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IFRS

Conceptual Framework

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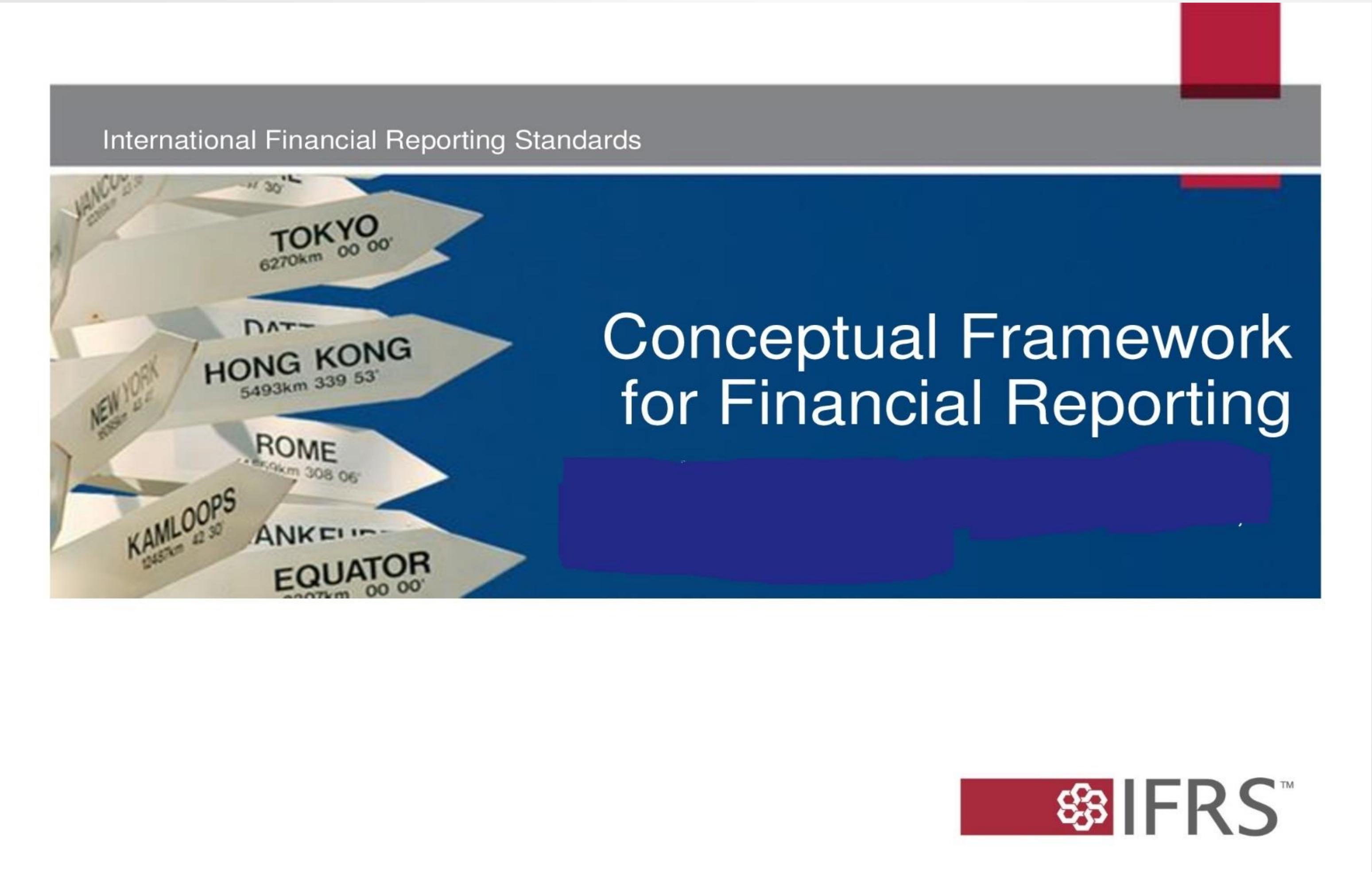

Role of the Conceptual Framework

- *Conceptual Framework* sets out **agreed concepts** that underlie financial reporting
  - objective, qualitative characteristics, element definitions
- IASB uses *Conceptual Framework* to set standards
  - enhances consistency across standards
  - enhances consistency over time as Board members change
  - provides benchmark for judgments

Qualitative characteristics

- If financial information is to be useful, it **must** be **relevant** and **faithfully represent** what it purports to represent (ie fundamental qualities).
  - Financial information without both relevance and faithful representation is not useful, and it cannot be made useful by being more comparable, verifiable, timely or understandable.

