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CONCEPTUAL FRAMEWORK FOR FINANCIAL REPORTING®

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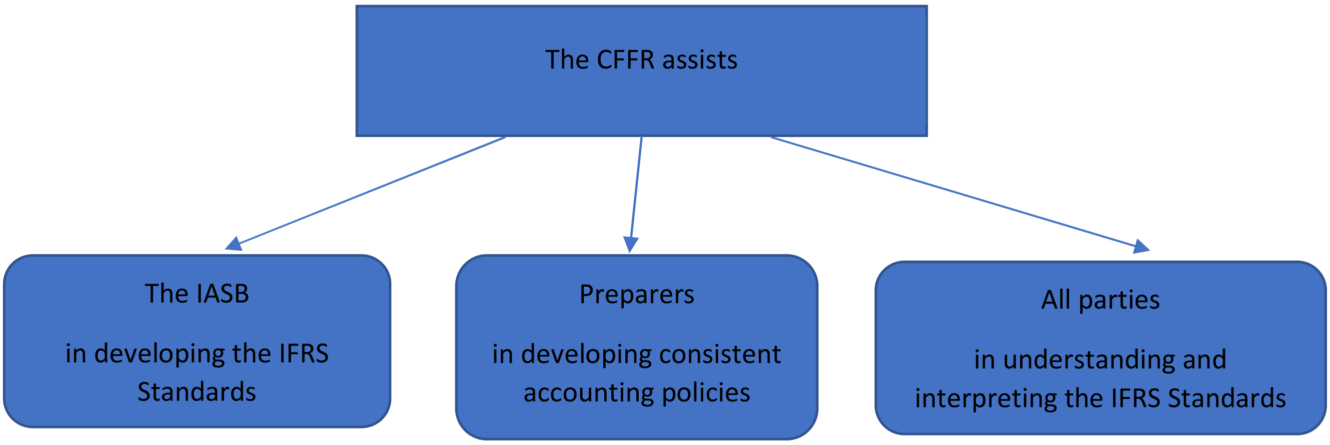
Conceptual Framework for Financial Reporting®

SCOPE AND KEY DEFINITIONS

The Conceptual Framework for Financial Reporting (CFFR) describes the objective of, and the concepts for, general purpose financial reporting (CF.SP1.1). The CFFR is useful to the International Accounting Standards Board (IASB), to preparers and to all parties interested in the IFRS Standards. These users have different goals when using general-purpose financial statements, but they are informed by the same CFFR, as explained in Figure 1.

Figure 1. The purpose of the CFFR



The CFFR assembles a theoretical, conceptually coherent, background for issuing, interpreting, and understanding the IFRS Standards. This base is necessary to have principle-based standards, such as IFRS Standards intend to be. The CFFR is not a standard in itself, and therefore IFRS Standards will always take precedence. However, the CFFR provides guidance on areas where no standards or no standard prescriptions exist, and sets the stage for an ethical, principle-based accounting, ensuring that financial statements provide useful and relevant information to users.

The CFFR is structured in 8 chapters: (1) the objective of general purpose financial reporting, followed by (2) the qualitative characteristics of useful financial statement information; (3) financial statements and the reporting entity; (4) the elements of financial statements; (5) recognition and derecognition; (6) measurement principles, (7) presentation and disclosure, and (8) concepts of capital and capital maintenance. We address each of these components in turn, to define and exemplify them.

(1) The objective of general purpose financial reporting

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 relating to providing resources to the entity (CFFR1.2).

An entity may have various types of users of financial information, such as investors, lenders, commercial partners, governments, or the public in general. However, general purpose financial reporting as designed by the IASB (the Board) and governed by the CFFR, is not primarily directed at all of them. This is because different users have different needs, and it is difficult for the standard setter to develop standards that satisfy all these needs. For example, investors, i.e., those providing resources to the entity by purchasing the entity's shares, need to assess the prospects for future cash flows to the entity. In return for their investment, these users expect returns such as dividends, interest, reimbursement of the principal or market price increases, or a combination of these. On the other hand, commercial partners are mainly interested in the going concern of the entity, ensuring ongoing business relations and compensation for their services and products.

Given the varied user needs, the Board decided to aim the financial reporting to the so-called primary users of financial information, which are the existing and potential investors, lenders and other creditors, having therefore a more homogeneous base in developing its concepts and standards.

