ELEMENTS OF ACCOUNTANCY COMMUNICATION

The International Accounting Standard Board (IASB) Conceptual Framework

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Introduction

The IASB Conceptual Framework consists of a set of fundamental principles and definitions which underlie financial accounting.

The main purpose of the Conceptual Framework is to assist IASB in the development of international standards.

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Introduction

The IASB contribution to the development of a Conceptual Framework is its *Conceptual Framework for Financial Reporting*.

It doesn’t represent an accounting standard and doesn’t override the standards; if there is a conflict between Conceptual Framework and an accounting standard, then the standard prevails.

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Introduction

The complete version of the IASB Conceptual Framework was issued on March 2018, and replaced the Framework for the Preparation and Presentation of Financial Statements, which was issued in 1989 by IASB's predecessor body (IASC – International Accounting Standard Committee).

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Purpose and status of the IASB Conceptual Framework

The IASB Conceptual Framework for Financial Reporting states the objectives of general purpose financial reporting, and then sets out concepts that underlie the preparation of general purpose financial reports.

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Purpose and status of the IASB Conceptual Framework

The main purposes of the Conceptual Framework are:

- to assist IASB in the development of international standards that are based on consistent concepts;

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Purpose and status of the IASB Conceptual Framework

- To assist those who prepare financial reports to develop consistent accounting policies when no international standard applies to a particular transaction event, or when an international standard permits a choice of accounting policy;
- to assist all parties to understand and interpret international standards.

Contents of the IASB Conceptual Framework

1. The objective of general purpose financial reporting;
2. Qualitative characteristics of useful financial information;
3. Financial statements and the reporting entity;
4. The elements of financial statements;

Contents of the IASB Conceptual Framework

5. Recognition and derecognition of the elements of financial statements;
6. Measurement of the elements of financial statements;
7. Presentation and disclosure;
8. Concepts of capital and capital maintenance.

Objective of General Purpose Financial reporting

The Conceptual Framework states that the objective of general purpose financial reporting is:

To provide financial information about the entity that is useful to existing and potential investors, lenders and other creditors, in making decisions relating to providing resources to the entity.

These users are referred to as PRIMARY USERS

Objective of General Purpose Financial reporting

In more detail, the Conceptual Framework states that:

a) Decisions by existing and potential investors depend upon the returns they expect to receive from an investment in the entity concerned (e.g. dividends or increases in the market value of the entity's shares); Decisions by primary users will also depend upon their assessment of the entity's management and its stewardship of the entity's resources.

Objective of General Purpose Financial reporting

b) Primary users rely on General Purpose Financial Reports for much of the information they need. However, these financial reports cannot provide all of the required information, hence primary users will also need information arising from other sources (e.g. general economic forecasts, industry outlooks, etc.).

c) General Purpose Financial Reports are not designed to show the value of the reporting entity; but may help primary users to estimate the entity's value.

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Objective of General Purpose Financial reporting

d) When developing international standards, the IASB seeks to ensure that financial reports prepared in accordance with those standards, will provide information that meets the needs of as many primary users as possible; however, nothing prevents an entity from disclosing additional information that might be useful to a particular subset of primary users.

e) Financial Reports are based to some extent upon estimates, judgements and models, and so they cannot be exact. The Conceptual Framework establishes the concepts that underlie those estimates, judgements and models.

Objective of General Purpose Financial reporting

f) In addition to primary users, other parties might find General Purpose Financial Reports useful. Conceptual Framework doesn’t list these other parties; but the IASC Framework issued in 1989 indicated that users of Financial Reports might also include:

- employees and their representatives, who may use Financial Reports to assess profitability and stability of an entity;
- customers, who may use Financial reports to help them assess whether the entity is likely to continue in business;
- governments and their agencies, who may use information provided in Financial Reports to help determine taxation policies, regulate business, and compile national statistics;
- the public, who may wish to assess an entity’s prosperity and developments in its range of activities.

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Information about an entity's resources and claims

General Purpose Financial Reports provide information about the financial position and financial performance of a reporting entity.

Such financial reports should also provide information about transactions and other events that change the entity's financial position.

Both types of information are useful when making decisions about providing resources to the entity.

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Information about an entity's resources and claims

Note that:

a) Information about an entity's financial position helps primary users to identify that entity's financial strengths and weaknesses, and to assess its liquidity and solvency.

b) Information about an entity's financial performance helps primary users to understand the return the entity has made on resources at its disposal, and whether those resources have been managed efficiently and effectively.