- The usefulness of financial information is enhanced if it is comparable, verifiable, timely and understandable (ie enhancing qualities—less critical but still highly desirable)
  - Financial information that is relevant and faithfully represented may still be useful even if it does not have any of the enhancing qualitative characteristics.

Underlying Assumption

Going concern

The financial statements are normally prepared on the assumption that an entity is a going concern and will continue in operation for the foreseeable future.

Assumption:

1. Liquidate
2. Cease Trading

Fundamental qualitative characteristics

- ***Relevance***: capable of making a difference in users' decisions
  - predictive value (allow users to either make their own *prediction* about the economic viability of the entity or assess predictions and assurances given by management as to the future success or otherwise of the entity)
  - confirmatory value
  - materiality (entity-specific)

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- ***Faithful representation***: faithfully represents the phenomena it purports to represent
  - completeness (depiction including numbers and words)
  - neutrality (unbiased)
  - free from error (ideally)

Note: faithful representation replaces reliability

Constraints

Constraints on relevant and reliable information

- Timeliness
- Balance between costs and benefits
- Balance between relevance and reliability
- True and fair presentation

Timeliness

Timeliness principle in accounting refers to the need for accounting information to be presented to the users in time to fulfill their decision making needs.

Normally within 6 months of reporting date (balance sheet).

Balance between costs & benefits

Cost of providing accounting information ≥ Benefit of the information it is reporting.

Example: Your cashbook register and bank statement differs by PKR 0.10. Rather than waste time to find the PKR 0.10, the accountant should record the amount as miscellaneous expense or income.

Enhancing Qualitative Characteristics

- ***Comparability*:** like things look alike; different things look different
- ***Verifiability*:** knowledgeable and independent observers could reach consensus, but not necessarily complete agreement, that a depiction is a faithful representation
- ***Timeliness*:** having information available to decision-makers in time to be capable of influencing their decisions
- ***Understandability*:** Classify, characterize, and present information clearly and concisely

Recognition

- Accrual basis of accounting
  - recognise element (eg asset) when satisfy definition and recognition criteria
- Recognise item that meets element definition when
  - **probable** that benefits will flow to/from the entity
  - has cost or value that can **measured reliably**

Recognition (Contd)

What does probable mean?

The meaning of probable is determined at the standards level. Therefore, inconsistent use across IFRSs

What does measure reliably mean?

To a large extent, financial reports are based on estimates, judgements and models rather than exact depictions.

Elements of accounting

Five elements of accounting are defined in the IASB Framework

- Assets
- Liabilities
- Equity
- Expenses
- Income

Elements – Financial Position

The elements of a financial position are:

- **Assets** are the probable future economic benefits obtained and controlled by a company as a result of past transactions or events.

- **Liabilities** are the probable future sacrifices of economic benefits arising from present obligations of a company to transfer assets or provide services in the future as a result of past transactions or events.

- **Equity** is the owners' residual interest in the assets of a company that remains after deducting its liabilities.

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- Assets are 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

- Three key characteristics of the definition:

  1. There must be **future economic benefits**
  2. The reporting entity must **control** the future economic benefits
  3. The transaction or other event giving rise to the control **must have occurred**

An asset is to be recognised in the financial statements if:

- it is probable that any future economic benefit associated with the asset will flow to or from the entity; and
- the item has a cost or value that can be measured with reliability

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Flow of Future Economic Benefit

(a) used singly or in combination with other assets in the production of goods or services to be sold by the entity;

(b) exchanged for other assets;

(c) used to settle a liability; or

(d) distributed to the owners of the entity.

Physical form

Many assets, for example, property, plant and equipment, have a physical form.