The CFFR explains and clarifies the role of financial reporting as presented in Figure 2:

Figure 2. General purpose financial reports

General purpose financial reports are directed toward users who cannot require direct information from the entity

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General purpose financial reports do not and cannot include all the information that is necessary for making decisions

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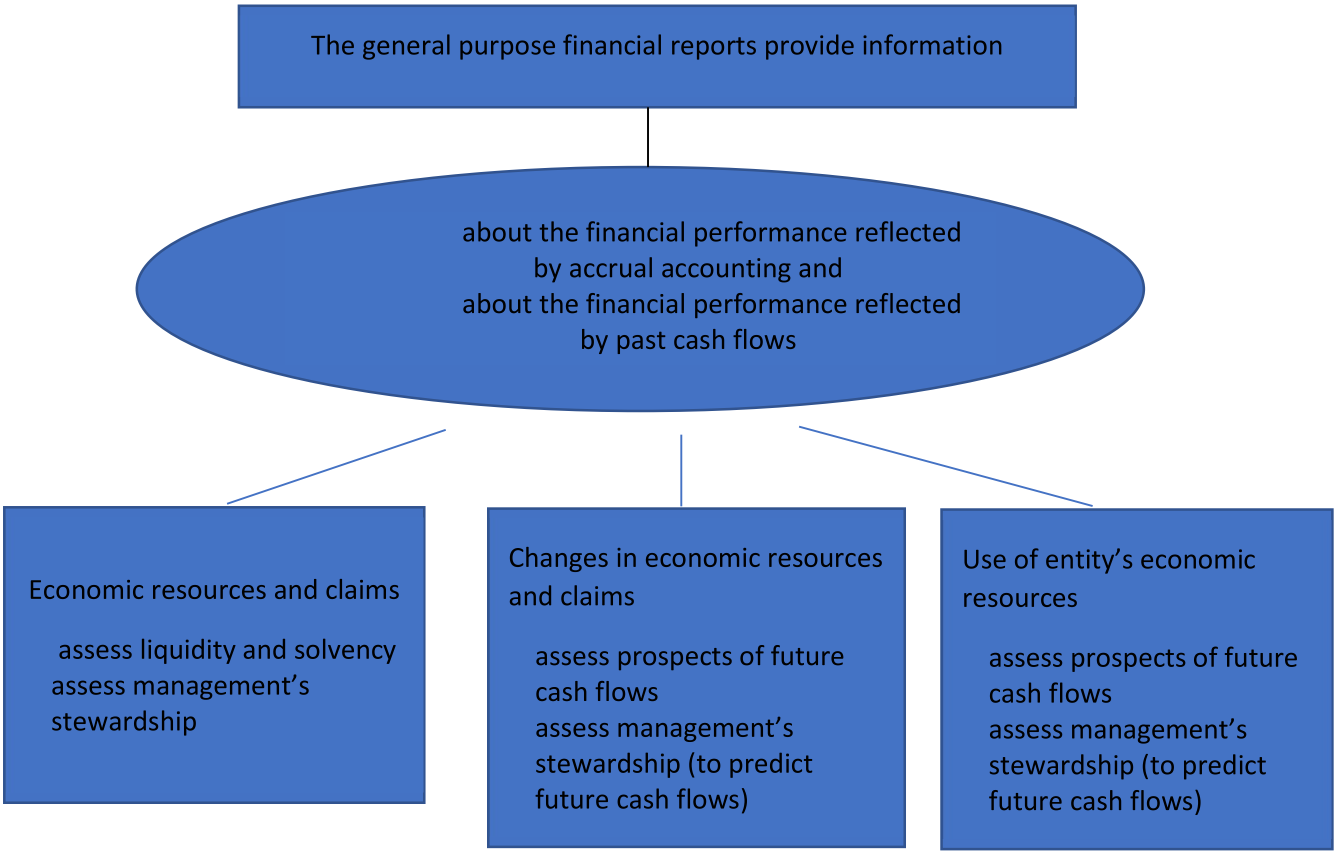
General purpose financial reports do not provide the value of an entity, but provide information that is useful in estimating it

To make decisions, existing and potential investors, lenders and other creditors need information about the economic resources of the entity, about the claims against the entity and the changes in those resources and claims; and how efficiently and effectively the entity’s management and governing board(s) have discharged their responsibilities for the use of the entity’s economic resources (CFFR1.4). Users need at least a basic level of understanding to read and interpret financial statements, and they may and should use other sources of information besides the financial statements.

General purpose financial reports provide the following type of information (Figure 3):