Information about an entity's resources and claims

c) Financial performance information is prepared on an accrual accounting basis; this means that transactions and other events are recognised in the periods in which they occur. However, information about cash flows during a period is also important, since it indicates how an entity generates and spends cash, and helps users to assess the entity's ability to generate future net cash inflows.

d) Information about changes in an entity's financial position not resulting from its financial performance (e.g. changes caused by share issues) is also necessary, since it gives users a complete understanding of how and why the entity's financial position has changed.

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Qualitative characteristics of financial information

The Conceptual Framework identifies six qualitative characteristics of useful financial information. Two of the qualitative characteristics are stated to be fundamental; these are: RELEVANCE and FAITHFUL REPRESENTATION. The remaining four qualitative characteristics are described as enhancing characteristics; they are: COMPARABILITY, VERIFIABILITY, TIMELINESS and UNDERSTANDABILITY.

Each of these characteristics is explained as follows:

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Qualitative characteristics of financial information

RELEVANCE

The first fundamental qualitative characteristic of useful financial information is that it should be relevant to users' decision-making needs. In particular, information is relevant if it has predictive value or confirmatory value, as follows:

a) Information has a predictive value if it can help users to predict future outcomes;
b) Information has a confirmatory value if it provides feedback which helps to confirm or reject previous predictions.

Qualitative characteristics of financial information

FAITHFUL REPRESENTATION

The second fundamental qualitative characteristic of useful financial information is that it must faithfully represent transactions and other events that it purports to represent. A perfectly faithful representation would be: COMPLETE, NEUTRAL and FREE FROM ERROR.

COMPLETENESS: Financial information is complete if it includes all pieces of information required, in order to understand transactions and other events being represented.

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Qualitative characteristics of financial information

NEUTRALITY: A neutral representation is one that is unbiased. The Conceptual Framework states that neutrality is supported by application of prudence, where prudence is the exercise of due caution when making judgements under conditions of uncertainty.

FREEDOM FROM ERROR: Freedom from error implies that there are no errors or omissions in the description of the items being represented; and that no errors have been made when selecting and applying the process used to produce the reported information.

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Qualitative characteristics of financial information

The Conceptual Framework makes it clear that the use of reasonable estimates is essential to the preparation of financial information, and doesn't undermine usefulness of that information as long as the estimates are clearly explained.

Furthermore, financial information must represent the economic substance of transactions and other events.

If the legal form of such transactions and events differs from their economic substance, then providing information only about their legal form wouldn't give a faithful representation. This is the substance over form concept.

Qualitative characteristics of financial information

COMPARABILITY

This characteristic enables users to compare financial information about an entity for a reporting period with similar information about other entities for the same period; and with similar information about the same entity for other periods.

Comparability is improved through consistency. Consistency refers to the use of the same accounting treatments for the same types of items; either from period to period by one reporting entity, or in a single period across entities.

The IASB takes the view that permitting alternative accounting treatment for an item diminishes consistency and therefore diminishes comparability.

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Qualitative characteristics of financial information

VERIFIABILITY

Financial information is said to be verifiable if independent. Verification may be direct or indirect.

- Direct verification involves direct observation (e.g. counting cash).
- Indirect verification involves checking the inputs to a model and then recalculating the outputs of that model.

For example, closing inventory measured by the FIFO cost formula, may be verified by checking inventory movements and costs during the reporting period, and then using the FIFO formula to recalculate closing inventory.

Qualitative characteristics of financial information

TIMELINESS

Financial information is timely if it is made available to users in time for it to be capable of influencing their economic decisions.

UNDERSTANDABILIY

It is clearly desirable that the information provided in financial reports should be understandable by users. Understandability of financial information is improved if it is classified and presented clearly and concisely.

Qualitative characteristics of financial information

Omitting unavoidable complex information for financial reports, on the grounds that it would be difficult to understand is not acceptable, since this would make those reports incomplete.

IASB Conceptual Framework states that financial reports are prepared for users who have a reasonable knowledge of business and economic activities, and who review and analyse information diligently.

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 stewardship of the entity's economic resources.

