IFRS in Focus

IASB issues a revised *Conceptual Framework*

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Further information

For more information please see the following websites:

www.iasplus.com

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The International Accounting Standards Board (the IASB) has issued a revised *Conceptual Framework*.

In this edition of IFRS in Focus, we outline the main changes and the key concepts in the revised *Framework*.

The new Framework:

- Reintroduces the terms *stewardship* and *prudence*.
- Introduces a new asset definition that focuses on rights and a new liability definition that is likely to be broader than the definition it replaces, but does not change the distinction between a liability and an equity instrument.
- Removes from the asset and liability definitions references to the expected flow of economic benefits–this lowers the hurdle for identifying the existence of an asset or liability and puts more emphasis on reflecting uncertainty in measurement.
- Discusses historical cost and current value measures, and provides some guidance on how the IASB would go about selecting a measurement basis for a particular asset or liability.
- States that the primary measure of financial performance is profit or loss, and that only in exceptional circumstances will the IASB use other comprehensive income and only for income or expenses that arise from a change in the current value of an asset or liability.
- Discusses uncertainty, derecognition, unit of account, the reporting entity and combined financial statements.

The IASB has also updated references in Standards so that they will refer to the new Framework, but it has not made consequential amendments to Standards to reflect changes in the Framework such as changing the asset and liability definitions in the Standards.

The new Framework came into effect on publication by the IASB.

Overview

The main purpose of the Framework is to guide the IASB when it develops International Financial Reporting Standards. The Framework can also be helpful for preparers and auditors when there are no specific or similar standards that address a particular issue.

The IASB's Framework was published initially in 1989. In 2005 the IASB started working with the US FASB to develop a common Framework. The boards published chapters setting out the objective of general purpose financial reporting and the qualitative characteristics of useful financial information in 2010, and these were incorporated into the IASB's Framework.

The IASB then decided to continue its work alone. In May 2015 it published an exposure draft proposing six new chapters, and some changes to the chapters it had completed with the FASB. The IASB finalised this work and issued a revised Framework on 29 March 2018. It came into effect as soon as it was published, although the practical consequences are unlikely to be significant in the short term.

The new Framework has an introduction, eight chapters and a glossary. Five of the chapters are new, or have been revised substantially: Financial statements and the reporting entity; The elements of financial statements; Recognition and derecognition; Measurement; and Presentation and disclosure. The revised Framework is about three times the length of the version it replaces.

Introduction to the Framework

The introduction clarifies that the purpose of the Framework is to help the IASB develop Standards and to help preparers develop accounting policies when the Standards do not provide relevant guidance.

The Framework does not override the requirements in any Standard. If there is a conflict, or inconsistency, between the Framework and a Standard, the requirements in the Standard take precedence. The IASB has decided not to automatically change existing Standards as a result of the changes it has made to the Framework. The IASB will expose any proposed amendments to an existing Standard just as it would do with any other proposed amendment.

Chapter 1 *The objective of general purpose financial reporting* and Chapter 2 *Qualitative characteristics of useful financial information*

The first two chapters of the new Framework are largely unchanged from the versions issued, with the FASB, in 2010. However, the IASB has reinstated the terms *stewardship* and *prudence.*

Chapter 1 of the Framework published in 2010 said that the primary users of an entity's financial statements need information to help them assess "how efficiently and effectively the entity's management and governing board have discharged their responsibilities to use the entity's resources." In pre-2010 versions of the Framework this was labelled as *stewardship*. The IASB decided to reintroduce that term into the new Framework. The revised Chapter states that users need information to help them assess management's stewardship so that they can hold management to account for resources entrusted to their care. This assessment in turn helps users make decisions about providing resources to the entity, which is the objective of general purpose financial reporting.

In Chapter 2, the IASB reintroduced explicit references to substance over form and prudence. In order for information to represent an economic phenomenon faithfully, that information must reflect the substance of the economic phenomenon and not merely its legal form. That information must also be neutral. Neutrality is supported by the exercise of prudence, which is the exercise of caution when making judgements under conditions of uncertainty. Because neutrality means 'depiction without bias' prudence is not biased towards recognising fewer assets and more liabilities–assets and liabilities should be neither overstated nor understated.

Observations
Although the IASB states that the exercise of prudence does not imply a need for asymmetry between recognising assets and liabilities, it acknowledges that Standards may contain asymmetric requirements. For example, IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* requires a higher recognition threshold for contingent assets than for contingent liabilities. However, the IASB views this as a consequence of selecting a recognition criterion that provides the most relevant information that faithfully represents the underlying economic phenomenon for each case, rather than a deliberate decision to apply asymmetric prudence.

