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IASB Proposes Revisions to Its Conceptual Framework

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Introduction

In May 2015, the IASB released an exposure draft (ED)[1] that proposes revisions to its conceptual framework for financial reporting.[2] The purpose of the proposal is to clarify, update, and fill in gaps in the IASB's existing framework, which addresses a range of fundamental accounting topics, such as determining what is an asset or liability. Comments on the ED are due by October 26, 2015. The IASB expects to complete the revisions in 2016.

Editor's Note: The IASB uses the framework as a guide in developing IFRSs based on consistent concepts. Further, preparers use the framework when creating accounting policies related to topics that are not specifically addressed in IFRSs or when selecting or changing accounting policies related to topics for which IFRSs give a choice of accounting policies. An entity that has developed or selected an accounting policy on the basis of the current framework should identify and understand any revision to the framework that might affect the appropriateness of such a policy. An entity might be required to change its policy if it is inconsistent with the revised framework. The IASB proposes a transition period of approximately 18 months for such changes.

When the framework conflicts with a specific IFRS, the requirements of the IFRS apply. The proposed revised framework is inconsistent with existing IFRSs in two key respects: (1) its definitions of liabilities and equity are inconsistent with the approach to classifying financial instruments as liabilities or equity under IAS 32[3] (e.g., share-settled debt and certain puttable instruments) and (2) its guidance on liabilities is inconsistent with the accounting for levies under IFRIC 21.[4]

Project Overview

The IASB framework was originally published in 1989. In 2004, the IASB and FASB began a joint project to develop a common framework. That project resulted in the boards' 2010 issuance of two chapters of a shared framework[5] that discuss the objective of general-purpose financial reporting and the qualitative characteristics of useful financial information. In addition, the boards published a joint ED[6]

[1] IASB Exposure Draft, *Conceptual Framework for Financial Reporting*.
[2] Simultaneously, the IASB released an ED that would amend existing IFRSs to update references to the framework. That ED proposes a transition period of approximately 18 months, with early application permitted.
[3] IAS 32, *Financial Instruments: Presentation*.
[4] IFRIC Interpretation 21, *Levies*.
[5] FASB Concepts Statement No. 8, *Conceptual Framework for Financial Reporting — Chapter 1*, The Objective of General Purpose Financial Reporting, *and Chapter 3*, Qualitative Characteristics of Useful Financial Information — a replacement of FASB Concepts Statements No. 1 and No. 2.
[6] IASB Exposure Draft, *Conceptual Framework for Financial Reporting — The Reporting Entity*.

on the concept of a reporting entity in March 2010. (For a discussion of this ED, see Deloitte's March 25, 2010, *Heads Up*.)

However, the IASB and FASB discontinued work on their joint framework project in 2010 to focus on more urgent projects. The IASB initiated an IASB-only project to revise its framework in 2012, and the FASB began a separate, FASB-only project in 2014. Accordingly, we no longer expect the two boards to develop a common framework.

In 2013, the IASB published a discussion paper[7] containing its preliminary views on a range of fundamental accounting topics, such as determining what an asset or liability is and distinguishing between liabilities and equity. (See Deloitte's August 26, 2013, *Heads Up* for more information.) The FASB is currently deliberating disclosure, presentation, and measurement issues. In March 2014, the FASB issued an ED[8] describing a proposed disclosure framework that the Board would use in setting disclosure requirements. (For a discussion of this ED, see Deloitte's March 6, 2014, *Heads Up*.) The FASB's discussions related to measurement and presentation are still in an initial stage.

Overview of the ED

The proposed revised conceptual framework contains the following eight chapters (which are discussed in greater detail below):

Chapter	Title	Proposed Revisions
1	"The Objective of General Purpose Financial Reporting"	Limited changes emphasizing the importance of information for assessing management's stewardship of an entity's resources.
2	"Qualitative Characteristics of Useful Financial Information"	Limited changes reintroducing a reference to the notion of prudence and providing guidance on the concept of substance over form and the impact of measurement uncertainty.
3	"Financial Statements and the Reporting Entity"	New chapter describing the role of financial statements, including the going-concern assumption, and the definition of a reporting entity.
4	"The Elements of Financial Statements"	New chapter proposing conceptual definitions of assets, liabilities, equity, income, and expenses.
5	"Recognition and Derecognition"	New chapter proposing recognition criteria and discussing the aim of derecognition requirements.
6	"Measurement"	New chapter describing measurement bases and factors for an entity to consider when selecting measurement bases.
7	"Presentation and Disclosure"	New chapter proposing high-level concepts about information included in the financial statements and how that information is presented and disclosed as well as guidance on reporting comprehensive income and the use of other comprehensive income (OCI).
8	"Concepts of Capital and Capital Maintenance"	Minor changes to the existing IASB framework.

