

Commentaries on financial reporting #1

The conceptual framework: cornerstone of high quality financial reporting¹

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Why another paper on the conceptual framework?

1. The IASB's decision to reactivate its conceptual framework project and its desire to complete the project expeditiously has created an atmosphere of both optimism and apprehension in the financial reporting community. Optimism because it signals a commitment on the part of the Board to complete what it heralded as one of its most important projects, in the context of establishing a set of high quality global accounting standards, when it first commenced the project in 2004. Apprehension because the Board has signalled its intention to complete the project in a time frame that most experienced observers would consider to be very ambitious and in so doing may expose itself to the risk of compromising the quality of the finished product.

2. We have a deep interest in the conceptual framework project. We believe the conceptual framework is the cornerstone of high quality financial reporting and that standard setters are custodians, not owners, of the conceptual framework. We have spent a considerable portion of our professional careers developing conceptual frameworks nationally and internationally, using those frameworks in developing accounting standards nationally and internationally and advising on the practical application of those frameworks and the standards based on them. We are convinced that the quality of financial reporting is enhanced significantly if accounting standards, and ultimately decisions taken in practice, are based on a set of logically interrelated concepts.

3. We view the IASB's decision to devote significant resources to improving and completing the conceptual framework as a significant event in the development of a set of high quality global accounting standards; it is an opportunity to put in place something that

will have lasting benefit for those involved in and impacted by financial reporting. This opportunity arises only rarely, so it is important that the Board and its constituents are given the necessary time to make the most of the opportunity. In this respect, we encourage interested parties to participate in the IASB's process, and refer them to its recently issued discussion paper, "*A Review of the Conceptual Framework for Financial Reporting*".

4. In this short paper, we explain why we believe the conceptual framework is the cornerstone of high quality financial reporting and why the IASB's decision to reactivate the conceptual framework project is warranted. In addition, we identify the remaining areas of the framework that we believe need to be updated or developed. These include the areas of the framework that were previously addressed but not completed by the IASB in conjunction with the FASB in an early incarnation of this project, i.e. the reporting entity, definition and recognition of the elements of the financial statements and measurement. They also include two additional sections: the scope of financial reporting, and presentation and disclosure.
5. We also identify what we believe are the desirable qualities of a conceptual framework, noting that the lower levels of the framework should be built on the higher levels (i.e. the objective of financial reporting and the qualitative characteristics of financial information), which have recently been revised by the IASB, and that the framework should be *aspirational* in nature. We believe designing the conceptual framework in this way is essential if it is to continue to be the primary platform for developing improvements in financial reporting and if those improvements are going to be able to successfully address the concerns we often hear about the lack of relevance of the existing financial reporting model.

6. We hope that by sharing our views and experiences with standard setters and others who may be intimately involved in the project, we can contribute to the development of a comprehensive, high quality conceptual framework that will better enable standard setters and practitioners to meet the ongoing financial reporting challenges they will face.

Financial reporting and standard setting prior to the advent of conceptual frameworks

7. Prior to the advent of conceptual frameworks, accounting standards and financial reporting were based on vague principles and conventions, such as true and fair view, prudence, stewardship, conservatism, matching and earnings process, rather than on a robust set of inter-related concepts reflecting underlying economic phenomena. Standard setters developed 'rules' that typically reflected emerging consensus in practice and sometimes involved eliminating 'undesirable' practices rather than identifying 'best practice'. Their frame of reference was implicit and held individually (personal conceptual frameworks) rather than being explicit and commonly applied. As a result, decisions tended to be ad hoc, inconsistent and unrelated to higher order outcomes. Those involved with trying to improve financial reporting during this time were well motivated and brought about improvements in financial reporting. However, progress was slow and there was no explicit benchmark against which to assess whether the quality of financial reporting was being advanced or retarded.
8. The first seeds of a conceptual framework emerged in the United States in the 1960's with attempts to identify an objective of financial reporting. It gained real momentum at the beginning of the next decade as the newly established Financial Accounting Standards

Board (FASB) immediately experienced the frustration of trying to resolve issues without a common frame of reference.