The revised Chapter 2 also includes a section on measurement uncertainty under the qualitative characteristic of faithful representation. The new Framework emphasises that estimates are an essential part of financial reporting and they do not undermine the usefulness of the reported information if the estimates are properly determined and the uncertainties disclosed. Even a high level of measurement uncertainty does not prevent an estimate from providing useful information.

However, the Framework acknowledges the trade-off between measurement uncertainty and relevance. There could be cases when the most relevant information about an economic phenomenon is a measure that has such a high level of estimation uncertainty that it does not faithfully represent the underlying phenomenon, even with additional disclosures. The most useful information about that phenomenon might be a different measure that is less relevant but has less measurement uncertainty.

Measurement uncertainty affects whether an item is recognised and the selection of an appropriate measurement basis for it. This is discussed further in Chapters 5 and 6.

Chapter 3 *Financial statements and the reporting entity*

The material in this chapter is new to the Framework.

The role of financial statements

The new Framework states that financial statements are prepared from the perspective of the entity as a whole, rather than from the perspective of any particular group of investors, lenders or other creditors (the entity-perspective). It is important for matters such as non-controlling interests (NCI) in a group. As far as the reporting entity is concerned, NCI has the characteristics of equity.

This chapter includes the statement (brought forward from the 2010 Framework) that the financial statements are prepared on the assumption that the reporting entity is a going concern and will continue in operation for the foreseeable future.

The reporting entity

A reporting entity is an entity that chooses, or is required, to prepare financial statements.

The most obvious examples of a reporting entity are a single legal structure, such as an incorporated company, and a group comprising a parent and its subsidiaries. The new Framework describes the financial statements of a parent entity as unconsolidated financial statements, which is a new term. IAS 27 *Separate Financial Statements* and other Standards use the term separate financial statements. The financial statements of a group are defined as consolidated financial statements.

A reporting entity need not be a legal entity, but the new Framework acknowledges that it can be difficult to establish clear boundaries when it is not a legal entity, or a parent-subsidiary group. If a reporting entity is not a legal entity, the boundary of the reporting entity should be set by focusing on the information needs of the primary users. Accordingly, the boundary needs to be set in such a way that the financial statements provide relevant information to the primary users that faithfully represents the economic activities of the entity, with specific focus on providing complete and neutral information. A reporting entity could also be a portion of a legal entity, such as a branch or the activities within a defined region. However, the new Framework does not indicate when financial statements could be prepared on a carve-out basis because the IASB notes that it has no authority to make such a decision.

The new Framework also acknowledges combined financial statements. These are financial statements prepared by a reporting entity comprising two or more entities that are not linked by a parent-subsidiary relationship. Again, there is no discussion on when or how entities could prepare them. The IASB concluded that this concept would be best developed as a separate standards-level project, rather than in the Framework.

Chapter 4 *The elements of financial statements*

Chapter 4 discusses the definitions of the elements of financial statements, i.e. assets, liabilities, equity, income and expenses. The IASB has changed the definitions of an asset and a liability. The definitions of the other elements remain largely unchanged.

	2010 Framework definition	New Framework 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.	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.)
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.	A present obligation of the entity to transfer an economic resource as a result of past events.

Removal of the reference to 'expected flow of economic benefits'

The most significant change to the asset and liability definitions is the removal of the reference to the expected flow of economic benefits. A similar change has been made to remove the probability criterion from the recognition criteria (see Chapter 5).

The IASB made these amendments because some people associated the word 'expected' with a probability threshold. This association made the presence of the probability recognition criterion superfluous. Furthermore, the IASB considered the concept of a probability threshold problematic because it excludes many items that are clearly assets and liabilities from being recognised, e.g. an out-of-the-money option because it is unlikely to be exercised.

The focus of the definitions is now on the existence of a right (or an obligation) that has the *potential* to produce (or require an entity to transfer) economic benefits. For that potential to exist it does not need to be certain, or even likely, that the right will produce economic benefits. It is only necessary that in at least one circumstance it would produce economic benefits, however remote that occurrence might be. This means that a right can meet the definition of an economic resource, and hence can be an asset, even if the probability of its producing economic benefits is low. The same goes for an obligation. However, the new Framework also states that recognising an item that has a very low probability of producing or requiring the transfer of economic benefits might not provide relevant information. Accordingly, the IASB could decide that some items that meet the definition of asset or liability should not be recognised.