7 IASB Discussion Paper, *A Review of the Conceptual Framework for Financial Reporting*.
8 FASB Proposed Concepts Statement, *Conceptual Framework for Financial Reporting: Chapter 8: Notes to Financial Statements*.

Detailed Summaries of the Framework Chapters

Chapter 1, "The Objective of General Purpose Financial Reporting"

The IASB is proposing only limited changes to the first two chapters of the framework. Proposed changes to chapter 1 include new guidance on stewardship and primary users of financial statements. According to paragraph 1.22 of the ED, "[i]nformation about how efficiently and effectively the entity's management has discharged its responsibilities to use the entity's resources helps users assess management's stewardship of those resources" and predict how efficiently and effectively these resources will be used in the future. In addition, the ED proposes that the terms "user" and "primary user" should refer to "those existing and potential investors, lenders and . . . creditors who must rely on general purpose financial reports for much of the financial information they need."

> **Editor's Note:** Chapters 1 and 2 of the IASB's framework are currently converged with two chapters of the FASB's conceptual framework (although the FASB numbers the IASB's chapter 2 as its chapter 3).[9] Therefore, any changes that the IASB makes to these chapters would cause differences between the two frameworks.

Chapter 2, "Qualitative Characteristics of Useful Financial Information"

The ED would add a discussion about measurement uncertainty to chapter 2 of the framework. While the use of estimates is essential to the preparation of financial information, an item with a high level of measurement uncertainty is less relevant than one with a low measurement uncertainty.

In addition, paragraph 2.14 of the ED states that "faithful representation provides information about the substance of an economic phenomenon instead of merely providing information about its legal form." In particular, when the legal form differs from the economic substance, information only about the legal form "would not result in a faithful representation."

Further, paragraph 2.18 of the ED points out that financial statement neutrality "is supported by the exercise of prudence." The ED defines prudence as "the exercise of caution when making judgements under conditions of uncertainty." When prudence is properly applied, assets and liabilities are neither overstated nor understated.

Chapter 3, "Financial Statements and the Reporting Entity"

Chapters 3–7 of the ED are new. Chapter 3 discusses the role of financial statements and the concept of a reporting entity.

The Role of Financial Statements

The ED describes the role of financial statements and indicates that "financial statements are prepared from the perspective of the entity as a whole, instead of from the perspective of any particular group of investors, lenders or . . . creditors." In addition, the ED "sets out the going concern assumption, which has been brought forward largely unchanged from the existing [framework]."

[9] The FASB released those chapters in Concepts Statement 8.

The Reporting Entity

The ED discusses the definition and "boundary" of a reporting entity.

Editor's Note: In developing the discussion about reporting entities, the IASB took into consideration comments received on its ED on this topic, which the IASB issued jointly with the FASB in March 2010.

The ED defines a reporting entity as "an entity that chooses, or is required, to prepare general purpose financial statements." Paragraph 3.14 of the ED states that either of the following can be used to determine the boundary of a reporting entity:

- Direct control only, in which case the parent reports only on its own assets and liabilities (unconsolidated financial statements).
- Both direct and indirect control, in which case the reporting entity reports on both its own assets and liabilities and those of its subsidiaries (consolidated financial statements).

The ED notes that unconsolidated financial statements can contain useful information but are not a substitute for consolidated financial statements. An entity that prepares unconsolidated financial statements should disclose how users can obtain the consolidated financial statements.

Further, the ED acknowledges that combined financial statements that are "prepared for two or more entities that do not have a parent-subsidiary relationship" can sometimes contain useful information. However, the ED does not discuss when or how entities would prepare such financial statements.

Chapter 4, "The Elements of Financial Statements"

Chapter 4 discusses the definitions of the elements of financial statements. These elements comprise assets, liabilities, and equity (which provide information about the reporting entity's financial position) as well as income and expenses (which provide information about the reporting entity's financial performance).

