;
b. To reintroduce an explicit reference to the notion of prudence (described as caution when making judgments under conditions of uncertainty) and state that prudence is important for achieving neutrality; and
c. To state explicitly that a faithful representation represents the substance of an economic phenomenon rather than merely representing its legal form.

Financial statements and reporting entities

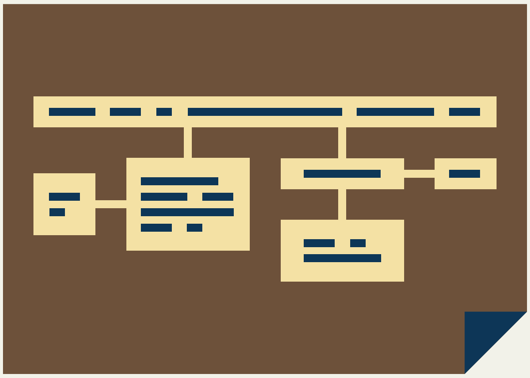
The existing *Conceptual Framework* does not discuss what a reporting entity is and the boundary of a reporting entity. In the exposure draft, a reporting entity is described as an entity that chooses, or is required, to prepare general purpose financial statements and it does not have to be a legal entity. With respect to the boundary of a reporting entity, the exposure draft states that when one entity (the parent) has control over another entity (the subsidiary), the boundary of the reporting entity can be determined by either direct control only (leading to unconsolidated financial statements) or by direct and indirect control (leading to consolidated financial statements).

In general, the IASB believes that consolidated financial statements are more likely to provide useful information to users of financial statements than unconsolidated financial statements, even though unconsolidated financial statements may also provide useful information. The IASB believes that if an entity chooses, or is required, to prepare unconsolidated financial statements, it would need to disclose how users obtain the consolidated financial statements.

Revised definitions of assets and liabilities

The IASB believes that the existing definitions of assets and liabilities could be refined. The exposure draft suggests revised definitions that:

- An asset is a present economic resource controlled by the entity as a result of past events. An economic resource is a right that has the potential to produce economic benefits, which need not be certain or even probable, that the resource will produce economic benefits; and
- A liability is a present obligation of the



entity to transfer an economic resource as a result of past events.
- In particular, the exposure draft suggests that an entity has a present obligation to transfer an economic resource if both:
  a. The entity has no practical ability to avoid the transfer; and
  b. The obligation has arisen from past events, i.e. the entity has received the economic benefits, or conducted the activities, that establish the extent of its obligation.

The exposure draft does not propose to make changes to the existing definitions of liabilities and equity to address the problems that arise in classifying instruments with characteristics of both liabilities and equity. Instead, the IASB has decided to further explore how to distinguish between liabilities and equity in its separate research project *Financial Instruments with the Characteristics of Equity*.

Recognition and derecognition

The exposure draft proposes to describe relevance, faithful representation and the cost benefit constraint as criteria for recognition. As a result, assets and liabilities (and any related income, expenses or changes in equity) should be recognized if:

a. Recognition of the asset or liability provides users of financial statements with relevant information about the asset or liability and about any income, expenses or changes in equity;
b. Recognition of the asset or liability provides a faithful representation of the asset or liability and of any income, expenses or changes in equity; and
c. The benefit of the information given by recognizing the asset or liability outweighs the cost of doing so.

With respect to the element of derecognition, the exposure draft proposes that accounting requirements for derecognition should aim to represent faithfully both:

a. The assets and liabilities (if any) retained after the transaction or other event that led to the derecognition; and
b. The change in the entity's assets and liabilities as a result of that transaction or other event.

Moreover, the exposure draft attempts to describe the approaches available, and discuss what factors to consider, in deciding at the standards level how best to portray the changes that result from a transaction in which an entity retains only a component of an asset or a liability and what is the appropriate accounting treatment when the terms of a contract are modified.

Measurement

The exposure draft proposes to categorize measurement bases as historical cost or current value (including fair value, value in use for assets and fulfillment value for liabilities). When selecting a measurement basis, the exposure draft discusses the factors to consider when selecting a measurement basis and how considering the qualitative characteristics of useful financial information affects the selection. The exposure draft also notes that the cost constraint affects the selection of a measurement basis.