Asset

Rights

The chapter contains an expanded discussion on what constitutes 'rights'. The IASB has shifted the focus away from viewing an economic resource as an object as a whole to viewing it as a set of rights–the right to use, sell, or pledge the object, as well as other undefined rights.

In principle, each right could be a separate asset. However, so as to present the underlying economics in the most concise and understandable way, related rights will most commonly be viewed collectively as a single asset that forms a single unit of account (e.g. recognising a ship as a single asset instead of recognising the different rights underlying the ownership of the ship as different assets).

Observations
Componentisation of rights in this manner is consistent with the IASB's recent decisions on recognising a right-of-use asset in IFRS 16 *Leases*. The IASB drew on some concepts developed in recent projects when developing the revised Framework because they reflect the IASB's most updated thinking on these matters.

Control
Control links a right (i.e. the economic resource) to an entity.

The concept of control mirrors the one in IFRS 10 *Consolidated Financial Statements* and IFRS 15 *Revenue from Contracts with Customers*. In other words, control encompasses both a power and a benefits element: an entity must have the present ability to direct how a resource is used and be able to obtain the economic benefits from that resource in order to control it. An economic resource can be controlled by only one party at any point in time.

Liability
The new liability definition, and the definition it replaces, require that a present obligation be as a result of past events. However, the IASB has been looking more closely at situations when an entity has the ability to avoid having to transfer economic resources to another party, but only by taking what the IASB would consider extreme or impractical steps.

No practical ability to avoid the transfer
The new Framework says that an obligation is a duty or responsibility that an entity has no practical ability to avoid.

The focus is on whether the entity has the *practical ability* to avoid a transfer of economic resources as opposed to whether it has a theoretical right to avoid the transfer (the theoretical concept is used in IAS 37 as interpreted by IFRIC 21 *Levies*). This means that:

- Neither management's intention nor the likelihood of a transfer affects the practical ability assessment.
- An entity may have no practical ability to avoid a transfer if any action that it could take to avoid the transfer would have economic consequences significantly more adverse than the transfer itself.
- Preparing financial statements on a going-concern basis implies that the entity has no practical ability to avoid a transfer that could be avoided only by liquidating the entity or by ceasing to trade.

The Framework does not provide detailed guidance on how to make this assessment because whether an entity has the practical ability to avoid a transfer will depend on the nature of the entity's obligation.

Present obligation as a result of past events
A present obligation exists as a result of past events only if:

- the entity has already obtained economic benefits, or taken an action; and
- as a consequence, the entity will or may have to transfer an economic resource that it would not otherwise have had to transfer.

The new Framework clarifies that if new legislation is enacted, a present obligation arises only when an entity obtains economic benefits, or takes an action, within the scope of that legislation. The enactment of legislation is not in itself sufficient to give an entity a present obligation.

Observations

The IASB has not changed how an entity would distinguish between a liability and an equity instrument. This is being explored in the *Financial Instruments with the Characteristics of Equity* research project. A discussion paper is expected to be published later in 2018. Depending on the outcome of that project, the Framework could eventually be amended.

Unit of account

The concept of unit of account has proven to be a difficult topic for the IASB in recent years. It affects decisions about recognition, derecognition, measurement as well as presentation and disclosure.

The new Framework notes that how the unit of account is determined depends on the specific features of an item and cannot be established at a conceptual level. The unit of account, recognition and measurement requirements for a particular item are linked and the IASB will consider these aspects together when developing standards. It is possible that the unit of account for recognition will differ from that used for measurement for a particular matter–e.g. a Standard might require contracts to be recognised individually but measured as part of a portfolio.

Chapter 5 *Recognition and derecognition*

Revised recognition criteria

The revised recognition criteria require an entity to recognise an asset or a liability (and any related income, expenses or changes in equity) if such recognition provides users of financial statements with:

- relevant information; and
- a faithful representation of the underlying transaction.

The recognition criteria no longer include a probability or a reliable measurement threshold. Instead, uncertainty about the existence of an asset or liability or a low probability of a flow of economic benefits are noted as circumstances when recognition of a particular asset or liability might not provide relevant information.

For an asset or liability to be recognised it must also be measured. Most measures must be estimated, which means that they will be measured with some uncertainty. The Framework discusses the trade-off between providing a more relevant measure that has a high level of estimation uncertainty and a measure that might be less relevant but has lower estimation uncertainty. In limited circumstances all relevant measures may be subject to high measurement uncertainty, such that the asset or liability should not be recognised.

The chapter provides a high-level overview of how different types of uncertainty (e.g. existence, outcome and measurement) could affect the recognition decision. There is no detailed guidance, because it is a matter of assessing several factors that will depend on the facts and circumstances of each case. The IASB will consider these factors when developing Standards. It might be that some uncertainties should result in more supplementary information being provided by reporting entities.