Definitions of Asset, Liability, and Equity

	Existing IASB Definition	Existing FASB Definition	Proposed IASB Definition
Asset	An asset is 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 are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.	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.
Liability	A liability is 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.	Liabilities are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities as a result of past transactions or events.	A liability is a present obligation of the entity to transfer an economic resource as a result of past events.
Equity	Equity is the residual interest in the assets of the entity after deducting all its liabilities.	Equity, or net assets, is the residual interest in the assets of an entity that remains after deducting its liabilities.	No change to the existing IASB definition.

Editor's Note: The FASB's Concepts Statement 6[10] contains its definitions of assets, liabilities, and equity (or net assets) as described in the middle column above. As with the existing IASB framework, the FASB's current definitions of assets and liabilities require that a flow of economic benefits be probable.

The Role of Probability in the Definitions of Assets and Liabilities

The ED proposes that the definitions of assets and liabilities should not require an "expected" or "probable" inflow or outflow. According to the ED, it should be sufficient that a resource or obligation has the "potential to produce [or to transfer] economic benefits," and this is reflected in the proposed definitions. For example, a stand-ready obligation to transfer resources if a specified, uncertain event outside the entity's control (e.g., an insurance contract obligation or guarantee obligation) occurs would qualify as a liability even though the obligation to transfer resources is conditional. However, outcome uncertainty may affect the measurement of an asset or liability.

Editor's Note: The existing IASB framework's definitions of assets and liabilities require an expectation of future economic benefits or a future outflow of resources. In addition, the guidance requires that a flow of future economic benefits be "probable." Some interpret these definitions as meaning that an asset or liability does not exist or should not be recognized unless a minimum probability threshold is met. This interpretation raises the question of whether, for example, a purchased option that is not expected to be exercised qualifies as an asset or whether a written guarantee that is not expected to be called upon qualifies as a liability. Further, it is unclear whether the references to expectations and probable flows refer to uncertainty about the existence of an asset or a liability (e.g., litigation over whether an obligation exists) or uncertainty about the outcome (e.g., uncertainty about whether an entity will collect a receivable or the potential exercise of an option).

The Focus on Rights

The existing asset definition uses the term "resource." The proposed definition uses the term "economic resource," which is "a right that has the potential to produce economic benefits." The term "economic resource" helps emphasize that the resource in question is not, for example, a physical object (e.g., an item of property, plant, and equipment) but a right (or set of rights) over that physical object. This is a shift away from accounting for physical objects and toward accounting for different rights composing economic resources. However, the ED acknowledges that "describing the set of rights as the physical object will often provide the most concise, clear and understandable information."

Rights that constitute economic resources may take various forms; they may be established by contract, legislation, or similar means; they may arise from a constructive obligation of another party; or they may arise from legal ownership of a physical object, such as the right to use the object, the right to sell the object, and the right to pledge the object.

[10] FASB Concepts Statement No. 6, *Elements of Financial Statements*.

Editor's Note: Under the existing definition, an asset can be a physical object. For example, an entity that leases a ship considers the ship itself in determining whether it should be recorded in the statement of financial position and records the whole ship in this statement.

Under the proposed definition, an asset could be an individual right in a bundle of rights; therefore, in the above scenario, the entity would record the right to use the ship rather than the ship itself.

Control of an Economic Resource

The ED proposes that the framework's concept of control be in line with its definition of an asset. Specifically, paragraph 4.18 of the ED states that "[a]n entity controls an economic resource if it has the present ability to direct the use of the economic resource and obtain the economic benefits that flow from it."

An assessment of control helps an entity determine what economic resources it should account for. Paragraph 4.17 of the ED cites the example of an entity that has "a right to a proportionate share in a property without controlling the entire property." This paragraph further indicates that "[i]n such cases, the entity's asset is its share in the property, which it controls, not the property itself, which it does not."

Present Obligation

Both the existing and proposed liability definitions require a present obligation as a result of past events. Under the existing framework, questions have arisen in practice because, when an event has occurred that could result in a future transfer of economic resources but an entity still has some ability to avoid the transfer, it is unclear how limited this ability must be for the entity to have a "present obligation." The ED proposes that two conditions must be met for a present obligation to exist:

- "[T]he entity has no practical ability to avoid the transfer."
- "[T]he obligation has arisen from past events; in other words, the entity has received the economic benefits, or conducted the activities, that establish the extent of its obligation."

Editor's Note: The IASB is not currently proposing any changes to the definitions of liabilities and equity to address issues related to the classification of instruments with characteristics of both liabilities and equity. Some of the guidance in IAS 32 on classifying financial instruments as liabilities or equity conflicts with the definitions in the framework (e.g., the classification of share-settled debt and certain puttable instruments). These issues are being explored in a separate research project.