However, physical form is not essential to the existence of an asset; hence patents and copyrights, for example, are assets if future economic benefits are expected to flow from them to the entity and if they are controlled by the entity.

Right of ownership

Many assets, for example, receivables and property, are associated with legal rights, including the right of ownership.

In determining the existence of an asset, the right of ownership is not essential; thus, for example, property held on a lease is an asset if the entity controls the benefits which are expected to flow from the property.

Past Event

The assets of an entity result from past transactions or other past events.

Transactions or events expected to occur in the future do not in themselves give rise to assets; hence, for example, an intention to purchase inventory does not, of itself, meet the definition of an asset.

Close association between incurring expenditure and generating assets

An entity incurs expenditure, this may provide evidence that future economic benefits were sought but is not conclusive proof that an item satisfying the definition of an asset has been obtained.

Similarly the absence of a related expenditure does not preclude an item from satisfying the definition of an asset and thus becoming a candidate for recognition in the balance sheet; for example, items that have been donated to the entity may satisfy the definition of an asset.


Liability

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<u>Definition and recognition of **liabilities**</u>

- Liabilities 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

There are three main characteristics

1. There must be a future disposition or sacrifice of economic benefits to other entities
2. It must be a present obligation
3. A past transaction or other event must have created the obligation

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Present obligation and a future commitment.

- A decision by the management of an entity to acquire assets in the future does not, of itself, give rise to a present obligation.

- An obligation normally arises only when the asset is delivered or the entity enters into an irrevocable agreement to acquire the asset.

Settlement of a present obligation

(a) payment of cash;

(b) transfer of other assets;

(c) provision of services;

(d) replacement of that obligation with another obligation; or

(e) conversion of the obligation to equity.

An obligation may also be extinguished by other means, such as a creditor waiving or forfeiting its rights.

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Liabilities do not necessarily need to be 'legally enforceable'

- An essential characteristic of a liability is that the entity has a present obligation. Obligations can be legally enforceable
- However, obligations also arise from normal business practice, custom and a desire to maintain good business relations or act in an equitable manner
- Hence the liabilities that appear within an entity's statement of financial position might include obligations that are legally enforceable as well obligations that are deemed to be equitable or constructive

- An equitable obligation is governed by social or moral sanctions or custom rather than legal sanctions. A constructive obligation is created, inferred or construed from the facts in a particular situation rather than contracted by agreement with another entity or imposed by government

- **So … don't assume that all liabilities shown in a statement of financial position (balance sheet) are legally enforceable**

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Elements – Financial Performance

- **Income** is 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.

- **Expenses** are 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

Income

Income = Revenue + Gain

- **Revenue** arises in the course of the ordinary activities of an entity and is referred to by a variety of different names including sales, fees, interest, dividends, royalties and rent.

- **Gains** represent increases in economic benefits and as such are no different in nature from revenue.

Gain (Contd....)

Gains include, for example, those arising on the disposal of non-current assets. The definition of income also includes unrealised gains; for example, those arising on the revaluation of marketable securities and those resulting from increases in the carrying amount of long-term assets.

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Realized income or losses refer to profits or losses from completed transactions. **Unrealized** profit or losses refer to profits or losses that have occurred on paper, but the relevant transactions have not been completed

Gains are often reported net of related expenses.

Expenses

Losses + those expenses that arise in the course of the ordinary activities of the entity

They usually take the form of an outflow or depletion of assets such as cash and cash equivalents, inventory, property, plant and equipment.

Losses represent decreases in economic benefits

Losses (Contd)

Losses include, for example, those resulting from disasters such as fire and flood, as well as those arising on the disposal of non-current assets.

The definition of expenses also includes unrealised losses, for example, those arising from the effects of increases in the rate of exchange for a foreign currency in respect of the borrowings of an entity in that currency.

Losses are often reported net of related income.

Measurement of elements of financial statements

Measurement is the process of determining the monetary amounts at which the elements of the financial statements are to be recognised and carried in the balance sheet and income statement.

1. Historical cost
2. Current cost
3. Realisable value
4. Present value

Historical Cost

Assets are recorded at the amount of cash or cash equivalents paid or the fair value of the consideration given to acquire them at the time of their acquisition.

