Revisiting the Fundamental Concepts of IFRS

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Summary

This paper shows discussions and views on a number of important issues that are raised in the IASB Conceptual Framework project from an academic and research perspective. The aim is to contribute to the current debate on objectives of financial reporting and prudence, and also briefly touch on derecognition and measurement.

The role of the Conceptual Framework

A basic question is whether a conceptual framework should serve as a basis for deductive reasoning or whether it is just an attempt to rationalize existing standards. The 2013 DP is explicit in that the Conceptual Framework should include a set of concepts and principles to be used primarily by the IASB in developing or revising standards. While this view is understandable, it is almost unavoidable that conflicts arise between the Conceptual Framework and new or revised standards. An ideal framework needs to be sufficiently flexible to promote the evolution of standards. Thus, it should be comprehensive, but not too detailed in its prescriptions. Consistency between standards and the Conceptual Framework is desirable, but conflicts seem to be inevitable. Raising the status of the Conceptual Framework and requiring an override of existing standards should be carefully considered.

Objectives and uses of financial reporting

A fundamental issue addressed in the framework is the objectives and uses financial reporting is destined for. The revised Conceptual Framework defines decision usefulness to capital providers as the overarching objective, while stewardship is only a secondary objective. The Conceptual Framework also contains no discussion of potential conflicts between decision usefulness and stewardship, suggesting there are no conflicts between these objectives. To restrict the focus to one important use may be conceptually appealing and facilitate development of standards, but is not in line with the reality of how the standards are in fact used. Research shows that the objectives of decision usefulness and stewardship may, but need not, be best served by the same kind of accounting information. Intuitively, decision usefulness is served by information useful to better forecast future cash flows, which is important to improve price efficiency on the market. Stewardship, on the other hand, requires information about management decisions taken under asymmetric information, which helps improve economic efficiency, which often differs from price efficiency. The paper shows several examples which illustrate settings in which the two objectives can lead to different conclusions. A major argument to not include stewardship as a separate objective in the 2010 revision of the Conceptual Framework is that users interested in stewardship are viewed as being able to demand the information they need and use this information in individual contracting. However, an important deficiency of this view is that it ignores contracting costs. Another issue is whether a framework should consider the institutional environment companies operate in. This issue is particularly important because the Conceptual Framework is the basis for IFRS that are also used by non-listed companies in many countries and for the IFRS for SMEs, which have different users and uses of financial information to listed companies.

Prudence

Prudence was removed altogether in the 2010 revision of the Conceptual Framework which is a very controversial issue. IASB argues that the reason to omit the concept is related with trying to be unambiguous and to avoid misinterpretations. Academic literature shows there exist different types of prudence or conservatism. Conditional conservatism (news driven, ex post conservatism), which provides unfavorable news in a more timely fashion than good news, has drawn much attention in the literature. The value of unconditional conservatism (news unrelated, ex ante conservatism), which measures assets at a lower amount than their actual value is doubtful, although still a matter of research. Existing research suggests that conditional conservatism is important in debt contracting, it facilitates the monitoring of debt-contracts and reduces cost of debt, facilitates the access to additional debt funds, and reduces risk-shifting and shareholder-bondholder conflicts over dividends. The potential value of conditional conservatism for equity holders has been analyzed, focusing on adverse selection and on moral hazard, and shows that general conditional conservatism could reduce in some cases agency costs and opportunities for earnings management, although the optimum level of conditional conservatism is contextual. There is some ambiguous evidence on the effect of conditional conservatism on investment efficiency. The IASB could try to re-introduce prudence with a clear definition. The conceptual framework could be a good way of encouraging or incentivizing the type of conservatism that has been shown to create value for capital providers.

Uncertainty in recognition of assets and liabilities

The IASB 2013 DP proposes that the definitions of assets and liabilities should not include any particular probability thresholds to avoid misinterpretation. It further proposes that there is also no probability threshold for recognition. According to the DP the limit for recognition is not the uncertainty of the item, but the irrelevance of the information or the cost of the information. However, the understanding of relevance will probably differ among board members and constituents as well as across time, which may result in inconsistent decisions on standards and on the application of standards.

Derecognition

Derecognition has been debated by the IASB and the FASB for a long time without arriving at a solution. The DP discusses derecognition in the context of financial instruments and leasing. From a conceptual perspective there is no need for special derecognition principles in a conceptual framework. Formerly recognized assets or liabilities would be derecognized when the definition of assets and liabilities or the recognition criteria are no longer met. It is not yet clear whether the IASB aims at providing a (perhaps inconsistent) basis for existing derecognition rules or whether it aims at developing a clear principle for derecognition. Including specific derecognition rules in the Conceptual Framework might give the standard setter more discretion in issuing a standard with complex derecognition without a need to describe and explain departure from the recognition principles in the Conceptual Framework.

Measurement issues

Another sweep issue is the distinction between recognition and measurement. The distinction is relevant, though, if different measurement bases are considered appropriate. The DP does not propose a single measurement base for all assets and liabilities, but suggests that the measurement base may differ according to what measurement is most appropriate, which depends on the expected use of the assets and liabilities that are to be measured. The discussion of measurement bases in the DP evolves around searching for adequate criteria that could be used to select the most appropriate measurement under given circumstances. The DP appears to contain different lines of arguments that are not necessarily consistent across asset classes

Conclusion

In general, the paper concludes that there is a need and there will surely be ample opportunities for a fruitful discourse between accounting academics and standard setters on the fundamental issues that are addressed in the framework development.