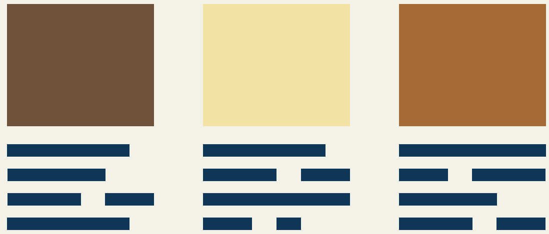
There are situations in which more than one measurement basis is needed to provide relevant information about an asset, liability, income or expenses. The exposure draft states that:

a. In most cases, the most understandable way to provide that information is to use one measurement in both the statement of financial position and the statement(s) of financial performance, and to use the other measurement basis for disclosure only; and
b. In some cases, more relevant information is provided by using a current value measurement basis in the statement of financial position and a different measurement basis to determine the related income or expenses in the statement of profit or loss.

Presentation and disclosure

The exposure draft reconfirms the proposal in the discussion paper that the IASB should develop disclosure and presentation requirements that promote effective communication of useful financial information. As a result, the exposure draft includes in the *Conceptual Framework* those communication principles proposed in the discussion paper and discusses how they related to the qualitative characteristics of useful financial information. Specifically, effective and efficient communication of information requires consideration of the following:

a. Promote the disclosure of useful information that is entity-specific;
b. Result in disclosures that are clear, balanced and understandable;
c. Avoid duplication of the same informa-



tion in different parts of the financial statements; and

d. Optimize comparability without compromising the usefulness of the information disclosed.

Financial performance

The exposure draft does not define profit or loss. Instead it describes the statement or section of profit or loss as the primary source of information about an entity's financial performance for the period and requires a total or subtotal for profit or loss to be provided.

This has been a particularly controversial part of the IASB's proposals and some respondents to the discussion paper provided suggestions as to how the IASB might approach developing the definition or a description of profit or loss. For example, one view is profit or loss as an all-inclusive measure of irreversible outcomes. Another view considers profit or loss as a measure of management's performance.

Because the IASB is of the view that the statement of profit or loss is the primary source of information about an entity's financial performance for the period, there is a presumption that all income and all expenses will be included in the statement of profit or loss. In particular, the IASB tentatively considers that presumption cannot be rebutted for:

a. Income and expenses related to assets and liabilities measured at historical cost; and
b. Components of income or expenses related to assets and liabilities measured at current values if the components are separately identified and are of the type that would arise if the related assets and liabilities were measured at historical cost. For example, if an interest-bearing asset is measured at a current value and if interest income is identified as one component of the change in the carrying amount of the asset, that interest income would need to be included in the statement of profit or loss.

Moreover, the presumption that all income and all expenses will be included in the statement of profit or loss can only be rebutted if:

a. The income or expenses (or components of them) relate to assets or liabilities measured at current values and are not of the type described in paragraph (b) mentioned in the above: and
b. Excluding those income or expenses (or components of them) from the statement of profit or loss would enhance the relevance of the information in that statement for the period.

When this is the case, those income or expenses (or components of them) are included in other comprehensive income.

One example when this could be the case is when a current measurement basis is selected for an asset or a liability for the statement of financial position and a different measurement basis is selected for determining the related income and expenses in the statement of profit or loss.

If income or expenses are included in other comprehensive income in one period, there is a presumption that it will be reclassified into the statement of profit or loss in some future period (i.e. recycled).

Reclassification takes place when doing so will enhance the relevance of the information included in that statement of profit or loss for that future period. The presumption could be rebutted, for example if there is no clear basis for identifying the period in which reclassification would enhance the relevance of information in the statement of profit or loss. If no such basis can be identified, this may indicate that the income or expenses should not be included in other comprehensive income.

Other issues

Unit of account

The IASB notes that there are repeated requests for guidance on the unit of account. As a result, the exposure draft proposes that the unit of account is the group of rights, the group of obligations or the group of rights and obligations, to which recognition and measurement requirements are applied. The exposure draft also describes some possible units of account and provides a list of factors to consider when selecting a unit of account.

Executory contracts

The exposure draft includes concepts explaining the nature of the assets and liabilities in executory contracts. An executory contract is defined in the exposure draft as a contract that is equally unperformed: neither party has fulfilled any of its obligation, or both parties have fulfilled their obligations partially and to an equal extent. An executory contract establishes a right and an obligation to exchange economic resources and that combined right and obligation constitute a single asset or liability. The entity has an asset if the terms of the exchange are favourable or otherwise it has a liability if the terms of the exchange are unfavourable.

The next steps

The Institute's Financial Reporting Standards Committee is deliberating the proposals and welcomes comments on any parts of the proposals by 14 September. Please provide your comments to the Standard Setting Department.

This article is contributed by the Institute's Standard Setting Department