Liabilities are recorded at the amount of proceeds received in exchange for the obligation, or in some circumstances (for example, income taxes), at the amounts of cash or cash equivalents expected to be paid to satisfy the liability in the normal course of business.

Current Cost

Assets are carried at the amount of cash or cash equivalents that would have to be paid if the same or an equivalent asset was acquired currently.

Liabilities are carried at the undiscounted amount of cash or cash equivalents that would be required to settle the obligation currently.

Realizable Value

Assets are carried at the amount of cash or cash equivalents that could currently be obtained by selling the asset in an orderly disposal.

Liabilities are carried at their settlement values; that is, the undiscounted amounts of cash or cash equivalents expected to be paid to satisfy the liabilities in the normal course of business.

Present Value

Assets are carried at the present discounted value of the future net cash inflows that the item is expected to generate in the normal course of business.

Liabilities are carried at the present discounted value of the future net cash outflows that are expected to be required to settle the liabilities in the normal course of business.

Accounting Concepts

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1. Accruals basis
2. Completeness
3. True & fair view/faithful representation
4. Materiality
5. Prudence
6. Going concern basis
7. Substance over form

Accrual Basis

- Revenue from sales and other income should be reported in the period when the income arises (which might not be the same as the period when the cash is received).
- The cost of sales in the statement of comprehensive income must be matched with the sales. Income and 'matching' expenses must be reported in the same financial period.
- Other expenses should be charged in the period to which they relate, not the period in which they are paid for.

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Illustration: Statement of comprehensive income

	Rs
Revenue (from sales made in the period)	X
Cost of sales (costs matched with sales made in the period	(X)
Gross profit	X
Other costs (charged in the period in which the benefit paid for is used)	(X)
Net profit	X

Example 1: Accruals basis

A company prepares its financial statements to the 30 June each year. It sells goods for Rs. 50,000 to a customer on 6 June Year 2, but does not receive a cash payment from the customer until 15 August Year 2.

Accruals basis:

The sale is recognised as income in the year to 30 June Year 2, even though the cash is not received until after the end of this financial year.

Example 2: Accruals basis

A company starts in business on 1 September Year 1. It acquires an office for which it pays one year's rent in advance, to 31 August Year 2. The cost of the annual rental is Rs. 120,000. The company prepares its financial statements for a financial period ending on 31 December each year.

Accruals basis:

The office rental cost in the period to 31 December Year 1 is the cost of just four months' rent. The expense is therefore Rs. 40,000 (Rs. 120,000 * 4/12) in Year 1, and there has been a prepayment for Rs. 80,000 that relates to the next financial period, the year to 31 December Year 2.

Prepayments

A prepayment is an amount of money paid in advance for benefits that will be received in the next accounting period.

A company rents office space at a cost of Rs. 6,000,000 per year paid 12 months in arrears (this means that the company pay the rent at the end of the year). The first payment is due on 30 June Year 2. The company prepares its financial statements to 31 December each year.

Accruals basis:

- The company will not have received an invoice for the rent when it is preparing its financial statements for 31 December Year 1
- However, it knows that it has occupied the office space for six months. The company would recognise a liability for rental costs for six months (Rs. 3,000,000) and also include this as an expense in profit and loss for Year 1.

This is described as accruing an expense or making an accrual.

Consistency

An entity shall retain the presentation and classification of items in the financial statements from one period to the next unless:

(a) it is apparent, following a significant change in the nature of the entity's operations or a review of its financial statements, that another presentation or classification would be more appropriate having regard to the criteria for the selection and application of accounting policies in IAS 8; or

(b) an IFRS requires a change in presentation.

An entity changes the presentation of its financial statements only if the changed presentation provides information that is reliable and more relevant to users of the financial statements and the revised structure is likely to continue, so that comparability is not impaired.

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Example: Consistency

A manager of a business has been promised a bonus if he can improve gross profit to more than 10% above what it was last year.

In the event the results of the business have been exactly the same but the manager has prepared the financial statements on a slightly different basis.

