Conceptual Framework for Financial Reporting – Robust Framework for the new century

As part of the convergence of Indian Accounting Standards (Ind AS) with the International Financial Reporting Standards (IFRS) Standard, the Exposure Draft (ED) of the Conceptual Framework has been issued recently for public comments. The Exposure draft of the Conceptual Framework is based on the Conceptual Framework 2018 issued by the International Accounting Standards Board (IASB). The Conceptual Framework is the foundation of the financial reporting standards and acts as mentor, philosopher and guide to the accounting standard-setter. The Conceptual Framework developed by the IASB has undergone a complete overhaul and refinement in recent years and expected to be foundation for international financial reporting standard setting in the new millennium. Read on...

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Conceptual Framework- The Foundation for Accounting Standard-setting

The *Conceptual Framework for Financial Reporting* describes the objective of and concepts for general purpose financial reporting. The Conceptual Framework is a practical tool that helps the Standard Setting Body to develop requirements in the individual Standards based on consistent concepts. It also help preparers to develop consistent accounting policies for areas that are not covered by a standard or where there is choice of accounting policy, and assist all stakeholders to understand and interpret the Standards.

It is important to note that the Conceptual Framework is a set of accounting and reporting concepts but does not override any individual Standard. In the absence of a Standard that specifically applies to a transaction, management uses its judgement in developing and applying an accounting policy that results in information that is relevant and reliable. In making that judgement, IAS 8/Ind AS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*, requires management to consider the definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses in the Conceptual Framework.

International Developments -Genesis of the new Conceptual Framework issued by the International Accounting Standards Board (IASB)

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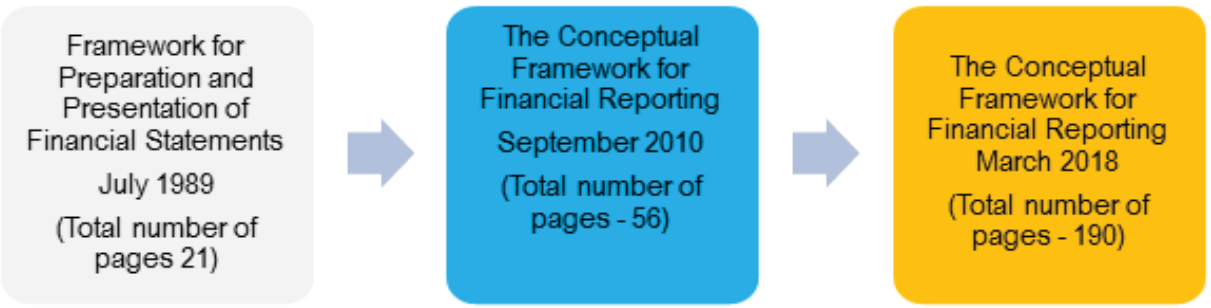
In March 2018, the IASB issued a comprehensive framework titled 'Conceptual Framework for Financial Reporting (Conceptual Framework) after five years of extensive deliberations since the Discussion Paper issued in 2013.



❖ **Mandatory Effective date**
- ➢ IASB/IFRS Interpretation Committee – March 2018 (immediately from issue date)
- ➢ Preparers and others – January 2020, early adoption permitted.

Journey of IASB's Conceptual Framework at Glance			
	July 1989	International Accounting Standards Committee (predecessor of IASB) issued the Framework for the Preparation and Presentation of Financial Statements (Framework 1989)	
	April 2001	The IASB adopted the Framework 1989 issued by its predecessor body	
Revision of Conceptual Framework			
Phase I- jointly by IASB and Financial Accounting Standards Board, US national standard-setter	July 2006	• Discussion Paper on revision of Conceptual Framework published by IASB and FASB	179 Comment letters received
	May 2008	• Exposure Draft published jointly by IASB and FASB	142 Comment letters received
	Sept 2010	• Conceptual Framework issued with newly developed Chapters 1 to 2 and Introduction Section • Remaining text of 1989 Framework carried forward	
Phase II- IASB individual project	July 2013	• Discussion Paper - *A Review of the Conceptual Framework for Financial Reporting issued*	**Comment Letters - 229 on DP, 233 on ED and 40 on ED update references** **Public Meetings > 230** (Investors, analysts, preparers, actuaries, regulators, standard-setters, accounting firms and others) **Consultative Group** Accounting Standards Advisory Forum (ASAF) **Field Testing** Case studies in World Standards Conference 2016
	May 2015	• Exposure Draft of Conceptual Framework for Financial Reporting issued by IASB • Exposure Draft Updating References to the Conceptual Framework issued	
	March 2018	• The Conceptual Framework for Financial Reporting was issued	