Observations

The IASB decided to remove the probability criterion and to incorporate the reliable measurement criterion into the 'faithful representation' criterion because the existing recognition requirement (probability and reliable measurement) has caused problems in the past. Some Standards do not apply the probability criterion whilst others apply different probability thresholds. The reliable measurement criterion, on the other hand, is often associated with measurement uncertainty.

The removal of the probability criterion is consistent with the removal of the reference to the expected flow of economic benefits from the definitions of an asset and a liability (see Chapter 4 above). Their removal was not without contention. Some respondents to the exposure draft were concerned that the revised criteria would result in more assets and liabilities being recognised. The IASB emphasised that it did not intend to increase or decrease the range of assets and liabilities to be recognised when developing the revised recognition criteria.

Some respondents were concerned that the revised recognition criteria were too abstract and subjective and would lead to different interpretations of what information is relevant and whether it faithfully represents the underlying economic phenomenon. They were concerned that the lack of specific guidance could lead to diversity in practice. In contrast, the IASB believe the revised recognition criteria to be principle-based and that they will help it set recognition requirements for individual Standards.

Derecognition

The new Framework states that derecognition should aim to represent faithfully both:

- any assets and liabilities retained after the transaction that led to the derecognition; and
- the change in the entity's assets and liabilities as a result of that transaction.

The focus of this section is on cases when these two aims conflict. This is sometimes the case when an entity disposes of only part of an asset or a liability or retains some exposure. The Framework sets out the factors that the IASB should consider when assessing whether derecognition will meet both of the aims noted above. In situations when derecognition supported by disclosure is not sufficient to meet both aims, it might be necessary for an entity to continue to recognise the transferred component.

The two aims are akin to the control approach and the risks-and-rewards approach to derecognition respectively. However, the IASB chose not to specify the use of the either approach because it views both as valid and that neither approach trumps the other.

The chapter includes a discussion on how derecognition works in the case of contract modifications.

Chapter 6 *Measurement*

The material in this chapter is new to the Framework.

Chapter 6 discusses:

- the different measurement bases and the information they provide; and
- the factors to consider when selecting a measurement basis.

Measurement bases

The new Framework describes two measurement bases: historical cost and current value. The Framework asserts that both bases can provide predictive and confirmatory value to users but one basis might provide more useful information than the other under different circumstances. As such, the Framework does not favour one measurement basis over the other.

Historical cost

Historical cost reflects the price of the transaction or other event that gave rise to the related asset, liability, income or expense.

Current value

A current value measurement reflects conditions at the measurement date. Current value includes:

- fair value,
- value in use (for assets) and fulfilment value (for liabilities), and
- current cost.

The table below describes each measurement basis.

Measurement basis	Information provided by the measurement basis	Entry or exit value?
Historical cost	**Asset** Historical cost, including transaction costs, to the extent unconsumed (or uncollected) and recoverable. It includes interest accrued on any financing component. **Liability** Historical consideration as yet owing in respect of goods and services received (net of transaction costs), increased by any onerous provision. It includes interest accrued on any financing component.	Entry
Fair value (market participant assumptions)	The price that would be received to sell an asset, or paid to transfer a liability, in an orderly transaction between market participants at the measurement date. It excludes any potential transaction costs on sale or transfer.	Exit
Value in use/ Fulfilment value (Entity-specific assumptions)	**Asset** Present value of future cash flows from the continuing use of the asset and from its disposal, net of transaction costs on disposal. **Liability** Present value of future cash flows that will arise in fulfilling the liability, including future transaction costs.	Exit
Current cost	**Asset** Consideration that would be given to acquire an equivalent asset at measurement date plus transaction costs. It reflects the current age and condition of the asset. **Liability** Consideration that would be received to incur an equivalent liability at measurement date minus transaction costs.	Entry

Factors to consider when selecting a measurement basis

The objective in selecting a measurement basis is consistent with that of financial statements: i.e. to provide relevant information that faithfully represents the underlying substance of a transaction.

As part of this selection process, the new Framework says that it is important to consider the nature of the information that the measurement basis will produce in both the statement of financial position and the statement of financial performance. The relative importance of the information presented in these statements will depend on facts and circumstances.

Relevance

The Framework states that the characteristics of the asset or liability and how it contributes to future cash flows are two of the factors that can affect whether a particular measurement basis provides relevant information. For example, if an asset is sensitive to market factors, fair value might provide more relevant information than historical cost. However, depending on the nature of the entity's business activities, and thus how the asset is expected to contribute to future cash flows, fair value might not provide relevant information. This could be the case if the entity holds the asset solely for use or to collect contractual cash flows rather than for sale.

