Conceptual Framework for Financial Reporting

Outreach event Oslo 16 September 2015

International Financial Reporting Standards

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16 September 2015

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The views expressed in this presentation are those of the presenter, not necessarily those of the IASB or IFRS Foundation.

Session overview

International Financial Reporting Standards

Qualitative characteristics of useful financial information

Objective and qualitative characteristics

The objective of general purpose financial reporting is to provide **useful financial information**

Relevance
- Relevant financial information is capable of making a difference in a decision made by users

Faithful representation
- Representation of relevant economic phenomena and faithful representation of the phenomena that it purports to represent
- Complete, neutral and free from error

Enhancing characteristics
Comparability • Verifiability • Timeliness • Understandability

Cost constraint

Objective of financial reporting

- No fundamental rethink of the existing chapters but changes proposed in response to comments received on the 2013 Discussion Paper

Stewardship	• Give more prominence to the need to provide information to assess management's stewardship of the entity's resources
Primary users of financial statements	• Confirm focus on existing and potential investors, lenders and other creditors – Includes long-term investors

Qualitative characteristics

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Prudence	• Reintroduce an explicit reference to the notion of prudence (exercise of caution when making decisions under conditions of uncertainty) • No overstatement or understatement of assets, liabilities, income or expenses (ie neutral)
Reliability	• If an estimate is too uncertain, it might not provide relevant information • Trade-off against other factors that affect relevance • Retain faithful representation as a label for that qualitative characteristic
Substance over form	• Reintroduce explicit reference to substance over form within description of faithful representation

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Stewardship

- Welcomes the greater prominence given to the assessment of management's stewardship of the entity's resources in the description of the objective of financial reporting.
- Disagrees with subsuming stewardship in a general objective of providing useful information to support decisions involving buying, selling or holding equity and debt instruments, and providing or settling loans and other forms of credit.

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Stewardship

- EFRAG/ICAS study on the use of financial information – does it depend on the objective?
- Financial statements seems more important for the assessment of stewardship than for buying, holding and selling decisions.

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Prudence

- Welcomes the re-introduction of prudence.
- Agrees with the Basis for Conclusion that prudence may lead to asymmetry in the recognition of assets/income and liability/expenses without introducing any undesirable bias in financial reporting.
- But the conclusions in the Basis for Conclusions should be included in the Conceptual Framework itself.

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Prudence

- Disagrees that prudence should not be subservient to neutrality.
- The focus should be on how it affects standard-setting rather than the behaviour of preparers of financial statements.

Faithful representation and relevance

- Measurement uncertainty should be an element of ‘faithful representation’ rather than of ‘relevance’.
- Should ‘reliability’ be used instead of ‘faithful representation’?
  - Is it an opportunity for gaining a better understanding of the boundary of a reliable measurement?
  - Is ‘faithful representation’ well understood?

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Substance over form

- Welcomes the reintroduction of ‘substance over form’.
- But should be clearer that legal arrangements should not be disregarded.

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Financial statements and the reporting entity

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Reporting entity

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A reporting entity is an entity that chooses, or is required, to present general purpose financial statements

- Does not have to be a legal entity
- Can be a portion of an entity
- Can be two or more entities
  - normally consolidated
  - can be combined

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Boundary of a reporting entity

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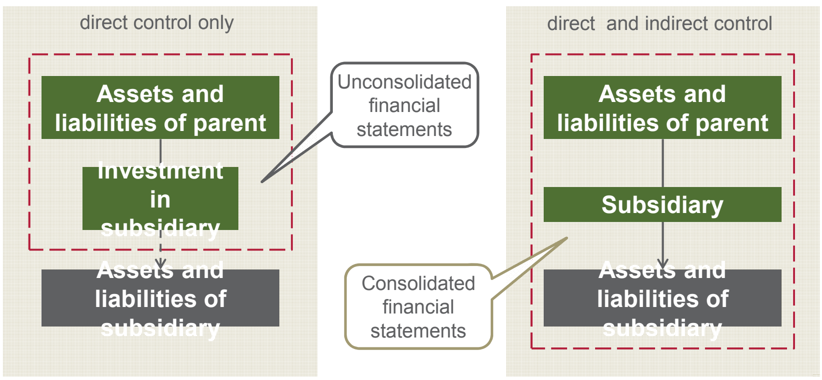

In general consolidated financial statements are more likely than unconsolidated financial statements to provide useful information.