9. The FASB developed the first conceptual framework during the 1970's and 1980's. This path-breaking work led to a flurry of activity amongst other national standard setters, and at an international level [the International Accounting Standards Committee (IASC)], as they sought to emulate and build on the FASB's framework.

How did the conceptual framework change things?

10. The conceptual frameworks were originally and primarily designed to aid standard setters in their standards development activities. However, their role evolved into a more direct impact on practice as the IASC, followed by the Australians and New Zealanders (and ultimately the IASB), embedded the framework in their standards dealing with the selection of accounting policies.
11. The advent of the conceptual framework had a profound effect on standard setters and practitioners and by extension the quality of financial reporting. Standard setters now had a common frame of reference for their decision making, which was comprised of a set of inter-related concepts based on the decision making needs of the users of financial statements. This imposed a degree of discipline on standard setters that had previously been lacking. The onus was now on standard setters to formulate standards that, where possible, were consistent with the framework and would therefore be expected to meet the objective of the framework, i.e. to provide information that is useful to the users of financial statements in making economic decisions.
12. This self-imposed discipline had two related effects on the behaviour of standard setters. It improved the consistency of their decision making as fundamental issues were less

likely to be debated as new standards were developed or existing standards were improved or as membership of the standard setting body changed. It also provided standard setters' constituents with a clear frame of reference for making standard setters accountable for their decisions, since the concepts or principles underpinning the standards were now explicit and any departures from them more evident. Indeed, as part of this self-imposed discipline, standard setters typically undertook to explain in an addendum to new or amended standards how the decisions on key issues were consistent with the framework or, if they were not, why the standard setter had decided to deviate from the framework.

13. Practitioners have been affected by the advent of the conceptual framework in a variety of ways. Since standards henceforth would be developed in the context of the framework, practitioners needed to be schooled in the framework in order to understand fully the particular requirements of standards. Moreover, in those countries where the framework was embodied in standards specifying a hierarchy for determining appropriate accounting policies for matters not specifically addressed in a standard or an interpretation, practitioners have been required to apply the framework directly in resolving those practice issues. With the widespread use of IFRSs around the world, practitioners in most countries are now applying the framework in practice. Professional bodies and educators have generally responded to this changed environment by changing their professional requirements and course content to include knowledge of the conceptual framework.

14. Practitioners, and standard setters' constituents more generally, were also impacted by the conceptual framework in the context of their interactions with standard setters. Because standards henceforth were to be developed in the context of the framework, constituents soon realised that if they were to be able to communicate effectively with the

standard setter they would have to adopt the new standard setting language. This too contributed to the ‘education’ of practitioners about the conceptual framework. It also enhanced the quality of the dialogue between standard setters and their constituents and contributed to improved understanding of their respective points of view.

15. The combined effect of these changes has in our view been a demonstrable improvement in the quality of financial reporting.
16. Standard setters are now developing accounting standards with a clear objective in mind – to meet users’ information needs. Because that objective focuses on economic decision making, the concepts supporting the objective (and ultimately the standards based on them to the extent possible) have been framed in a way that reflects ‘real world’ economic phenomena, i.e. scarce resources, claims to scarce resources and changes in scarce resources and claims. This has enhanced the relevance of the information provided to users by better reflecting the economic substance of transactions and other events. It has also helped improve the comparability of reported information by having economically similar transactions and other events accounted for in like ways and economically dissimilar transactions and other events accounted for differently.
17. Practitioners have become better equipped to apply the improved standards as intended by the standard setters, as a result of their enhanced knowledge of underlying concepts, and better able to use their professional skill and judgement in a conceptually consistent manner in resolving issues not explicitly dealt with in the literature. Again, this has helped improve the quality of financial statements and the usefulness of reported information in the hands of users.

18. Standard setters and their constituents are now better able to communicate with each other, and this has enhanced the effectiveness of the standard setting process. While we acknowledge that the timeliness of needed improvements in the quality of financial reporting continues to be an issue, the fact that the engagement of standard setters with their constituents now takes place in the context of a commonly understood set of concepts has contributed to improving the quality of accounting standards and ultimately the quality of financial reporting.

