

Applying IFRS

IASB issues revised
*Conceptual Framework
for Financial Reporting*

April 2018

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What you need to know

- ▶ The IASB issued the revised *Conceptual Framework for Financial Reporting* (the revised Conceptual Framework) on 29 March 2018.
- ▶ The Conceptual Framework sets out a comprehensive set of concepts for financial reporting, standard setting, guidance for preparers in developing consistent accounting policies and assistance to others in their efforts to understand and interpret the standards.
- ▶ The changes to the Conceptual Framework may affect the application of IFRS in situations where no standard applies to a particular transaction or event.
- ▶ The revised Conceptual Framework is effective immediately for the IASB and the IFRS Interpretations Committee. For preparers who develop accounting policies based on the Conceptual Framework, it is effective for annual periods beginning on or after 1 January 2020.

The revised Conceptual Framework is accompanied by a Basis for Conclusions, as well as a separate document that sets out the amended references to the revised Conceptual Framework.

Overview

The International Accounting Standards Board (the IASB or the Board) issued the revised *Conceptual Framework for Financial Reporting* (the revised Conceptual Framework) on 29 March 2018. The revised version includes comprehensive changes to the previous Conceptual Framework, issued in 1989 and partly revised in 2010.

The previous Conceptual Framework (the 2010 Conceptual Framework) was criticised for its lack of clarity, the exclusion of certain important concepts and for being outdated in terms of the IASB's current thinking. Following 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 in July 2013 and an exposure draft in June 2015.

In revising the Conceptual Framework, the Board was looking to underpin high-level concepts with sufficient detail for it to set standards and to help others to better understand and interpret the standards.

The revised Conceptual Framework includes some new concepts, provides updated definitions and recognition criteria for assets and liabilities and clarifies some important concepts. It is arranged in eight chapters, as follows:

- ▶ Chapter 1 - The objective of financial reporting
- ▶ Chapter 2 - Qualitative characteristics of useful financial information
- ▶ Chapter 3 - Financial statements and the reporting entity
- ▶ Chapter 4 - The elements of financial statements
- ▶ Chapter 5 - Recognition and derecognition
- ▶ Chapter 6 - Measurement
- ▶ Chapter 7 - Presentation and disclosure
- ▶ Chapter 8 - Concepts of capital and capital maintenance

The revised Conceptual Framework is accompanied by a Basis for Conclusions. The Board has also issued a separate accompanying document, *Amendments to References to the Conceptual Framework in IFRS Standards*, which sets out the amendments to affected standards in order to update references to the revised Conceptual Framework. In most cases, the standard references are updated to refer to the revised Conceptual Framework. However, there are two exemptions, one for IFRS 3 *Business Combinations* and one for those applying IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* in developing accounting policies for regulatory account balances. We will deal with these exemptions in more detail in our commentary on Chapter 4.

Status and purpose of the Conceptual Framework

As a reminder, the Conceptual Framework is not a standard, and none of the concepts override the concepts or requirements in any standard. The purpose of the Conceptual Framework is to assist the Board in developing standards, to help preparers develop consistent accounting policies where there is no applicable standard in place and to assist all parties to understand and interpret the standards.

Summary of the concepts

Chapter 1 - The objective of financial reporting

This chapter describes the objective of general purpose financial reporting, the information needed to achieve that objective and who uses the financial reports. This chapter was issued with the 2010 Conceptual Framework, and its concepts have been brought forward to the revised Conceptual Framework, with some additions and clarifications, as discussed below.

The Board reintroduced stewardship and clarified the resulting information need.

The term 'stewardship' was removed from the 2010 Conceptual Framework, and users were concerned that this meant that their need to assess management's accountability was being neglected. The Board therefore used the revision of the Conceptual Framework in 2018 as an opportunity to reintroduce the concept of stewardship and to clarify its meaning. The Board sets out the information needed to assess management's stewardship, and separates this from the information that users need to assess the prospects of the entity's future net cash flows. Both types of information are required to provide information that is useful for making decisions about providing resources to the entity, and therefore achieves the objective of financial reporting.

Chapter 2 - Qualitative characteristics of useful financial information

This chapter clarifies what makes financial information useful, that is, information must be relevant and must faithfully represent the substance of financial information. This chapter was also included in the 2010 Conceptual Framework, and was not fundamentally changed during the revision, although some of the wording is clarified.