Revision in 2010: Joint Project of IASB with FASB US national standard-setter

When the international standard-setting body, the IASB was restructured in 2001, it signed an historic agreement called 'Norwalk Agreement' with FASB to make best efforts to make their standards compatible with each other. Subsequently in 2006, IASB and FASB entered into MoU, inter-alia, to achieve the objective of Norwalk Agreement. In this background, IASB and FASB in 2006 embarked on a joint-work to revise their respective Conceptual Framework. The revision of Conceptual Framework work was decided to be taken up in phases as changes were large and structural as well as conceptual. First phase of initiative (in 2010) culminated in IASB issuing two chapters of Conceptual Framework. The Chapters added were Chapter 1, *The Objective of general purpose financial reporting* and Chapter 2, *The qualitative characteristics of useful information*. The remaining chapters carried forward from Framework 1989. Chapter 1 widened the scope of Conceptual Framework to include objective of 'financial reporting' and not just 'financial statements'. At the same time, it also made the spectrum of users of financial reports more focused and narrowed it down to primary users, i.e., existing potential investors, lender and other creditors.

In case of Chapter 2, *The qualitative characteristics of useful information*, major changes are as follows:

- 'Reliability' was replaced with the term 'Faithful Representation'. Substance over Form was not considered a separate component of Faithful Representation.
- Prudence was not included because it could be understood in a way that is inconsistent with neutrality.
- Verifiability was described as an enhancing qualitative characteristic rather than as part of the fundamental qualitative characteristic.

The IASB suspended work on the revision of remaining part of Conceptual Framework in 2010 so that it could focus on more urgent projects that arose from the global financial crisis.

Revision in 2018: New Conceptual Framework

In 2013, the IASB resumed the project of revising remaining part of the Conceptual Framework based on its 2011 public consultation Agenda for next five years. In 2018, the IASB completed its Conceptual Framework project and issued a comprehensive Conceptual Framework 2018. The main changes introduced are as follows:

New Topics	• Concepts on measurement, including factors to be considered when selecting a measurement basis
	• Concepts on presentation and disclosure, including when to classify income and expenses in other comprehensive income
	• Derecognition Guidance on when assets and liabilities are removed from financial statements
Revision	• Definitions of Assets and Liabilities
	• Recognition criteria for including assets and liabilities in financial statements
Clarification	• Regarding Prudence, Stewardship, Measurement uncertainty and Substance over Form

The approach of revising in 2018 was to fill the gaps, clarify and update certain areas as the 2010 Conceptual Framework work had following deficiencies:

(a) some important areas were not covered;

(b) the guidance in some areas was unclear; and

(c) some aspects were out of date.

It may be noted that the IASB's Conceptual Framework 2018 did not address classification of financial instruments with characteristics of both liabilities and equity because of its research project on Financial Instruments with Characteristics of Equity (FICE). It also did not address the equity method of accounting and the translation of amounts denominated in foreign currency or the restatement of the measuring unit in hyperinflation. The IASB concluded that these issues would best be dealt with if it were to carry out projects to consider revising Standards on these topics. The IASB also suitably addressed the stakeholders concern regarding Substance over Form, Prudence and Management Stewardship in finalising the March 2018 version of the Conceptual Framework.

Consequential Amendments to IFRS/IAS

While it is not intended that entire set of standards are required to be revised immediately, as and when Conceptual Framework is revised, the IASB had decided to amend certain standards as they contain specific reference to the Framework 1989. Therefore, henceforth these Standards will have to be applied using the

definition of elements in the new Conceptual Framework. But it is not expected that there will be significant changes in actual application due to these amendments. The individual Standards that are amended for reference to the Conceptual Framework 2018 are IFRS 2, IFRS 6, IFRS 14, IAS 1, IAS 34, IAS 37, IAS 38, IFRIC 12, IFRIC 19, IFRIC 20, IFRIC 22, and SIC-32. It may be noted that IASB decided not to amend IFRS 3* and IAS 8. Hence, in case of IFRS 3, entities have to apply the definitions of elements of financial statements as provided under Framework 1989. Also, in case of IAS 8, through specific paragraph (paragraph 54G) an exception has been created for entities not applying IFRS 14 to continue to use the definitions, recognition criteria and measurement in the Framework 1989 instead of new Conceptual Framework.

