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Conceptual Framework for Financial Reporting

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CASE STUDY - CONCEPTUAL FRAMEWORK FOR FINANCIAL REPORTING

Introduction

IFRS financial statements are expected to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions relating to providing resources to the entity (CF.1.2). To this purpose, the information must meet the qualitative characteristics of useful financial information as presented in the Conceptual Framework for Financial Reporting (thereafter, the Framework). Financial statements should faithfully represent relevant economic phenomena in both words and numbers; therefore, entities should report both numbers (in the main financial statements) and words (in the notes), about how items are recognised and measured.

The aim of this case study is to develop a wider understanding of how entities should respond to the requirements of the Framework.

The Case Information

You are a financial analyst covering several small entities applying for funding for their investment projects to your financial institution. Before moving forward with the approval process, you are expected to conduct a general review of the quality of the financial statements provided by the applicant entities.

Now you study the financial statements of two entities, Black Ltd., and White Ltd. These entities operate in the construction industry in Buildland and must prepare IFRS financial statements. However, the application of IFRS in Buildland started only a few years ago and the local profession is not very experienced with these standards. Moreover, studies of the local application of IFRS found that entities, particularly the smaller ones, face many difficulties in applying IFRS, and that the levels of compliance with IFRS are quite low. Therefore, the first step in the coverage of any entities (which is the overall work of reviewing financial statements and reporting on the entities' activity) is to conduct a general analysis of how financial statements are prepared.

The financial statements excerpt regarding inventories are the following, for each entity:

- **Black Ltd.** (financial statements are not audited; they are released within a month from the end of the year)

Statement of financial position	**Year 20X1** (CU thousands)
Assets	
……………	……….
Raw materials	125,000
Work in progress	45,500
Finished goods	242,000
……….	…………

Note X: Inventories

Inventories are measured at cost.

- **White Ltd.** (financial statements are audited; they are released within three months from the end of the year)

Statement of financial position	Year 20X1 (CU thousands)	Year 20X0 (CU thousands)
Current assets		
Inventories	487,500	456,000
……..	…….	…………

Note X: Inventories

Inventories are measured at the lower of cost and net realisable value.

The entity has the following types of inventories: raw materials (materials for construction), work in progress and finished goods. [Then, the entity reports for each inventory type their beginning and ending values, and any increases, decreases, and write-downs recognised during the period].

First-In-First-Out (FIFO) is used for inventories of raw materials since it is common within the construction industry. Inventories of work in progress and finished goods refer to 5 projects (3 projects in progress and 2 finished). [Then, the entity reports for each project its location and the number of apartments that are being constructed].

Discussion Questions

Prepare a short note with some general comments regarding the presentation of the financial statements by each entity, particularly considering the principles stated in the Framework.

SOLUTION OF CASE STUDY – CONCEPTUAL FRAMEWORK FOR FINANCIAL REPORTING

Black Ltd.

The fundamental qualitative characteristics are relevance and faithful representation. The value of assets (inventory) is relevant information. However, the faithful representation is negatively impacted by the measurement at cost (prudence might not be respected) and by the lack of information regarding the types of inventories and their measurement (completeness and free from error characteristics are impacted).

Several enhancing qualitative characteristics are also impacted. The information is timely, since financial statements are released within a month from year end. But the entity's financial statements are not audited, which impedes on the characteristic of verifiability. Moreover, assets are not classified as current and non-current, which impedes on the understandability of financial statements. Finally, and importantly, only one year of data are reported, which impedes on comparability.

White Ltd.

The fundamental qualitative characteristics of relevance and faithful representation seem to be well ensured. The value of assets (inventories) is relevant information. Moreover, information is faithfully represented since the entity provides all the relevant information regarding the types of inventories it uses and their measurement. The details presented in the notes contribute to the completeness of the information reported.

The enhancing characteristics are also achieved in this case. White's financial statements are audited, which supports their verifiability, and relevant aggregation (in the statement of financial position) and details (in the notes) help ensure understandability. Financial statements are released within three months from year end, which ensures a reasonable timeliness of the information. Data reported for two years ensure comparability over time, and the use of the FIFO method ensures comparability with other entities in the industry. This in turn allows for predicting future cash flows (thus enhancing the relevance of financial statements).