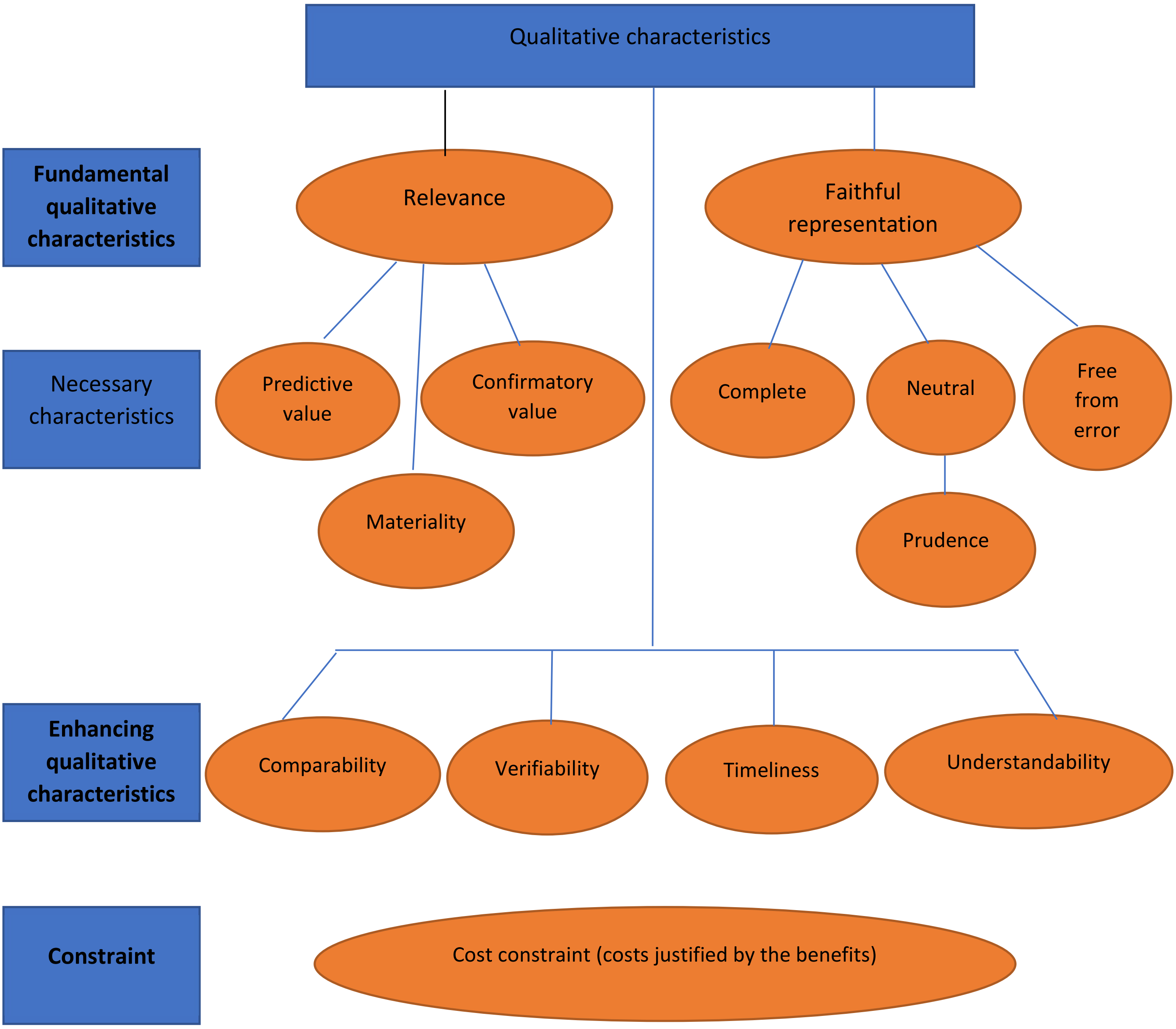
Figure 3. Information provided by the general purpose financial reports



(2) The qualitative characteristics of useful financial information

The qualitative characteristics of useful financial information discussed in the CFFR describe the types of information that are likely to be most useful to existing and potential investors, lenders and other creditors for making decisions about the reporting entity on the basis of information that is included in its financial reports (see Figure 4).

Figure 4. Qualitative characteristics of useful financial information



The CFFR is constructed around two fundamental qualitative characteristics and their components, four enhancing qualitative characteristics, and a pervasive constraint. The two fundamental qualitative characteristics are relevance and faithful representation.

Relevant financial information is capable of making a difference in the decisions made by users (CFFR2.6), which is possible when the information has predictive value (it is used as input to predict future outcomes), confirmatory value (offers feedback about previous evaluations) or both.

For example, if potential investors are interested in investing in an entity, the value of the entity's assets, liabilities, and past performance provided in its financial statements is relevant, because it helps potential investors predict the entity's cash flows and to confirm or correct previous predictions.

Materiality is an entity-specific aspect of relevance (CFFR2.11). Information is material if omitting, misstating or obscuring it could reasonably be expected to influence decisions that the primary users of general purpose financial reports make on the basis of those reports (CFFR2.11). Materiality is judged both in terms of nature and magnitude of an item.

For example, let's assume that entities A and B have each gained CU10,000 from an activity that was dropped during the reporting period. Entity A's (B's) operating income was CU1,000,000 (CU30,000), including the profit from the activity that was dropped. The question is if this gain should be reported separately from the entities' operating income. The gain from the dropped activity is immaterial in the case of entity A, being 1% of its value, and future predictions are not significantly impacted by its presentation. But in case of entity B, reporting separately the gain from the dropped activity is relevant. Any profit forecasts should consider an operating income of CU20,000, i.e., the one generated by the entity's recurring activities.

Financial reports represent economic phenomena in words and numbers. To be useful, financial information must not only represent relevant phenomena, but it must also faithfully represent the substance of the phenomena that it purports to represent (CFFR2.12) A faithful representation is complete (all necessary information is reported), neutral (no bias in the selection or presentation of financial information; neutrality is supported by the exercise of prudence) and free from error (no errors or omissions).