Definitions of Income and Expenses

The IASB proposes continuing with the existing approach of defining income and expenses in terms of changes in assets and liabilities.

Chapter 5, "Recognition and Derecognition"

The Recognition Process

The ED defines recognition as the "process of capturing, for inclusion in the statement of financial position or the statement(s) of financial performance, an item that meets the definition of an element."

Recognition Criteria

Under the ED, an entity would recognize an asset or a liability if such recognition provides financial statement users with:

- "[R]elevant information about the asset or the liability and about any income, expenses or changes in equity."
- "[A] faithful representation of the asset or the liability and of any income, expenses or changes in equity."
- "[I]nformation that results in benefits exceeding the cost of providing that information."

Editor's Note: The existing recognition requirements (probability and reliable measurement) have caused issues in the past. Under some IFRSs (e.g., IFRS 9[11]), an entity is not required to apply the probability criterion at all, while other IFRSs use the term "probable" ambiguously. The IASB therefore proposes that the probability criterion be removed and that an entity consider probability and reliable measurement in assessing the relevance of financial information.

Under U.S. GAAP, the FASB's Concepts Statement 5[12] contains four criteria for recognition of an item:

- "The item meets the definition of an element of financial statements."
- "It has a relevant attribute measurable with sufficient reliability."
- "The information about it is capable of making a difference in user decisions."
- "The information is representationally faithful, verifiable, and neutral."

Those criteria are "subject to a cost-benefit constraint and a materiality threshold."

Paragraph 5.18 of the ED indicates that a low probability of a flow of economic benefits does not in and of itself preclude recognition, "especially if the measurement of the asset or the liability reflects the low probability and is accompanied by explanatory disclosures."

Derecognition

The ED defines derecognition as "the removal of all or part of a previously [recognized] asset or liability from an entity's statement of financial position." Derecognition is not appropriate when an entity has retained control of an economic resource. Paragraph 5.29 of the ED notes that an entity's retention of "exposure to positive or negative variations in the amount of economic benefits produced by an economic resource" may indicate that the entity has retained control of that resource.

Chapter 6, "Measurement"

The ED defines measurement as "the process of quantifying, in monetary terms, information about an entity's assets, liabilities, equity, income and expenses." The ED describes two categories of measurement bases: historical cost and current value.

Historical Cost

The focus of measures based on historical cost is the past transaction or event that created an asset, liability, income, or expense. For an asset, the historical cost at initial recognition is "the value of all the costs incurred in acquiring or constructing the asset, including both the consideration given and the transaction costs incurred." For a financial liability, this cost is the value of the consideration less

[11] IFRS 9, *Financial Instruments*.
[12] FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*.

transaction costs. This measure is subsequently adjusted for consumption, impairment, and fulfillment changes but not for price changes.

The ED suggests that income or expenses measured at historical cost can have predictive value (i.e., an entity can assess the impact of those changes on future cash flows or margins). They can also have confirmatory value when an entity compares them with previous estimates of cash flows or margins.

However, information about the historical cost of assets and liabilities can sometimes be less relevant than information about current cost, especially if the price changes are significant.

Current Value

Current values include fair value and value in use for assets and fulfillment value for liabilities.

Paragraph 6.28 of the ED indicates that it can be predictive to measure assets and liabilities at fair value since such measurement takes into account market participants' expectations about "the amount, timing and uncertainty of the cash flows." Such measurement can also be confirmatory "by providing feedback about previous estimates." Fair value measurement of income and expenses can only be predictive and confirmatory when it is split (e.g., into the expected return, the return generated by the entity's use, and the effect of changes in market participants' expectations).

The ED suggests that if the business activities do not involve selling an asset or transferring a liability, the fair value measurement of income and expenses may not constitute useful information. However, the measurement of identical assets and liabilities at fair value increases comparability since such assets or liabilities are measured at the same amount regardless of when they are acquired or incurred.

While fair value is market-specific, value in use and fulfillment value are entity-specific. The ED defines value in use as the "present value of the cash flows that an entity expects to derive from the continuing use of an asset and from its ultimate disposal." Further, fulfillment value is defined as "the present value of the cash flows that an entity expects to incur as it [fulfills] a liability."

Value in use and fulfillment value have predictive value since they contain information about the estimated cash inflows and outflows of the asset or liability. Both have confirmatory value because they allow an entity to compare previous values with actual outcomes.