**Subsequently, IASB has issued amendments to address this aspect.*

Conceptual Framework for Financial Reporting under Indian Accounting Standards

The Institute of Chartered Accountants of India (ICAI), in the past, has issued a pronouncement with the title *'Framework for the Preparation and Presentation of Financial Statements under Indian Accounting Standards'* (hereinafter referred as existing Framework). This framework was primarily based on the Framework issued by IASB's predecessor body IASC in 1989 (Framework 1989).

In view of the developments at the international level as mentioned in preceding paragraphs and with an objective to remain converged with the global accounting framework, the Accounting Standards Board, ICAI developed the Exposure Draft of *Conceptual Framework for Financial Reporting under Ind AS* (hereinafter referred as Conceptual Framework - ED) corresponding to IASB's Conceptual Framework 2018. Substantially, Exposure Draft of Conceptual Framework under Ind AS is similar to IASB's Conceptual Framework 2018, however, the following changes are made to align it with Ind AS and Indian Law:

- For the terms 'Statement of financial position' and 'Statement of financial performance, the terms 'Balance Sheet' and 'Statement of Profit and Loss' respectively are used.
- In case the requirement in any Ind AS that departs from aspects of the Conceptual Framework under Ind AS, ICAI will explain the departure in the Appendix to the relevant Ind AS.
- Definition of Consolidated Financial Statements (CFS) in Conceptual Framework under Ind AS covers only subsidiaries. In this regard, stakeholders' attention is drawn by way of a footnote that Companies Act, 2013, requires a company which has no subsidiary but has an associate and/or joint venture to prepare CFS in accordance with applicable Accounting Standards.

It is critical to highlight that there are certain substantial changes in the Conceptual Framework - ED. The changes are structural as well as conceptual. This new Conceptual Framework can be called a comprehensive framework as it comprises discussion on almost all of the important topics needed for standard setting, contain detailed commentary/explanation and are based on contemporary concepts. Conceptual Framework - ED is structured into 'Eight' chapters and includes an appendix containing definitions of various terms. It also has a separate section on Status and Purpose of Conceptual Framework.

Main changes from existing Framework

Summary of structural changes

Existing Framework	Conceptual Framework - ED
Introduction	Status and Purpose of the Conceptual Framework
The Objective of Financial Statements	Chapter 1 – The Objective of General Purpose Financial Reporting
Underlying Assumptions	Moved to Chapter 3 – Financial Statements And The Reporting Entity
Qualitative Characteristics of Financial Statements	Chapter 2 – Qualitative characteristics of useful financial information
--	Chapter 3 – Financial Statements and Financial Reporting
The Elements of Financial Statements	Chapter 4 – The Elements of Financial Statements
Recognition of the Elements of Financial Statements	Chapter 5 – Recognition and Derecognition
Measurement of the Elements of Financial Statements	Chapter 6 – Measurement
---	Chapter 7 – Presentation and Disclosure
Concepts of Capital and Capital Maintenance	Chapter 8 – Concepts of Capital and Capital Maintenance
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Summary of Conceptual Changes

Status and purpose of the Conceptual Framework

This section describes the purpose of the Conceptual Framework which was earlier broadly covered in Purpose and Status section. Its purpose is to assist ICAI in formulation of Ind AS, to assist preparers to develop consistent accounting policies when no Ind AS applies and to assist all parties to understand and interpret the Ind AS. An important clarification provided by this section is that Conceptual Framework will assist preparers to develop consistent accounting policies when an Ind AS allows a choice of accounting policy, i.e., when an entity exercise a choice of accounting policy available in Ind AS, it shall bear in mind the concepts enunciated in the Conceptual Framework.

Chapter 1 : *The Objective of General Purpose Financial Reporting*

This chapter contains discussions around objectives of general purpose financial reporting (GPFR) and users and their information needs. These two aspects were covered in two separate parts in existing Framework. It states that the objective of general purpose financial reporting is to provide financial information about the reporting entity to existing and potential investors, lenders and other creditors in making decisions relating to providing resources to the entity. As a result of this new objective, the key changes are as follows:

- Scope of reporting information is widened from 'financial statements' to 'financial reporting'.
- New definition of General Purpose Financial Reporting has been added.
- Range of users of financial information has been narrowed from 'wide range of users' to 'primary users'. Primary users are defined as existing and potential investors, lenders and other creditors whereas under the existing Framework users of financial statements included present and potential investors, employees, lenders, suppliers and other trade creditors, customers, governments and their agencies and the public.
- It is explicitly stated that other parties such as regulators and members of the public other than investors, lenders and other creditors may also find Financial Reports useful but the General Purpose Financial Statements are not primarily directed to the other Groups.