For example, if a scandal breaks around an entity's products (resulting in products being withdrawn from the market), and the entity is being sued by numerous third parties, presenting faithful information means disclosing information about this phenomenon and any associated lawsuits. Withholding this information implies that information is not complete (it misleadingly omits potential future losses), not neutral (information is biased), and not free from errors (since liabilities are probably misstated).

Information must be both relevant and provide a faithful representation of what it purports to represent if it is to be useful. Neither a faithful representation of an irrelevant phenomenon nor an unfaithful representation of a relevant phenomenon helps users make good decisions (CFFR2.20).

There are four enhancing qualitative characteristics. Comparability is the qualitative characteristic that enables users to identify and understand similarities in, and differences among, items (CFFR2.24). Verifiability helps assure users that information faithfully represents the economic phenomena it purports to represent. Verifiability means that different knowledgeable and independent observers could reach consensus, although not necessarily complete agreement, that a particular depiction is a faithful representation (CFFR2.30). Users sometimes confuse verifiability with the existence of documentation such as invoices or contracts. While this can surely help, different observers may still reach different conclusions about the phenomena that are represented there, based on the specific circumstances of the events and transactions. Timeliness means having information available to decision-makers in time to be capable of influencing their decisions. Generally, the older the information is, the less useful it is (CFFR2.33) Classifying, characterising, and presenting information clearly and concisely makes it understandable (CFFR2.34).

Enhancing qualitative characteristics should be maximised to the extent possible. However, enhancing qualitative characteristics, either individually or as a group, cannot make information useful if that information is irrelevant or does not provide a faithful representation of what it purports to represent (CFFR2.37). Moreover, enhancing qualitative characteristics do not override the fundamental qualitative characteristics. For example, even if aggregation results in more understandable information, no aggregation or oversimplification should be performed if they result in information that is no longer relevant (precludes forecasting, hence losing its predictive value) or a faithful representation.

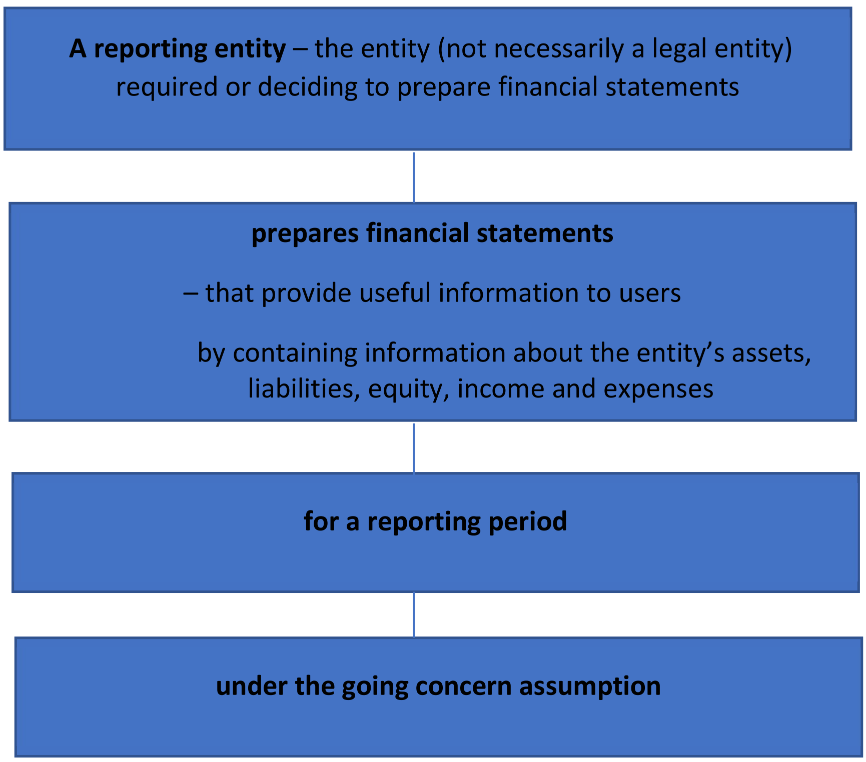
For example, entity A and entity B are competitors acting in the same industry and produce IFRS financial statements that are audited according to the regulations in place in the specific jurisdiction. Both companies use the First-In-First-Out (FIFO) method to assign costs to inventory. Entity A issues its financial statements immediately after the end of the reporting period, while entity B issues them three months after the end of the reporting period. Entity A prepares financial statements with fewer sub-groups and sub-totals compared to entity B. The implications in terms of the enhancing qualitative characteristics are the following: information is verifiable for both entities, since the financial statements are audited (auditors verified the financial statements). Moreover, information is comparable, since both entities employ the same cost flow assumption. However, the information is more timely (rapidly available to users) for entity A, but less understandable (fewer classifications) than that of Entity B.