	2012	2013
	Rs.000	Rs.000
Sales	25,000	25,000
Cost of sales:		
Production costs	10,000	10,000
Warehousing costs	10,000	
	(20,000)	(10,000)
Gross profit	5,000	15,000
Less: Other expenses	(4,000)	(14,000)
Net profit	1,000	1,000

The manager has presented the information in a different way. This year's presentation is inconsistent with last year's.

This might mislead the user of the financial statements (in this case the person who will decide if the manager will receive a bonus).

It might be that the manager's presentation is correct but in this case the previous year's results should be represented onto a consistent basis in order to prevent a misleading impression.

Completeness

Completeness refers to whether all transactions that occurred during the period have been recorded.

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Example: Completeness

The accruals example can be used to illustrate this.

A company rents office space at a cost of Rs. 6,000,000 per year paid 12 months in arrears (this means that the company pay the rent at the end of the year).

The first payment is due on 30 June Year 2.

The company prepares its financial statements to 31 December each year.

The company will not have received an invoice for the rent when it is preparing its financial statements for 31 December Year 1

If the company does not accrue for the expense that relates to the 6 months to 31 December year 1 the information would be incomplete.

True & Fair View/Faithful Representation

Financial statements should give a ***true and fair view*** of the financial position, financial performance and changes in financial position of an entity.

Faithful representation

Financial reports represent economic phenomena by depicting them in words and numbers.

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A perfectly **faithful representation** would have three characteristics. It would be:

- complete – the depiction includes all information necessary for a user to understand the phenomenon being depicted, including al necessary descriptions and explanations.
- neutral – the depiction is without bias in the selection or presentation of financial information; and
- free from error – where there are no errors or omissions in the description of the phenomenon, and the process used to produce the reported information has been selected and applied with no errors in the process.

Materiality

- Information is material if omitting it or misstating it could influence decisions that users make on the basis of financial information about a specific reporting entity.
- Omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions of users made on the basis of the financial statements.
- There is no absolute measure of materiality that can be applied to all businesses. In other words there is no rule that says any item greater than 5% of profit must be material.

Example: Materiality

Two similar businesses prepare financial statements that show that each has non-current assets of Rs. 10,000,000 and each has a profit for the year of Rs. 100,000.

Each business discovers a Rs. 20,000 error.

	Error	Comment
1:	This relates to how Business A arrived at the total of non-current assets which are now overstated by Rs. 20,000.	This is immaterial. Rs. 20,000 is a small error in the context of the non-current asset figure and its omission would not be misleading.
2	This relates to how Business B arrived at the profit for the year which is now overstated by Rs. 20,000.	This is material. Omitting this amount means that profit is misstated by 20%

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Example: Materiality

A business owes Mr A Rs. 1,000,000 and is owed Rs. 950,000 by Mr B.

Instead of showing an asset of Rs. 950,000 and a liability of Rs. 1,000,000, the business shows a single liability of Rs. 50,000.

This is a material misstatement. Although the amount is correct it hides the fact that the amount is in fact made of two much larger amounts. A user would be unable to judge the risk associated with Mr B's ability of pay unless the two amounts are shown separately.

Prudence

Financial statements must sometimes recognise the uncertainty in business transactions.

For example, if a business is owed Rs. 1,000,000 by a number of its customers, there will be some uncertainty as to whether all the money will actually be collected.

Prudence involves allowing for some caution in preparing financial statements, by making reasonable and sensible allowances in order to avoid overstating assets or income and to avoid understating expenses or liabilities.

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Example: Prudence

A company has receivables of Rs. 10,000,000.

The company knows from experience that about 2% of its receivables will not be collected because of customers being in financial difficulty.

It is prudent to make an allowance for doubtful debts to 2% of receivables (but it would be inappropriate to make an excessive allowance, say 10% of receivables).

The company would recognise an allowance of Rs. 200,000 to set against the receivable in the statement of financial position showing a net amount of Rs. 9,800,000 (10,000,000 less 200,000).

The Rs.200,000 would also be recognised as an expense in the statement of comprehensive income.