The Board has however reintroduced the concept of prudence, and defined the concept of measurement uncertainty in assessing the usefulness of financial information:

Useful information must be relevant and must faithfully represent the substance of the financial information.

- ▶ **Prudence** - the Board observed, during its outreach process, that users understand 'prudence' to mean different things, and the removal of the concept from the 2010 Conceptual Framework had led to further confusion amongst users. The Board believes that prudence supports neutrality of information and therefore describes prudence as 'the exercise of caution when making judgements under conditions of uncertainty'.
- ▶ **Measurement uncertainty** - in the revised Conceptual Framework, the Board acknowledged that measurement uncertainty is a factor that can affect faithful representation. For example, in some cases, relevant information may have a high level of measurement uncertainty, which may

reduce its usefulness. Slightly less relevant information with a lower measurement uncertainty may be preferable in such cases.

Further, in the 2010 Conceptual Framework, the concept of substance over form was not highlighted as a separate component of faithful representation, which led some users to think that the concept was no longer relevant. However, this was not the Board's intention, so the revised Conceptual Framework reinstates an explicit reference to the need to 'faithfully represent the substance of the phenomena that it purports to represent'.

How we see it

The Board notes that some stakeholders refer to prudence as being cautious when making judgements under conditions of uncertainty. Others use it to refer to applying systematic asymmetry. The Board believes that the concept of prudence meaning neutrality of information would support the goal of faithful representation of financial information.

Chapter 3 - Financial statements and the reporting entity

While Chapter 1 of the revised Conceptual Framework sets out the objective of general purpose financial reporting and Chapter 2 discusses the qualitative characteristics of useful financial information, Chapters 3-8 focus on information provided in the financial statements, and do not deal with other forms of financial reporting, such as management commentary.

Chapter 3 is a new chapter in the revised Conceptual Framework. It describes the scope and objective of financial statements, stating that financial statements are a particular form of financial report, which provides information about the assets, liabilities, equity, income and expenses of the reporting entity. Consolidated, unconsolidated and combined financial statements are all acknowledged as forms of financial statements in the revised Conceptual Framework.

Chapter 3 also provides a description of the reporting entity. The 2010 Conceptual Framework did not discuss what a reporting entity is or how to determine the boundary of such an entity. In developing concepts for the revised Conceptual Framework, the Board considered comments received on the 2010 Exposure Draft *Conceptual Framework for Financial Reporting - The Reporting Entity*, as well as comments received on the 2015 Conceptual Framework exposure draft. The Board acknowledged that it does not have authority to determine who must or should prepare financial statements, but it provides general guidance that a reporting entity is:

A reporting entity is an entity that chooses, or is required, to prepare financial statements, and is not necessarily a legal entity.

- ▶ An entity that chooses, or is required to, prepare financial statements
- ▶ Not necessarily a legal entity - it could take many forms, e.g. a portion of an entity. It is sometimes difficult to define the boundary of a reporting entity if it does not have typical legal form. In this case, the Board recommends that the boundary is determined by considering the users' information needs of that entity, based on the assumption (per Chapter 2) that users need information that is relevant and representationally faithful.

The definitions of an asset and a liability have been revised.

Chapter 4 - The elements of financial statements

This chapter defines the five elements of financial statements - an asset, a liability, equity, income and expenses. The major changes are to the definitions of an asset and a liability, as discussed below.

Definition of an asset:

Previous definition	New definition
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	A present economic resource controlled by the entity as a result of past events. An economic resource is a right that has the potential to produce economic benefits

The new definition clarifies that an asset is an economic resource, and that the potential economic benefits no longer need to be 'expected' to flow to the entity - they do not need to be certain or even likely (but if this is the case, the recognition and measurement of the asset may be affected).

Definition of a liability:

Previous definition	New definition
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	A present obligation of the entity to transfer an economic resource as a result of past events. An obligation is a duty of responsibility that the entity has no practical ability to avoid

The main difference is that the new definition clarifies that a liability is the obligation to transfer an economic resource, and not the ultimate outflow of economic benefits. The outflow also no longer needs to be 'expected', similar to the change in the definition of an asset, above. The Board also introduced the concept of 'no practical ability to avoid' to the definition of an obligation, and factors used to assess this will depend on the nature of an entity's duty or responsibility, which requires the use of judgement. Chapter 4 includes discussions of how to apply the concept in different circumstances.