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financial statements and the reporting entity

This information is provided in the following financial statements:

a) a statement of financial position, which shows or recognises the entity's assets, liabilities and equity (i.e. share capital, retained earnings, and reserves for a company);

b) a statement of financial performance, which shows the entity's income and expenses;

c) other statements and notes presenting information related to matters such as entity's cash flow, contributions received from equity holders (and distributions made to them), and methods, assumptions and judgements used in preparing financial statements

financial statements and the reporting entity

Financial statements are prepared for a specific period of time (i.e. reporting period), and they should also provide comparative information for at least one preceding period.

Financial statements do not typically provide forward-looking information, such as management forecasts.

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Going concern assumption

Conceptual Framework states that financial statements are normally prepared on the assumption that the reporting entity is a going concern, and will continue in operation for the foreseeable future.

It is assumed that the entity has neither the intention nor the need to close down or materially reduce the scale of its operations.

If the reporting entity is not a going concern, financial statements should be prepared on a different basis, and that basis should be disclosed.

Elements relating to financial position

Elements directly related to measurement of financial position are assets, liabilities and equity. They are defined as follows:

an **asset** is 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; other rights include:

- the right to receive money (e.g. trade receivables);
- the right to receive goods or services (e.g. a pre-payment);
- rights over physical items (e.g. PPE or inventories);
- the right to use intellectual property.

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Elements relating to financial position

There is no need for an item to be legally owned by the entity concerned in order that it should qualify as an asset, merely that it should be controlled by the entity.

This means that certain leased items may be classified as assets, and this is an application of the principle of substance over form.

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Elements relating to financial position

An asset can only arise as the result of a past event. Expected future transactions (e.g. the intention to buy an asset) do not give rise to assets at the present time.

An item cannot be classified as an asset unless it has the potential of generating future economic benefits for the entity. But if this potential is low, it is possible that the item might not be recognised as an asset in the entity's statement of financial position.

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Elements relating to financial position

A **liability** is a present obligation of the entity to transfer an economic resource as a result of past events. Note that:

- an essential characteristic of a liability is that the entity must be under an obligation. This means that the entity must have a duty or responsibility to transfer economic resources to another entity;
- a further characteristic of a liability is that the obligation must be a present obligation and not a future commitment (e.g. the decision to buy an asset in the future could be reversed);

Elements relating to financial position

- a present obligation exists as a result of past events, if the entity has already obtained economic benefits (e.g. by receiving goods or services), or has taken an action whereby it is under an obligation of payment;
- an obligation cannot be classified as liability unless it has the potential of requiring the entity to transfer economic resources to another entity.

Elements relating to financial position

Equity is the residual interest in the assets of the entity after deducting all its liabilities. This is an expression of the well-known accounting equation:

ASSETS = LIABILITIES + CAPITAL

The Conceptual Framework uses the term EQUITY rather than CAPITAL. In the case of a company, equity will usually consist of share capital, retained earnings and other reserves.

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Elements relating to financial performance

Elements directly related to the measurement of financial performance are income and expenses; they are defined as follows:

Income is increases in assets or decreases in liabilities that result in increases in equity; other than those related to contributions from holders of equity claims (e.g. share issues).

The term «income» includes both revenue arising in the course of an entity's ordinary activities, and also gains (e.g. gains arising from disposal or revaluation of long-term assets).

Elements relating to financial performance

Expenses are decreases in assets or increases in liabilities that result in decreases in equity, other than those related to distributions to holders of equity claims (e.g. dividends).

The term «expenses» includes both expenses arising in the course of an entity’s ordinary activities, and also losses (e.g. losses arising from disposal or revaluation of long-term assets).

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Recognition of the elements of financial statements

Recognition is defined as:

…. The process of capturing for inclusion in the statement of financial position or the statement of financial performance of an item that meets the definition of one of the elements of financial statements.

Conceptual Framework states that an asset or liability should be recognised only if the recognition of that asset or liability would provide users of financial statements with useful information.

In other words, information provided must be relevant to users' needs and must offer a faithful representation.

Recognition of the elements of financial statements

Recognition might not provide for useful information if (for example):

a) there is uncertainty as to whether the asset or liability exists, or
b) the probability of an inflow or outflow of economic benefits is low, or
c) there is a very high level of measurement uncertainty, so it is impossible to obtain a reasonable estimate of the monetary amount of the asset or liability concerned.

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Derecognition

Derecognition is defined as: the removal of all or part of a recognised asset or liability from an entity's statement of financial position.

Derecognition of an item should occur when the item concerned no longer meets the definition of an asset or liability.

For an asset, this is normally when the entity loses control of that asset.