What is the current state of play with the IASB's conceptual framework?

19. The IASB's conceptual framework is incomplete. It does not contain sections on the scope of financial reporting, the reporting entity or presentation and disclosure. In addition, the section dealing with measurement of the financial statement elements does not contain measurement concepts but merely describes a number of measurement bases and techniques that have been applied in practice.

20. Older sections of the framework are in need of revision. The IASB recently revised the sections of the framework dealing with the Objective of General Purpose Financial Reporting and the Qualitative Characteristics of Useful Financial Information. However, the sections dealing with the Definition and Recognition of the Elements of the Financial Statements were developed many years ago, and it is evident from the work of the Board at a standards level that its thinking relating to these concepts has been evolving. For example, the standards dealing with financial instruments and business combinations, work on revising IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and the current proposals on insurance contracts provide examples of the Board taking decisions

at variance with the conceptual framework and provide evidence of the need for it to be revised, as illustrated below:

- (a) in IAS 32 *Financial Instruments: Presentation*, the IASB required certain transactions involving share-based payments to be treated as liabilities even though they did not meet the definition of a liability in the framework, and certain transactions involving shares that can be put back to the issuing entity to be classified as equity even though they appear to meet the definition of a liability in the framework.
- (b) in IFRS 3 *Business Combinations*, the Board required ‘contingent liabilities’ to be recognised as liabilities of the acquiring entity even though IAS 37 prohibited their recognition as liabilities of the acquiree, presumably in accordance with the then Board’s interpretation of the framework definition of a liability. (The IASB subsequently proposed to amend IAS 37 to be consistent with the view taken in IFRS 3.)
- (c) in IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 9 *Financial Instruments*, and in the insurance contract proposals and the proposed revisions to IAS 37, separate criteria for the recognition of assets and liabilities were either not included or were modified from those in the framework.

21. Apart from the gaps in the framework that need to be filled and the evolution in thinking that (subject to due process) needs to be captured in future revisions to the framework, the Board needs to address a related concern. There continues to be a number of standards that have not been revised to reflect, to the extent feasible, the concepts in the existing conceptual framework let alone possible improvements to the framework. These include IAS 19 *Employee Benefits*, IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*, IAS 28 *Investments in Associates* and IAS 38

Intangible Assets. The improvements in financial reporting referred to earlier in this paper resulting from improved standards developed in the context of the conceptual framework will not be realised to the extent possible until these revisions take place. The Board's renewed focus on the conceptual framework provides an opportunity for it to also renew a commitment of its predecessor standard setters to revise these older standards and where possible align them with the concepts in the framework.

What needs to be done?

Reaffirm the role of the conceptual framework

22. The IASB (and its standard setting partners) should reaffirm the role of the conceptual framework in the standard setting process.

23. Conceptual frameworks have traditionally been viewed by standard setters as aspirational documents, setting the direction for reform of financial reporting while acknowledging that at any point in time the 'conceptually correct' approach may not be achievable at a standards level. If financial reporting is to continue to evolve and meet the needs of the users of financial statements, it is important that this continues to be the case. There will always be a temptation when standard setters revisit the conceptual framework to see it as an opportunity to justify previous decisions at a standard setting level that, at the time, were driven more by compromise and pragmatic solutions than underlying concepts. Such re-engineering would undermine the integrity of the conceptual framework both as a vehicle for facilitating the development of new ideas by the standard setter at a standards level and as vehicle for holding the standard setter accountable for its decisions.