As mentioned earlier in this publication, the Board has decided that preparers applying IFRS 3 and preparers developing accounting policies for regulatory account balances using IAS 8, must continue to apply the definitions of an asset and a liability (and supporting concepts) in the 2010 Conceptual Framework, and not the definitions in the revised Conceptual Framework.

IFRS 3 refers to the definitions of assets and liabilities in the 2010 Conceptual Framework, which are used in deciding whether to recognise assets and liabilities as part of a business combination. The Board considered whether to replace these references with references to the revised definitions in the revised Conceptual Framework. The Board recognised, however, that in some cases, applying the revised definitions would change

which assets and liabilities would qualify for recognition in a business combination. As a consequence, post-acquisition accounting required by other standards could lead to immediate derecognition of such assets or liabilities, causing 'day 2 gains or losses' to arise, which do not depict economic gains or losses. The Board, therefore, plans to assess how IFRS 3 can be updated for the revised definitions, without these unintended consequences.

There are two exemptions for applying the revised definitions of an asset and a liability.

The Board also decided to provide a relief for entities that otherwise would be revising accounting policies for regulatory account balances twice - once for the revised Conceptual Framework and again when a revised standard on rate-regulated activities is issued.

Chapter 4 has also been amended for the following:

- ▶ **Income and expenses** - the definitions have changed to reflect changes in the definitions of an asset and a liability
- ▶ **Equity** is still defined as the residual interest in the assets of an entity after deducting all the liabilities. The boundary between liabilities and equity will be further explored by the IASB in its research project on *Financial Instruments with Characteristics of Equity*
- ▶ **Unit of account** - decisions about selecting a unit of account for recognition and measurement of an element of the financial statements would need to be made at the standard level, but the chapter includes a discussion of factors to consider when determining which unit of account to use
- ▶ **Executory contracts** - revised and more extensive supporting guidance has been provided for these types of contracts.

Chapter 5 - Recognition and derecognition

The derecognition guidance in the revised Conceptual Framework is new.

This chapter discusses criteria for recognising assets and liabilities in financial statements, and provides guidance on when to remove - or derecognise - them. The recognition criteria have been revised from the 2010 Conceptual Framework, however the derecognition guidance is new. The 2010 Conceptual Framework did not define derecognition, or describe when it occurs.

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 an asset, a liability, equity, income or expenses'.

The revised Conceptual Framework goes on to state that recognition is only appropriate if it results in both relevant information about the element being recognised, and faithful representation of that element. This differs from the 2010 Conceptual Framework, which stated that an entity should recognise an item if it was probable that economic benefits would flow to the entity, with a cost/value that could be determined reliably. The Board's aim is to refer explicitly to the qualitative characteristics of useful information, in order to provide a more coherent set of concepts across the revised Conceptual Framework.

Derecognition - is 'the removal of all or part of a recognised asset or liability from an entity's statement of financial position'. It goes on to say that derecognition normally occurs:

- ▶ For an asset, when the entity loses control of all or part of the recognised asset
- ▶ For a liability, when the entity no longer has a present obligation for all or part of the recognised liability

Derecognition should aim to faithfully represent those assets and liabilities retained after the transaction, if any, and any change in assets and liabilities as a result of the transaction that led to the derecognition.

How we see it

The guidance on derecognition reflects the Board's view that both the control approach and the risk-and-rewards approach to derecognition are valid. Therefore, it does not specify the use of one or the other. The Board has adopted an approach that aims to faithfully represent both the change in the entity's assets and liabilities as a result of the derecognition transaction or event, and the assets and liabilities (if any) that are retained.

Chapter 6 - Measurement

This chapter describes various measurement bases, the information they provide and factors to consider when selecting a measurement basis. The 2010 Conceptual Framework did not include much guidance on measurement.