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Financial statements and reporting entities

- A reporting entity is not necessarily a legal entity.
- An entity can prepare both individual and consolidated financial statements.
- Should not include a statement that consolidated financial statements are more likely to provide useful information without acknowledging the circumstances where this may not be the case.
- Should explain the implications of the entity approach.

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Financial statements and reporting entities

- Asks whether there is an urgent need to justify the choice of control as the basis for consolidation from a conceptual perspective.

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The elements of financial statements

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Elements: Definitions of assets and liabilities

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	Existing definitions	Exposure Draft
Asset (of an entity)	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.
Liability (of an entity)	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.
Economic resource	Not defined	A right that has the potential to produce economic benefits.

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Elements: Liabilities

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Present obligation to transfer an economic resource

No practical ability to avoid the transfer

AND

The extent of the obligation is determined by reference to past activities or benefits received

Consider in Standards

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Present obligation – example

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Fact pattern

An entity must pay a levy if it is operating as a bank at the end of its financial reporting period.

The amount of the levy is 2% of the bank's liabilities at that date.

But if the financial reporting period is shorter or longer than one year, the levy is reduced or increased proportionately. So:

$$\text{Levy} = 2\% \times \text{liabilities} \times \frac{\text{length of financial reporting period (days)}}{365}$$

Application of proposed concepts

- Extent of obligation increases each day – levy increases by 1/365th of annual amount.
- If it is judged that the entity has no practical ability to avoid being a bank on the last day of its reporting period, a liability and expense arise progressively over period.

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Elements: Definition of equity

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- No amendments to existing definitions at this time
- No detailed guidance on how to distinguish liabilities from equity instruments
- Explore how to distinguish liabilities from equity, including whether to amend the definitions of liability and equity, in a research project

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Definitions of elements

- Appears that the proposed definitions are easier to understand – but will test.
- Disagrees with removing the description of revenue.
- Disagrees with stating that if one party has a liability another party has an asset.
- Asks constituents whether the asset/liability approach leads to more robust and consistent financial reporting than a pure matching approach.

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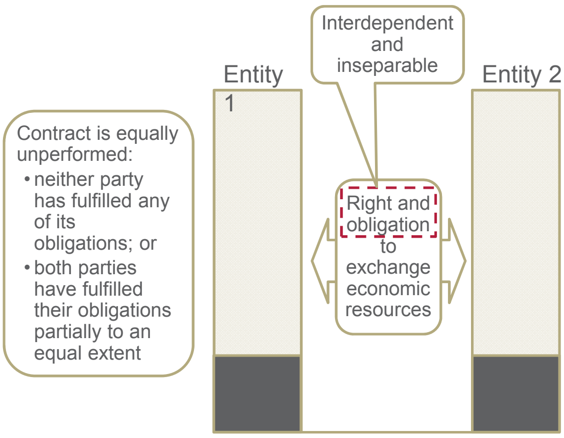
Present obligation

- Generally agrees with how a ‘present obligation’ is described – but consequences need to be assessed (e.g. deposit guarantee scheme).
- Generally agrees with the description of a constructive obligation.

Executory contracts



- Combined right and obligation constitute:
  - a single asset (if terms are favourable); or
  - a single liability (if terms are unfavourable)
- Measurement based on historical cost will normally lead to measurement at zero unless the contract is onerous

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Executory contracts and unit of account

- Disagrees with the guidance on executory contracts.
  - Need for criteria for when an executory contract should be measured on a basis other than cost.
  - Same measurement basis initially and subsequently as long as contract remains executory.
- Guidance on unit of account may be insufficient.