Chapter 2 : *Qualitative Characteristics of Useful Financial Information*

Existing Framework	Conceptual Framework - ED
The existing Framework refers to 4 (four) principal qualitative characteristics: a) Understandability, b) Relevance – Materiality c) Reliability - Faithful Representation, Substance over Form, Neutrality, Prudence, Completeness, and d) Comparability.	Conceptual Framework - ED divides the qualitative characteristics into two broad heads in order to distinguish between the 'Fundamental qualitative characteristics' that are the not critical and other called as 'Enhancing qualitative characteristics' which are less critical but highly desirable. (i) Fundamental qualitative characteristics – relevance and faithful representation (ii) Enhancing qualitative characteristics – comparability, verifiability, timelines and understandability.
Neutrality, Prudence and Substance over Form were separately discussed as part of Reliability	In the Conceptual Framework – ED, Prudence and Substance over Form are discussed as part of Fundamental qualitative characteristics of 'Faithful Representation'. The category 'Reliability' has been removed and replaced by 'Faithful Representation'. One of the reasons for removal is difference in understanding of the term 'reliability' by stakeholders and its confusion with measurement uncertainty.

Chapter 3: *Financial Statements and the Reporting Entity*

This is a new Chapter and contains the following:

- Objective and scope of financial statements which are based on the description of objectives and scope of general purpose financial reporting discussed in Chapter 1 of Conceptual Framework – ED and objectives of financial statements stated in Ind AS 1, *Presentation of Financial Statements*. However, in respect of latter, there are differences between the two.
- Going concern assumption description is continued but there is change in a phrase used, i.e., 'cease trading' replaces the earlier phrase 'curtail materially the scale of its operation' in the description of going concern.
- Reporting entity, a new topic has been introduced. Conceptual Framework -ED describes reporting entity, its boundaries and states that it is not necessarily a legal entity.
- Consolidated and unconsolidated financial statements: This section discusses the usefulness of financial information provided in consolidated financial statements and unconsolidated financial statements. The latter is described as the financial statements of a reporting entity that is the parent alone.
- Combined financial statements: This new concept is explicitly recognised and described as those of reporting entity which comprises of two or more entities that are not linked by a parent-subsidiaries relationship.

Chapter 4: *The Elements of Financial Statements*

This Chapter contains description of a few critical elements, viz., Assets, Liabilities, Income and Expenses. There is a major change in the definitions of Assets and Liabilities. Another major change is inclusion of a separate definition of 'economic resources'. Two major reasons for changing the definition of assets and liabilities are as follows:

- explicit reference in the definitions of an asset and a liability to the flows of economic benefits blurred the distinction between the economic resource or obligation and the resulting flows of economic benefits
- the term 'expected' was understood by many as probability threshold and there was lack of clarity between the terms 'expected' and 'probable'.

Key changes in the definition

Existing definition	Revised definition
Asset: 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.	**Assets:** A present economic resource controlled by the entity as a result of past events.
Liability: 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.	**Liability:** A present obligation of the entity to transfer an economic resource as a result of past events. With regard to Obligation, the Conceptual Framework-ED developed 'no practical ability to avoid' criteria.
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.	**Income:** Increases in assets, or decreases in liabilities, that result in increases in equity, other than those relating to contributions from holders of equity claims.
Expenses are decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrence of liabilities that result in decreases in equity, other than those relating to distributions to equity participants.	**Expense:** Decreases in assets, or increases in liabilities, that result in decreases in equity, other than those relating to distributions to holders of equity claims.

Definitions of Income and Expenses are updated to reflect the refinement in the definitions of asset and liability respectively. Revision to definition of Income and Expenses are consequential to changes in definition of Asset and Liability but it does not mean that Standard- Setter's focus is solely on the Balance Sheet. Rather it is found to be better if the asset and liability are defined first.

The Conceptual Framework – ED does not use the term 'contingent liability' because:

- Contingent liabilities are not a further element of financial statements, additional to liabilities and equity. Moreover, some 'contingent liabilities' are liabilities, but others are not.
- In common usage, the term 'contingent liability' is not used in the same way as in Ind AS 37. It often refers to an item that may give rise to an outflow of economic resources if some uncertain future event occurs.