Cost is always a constraint in producing financial information. As reporting financial information involves costs, it is important that those costs are justified by the benefits of reporting that information (CFFR2.39). The logic here is that users should benefit more from the information than the costs that they incur in obtaining it. While costs are always more visible (e.g., staff training, hardware and software, information collection), the benefits are not always easily ascertainable. Such benefits refer to more relevant and faithful information, perhaps in terms of timing or comparability. The ultimate benefit would be in terms of making good decisions, but this is also a very challenging benefit to ascertain.

(3) Financial statements and the reporting entity

This section provides details about the financial statements, the reporting entity, and the reporting period (see Figure 5).

Figure 5. Financial statements and the reporting entity



The objective of financial statements is to provide financial information about the reporting entity's assets, liabilities, equity, income, and expenses, that is useful to users of financial statements in assessing the prospects for future net cash inflows to the reporting entity and in assessing management's stewardship of the entity's economic resources (CFFR3.2). Financial statements are prepared for a specified period called the reporting period, with comparative information being provided for at least one preceding reporting period. Financial statements are normally prepared under the assumption that the reporting entity is a going concern and will continue in operation for the foreseeable future (CFFR3.9).

A reporting entity is an entity that is required, or chooses, to prepare financial statements. A reporting entity can be a single entity or a portion of an entity, or can comprise more than one entity. A reporting entity is not necessarily a legal entity (CFFR3.10).

For example, entity A is the parent entity to three subsidiaries. Together they form a group. The group prepares financial statements for the period April 1 to March 31 of each year. The reporting entity is the group, and the reporting period is the 12-month period from April 1 to March 31.

As one can note here, this approach to the CFFR and many of the IFRS Standards, of permitting flexibility in an entity's choices supports the idea of principle-based standards that the IFRS Standards subscribe to. Here, the reporting entity is not necessarily a legal entity, but the choice of preparing financial statements qualifies it as a reporting entity. Similar approaches exist in other IFRS Standards. Take for example IAS 16 Property, Plant and Equipment. IAS 16 does not prescribe the unit of aggregation for recognizing an asset under its principles. So, judgment must be exercised by management in assessing what an asset is, or what is the reporting level in the case of the group composed by entity A and its three subsidiaries.

(4) The elements of financial statements

The elements of financial statements that are defined in the CFFR are: assets, liabilities, and equity (all related to a reporting entity's financial position); and income and expenses, related to a reporting entity's financial performance (CFFR4.1).

The definition of an asset has changed in the 2018 revision of the CFFR. According to this new definition, an asset is a present economic resource controlled by the entity as a result of past events (CFFR4.3). An economic resource is a right that has the potential to produce economic benefits (CFFR4.4)

For example, a van that was purchased to transport merchandise is an asset for the entity that controls it. The purchase gives the entity the right to use the van for its activity. The van is controlled, being purchased, and has the potential to produce economic benefits, given its contribution to the commercial activity of the entity.

As another example, an entity uses open-source software in its activity. The entity has the right to use the asset, as the software is open source. The software has therefore the potential to produce economic benefits for the entity. However, the entity does not have control over the software, it being in the public domain. Therefore, the software is not an asset for the entity that uses it.

A liability is a present obligation of the entity to transfer an economic resource as a result of past events (CFFR4.26) Three criteria must all be satisfied for a liability to exist: the entity has an obligation, the obligation is to transfer an economic resource, and the obligation is a present obligation that exists as a result of past events (CFFR4.27).

For example, borrowing money from a bank generates a liability for the reporting entity, because it has an obligation to reimburse the loan, i.e., to transfer cash to the bank in future periods. This obligation results since when the loan is contracted (i.e., the past event).

Equity is the residual interest in the assets of the entity after deducting all its liabilities (CFFR4.63). So, for example, the equity of an entity with assets of CU200,000 and liabilities of CU150,000 amounts to CU50,000. This is what eventually remains to be distributed to the entity's shareholders (owners) after paying all its liabilities. This position is a very risky one for investors, because they will only benefit from this capital to the extent that any capital remains after paying all the entity's liabilities (e.g., to its employees, creditors such as banks, suppliers, national states etc.). It is probably one of the reasons why the Board has preferred investors over the other categories of users in focusing the financial statements. They are also supposed to have a good level of understanding of financial reporting, being capable of assessing financial information that is being produced.

Income is increases in assets, or decreases in liabilities, that result in increases in equity, other than those relating to contributions from holders of equity claims (CFFR4.68). Transactions such as loans or donations from the entity's owners do not, therefore, count as income.

Expenses are decreases in assets, or increases in liabilities, that result in decreases in equity, other than those relating to distributions to holders of equity claims (CFFR4.69). Any distributions of profit (e.g., in the form of dividends, for example) do not qualify as expenses.

For example, when an entity sells for a price of CU10 merchandise that had cost CU8, it recognizes income of CU10 as it has the right to receive CU10 from the buying customers in exchange for the merchandise. This right comes in the form of an increase in assets, contributing to an increase in equity, and from a transaction other than those relating to contributions from shareholders. Additionally, selling the inventory results in a decrease of assets (in inventory) and therefore in a decrease in equity, from a transaction other than those with shareholders, which implies the recognition of an expense in the amount of CU8.