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Recognition and derecognition

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Recognition and derecognition

	Existing criteria	Exposure Draft
Recognition	• Meet the definition of an asset or a liability • Probable that any future economic benefit associated with the asset or liability will flow to the entity • The asset or liability has a cost or value that can be measured reliably	• Meet the definition of an asset or a liability • Relevance • Faithful representation • Cost/benefit

Derecognitio n	• None	• Aim is to faithfully represent both:
		  • the entity's retained assets and liabilities; and
		  • any resulting changes in its assets and liabilities

Recognition and derecognition

- Broadly agrees with the guidance on recognition.
- In some areas, the guidance may be insufficient to ensure consistent standard-setting (e.g. unclear how uncertainty will affect recognition).
- Agrees with the guidance on derecognition.

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Measurement

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Measurement bases

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Measurement bases

Historical cost

Uses information derived from the transaction or event that created the asset or liability.

Current value

Uses information that is updated to reflect conditions at the measurement date.

Measurement based on:

Market participant's assumptions	Entity-specific assumptions
Fair Value	• Value in use (assets) • Fulfilment value (liabilities)

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Selecting a measurement basis

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For information provided by a particular measurement basis to be useful, it must be:

Relevant | Faithfully represented

Enhancing characteristics
Comparability • Verifiability • Timeliness • Understandability

Cost constraint

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Factors when selecting a measurement basis

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Relevance

- Information produced in both statement of financial position and statement(s) of financial performance
- How an asset or liability contributes to future cash flows
  - depends in part on business activities being conducted
- Characteristics of asset or liability
  - eg nature or extent of variability in cash flows, sensitivity to risks etc
- Level of uncertainty
  - but sometimes a measurement with a high degree of uncertainty is the only relevant measurement

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Factors when selecting a measurement basis

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Faithful representation

- Consider how best to portray link between items

Others

- Understandability
  - Using new or different measurement bases could reduce understandability
  - Avoid unnecessary changes in measurement bases
- Cost constraint
  - Benefit of providing useful information should always exceed the cost of doing so

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Measurement

- Broadly agrees with the categorisation of measurement bases.
- Broadly agrees with the description of the information provided by each of the measurement bases.
- Should have considered other market-consistent measurement bases than fair value.
- Guidance on how to select a measurement bases is insufficient – outcomes in future standard setting will heavily rely on the IASB's judgement of what 'relevant' information is.

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Measurement

- Asks constituents how to select measurement bases when listed factors conflict.
- Asks constituents about the use of different measurement bases for the statement of financial position and the statement of profit or loss.
- Ideas on measurement for consultation are also published in the Bulletin *Profit or loss versus OCI.*

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Presentation and disclosure

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Presentation and disclosure

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Exposure Draft

- Objective and scope of financial statements
- Classification, aggregation and offsetting
- Information in the notes
- Communication principles

Disclosure Initiative

- Portfolio of projects aimed at improving the effectiveness of disclosures:
  - Principles of Disclosure
  - Review of existing Standards
  - Materiality
  - Amendments to IAS 1 *Presentation of Financial Statements*
  - Amendments to IAS 7 *Statement of Cash Flows*: reconciliation of liabilities from financing activities

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Presentation in profit or loss

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This statement is the primary, but not the only, source of information about an entity's financial performance in the period

Statement of profit or loss

	20X5	20X4
Revenue from customers	234,439	212,367
Cost of sales	(112,764)	(106,259)
…	…	…
Taxes	(21,546)	(20,587)
…	…	…
Profit (loss) for the year	**18,897**	**16,763**

Profit or loss is a required total or subtotal

Rebuttable presumption that income and expenses are included in profit or loss

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Presentation in OCI

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Income and expenses included in OCI only if that enhances relevance of profit or loss in the period

Presumption that income and expenses included in OCI in one period are subsequently included in profit or loss (recycled)

Statement of comprehensive income

	20X5	20X4
Profit (loss) for the year	18,897	16,763
Currency translation	68	(51)
FV adjustment cash flow hedging	(2,764)	6,259
…	…	…
Taxes	(215)	87
Other comprehensive income for the year	*(2,546)*	*4,253*
Total comprehensive income for the year	**16,351**	**21,016**