24. In our view, the IASB faces precisely this issue in its conceptual framework project as it endeavours to respond to calls from some of its constituents for it to identify a conceptual basis for the recognition of items of income or expense in ‘other comprehensive income’. Decisions by standard setters in the past to allow or require this treatment have been made in response to concerns by constituents, in particular concerns by preparers, about volatility in reported profit or loss resulting from recognising changes in the values of assets and liabilities in profit or loss in the accounting periods in which those changes occur.
25. Whether items are recognised ‘above or below the line’ in the performance statement they will, in the period in which the changes are first recognised, in concept be income or expense and will be a part of an entity’s net result for that period. Changing the geography of the performance statement does not change the conceptual nature of the items. On the other hand, recycling these items from ‘other comprehensive income’ to profit or loss in subsequent accounting periods results in items being included in profit or loss that are characterised as income or expense of the period but do not meet the existing conceptual definitions of income and expense because they do not result from changes in assets and liabilities in that period. If the conceptual framework were to be amended to incorporate this practice, presumably it would require the existing definitions of income and expense to be amended to include recycled items from previous reporting periods. That would result in the definitions no longer being solely a description of economic phenomena but rather being a combination of such descriptions and a practice condoned by the standard setter. We recall something similar that emerged in the United States in pre conceptual framework days when the then standard setter developed the following definitions of assets and liabilities:

- assets are economic resources and certain deferred debits that are not resources but are recognised and measured in conformity with GAAP; and
- liabilities are economic obligations and certain deferred credits that are not obligations but are recognised and measured in conformity with GAAP.

26. It is also important for standard setters to understand the role of the cost constraint section of the conceptual framework within the overall role of the framework, and to apply the constraint conscientiously. This section of the framework acknowledges that cost is a pervasive constraint on the information that can be provided by financial reporting and states that the standard setter needs to assess whether the benefits of reporting particular information are likely to justify the costs incurred to provide and use the information. When a standard setter invokes the cost constraint as a justification for not requiring an approach that would be more consistent with the relevant concepts in the framework, it is actually complying with the framework. Standard setters need to resist the temptation to opportunistically invoke the cost constraint when endeavouring to navigate contentious financial reporting issues.

Reaffirm the status of the conceptual framework

27. In some parts of the world that are yet to embrace IFRSs the conceptual framework does not have the same status it has in IFRS literature. In those countries the conceptual framework is used by the standard setter in developing accounting standards but is not required to be used by practitioners in applying the standards. For the reasons stated earlier in this paper, we believe that, while the primary role of the framework is as an aid to the standard setter, making it mandatory for use by practitioners in specified circumstances has both enhanced the standard setting process and helped improve the quality of financial reporting. Accordingly, we believe it is important for the IASB to

confirm the existing status of the conceptual framework in its literature and also encourage those standard setters not yet using IFRSs to elevate its status in their jurisdictions.

Update the framework for changes at a standards level

28. Earlier in the paper we mentioned that the IASB's conceptual thinking seems to have been evolving at a standards level, particularly in the areas of definition and recognition of the elements of the financial statements. The review of the conceptual framework provides the opportunity to formally translate these developments into tangible revisions of the relevant concepts, including explaining the underlying conceptual rationale for the changed thinking. This will reduce or eliminate perceived differences between the conceptual framework and the relevant standards and will provide a stronger foundation for reaching consistent conclusions when deliberating issues at a standards level in the future.

Complete the work commenced by the IASB jointly with the FASB

29. The IASB and the FASB devoted a considerable amount of time and effort to three as-yet-uncompleted sections of their conceptual frameworks: namely, the reporting entity, definition of the elements of the financial statements, and measurement of the elements of the financial statements.

Reporting entity

30. Work on the reporting entity was all but completed. This work needs to be brought to a conclusion as soon as possible because it deals with a number of fundamental concepts, including the concept of 'control' and its role in circumscribing the boundaries of a

reporting entity. We see little point in the IASB conducting lengthy redeliberations, as the relevant issues have already been subjected to extensive due process.

Definition of the elements

31. An extensive amount of work has already been undertaken on definitions of the elements: at a conceptual level with the FASB, where tentative decisions were reached on definitions of assets and liabilities; and, at a standards level with the FASB (financial instruments with characteristics of equity) and separately by the IASB (review of IAS 37, revision of IAS 32, etc). This work should inform the IASB and hopefully enable it to accelerate its deliberations.

Measurement of the elements

32. Work on measurement of the elements by the IASB and the FASB reached only a preliminary stage and tended to be more descriptive than aspirational. We encourage the IASB to make a fresh start in this area and try to develop measurement concepts that are based on higher levels of the framework, i.e. try to identify a measurement basis or measurement bases that would provide the most useful information for users of the financial statements. A forthcoming paper by Mary Barth, a former member of the IASB, entitled *Measurement in Financial Reporting: The Need for Concepts*, outlines how such an approach might be applied.