(5) Recognition and derecognition

Recognition is the process of capturing for inclusion in the statement of financial position or the statement(s) of financial performance an item that meets the definition of one of the elements of financial statements—an asset, liability, equity, income, or expenses. Recognition involves depicting the item in one of those statements—either alone or in aggregation with other items— in words and by a monetary amount and including that amount in one or more totals in that statement. The amount at which an asset, a liability or equity is recognised in the statement of financial position is referred to as its 'carrying amount' (CFFR5.1). Only items that meet the definition of an element are recognized, but not all items that meet the definition are recognized. Items are recognized when the information is useful, i.e., relevant and a faithful representation, and such information is produced at a cost that is smaller than the benefits obtained from it.

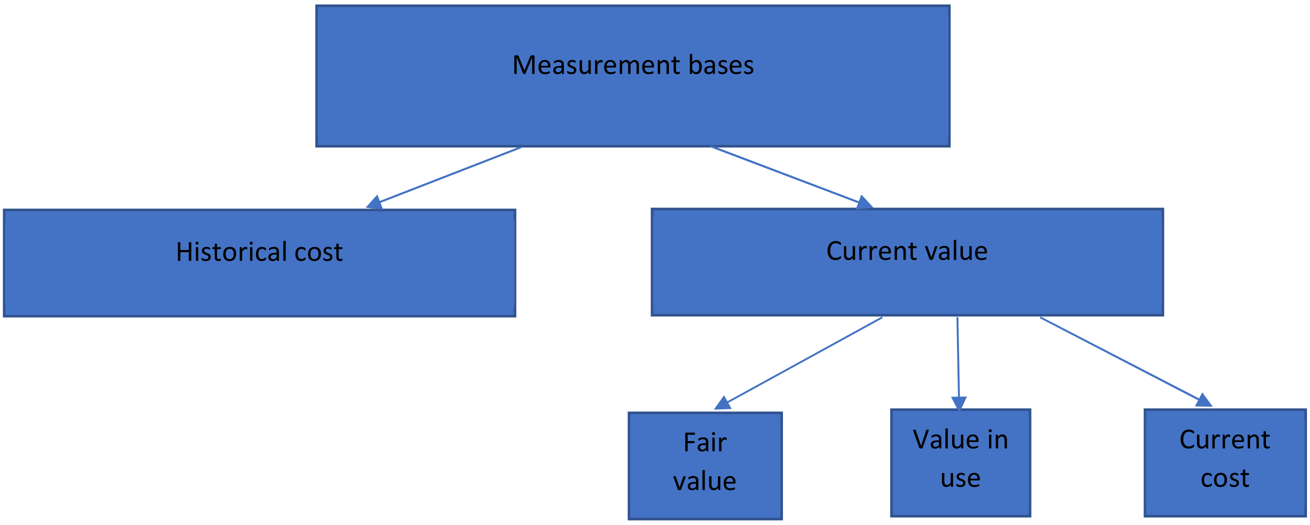
For example, even if an item meets the definition of an asset, it may be too costly to determine a value for it. Considering the cost constraint, and the cost-benefit relationship, the item might not be recognized in the statement of financial position.

Derecognition is the removal of all or part of a recognised asset or liability from an entity's statement of financial position. Derecognition normally occurs when that item no longer meets the definition of an asset or of a liability (CFFR5.26). For example, this occurs when items of assets are realised (through sale or consumption), or items of liability are settled (through payment or transfer to a third party).

(6) Measurement principles

Elements recognised in financial statements are quantified in monetary terms. This requires the selection of a measurement basis (CFFR6.1) (see Figure 6).

Figure 6. Measurement bases



Historical cost measures provide monetary information about assets, liabilities and related income and expenses, using information derived, at least in part, from the price of the transaction or other event that gave rise to them (CFFR6.4). Such information may have a large degree of verifiability but may not be very relevant in making some decisions. Quite a lot of financial statement elements are measured, nevertheless, at historical values.

Current value measures provide monetary information about assets, liabilities and related income and expenses, using information that is updated to reflect conditions at the measurement date. Because of the updating, current values of assets and liabilities reflect changes since the previous measurement date, in estimates of cash flows and other factors reflected in those current values (CFFR6.10). Current value measurement bases include fair value, value in use for assets and fulfilment value for liabilities, and current cost (CFFR6.11). Such values may be very relevant for making some decisions and are, therefore, used to value certain financial statement elements.

Fair value is the price that would be received to sell an asset, or paid to transfer a liability, in an orderly transaction between market participants at the measurement date (CFFR6.12).

Value in use is the present value of the cash flows, or other economic benefits, that an entity expects to derive from the use of an asset and from its ultimate disposal. Fulfilment value is the present value of the cash, or other economic resources, that an entity expects to be obliged to transfer as it fulfils a liability (CFFR6.17).