OCI only for some income and expenses from changes in current measures of assets and liabilities

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Use of OCI in existing Standards – examples

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	A change in a current measure of asset / liability?	Use of OCI enhances relevance of profit or loss?	Rebuttable presumption on recycling?
Effective portion of changes in fair value of cash flow hedging instruments	✓	✓	✓
'Own credit risk' when fair value option used for financial liabilities	✓	✓	✘
Exchange differences on net investments in foreign operations	✓	?	✓
Remeasurement of net defined benefit pension assets or liabilities	✓	?	✘

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Presentation and disclosures

- Supports the proposals on the objective and scope of financial statements and communication.
- But should consider how to distinguish between presentation and disclosure.

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Presentation and disclosures

- Supports the description of the statement of profit or loss.
- Should ensure a common understanding of ‘return on an entity’s economic resources’.
- Profit or loss should not be “as inclusive as possible”.
- Ideas on how OCI should be used are published in the Bulletin *Profit or loss versus OCI.*
- Recycling should be based on a principle.

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Bulletin *Profit or loss versus OCI*

- The ED states that only income and expenses arising from remeasurements can be reported in OCI.
- It presumes that all income and expenses go to P&L, unless excluding them makes P&L more relevant.
- But it does not explain when the IASB should overcome the presumption.

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Bulletin *Profit or loss versus OCI*

- Extends and rationalises the ED proposals.
- Aims at relevant performance reporting from a business model perspective.
- Builds on debates held in the IASB Accounting Standards Advisory Forum (ASAF).

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Bulletin *Profit or loss versus OCI*

Step 1: Identify business model
- Price change
- Transformation
- Long-term investment
- Liability driven.

Step 2: Determine relevant measurement basis for primary performance (profit or loss)

Step 3: Test whether this measurement basis is relevant for the statement of financial position – if not, the difference is reported in OCI.

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Bulletin *Profit or loss versus OCI*

Potential outcomes:
- Fewer options for PPE, inventories and investment properties.
- No impact in profit or loss of revaluation of items in a long-term business model.
- Changes in estimates of expected cash outflows in relation to pension liabilities are reported in profit or loss.
- Business model could play a role for financial instruments which do not meet the SPPI test.

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Timeline

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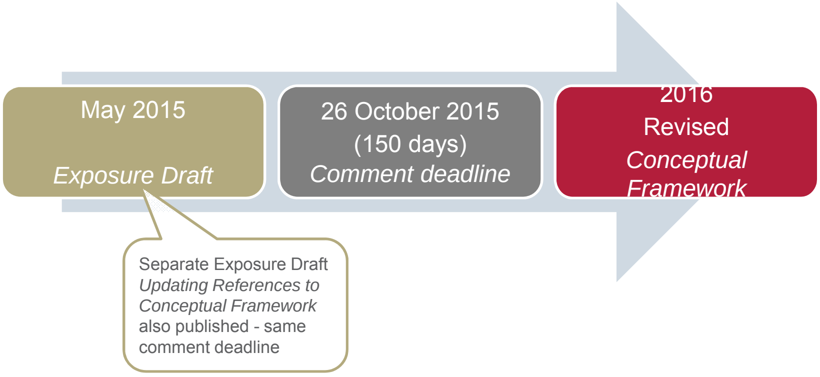

Further information

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- Exposure Draft *Conceptual Framework for Financial Reporting*
  http://go.ifrs.org/ED-CF-May2015
- Conceptual Framework website
  http://go.ifrs.org/Conceptual-Framework
- Submit a comment letter
  http://go.ifrs.org/comment_CF
- Snapshot
  http://go.ifrs.org/CFSnapshot2015
- Register for email alerts
  http://eifrs.ifrs.org/eifrs/Register

Comments on EFRAG's draft comment letter
should be submitted by 26 October 2015* to commentletters@efrag.org

*** The comment period may be extended should the IASB decide to extend its comment period.**

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