Chapter 5: *Recognition and Derecognition*

There is a structural change in this area. There is elaborate description of recognition process and a discussion around an important accounting area, viz., derecognition. While the derecognition is being discussed, there is no specific prescription whether to use control approach or risk-reward approach, for laying down derecognition principles. There is a major change in the description of recognition criteria as can be seen from the following table:

Existing Framework	Conceptual Framework - ED
An entity should recognise an item that met the definition of an element of financial statements if it is probable that any future economic benefit associated with the item will flow to or from the entity and if the item has a cost or value that can be determined reliably.	Recognition criteria refer explicitly to the qualitative characteristics of useful information. The Conceptual Framework – ED provides that only items that meet the definition of an asset, a liability or equity and income or expenses are recognised.
No guidance is provided on derecognition	The Conceptual Framework – ED provides that derecognition aims to faithfully represent both (a) any assets and liabilities retained after the transaction that led to the derecognition (b) the change in the entity's assets and liabilities as a result of that transaction.

The rationales for above fundamental changes are:

- Probability criteria used in different standards was not consistent. Different thresholds, like, 'probability', 'reasonable certainty', 'more-likely than not', etc. were used.
- Application of probability criterion for recognition could lead to loss of relevant information.
- Use of 'reliability' in the above definition was not clear.
- Setting a more rigid recognition criteria in the Conceptual Framework does not help in standard-setting developing individual standards.

Chapter 6 : *Measurement*

Existing Framework	Conceptual Framework - ED
There is very little guidance on measurement. Existing framework has a brief discussion of following measurement bases: • Historical cost • Current cost • Realisable (settlement) value • Present Value • Fair value	Describes in detail what information measurement bases provide and explains the factors to consider when selecting a measurement basis. (i) The Conceptual Framework - ED identifies two categories of measurement bases – (a) historical cost bases; (b) current value bases comprise fair value, value in use, fulfillment value and current cost. It also describes how the fundamental qualitative characteristics of 'Relevance' and 'Faithful Representation' affect the selection of measurement basis. (ii) It discusses the general implications that the 'Enhancing qualitative characteristics', viz., comparability, understandability and verifiability and cost constraint have for selection of measurement basis.

Existing Framework	Conceptual Framework - ED
	(iii) It discusses situations in which more than one measurement basis is needed for an asset or liability and for related income and expenses to provide users of financial statements with useful information. (iv) It also states that it is necessary to consider the nature of information provided in both the balance sheet and statement of profit and loss by the measurement basis selected. (v) Factors to consider when selecting a measurement basis: (a) From the view point of – 'Relevance': • characteristics of the asset and liability and • contribution to future cash-flows (b) From the view point of – 'Faithful Representation: • whether the assets and liabilities are related in some way, and • measurement uncertainty

Chapter 7 : *Presentation and Disclosure*

There was no discussion about the principles of presentation and disclosure in existing Framework. This new Chapter discusses the following aspects:

(i) Communication tools - Information about assets, liabilities, equity, income and expenses is communicated through presentation and disclosure in the financial statements. 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.

(ii) Objectives and principles- It states that balance is needed between giving flexibility to entities and requiring information that is comparable.

(iii) Classification

- It should be based on shared characteristics of assets, liabilities, equity, income and expenses.
- Classification of dissimilar items together obscures information, relevance, understanding and comparability
- Provides high-level guidance on when it may be appropriate to present separately different classes of equity claims, and different components of equity.
- Off-setting is generally not considered appropriate.
- Aggregation is considered useful but balance needs to be maintained to avoid concealing disclosure of relevant information.
- Profit or loss and Other Comprehensive Income: (a) defines or describes profit or loss, (b) sets a ground that all income and expenses are included in the statement of profit or loss. Only in exceptional circumstances, it will be decided to include certain income and expenses in other comprehensive income provided doing so would result in providing more relevant information or reflection of more faithful representation of entity financial performance for the period and (c) whether and when the amounts included in other comprehensive income should be reclassified into the statement of profit or loss.

Chapter 8 : *Concepts of Capital and Capital Maintenance* - By and large contents of this Chapter under existing framework and Conceptual Framework are same.

Appendix Defined Terms – It is a new feature and includes definitions of various terms extracted or derived from relevant paragraphs of Conceptual Framework - ED.

As a consequence to the issuance of Conceptual Framework - ED, certain amendments are also proposed in some of the Ind AS that refers to the Conceptual Framework under Ind AS in place of existing Framework. The Exposure Draft of Conceptual Framework for Financial Reporting under Ind AS along with consequential amendments to references to Conceptual Framework in Ind AS can be accessed at https://resource.cdn.icai.org/57880icaiasb010120.pdf ■