The current cost of an asset is the cost of an equivalent asset at the measurement date, comprising the consideration that would be paid at the measurement date plus the transaction costs that would be incurred at that date. The current cost of a liability is the consideration that would be received for an equivalent liability at the measurement date minus the transaction costs that would be incurred at that date. Current cost, like historical cost, is an entry value: it reflects prices in the market in which the entity would acquire the asset or would incur the liability. Hence, it is different from fair value, value in use and fulfilment value, which are exit values. However, unlike historical cost, current cost reflects conditions at the measurement date (CFFR6.21).

For example, the historical cost of a building is the cost at which the building has been acquired, let's say CU10,000, adjusted for depreciation, i.e., CU2,000. This means a carrying amount of CU8,000. If similar buildings are sold in the market for an average price of CU12,000, this means that the fair value of the building is CU12,000. To purchase a similar building, including transaction costs, the current cost is estimated to be CU11,500. When future cash flows expected from the use of the building are discounted, a value in use of CU10,000 is obtained.

In selecting a measurement basis for an asset or liability and for the related income and expenses, it is necessary to consider the nature of the information that the measurement basis will produce in both the statement of financial position and the statement(s) of financial performance, as well as other factors (CFFR6.43), such as the contribution to future cash flows and the impact of the measurement on the qualitative characteristics.

For example, if the building referred to above produces indirect future cash flows, as it is used in combination with other assets (which is the case if it hosts the production activity), historical cost or current cost may provide more relevant information. If the building is rented, and produces cash flows independently, a current type of value, and particularly its fair value, might provide more relevant information.

In the case of financial assets, if these are held on the long term and the entity does not intend to sell them for speculation purposes, their historical cost might be more relevant for the users of financial statements, because providing updates for their fair value might induce some uncertainty in the users' judgment. But the fair value of very liquid financial assets, intended for immediate sale by the entity, is probably more relevant than their historical cost.

Two conclusions emerge here:

1) financial statements are presented in different values. Some elements are measured at historical values, others are measured at current values. Therefore, users must be informed about these policies and should be able to assess the implications, by providing any and relevant enough information to the users of financial information.
2) the different measurement bases significantly impact the financial statements. Fair value adjustments generally have a performance effect in the period of the adjustment, while historical values do not.

(7) Presentation and disclosure

Effective communication of information in financial statements makes that information more relevant and contributes to a faithful representation of an entity's assets, liabilities, equity, income and expenses. It also enhances the understandability and comparability of information in financial statements. Effective communication of information in financial statements requires focusing on presentation and disclosure objectives and principles rather than focusing on rules; classifying information in a manner that groups similar items and separates dissimilar items; and aggregating information in such a way that it is not obscured either by unnecessary detail or by excessive aggregation (CFFR7.2).

Classification is the sorting of assets, liabilities, equity, income or expenses on the basis of shared characteristics for presentation and disclosure purposes. Such characteristics include—but are not limited to—the nature of the items, their role (or function) within the business activities conducted by the entity, and how they are measured (CFFR7.7).

Aggregation is the adding together of assets, liabilities, equity, income or expenses that have shared characteristics and are included in the same classification (CFFR7.20) Different levels of aggregation may be needed in different parts of the financial statements. For example, typically, the statement of financial position and the statement(s) of financial performance provide summarised information, and more detailed information is provided in the notes (CFFR7.22). That is, most entities would report one line for inventory in their statement of financial position, thus aggregating different types of inventories such as raw materials, finished goods or merchandise. Inventory has the same role in the business, and it is generally measured at historical cost, thus making aggregation possible. The notes provide details about each type of inventory (such as cost assignment methods, or any write downs).