In developing the revised Conceptual Framework, the Board considered whether a single measurement basis should be mandated. However, it concluded that different measurement bases could provide useful information to users in different circumstances. Therefore, two categories of measurement basis were identified:

- ▶ Historical cost measurement basis
- ▶ Current value measurement basis

Historical cost measures provide information about elements that is derived from the historical price of the transaction or event that gave rise to the item being considered for measurement; so, for an asset, this would be the cost incurred in acquiring/creating the asset. For a liability, this would be the value of the consideration received to incur/take on the liability. The historical cost of both an asset and a liability will be updated over time to depict, for example, any consumption of the asset or fulfilment of the liability, or the impact of any events that cause the asset to become impaired or the liability onerous.

Current value measures provide monetary information about elements, using information updated to reflect conditions at the measurement date. Measurement bases may include fair value, value in use, fulfilment value and current cost. The description of fair value in the revised Conceptual Framework is in line with IFRS 13 *Fair Value Measurement*, and the descriptions of value in use and fulfilment value are derived from IAS 36 *Impairment of Assets*.

Selection of a measurement basis - consistent with the earlier chapters, the factors to be considered in selecting a measurement basis are in line with the qualitative characteristics of useful information - relevance and faithful representation:

Consideration of different factors is likely to result in different measurement bases for different assets, liabilities, income and expenses.

- ▶ **Relevance of information** provided by a measurement basis is affected by the characteristics of the asset or liability, and contribution to future cash flows
- ▶ **Faithful representation** of information provided by a measurement basis is affected by measurement inconsistency and measurement uncertainty

When selecting a measurement basis, the entity needs also to consider the nature of the information - whether it will be presented in the statement of financial position and/or the statement(s) of financial performance. Cost will also constrain the selection of a measurement basis. The Board acknowledges that consideration of all these factors is likely to result in the selection of different measurement bases for different assets, liabilities, income and expenses.

Chapter 7 - Presentation and disclosure

The topic of presentation and disclosure was not addressed in the 2010 Conceptual Framework. The outreach done by the Board indicated that effective communication of information in financial statements makes that information relevant and contributes to the faithful representation of an entity's financial position. The revised Conceptual Framework therefore introduces the following:

- ▶ Concepts describing how information should be presented and disclosed in financial statements
- ▶ Guidance on classifying income and expenses for the Board to use when it decides whether they are to be included in or outside of the statement of profit or loss
- ▶ Guidance for the Board on whether and when income and expenses included in other comprehensive income (OCI) should subsequently be recycled to profit or loss

In principle, all income and expenses should be included in the statement of profit or loss.

This chapter introduces the term 'statement(s) of financial performance' to refer to the statement of profit or loss together with the statement presenting OCI.

The statement of profit or loss is the primary source of information about the entity's financial performance. As a default, all income and expenses should be appropriately classified and included in the statement of profit or loss.

In exceptional circumstances, the Board may decide to exclude some income or expenses from the statement of profit or loss, and include those in **OCI**, for example, income or expenses arising from a change in the current value of an asset or liability.

Conversely, in principle, any income and expenses included in OCI in one period should be **recycled** to the statement of profit or loss in a future period, provided that the recycling results in more relevant and faithfully representative information in the statement of profit or loss. If recycling does not result in such information, the Board may decide that income and expenses included in OCI are not to be subsequently recycled.

How we see it

The revised Conceptual Framework does not include specific guidance on how the Board will decide whether items should be included in OCI, or whether items should not be subsequently recycled to the statement of profit or loss. The Board expects to take these decisions and explain its rationale when developing individual standards.

Chapter 8 - Concepts of capital and capital maintenance

The content of this chapter has been carried forward unchanged from the 2010 Conceptual Framework. The Board decided that updating this discussion could delay the completion of the revised Conceptual Framework. It agreed, however, that it would be appropriate to continue to include the concepts in the revised Conceptual Framework, as they are important to financial reporting. The Board may revisit the concepts in the future if necessary.

How we see it

We support the effort that the IASB has put in to the revision of the Conceptual Framework. The concept of useful information (relevant and faithfully representative) is consistently carried across all of the chapters, and will ultimately, it is hoped, make financial information more useful to the entity's various stakeholders.

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EYG no. 02013-183GbI
EY-000060659.indd (UK) 04/18.
Artwork by Creative Services Group London.
ED None



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