IASB issues the Conceptual Framework exposure draft

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What you need to know

• The IASB has proposed revisions to its Conceptual Framework.

• The purpose of this project is to provide the IASB with an updated and more complete set of concepts to use for standard-setting, guidance for preparers in developing accounting policies, and assistance to others in their efforts to understand and interpret the standards.

• The proposed changes to the Conceptual Framework may impact the application of IFRS in situations where no standard applies to a particular transaction or event, or when a standard allows a choice of accounting policy.

• The comment period ends 26 October 2015.
Overview

The International Accounting Standards Board (the IASB or the Board) issued Exposure Draft (ED) ED/2015/3 Conceptual Framework for Financial Reporting on 28 May 2015, which proposes comprehensive changes to its Conceptual Framework. The ED proposes revisions to the definitions of elements in the financial statements, includes guidance on derecognition, discussions on measurement bases, principles for including items in other comprehensive income (OCI) in relation to performance reporting, and includes high-level concepts for presentation and disclosure.

The existing Conceptual Framework was criticised for its lack of clarity, for not covering some important concepts and for not being reflective of the IASB’s current thinking. Following feedback received on the IASB’s agenda consultation in 2011, the Conceptual Framework project was added to the IASB’s work plan in September 2012. Since then, the IASB has issued a discussion paper (DP) A Review of the Conceptual Framework for Financial Reporting in J uly 2013. The Board aims to complete the revisions to the Conceptual Framework in 2016.

The topics covered in the ED are:

- Objective of general purpose financial reporting (GPFR)
- Qualitative characteristics of useful financial information
- General purpose financial statements (GPFS) and reporting entities
- Elements of financial statements
- Recognition and derecognition
- Measurement
- Presentation and disclosure
- Concepts of capital and capital maintenance

Summary of the proposals

Objective of GPFR and qualitative characteristics of useful financial information

The IASB has proposed limited amendments to these sections of the existing Conceptual Framework, which were issued in 2010 as part of the IASB’s joint project with the US Financial Accounting Standards Board (FASB).

One of the amendments relates to the discussion of management’s stewardship of an entity’s resources. The existing Conceptual Framework does not use the term ‘stewardship’, but, instead, describes what stewardship encapsulates. The IASB has proposed to include the term stewardship in order to emphasise the need for information required to assess the stewardship function, as a necessary part of the overall objective of financial reporting.

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1 This section covers the concepts of capital and capital maintenance, which are carried forward unchanged from the existing Conceptual Framework, apart from some minor edits.

2 The IASB and the US FASB started a joint project to revise their Conceptual Frameworks in 2004 and issued two chapters (describing the objective of GPFR and qualitative characteristics of useful financial information) in their respective Conceptual Frameworks in 2010.
In the existing Conceptual Framework’s section on qualitative characteristics of useful financial information, the IASB had not included a discussion on prudence, stating that prudence is inconsistent with neutrality. After considering feedback from constituents, the IASB decided to reinstate the concept of prudence in the ED. The Board believes that prudence is best described as caution when making judgements under conditions of uncertainty, that it has a role to play in financial reporting, and can help achieve neutrality. The IASB has further clarified that prudence works both ways: assets and liabilities should be neither overstated nor understated.

**Reporting entities**

The ED describes a reporting entity as an entity that chooses, or is required, to prepare GPFS, and it proposes guidance on how to set the boundary of a reporting entity. The Board proposes that the boundary can be determined by either direct control (which results in unconsolidated or individual financial statements) or by direct and indirect control (which results in consolidated financial statements).

The Board also acknowledges the need for combined financial statements in certain circumstances, but does not discuss in the ED when or how entities could or should prepare them, stating a preference to undertake a standard or standards-level project on this subject rather than deal with it in any great detail in the Conceptual Framework.

**Elements of financial statements**

The ED proposes to revise the current definitions of assets and liabilities. The ED defines an asset as ‘a present economic resource controlled by the entity as a result of past events’. The term ‘economic resource’ focuses on rights (or a bundle of rights) which have the potential to produce economic benefits. This represents a greater focus on accounting for different rights that compose economic resources, which encapsulates the notion of accounting for both tangible and intangible assets. The IASB has retained the concept of control in the definition, in order to assert that an entity must have both the ability to direct the use of, and rights to obtain, the benefits from the economic resource.

The proposed definition of a liability - “a present obligation of the entity to transfer an economic resource as a result of past events” - places emphasis on an entity’s obligation at the reporting date, as a consequence of a past transaction or other event that imposed the obligation on the entity. The ED also contains further guidance on what a present obligation is, which would essentially include any obligation arising from past events that an entity has no practical ability to avoid.

For the definitions of both assets and liabilities, the IASB decided not to retain the notion of an ‘expected inflow or outflow of resources’ in acknowledgement of concerns about varied interpretations of the term ‘expected’ and the notion of a threshold level of probability. The Board believes that this is best addressed within the recognition guidance.

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3 The existing Conceptual Framework defines an asset 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’.  
4 The existing definition of liability is ‘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.’
How we see it

The IASB acknowledges in the Basis for conclusions of the proposed Conceptual Framework that the requirements of IAS 37 Provisions, Contingent Liabilities and Contingent Assets as interpreted by IFRIC 21 Levies are inconsistent with the proposed new concepts for identifying liabilities. However, as the Conceptual Framework does not override the requirements of individual standards or interpretations, and any decision to make amendments to existing IFRSs would require the IASB to go through its due process of adding a project to its agenda and development of an ED, entities will have to continue applying the current applicable requirements.