Selecting a Measurement Basis

Paragraph 6.49 of the ED states that a measurement basis "must be relevant and it must faithfully represent what it purports to represent." Factors for an entity to consider when selecting one of the above-described measurement bases include the way an asset or a liability will contribute to future cash flows (e.g., if it is held for sale or use), the asset's or liability's characteristics, and the measurement uncertainty.

Measurement of Equity

Paragraph 6.78 of the ED states that "equity is not measured directly" but "equals the total of the carrying amounts of all [recognized] assets less the total of the carrying amounts of all [recognized] liabilities." However, individual classes or categories of equity may be measured directly.

Editor's Note: The FASB's Concepts Statement 5 contains limited guidance on measurement attributes (e.g., historical cost, current cost, current market value, net realizable (settlement) value, and present (or discounted) value of future cash flows). In addition, FASB Concepts Statement 7[13] discusses the use of present value techniques. The FASB has begun discussing issues related to the development of a new concepts statement on measurement. The next step of this project is yet to be determined.

Chapter 7, "Presentation and Disclosure"

This chapter discusses what information is included in financial statements and how that information should be presented and disclosed. The chapter also includes guidance on reporting financial performance, including the use of OCI.

The Objective and Scope of Financial Statements

Paragraph 7.2 of the ED states that the "scope of financial statements is determined by their objective, which is to provide information about an 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 entity and in assessing management's stewardship of the entity's resources."

Further, the ED notes that "[f]orward-looking information about likely or possible future transactions and events is included in financial statements only if that information is relevant to understanding the entity's assets, liabilities and equity that existed at the end of, or during, the period (even if they are [unrecognized]), or income and expenses for the period."

Presentation and Disclosure as Communication Tools

The ED emphasizes that "[e]fficient and effective communication of [information in financial statements] improves its relevance and contributes to a faithful representation of the assets, liabilities, equity, income and expenses."

The ED gives several examples of efficient and effective communication:

- "[C]lassifying information in a structured manner that reports similar items together and reports dissimilar items separately."
- "[A]ggregating information so that it is not obscured by unnecessary detail."
- "[U]sing presentation and disclosure objectives and principles instead of rules that could lead to a purely mechanistic compliance."

Editor's Note: The IASB is also undertaking a disclosure initiative — that is, implementation and research projects aimed at improving disclosures in IFRS financial reporting. In its Basis for Conclusions, the IASB states that as part of the disclosure initiative, it will seek to provide additional guidance to support the application of the presentation and disclosure concepts proposed in the ED.

In March 2014, the FASB issued an ED describing the proposed disclosure framework that it would use in setting financial statement note requirements (see Deloitte's March 6, 2014, *Heads Up* for a discussion of this ED). Further, the FASB has begun discussing issues related to the development of conceptual presentation guidance (e.g., presentation of line items in the financial statements). The next step of this project is yet to be determined.

[13] FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*.

Information About Financial Performance

The ED describes the statement of profit or loss as the "primary source of information about an entity's financial performance for the period, and requires a total or subtotal for profit or loss to be provided."

Further, the ED notes that because the statement of profit or loss is "the primary source of information about an entity's financial performance for the period, there is a rebuttable presumption that all income and all expenses will be included in that statement." This presumption can only be rebutted if:

- "[T]he income or expenses relate to assets or liabilities measured at current values."
- "[E]xcluding those items from the statement of profit or loss would enhance the relevance of the information in the statement of profit or loss for the period."

The presumption can only be rebutted by the IASB when setting standards, not by preparers in applying the standards.

One example in which the exclusion of income/expenses from profit or loss may enhance its relevance is the selection of (1) a current measurement basis for an asset or liability for the balance sheet and (2) a different measurement basis for the related income and expenses in the statement of profit or loss (i.e., "dual measurement").

In addition, under the ED, there is a presumption that income and expense items that are included in OCI "in one period will be reclassified into the statement of profit or loss in some future period (recycled)" when doing so "enhance[s] the relevance of the information" included in that statement in that period.

However, the ED indicates that "[t]his presumption could be rebutted, for example, if there is no clear basis for identifying the period in which that reclassification would enhance the relevance of the information in the statement of profit or loss." Further, "[i]f there is no such basis, it may indicate that the income or expense should not be included in [OCI]."

Chapter 8, "Concepts of Capital and Capital Maintenance"

Chapter 8 discusses the concepts of capital and capital maintenance. The text in this chapter has been carried forward from the existing IASB framework, with minor changes to make the terminology consistent.

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