Conceptual Framework: Objectives and qualitative characteristics

What is the objective of the project?

To provide the best foundation for developing principle-based standards, the Boards undertook the project to establish an improved Conceptual Framework (the revised Framework or the Conceptual Framework). The revised Framework is based on fundamental economic concepts rather than a collection of arbitrary conventions. The project forms part of the overall convergence, efforts of the Boards. The revised Framework will eventually replace the existing IASB and FASB Frameworks and result in a common basis for both standard-setters, which will eliminate the risk of reaching different conclusions about similar or even identical issues and events.

Scope

The revised Framework is applicable to all preparers of IFRS and US GAAP general purpose financial statements.

What is new?

Chapter 1: Objective of financial reporting

The objective of general purpose financial reporting forms the foundation of the Conceptual Framework, with other aspects of the Framework flowing from it.

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. Moreover, it is directed at users who provide resources to a reporting entity, but lack the ability to compel the entity to provide them with the information they need to make decisions about their investments.

The revised Framework limits the range of addressees of general purpose financial reporting. It lists as primary users of financial statements, existing or potential investors, lenders and other creditors. The existing Framework, in contrast, identified in addition to the addressees listed above, employees, suppliers, customers, governments and the general public. An assumption was included in the existing Framework that the information needs of investors meet the information needs of the other stakeholders to the maximum extent.
The revised Framework continues to acknowledge limitations of general purpose financial statements, as those may not provide information that serves all users’ needs. Furthermore, financial reporting is not intended to provide information about the value of a reporting entity.

Regulators have been omitted from the list of primary users as they have the power to demand information they need. Also, financial stability as an objective of general purpose financial reporting was not explicitly included. The Boards noted that the objectives laid out in the revised Framework are not inconsistent with financial stability as relevant and faithfully represented financial information improves user’s confidence, hence, financial stability.

In its attempt to create a conceptual framework based on fundamental economic concepts, the revised Framework changes terminology. It no longer refers to the presentation of an entity’s financial position, performance and changes in financial position to assessing the entity’s ability to generate cash flows. It rather introduces a broader reference to financial information, i.e., reporting of an entity’s economic resources, claims and changes therein.

### Chapter 3: Qualitative characteristics of useful financial information

The revised Framework distinguishes between two types of qualitative characteristics that are necessary to provide useful financial information:

- Fundamental qualitative characteristics (relevance and faithful representation)
- Enhancing qualitative characteristics (comparability, timeliness, verifiability and understandability)

### What are the fundamental qualitative characteristics?

Relevant financial information is capable of making a difference to the decision made by users. In order to make a difference, financial information has predictive value, confirmatory value or both. The revised Framework carries forward the notion of materiality as an element of ‘relevance’. However, the Boards have clarified that materiality is an entity-specific aspect of relevance based on the nature or magnitude of items to which the information relates, which cannot be specified in general terms to encompass every situation.

Faithful representation replaces the previously used term ‘reliability’, as the Boards determined there is a lack of common understanding of reliability. Financial information that faithfully represents economic phenomena has three characteristics:

- It is complete
- It is neutral
- It is free from error

### How we see it

The revised chapter on objectives of financial reporting follows a different approach in identifying the users of financial statements by limiting these to investors, lenders and other creditors. It also introduces more general terms with respect to financial information required to be provided to meet the user’s needs. The changes, however, are unlikely to result in immediate changes to the way financial statements are presented today.
The revised Framework acknowledges limitations in achieving a faithful representation, e.g., due to inherent uncertainties, estimates and assumptions. Accordingly, financial information might not always be entirely free from error. Faithful representation, however, is achieved if no errors or omissions affect the description of economic phenomena and the process applied to produce reported information has been selected and applied without errors.

What is the purpose of enhancing qualitative characteristics?

Comparability, timeliness, verifiability and understandability are directed to enhance both relevant and faithfully represented financial information. Those characteristics should be maximised both individually and in combination.

Comparability enables users to identify similarities and differences among items, both between different periods within a set of financial statements and across different reporting entities. Consistent application of methods to prepare financial statements helps to achieve comparability.

Verifiability is a new concept in the revised Framework. Financial information is verifiable when it enables knowledgeable and independent observers to reach a consensus on whether a particular depiction of an event or transaction is a faithful representation.

Timeliness of financial information is a qualitative characteristic under the existing framework. However, rather than stressing the balance between timely reporting and reliable information, the revised Framework refers more broadly to timeliness as being able to influence decision makers.

Understandability has been carried forward from the existing Framework. Financial information that is classified, characterised and presented in a clear and concise way is understandable.

What are the constraints on useful financial reporting?

In a change from the existing Framework, the revised Framework eliminates timeliness, however, continues to identify cost as a pervasive constraint to financial reporting. The Boards determined that it is important that benefits arising from financial reporting exceed the cost of preparation. Relevant and faithfully represented financial information, however, is assumed to result in more efficient functioning of financial markets and reduces cost of capital for the reporting entity.

How we see it

The revision to Chapter 3 does not result in fundamental changes to the Framework, but reorders and presents its characteristics in a more structured and comprehensive way. The distinction between fundamental and enhancing characteristics improves the understanding of those aspects of the revised Framework.

What does this mean for preparers?

Reporting entities might not necessarily conclude that the revised chapters of the Framework result in immediate changes to their financial reporting. The chapters, however, provide more clarity about the underlying principles of financial reporting. Therefore, they should be considered throughout the collection, processing, verification and dissemination of financial information.

Next steps

The Boards are currently working on Chapter 2 of the revised Framework which deals with the concept of the Reporting Entity for which an Exposure Draft was issued in March 2010.

The Boards already identified three further phases of the revision process which can be illustrated, as follows:

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<tr>
<th>Phase B</th>
<th>Chapter 4</th>
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<td>(DP 2011)</td>
<td>Definitions of elements, recognition and derecognition</td>
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<tr>
<th>Phase C</th>
<th>Chapter 4</th>
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<tr>
<td>(DP 2011)</td>
<td>Measurement</td>
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<th>Phase D</th>
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<td>(ED 03/2010)</td>
<td>Reporting entity concept</td>
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