Recognition and derecognition

Recognition

The recognition criteria in the current Conceptual Framework require that an item be recognised if it is: a) probable that any future economic benefit associated with it will flow to or from the entity; and b) it has a cost or value that can be measured with reliability. The Board observed that, across current standards, the application of the probability criterion is inconsistent. For example, in IFRS 9 Financial Instruments, there is no probability recognition criterion, otherwise instruments such as derivatives would not be recognised.

Therefore, the IASB proposed that the Conceptual Framework should set out criteria for recognition based on the qualitative characteristics of useful financial information. An asset or liability (and any related income, expense or change in equity) is recognised if:

- It provides users of financial statements with relevant information about the asset or liability and any resulting income, expense or change in equity
- It provides a faithful representation of the asset or liability and of any resulting income, expense or change in equity

And

- The benefit of the information provided by recognising the asset or liability outweighs the cost of doing so

Existence uncertainty

One of the challenges of recognition is existence uncertainty. In trying to address this issue, the IASB decided to propose listing existence uncertainty of an asset or liability as one of the indicators that may lead to a conclusion that recognition of that asset or liability may not produce relevant information. The IASB believes that it would not be useful to provide more detailed guidance on how to address existence uncertainty because the facts are likely to depend very much on particular circumstances.

How we see it

Although existence uncertainty is dependent on specific facts and circumstances, it would seem appropriate to address the conceptual basis at the Conceptual Framework level instead of leaving it to be dealt with at the standards level.
Derecognition

The existing Conceptual Framework does not provide guidance on derecognition and, currently, there are inconsistent approaches to derecognition being applied across the standards. In the ED, the IASB has included the following guidance:

- Consider to whom the asset or liability has been transferred, i.e., whether the transferee is acting as an agent, in which case, derecognition may not be appropriate
- Consider the exposure retained by the entity after the transaction
- The assets and liabilities retained and any changes in the entity’s assets and liabilities should be faithfully represented

Measurement

During development of the ED, the Board considered whether the Conceptual Framework should advocate the use of a single measurement basis. Considering the different assets and liabilities being measured, relevance and the cost constraint, the Board eventually concluded that a multiple measurement approach is more appropriate. The proposed measurement guidance in the ED would cover a significant gap in the existing Conceptual Framework literature.

The ED covers:

- A description of various measurement bases (historical cost and current value measures) and the information that these measurement bases provide
- Factors to consider when selecting a measurement basis
- Situations when more than one measurement basis provides relevant information
- Measurement of equity

Presentation and disclosure

The ED proposes high-level concepts that describe the information that should be included in financial statements and how that information should be presented and disclosed. These concepts will guide the IASB in setting presentation and disclosure requirements in individual standards and will guide entities in providing information in financial statements. In addition, the IASB is undertaking a Disclosure Initiative, a collection of implementation and research projects aimed at improving disclosure in IFRS financial reporting. In the Disclosure Initiative, the IASB will seek to provide additional specific guidance to support the application of the concepts.

The presentation and disclosure objectives and principles discussed in the ED are:

- The balance between entities’ flexibility to provide relevant information that faithfully represents the entity’s assets and liabilities and the transactions and other events of the period, and comparability among entities and across reporting periods.
- Entity-specific information is more useful than boilerplate language for efficient and effective communication.
- Duplication of information in various sections of the financial statements is unnecessary and makes financial statements less understandable.
Reporting financial performance and OCI

In the discussion of information about financial performance, the ED states that income and expenses in the statement(s) of financial performance are classified into either the statement of profit or loss (P/L) or OCI. The purpose of the P/L is to depict the return an entity has made on its economic resources during the period and to provide information that is helpful in assessing future cash flows and management's stewardship of the entity's resources. Therefore, income and expenses included in the P/L are the primary source of information about an entity's financial performance for the period. As such, there is a presumption that all income and all expenses will be included in the P/L.

The ED continues to explain that there are circumstances in which the exclusion of some income or expenses from the P/L resulting from a change in a current measure of an asset or liability would enhance the relevance of the information in the P/L. When this is the case, that income or expense is recognised in OCI. However, for an item recognised in OCI in one period, there is a presumption that it will be included in the P/L in a future period, unless there is no clear basis for identifying the period in which reclassification would enhance the relevance of the information in the P/L.

Transition and effective date

The IASB has considered how entities should account for changes in accounting policies resulting from the revision of the Conceptual Framework, and proposes that entities account for changes in accounting policy arising from an application of the revised Conceptual Framework retrospectively in accordance with IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors.

The IASB proposes to set an effective date that will allow a transition period of approximately 18 months between the issue of the revised Conceptual Framework and its effective date for entities, with early application permitted. This would allow entities time to review the effects of the revised concepts on their policies and prepare for retrospective application of the changes.

How we see it

We support the IASB’s proposal to update the Conceptual Framework. However, there are certain significant topics that are not addressed in the proposals, such as the distinction between equity and liability, the content of ‘financial performance’, the characteristics of income and expenses that should be presented in OCI, and the rationale for recycling of gains and losses in OCI to P/L. A framework that does not explore such topics in more detail may have gaps that will make its applicability less useful.

Next steps

The Conceptual Framework is, by nature, less dynamic than the standards, in terms of the frequency of amendments. Entities are, therefore, encouraged to take this opportunity to provide feedback to the IASB. The ED is open for comment until 26 October 2015.
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