Fill in the gaps in the existing framework

Scope of financial reporting

33. The existing conceptual framework does not have a section dealing with the scope of financial reporting. This is a significant omission, given the aspirational nature of the

framework on the one hand and the development of potentially competing reporting models on the other.

34. In our view, the conceptual framework should include an initial section that sets out a broad scope for financial reporting. This would facilitate the evolution of financial reporting as the demands of constituents' change, as the institutional environment within which information is provided changes, and as the capacity to provide new and enhanced information changes. For example, the conceptual framework should not be a barrier to the provision of more forward-looking information in financial statements. Nor should it be a barrier to financial reporting harnessing developments in information technology that endeavour to enhance the communication process between reporting entities and those that use the information they produce.
35. In addition, articulating a broad scope for financial reporting should clarify that other reporting models, such as integrated reporting, complement the 'conventional' reporting model rather than compete with it.
36. The growing interest in integrated reporting is symptomatic of growing discontent with the conventional reporting model. Preparers and users are increasingly voicing their concerns about the failure of financial statements prepared in accordance with existing accounting standards to provide relevant information, and are responding by developing and focussing on various non-GAAP measures. Whether or not such concerns are valid, they are sincerely and passionately held. Accordingly, standard setters need to respond, and need to have the tools at their disposal to respond in an effective manner. A broad scope for financial reporting and articulation of appropriate concepts relating to the presentation and disclosure of information (discussed below), would enable standard setters to explore alternative solutions that respond to the present concerns.

37. We also believe the scope section of the conceptual framework should identify that the concepts articulated within the framework are ‘transaction neutral’. In other words, the concepts should be capable of being applied by all reporting entities, irrespective of their operating structure, the sector of the economy in which they operate, i.e. private or public, and the operating objective they pursue, i.e. for-profit or not-for profit. We acknowledge that this is more of a medium-term objective and should ultimately be the product of a co-operative effort between the IASB and its public sector counterpart, the International Public Sector Accounting Standards Board, informed by the work of the FASB in addressing private sector not-for-profit entity issues. However, we think it is important for the IASB to acknowledge the desirability of having a single conceptual framework that can be applied by all reporting entities around the world. We note that ‘transaction neutral’ conceptual frameworks have been developed in the past by the Australian and New Zealand standard setters.

Presentation and disclosure

38. The existing conceptual framework also does not have a section dealing with presentation and disclosure. This too is a significant omission given the ongoing focus of users and preparers on presentation and disclosure issues (including, whether valid or not, concerns about complexity and disclosure overload) and given the current problems standard setters have in resolving presentation and disclosure issues.

39. We believe the IASB should try to develop presentation and disclosure concepts based on higher levels of the framework. This may involve investigating whether those higher levels are complete in terms of providing a basis for clear articulation of presentation and disclosure concepts. In this respect, we note that the IASB and FASB undertook a major project on financial statement presentation as part of their convergence programme and devoted a considerable amount of time and effort to developing some key presentation

and disclosure principles. In addition, we are aware of a recent paper by Kevin Stevenson, Chairman of the Australian Accounting Standards Board and a former head of staff at the IASB, entitled *Rethinking the Path from an Objective of Economic Decision Making to a Disclosure and Presentation Framework*, that contends there is a gap in the conceptual framework between the objective level and the lower levels. He argues that there are a limited number of generic types of information, termed stocks and flows, that characterise all types of entities and that by specifying these information components in the upper level of the conceptual framework a better, purpose-driven, disclosure and presentation framework can be developed.

Where to from here?

40. We strongly encourage all interested parties to join the debate and help the IASB develop a comprehensive, high quality conceptual framework. We would urge commentators to put aside their preferences and prejudices relating to what is or is not considered 'acceptable' in practice today and focus instead on the development of concepts that will give the revised conceptual framework a truly aspirational character. Such a framework will, we believe, be a powerful tool for the IASB and practitioners in the quest for ongoing improvements in the quality of financial reporting.