For a liability, this is normally when the entity no longer has a present obligation for that liability.

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Measurement of the elements of financial statements

Measurement is the process of determining the monetary amount at which an element is to be shown in the financial statements.

The Conceptual Framework identifies several different measurement bases which could be used; they are:

a) **HISTORICAL COST**: Assets are measured at the amount paid to acquire them. Historical cost of an asset will normally be updated overtime so as to reflect matters such as the consumption of all or part of the economic benefits provided by that asset (i.e. depreciation); or events that cause all or part of the historical cost to be irrecoverable (i.e. impairment).

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Measurement of the elements of financial statements

Liabilities are normally measured at the amount of the consideration received in exchange for taking on the obligation concerned.

However, in cases where there is no such consideration (e.g. tax liabilities) it may be necessary to measure a liability at the amount expected to be paid to satisfy the obligation.

Measurement of the elements of financial statements

b) **CURRENT VALUE**: The current value basis measures assets and liabilities by using information which has been updated so as to reflect conditions at the measurement date.

Current value measurement bases include:

- FAIR VALUE: It is defined as the price that would be received to sell an asset, or paid to transfer a liability, in an orderly transaction between market participants at a measurement date.

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Measurement of the elements of financial statements

- VALUE IN USE: The value in use of an asset is the present value of the net cash flows (or other economic benefits) that the entity expects to derive from the use of the asset, and from its eventual disposal.

- Similarly, the fulfilment value of a liability is the present value of the cash (or other economic benefits) that the entity expects to be required to transfer in order to fulfil the liability.

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Measurement of the elements of financial statements

- CURRENT COST: The current cost of an asset is the amount that is to be paid so as to acquire an equivalent asset at the measurement date (replacement cost).

- The current cost of a liability is the amount that would be received for taking on an equivalent liability at the measurement date.

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Selection of measurement basis

Factors which should be considered when choosing a measurement basis include:

a) RELEVANCE. The degree to which a measurement basis provides relevant information is affected by the characteristics of the asset or liability to which it is applied, and the way in which that asset or liability is expected to contribute to the entity’s future cash flows.

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Selection of measurement basis

b) FAITHFUL REPRESENTATION. The degree to which a measurement basis can provide a faithful representation is impacted by the level of uncertainty involved. A further factor to consider is measurement inconsistency. This arises if different measurement bases are used for related assets and liabilities, so that financial statements do not faithfully represent certain aspects of the entity's financial position and performance.

Presentation and disclosure

The Conceptual Framework states that the effective communication of information in an entity's financial statements makes that information more relevant, and contributes to a faithful representation of the entity's assets, liabilities, equity, income and expenses.

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Presentation and disclosure

Effective communication requires that:

a) information is classified in such a way that similar items are grouped together and dissimilar items are separated, and

b) information is aggregated in such a way that both unnecessary details and excessive aggregation are avoided.

Concepts of capital and capital maintenance

As already explained, Conceptual Framework defines income and expenses in terms of changes in an entity's equity.

Therefore, the profit or loss for a reporting period corresponds to the increase (or decrease) in the entity's equity during that period (other than increases/decreases due to contributions by the entity's owners, or distributions to those owners).

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Concepts of capital and capital maintenance

In general, we could say that an entity has maintained its equity if it owns as much equity at the end of a reporting period as it owned at the beginning of that period.

Conceptual Framework distinguishes between two main methods of comparing an entity's equity at the beginning and the end of a reporting period, and so determining the profit (loss) for that period.

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Concepts of capital and capital maintenance

They are:

a) FINANCIAL CAPITAL MAINTENANCE. Under this concept, a profit is earned only if the financial or money amount of an entity’s net assets at the end of a reporting period is greater than the financial or money amount of the net assets at the beginning of that period, after adjusting for any amount contributed by or distributed to equity owners during that period.

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Concepts of capital and capital maintenance

b) PHYSICAL CAPITAL MAINTENANCE. Under this concept, a profit is earned only if the physical operating capability of the entity at the end of an accounting period is greater than its physical operating capability at the beginning of that period, after adjusting for any amount contributed by or distributed to equity owners during that period.

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THANK YOU

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SOURCE:

Alan Melville, INTERNATIONAL FINANCIAL REPORTING, A PRACTICAL GUIDE – EIGHTH EDITION

English edition published 2022 – Copyright Pearson Education Limited 2013, 2022.

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