Going Concern Basis

- When preparing financial statements, management shall make an assessment of an entity’s ability to continue as a going concern.

- An entity shall prepare financial statements on a going concern basis unless management either intends to liquidate the entity or to cease trading, or has no realistic alternative but to do so.

- When management is aware, in making its assessment, of material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern, the entity shall disclose those uncertainties.

- When an entity does not prepare financial statements on a going concern basis, it shall disclose that fact, together with the basis on which it prepared the financial statements and the reason why the entity is not regarded as a going concern.

If a business entity is not a going concern, and is about to be closed down and liquidated, the value of its assets would be their estimated value in the liquidation process.

Substance Over Form

It implies that information should present clearly the transactions and other events that it is intended to represent.

The meaning of substance over form

1. Commercial substance reflects the financial reality of the transaction
2. Legal form is the legal reality of the transaction

Accounts are generally required to reflect commercial substance rather than legal form.

Applying substance over form

When assessing the validity of a transaction and its effects, it is important to consider the commercial sense of the transaction. Ask yourself:

● Does this make economic sense? – e.g. selling a property for less than market value.

● With what I know about business, does this make commercial sense? – e.g. why would a fi nancial institution purchase a factory that it will not use and then plans to resell it to the previous owner.

● Which party holds the signifi cant risks and rewards associated with the asset/liability? – has a party recorded a sale but will still be subject to the loss if the asset falls in value?

Example

A sells a machine to B for PKR 20,000 and at the same time agrees to buy it back in 1 year's time for PKR21,800. The machine remains on A's premises and A continues to use and to insure the machine. These related transactions are likely to arouse some suspicion. What is actually going on here?

In legal terms, following the first transaction, B is clearly the owner of the machine. However, the substance of the transaction is that A retains the risks and rewards of ownership, and effectively, has taken out a loan for a year at an interest rate of 9%.

Correcting accounting treatment

Applying the principle of substance over form, A should continue to carry the asset in its statement of financial position, with a corresponding liability to B. B would record the loan as a receivable in its own statement of financial position.

Why might this distinction between substance and form matter? What is the motivation for A to keep the loan off the statement of financial position?

Let us extend the example a little further. A is financed partly by long-term borrowing of PKR30,000. One of the conditions under which the loan was made (the 'covenant') was that A's total liabilities, both long- and short-term should not exceed PKR80,000. Extracts from two versions of A's statement of financial position, one drawn up to show substance over form and the other to show legal form after the transaction are as follows:

	Substance over form $	Legal form $
Non-current assets	100,000	80,000
Current assets	85,000	85,000
	185,000	165,000
Capital and reserves	90,000	90,000
Long-term borrowing	30,000	30,000
Current liabilities	65,000	45,000
	185,000	165,000

The statement of financial position prepared adopting the principle of substance over form shown total liabilities of PKR30,000 PKR65,000 PKR95,000. This clearly breached the terms of the covenant.

The statement of financial position prepared according to strict legal form, on the other hand, shown total liabilities of PKR30,000, PKR45,000 PKR75,000. The terms of the covenant, technically, have not been breached.

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Example: Substance over form (leases)

Alpha rents (leases) an asset from Beta.

The asset is expected to be useful for 10 years after which it will be scrapped.

Alpha has a contract to use the asset for 10 years.

Analysis:

The substance of the transaction is that Alpha has bought the asset from Beta.

Beta would only agree to let Alpha use the asset for all of its useful life if the rentals received from Alpha covered Beta's costs of buying the asset and gave Beta a financial return. This is the same as Alpha borrowing money and buying the asset.

Alpha must recognise the leased asset as if it owns it and also must recognise a liability to pay for the asset.

Example: Substance over form (sale and repurchase agreements)

Gamma sells an asset to Delta for Rs. 1,000,000.

There is a contract in place under which Gamma must buy the asset back off Delta for Rs. 1,100,000 in 12 months' time.

Gamma continues to use the asset in exactly the same way as before, even though Delta is now its legal owner.

Analysis:

The substance of the transaction is that Gamma has not sold the asset to Delta but has borrowed money from Delta.

Gamma must recognise a liability for Rs. 1,000,000.