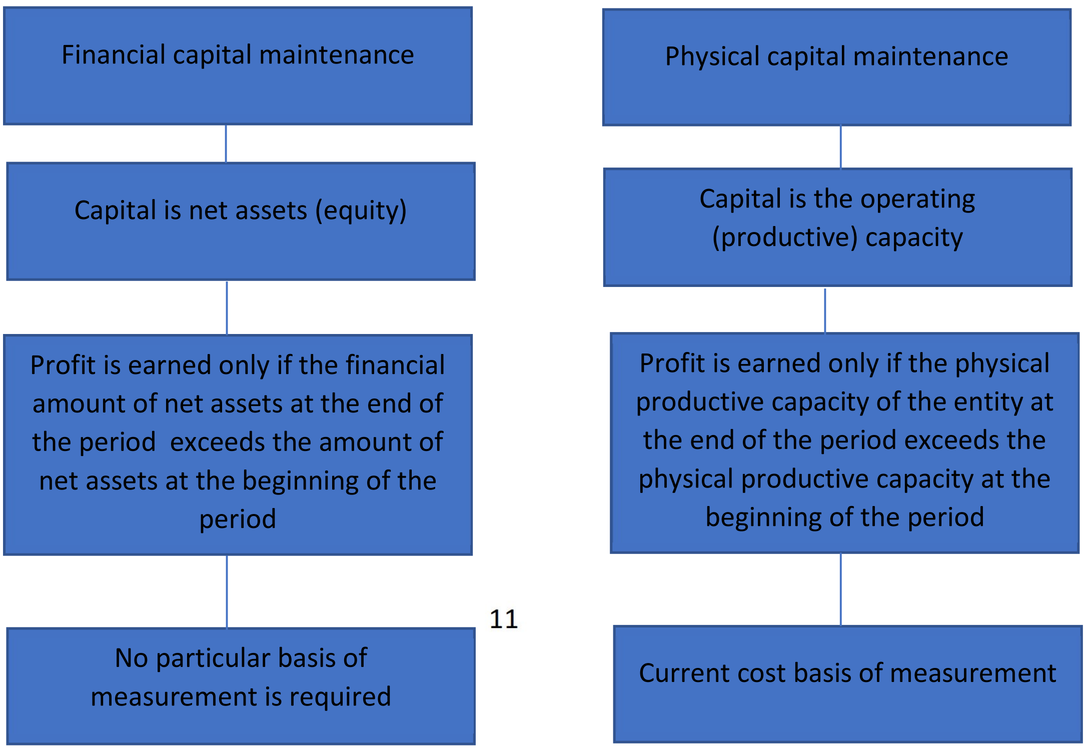
The choice of measurement bases is also influenced by the assessment of whether the entity is a going concern, i.e., it will continue its business as normal in the foreseeable future. If this assumption is rejected for an entity, then the measurement bases usually employed will also be adjusted toward liquidation (more current) values.

(8) Concepts of capital and capital maintenance

A financial concept of capital is adopted by most entities in preparing their financial statements. Under a financial concept of capital, such as invested money or invested purchasing power, capital is synonymous with the net assets or equity of the entity. Under a physical concept of capital, such as operating capability, capital is regarded as the productive capacity of the entity based on, for example, units of output per day (CFFR8.1).

The difference between the two concepts consists in how the effects of changes in prices of assets and liabilities are treated. Figure 7 below explains the meaning of the capital maintenance concepts and when profit is recognized in each case.

Figure 7. Capital maintenance approaches and implications on profit recognition



For example, if an entity holds 1,000 units of inventory at CU300 at the beginning of the period and at CU400 at the end of the period, profit would be recognized for CU100 under the financial capital maintenance concept. However, in physical terms, the quantity is the same (1,000 units), and therefore no profit would be recognized under the physical capital maintenance concept.

EXAMPLE

CFFR Ltd. is a group of entities publishing audited IFRS financial statements. The most recent set of financial statements covers the period 1 January – 31 December 20X1, with comparative information provided for 20X0. The financial statements are issued regularly within two months after the year end.

The statement of financial position reflects assets classified as current and non-current assets, and liabilities classified as current and non-current liabilities, with 3 or 4 lines in each category and with additional details being provided in the notes.

One of these items is property, plant, and equipment, and the entity reports in the notes to the financial statements the nature of the assets in this line, the main classes (land, buildings, and equipment), a numerical depiction of the changes during the year, and details about the measurement of the items. Buildings and equipment are measured at historical cost, while land is presented at revalued amounts. Land had been measured at cost until 20X0, but the entity changed the policy and decided to revalue it, similarly to the main players in the industry. Assets are not omitted from these classes and their value is not overstated.

The entity sold a building during the year, being pleased by the gain obtained. However, the gain is not reported separately from operating income, either on the face of the statement of profit or loss or in the notes.

Discuss the applicability of the CFFR to the case of CFFR Ltd.

SOLUTION

CFFR Ltd. is the reporting entity, and the calendar year is the reporting period.

The details provided about the CFFR Ltd. indicate the following aspects regarding the qualitative characteristics:

- the information provided is relevant. Historical cost may be relevant using information from past transactions and reflects the consumption of the assets and their impairment. Moreover, fair value may have predictive value, reflecting the current market expectations;

- the information provided is a faithful representation, since completeness (no assets are missing) and neutrality (resulting from the exercise of prudence) are obvious;

- verifiability is ensured (an enhancing qualitative characteristic), since financial statements are audited;

- classification of assets and liabilities contributes to the understandability of financial information, which is also an enhancing qualitative characteristic;

- information is timely, since the entity publishes financial statements relatively soon after year end;

- the details provided in the notes contribute to completeness, which is an attribute of faithful representation;

- the change in policy increases the comparability with the industry players.

Aggregating the value of land, buildings, and equipment in one line leads to effective communication, since similar items are grouped together, and aggregation avoids unnecessary details.

The measurement bases selected are historical cost (for buildings and equipment), and current values (for land). Given that buildings and equipment generate cash flows together with other assets, historical cost is a relevant information. There usually is an active market for land, so determining the current value may not be very costly.

The fact that the entity does not disclose separately the gain from selling the building negatively impacts the relevance of the accounting information. This aggregation may be misleading, particularly if it is material, when future profits are forecasted based on the current profit.