Faithful representation

The Framework states that a high level of measurement uncertainty does not render a particular measurement basis irrelevant. However, a balance must be achieved between relevance and faithful representation. This echoes the trade-off that may sometimes be required between relevance and measurement uncertainty as set out in Chapter 2.

Other considerations

The Framework does not preclude the use of different measurement bases for an asset or a liability in the statement of financial position and the related income and expenses in the statement of financial performance. However, it notes that in most cases, using the same measurement basis in both statements would provide the most useful information.

The Framework states that it would be normal to select the same measurement basis for the initial measurement of an asset or a liability that will be used for its subsequent measurement, to avoid recognising a 'day-2 gain or loss' solely due to a change in measurement basis.

No single factor is determinative when selecting an appropriate measurement basis. The relative importance of each factor will depend on facts and circumstances.

Chapter 7 *Presentation and disclosure*

The material in this chapter is new to the Framework.

This chapter includes high-level concepts about how information should be presented and disclosed. It also includes high-level principles on the use of other comprehensive income (OCI).

Observations

The IASB is currently working on the Disclosure Initiative, which is a collection of projects aimed at improving disclosure in financial reporting. In the Disclosure Initiative, the IASB will consider developing new concepts for the Framework to provide additional guidance on presentation and disclosure.

The IASB is also working on a research project on primary financial statements. The objective of that project is to make targeted improvements to the structure and content of the statement of financial performance.

Communication tools

The Framework states that including presentation and disclosure objectives in Standards can support effective communication. It also states that when developing presentation and disclosure requirements in Standards, the IASB needs to consider the balance between giving entities the flexibility to provide relevant information and requiring information that is comparable.

The use of other comprehensive income

The Framework states that the statement of profit or loss is the primary source of information about an entity's financial performance for the reporting period. The Framework presumes that all income and expenses are presented in profit or loss. Only in exceptional circumstances will the IASB decide to exclude an item of income or expense from profit or loss and include it in OCI, and only for income or expenses that arise from a change in the current value of an asset of liability.

The Framework also presumes that items presented in OCI will be reclassified from OCI to profit or loss, but reclassification must provide more relevant information than not reclassifying the amounts. If there is no clear basis that this will result in more useful information about an entity's profit or loss in a future period, the IASB may decide that reclassification should not take place.

Observations

The IASB concluded that it is not possible to make a conceptual distinction between profit or loss and OCI. As a result, the new Framework does not specify when including particular items in OCI may be appropriate, nor does it specify when subsequent reclassification may be appropriate. The IASB will make these decisions when developing Standards.

Chapter 8 *Concepts of capital and capital maintenance*

This chapter has been carried forward unchanged from the 2010 Framework (which, in turn, was carried forward from the 1989 Framework).

Effective date

The new Framework became effective as soon as it was published on 29 March 2018.

Updating References in Standards to the revised *Conceptual Framework*

Some Standards include references to the 1989 and 2010 versions of the Framework. The IASB has published a separate document *Updating References to the Conceptual Framework* which contains consequential amendments to affected Standards so that they refer to the new Framework. These amendments are effective for annual periods beginning on or after 1 January 2020, with earlier application permitted.

There is one exception. IFRS 3 *Business Combinations* states that, in a business combination, identifiable assets acquired and liabilities assumed must meet the definitions of assets and liabilities in the Framework. IFRS 3 refers to both the 1989 and 2010 Frameworks. The definitions of asset and liability in those Frameworks are also in IFRS Standards. IAS 38 *Intangible Assets* includes the 1989 and 2010 Framework definition of an asset and IAS 37 has the 1989 and 2010 Framework definition of a liability.

The IASB decided not to amend IFRS 3 at this stage, because they are concerned that an item that meets the definition of an asset or liability when the new Framework is applied might need to be derecognised immediately because it does not meet the asset or liability definition in IFRS Standards. The IASB will explore this issue in a separate narrow-scope project.

Further information

The new Framework is available on the IFRS Foundation website for holders of a professional or comprehensive eIFRS subscription. The new Framework will be included in the next updated set of unaccompanied Standards, which are available free of charge to registered users. That update is expected early in 2019.

If you have any questions about the new Framework, please speak to your usual Deloitte contact or get in touch with a contact identified in this IFRS in Focus.

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Designed and produced by The Creative Studio at Deloitte, London. J15739-1