B.The Financial Reporting Framework (Final Revision checklist)

Before reading please refer to
*- the **P2 competency Guide** for a clear focus on Competences 1 and 2*
- From F7 to P2 to appreciate the cognitive, analytical and application depths required to be exam sharp.

After reading

Practise, using the exercises in these illustrations and in the **Revision and Practice Plan**

B.1 THE APPLICATIONS, STRENGTHS AND WEAKNESSES OF AN ACCOUNTING FRAMEWORK

a) Evaluate the **valuation models** adopted by standard setters.[3]

1. Standard setters have used various **valuation models** to deal with various circumstances involving **measurement of value** (e.g. fair value, NRV, valuation) and of **profit** (e.g. fair value of investment property) and **recovery of value** (e.g. recovery through sale of property, business, etc. determines valuation basis as fair value or lower of carrying value and fair value less cost to sell).

2. An evaluation involves determining whether the individual valuation models are fit for purpose. The *Framework* is essential for this task in that it sets the ultimate objective of financial reporting and the qualitative characteristics to be met in satisfying that objective. For example, a valuation is only appropriate if it can lead to relevant and reliable information. What is relevant and reliable (decision useful) depends on the circumstances. Therefore different model are used for different circumstances as discussed below.

Valuation model	Definition	Derivatives & evaluation
Present value	Assets are measured at the present value of the net future cash flows generated from its use. Liabilities are measured at the present value of the net future cash outflows used in settling the related obligation.	**Value-in-use**. This is the total net cash flows from the use of an asset. Where value-in-use is higher than *fair value less cost* to *sell* this is compared with the carrying amount to determine the impairment of an asset. **Projected unit credit method** This is the method for measuring the annual charge for pension fund entitlement that accumulates to the total pension fund liabilities of the entity. The principle in IAS 19 *Employee benefits* is that post-employment benefits such as pension benefits are provided (charged) during the period the employee is rendering services that entitle it to the benefits. (In other words the benefit is vested i.e. entitlement accrues during the period of employment.) The **projected unit credit method** applies this principle by treating each completed year of service as adding an extra unit of benefit entitlement that is measured separately, and accumulated to give the total benefit entitlement at the end of the service. The liability for each

		completed year is the present value of the unit of benefit entitlement otherwise known as service cost.
Fair value	Fair value is the amount for which an asset can be sold and a liability transferred in an orderly transaction between market participants in the principal (or most advantageous market) on the measurement date and it reflects current market conditions.	**Fair value less cost to sell (e.g. IFRS 5)** This is the valuation basis for noncurrent asset and disposal group *held for sale*. It replaces the carrying value where the carrying value is higher. In that circumstance an *impairment loss* is recognised to write down the carrying value to fair value less cost to sell. This valuation basis is appropriate because the *carrying value* of the asset is recoverable by sale and any loss is consequently recognised immediately. **Net realisable value** This measurement basis is used to value stocks held for trading in the ordinary course of business where the original cost is deemed to be higher and consequently not recoverable. **Highest and best use** Exit values and market based valuation (not entity-specific) valuation; reflects assumptions of market participants. It is not really a derivative of fair value because it is inherent in it. The intention of the entity is not relevant. Thus an asset that is idle from the entity's perspective can nevertheless have a fair value.
Current cost	Assets are carried at their current purchase price Liabilities are carried at the undiscounted amount currently required to settle them.	Where inflation is significant the current purchase price becomes relevant in determining the value of assets. Historical prices would be adjusted for the changes in purchasing power so as to indicate the effect of changes in purchasing power on the entity's ability to replace its operating and trading assets. Stocks and long-lived assets would be valued at the amounts that would be required to replace them. The capital maintenance concept would be **financial capital** which is the **money capital** adjusted for the effects of changes in purchasing power.
Historical cost	Acquisition costs of assets and liabilities. The cash price paid to acquire an asset unadjusted for inflation (nominal value).	Under IAS 16 **noncurrent assets** can be accounted for under two models: **Cost model** or **Fair value model** Under the cost model historical cost can be modified to include revaluations and impairments. The carrying amounts are determined by

	The amount paid to settle or transfer a liability.	deducting the cumulative depreciation from the cost or revalued amounts. This **measurement basis** is appropriate because i) Assets are long-lived and used in generating income for the business. They are financed with money invested which is measured in nominal terms as "**money capital**". This transaction based approach preserves the initial capital invested in the business in that before profit is recognised the valuation model allows a portion of the cost consumed to be deducted in the form of depreciation. ii) In circumstances where the asset is impaired depreciation is accelerated by recognising additional amounts of charge for the use of the asset, thereby preserving capital prudently iii) Revaluations reflect the changes in asset values which is appropriate given the requirement for relevance and reliability. Capital is maintained by adjusting the depreciation amounts to reflect the increased valuation.

Discuss the use of an **accounting framework** in underpinning the production of accounting standards. [3]

3. The conceptual accounting framework is a statement of the concepts, definitions, objectives and practices of accounting which form an agreed reference for the coherent development and implementation of new accounting and reporting practices and the evaluation of existing ones. The Framework in providing guidance on how useful financial information should be produced helps to i) determine which transactions should be accounted for, ii) how they should be measured and iii) how they should be communicated to users.

4. The objective of integration and harmonisation of standards has already resulted in two important standards being published in 2011: IFRS 12 *Disclosure of interest* in other entities and IFRS 13 *Fair Value Measurement*. IFRS 13 acts as a source of reference for other standards, fostering consistency by standardising definitions, recognition criteria and measurement concepts across all applicable standards.

5. The table below illustrates how the accounting framework underpins the production of accounting standards.

HOW THE CONCEPTUAL FRAMEWORK UNDERPINS THE PRODUCTION OF ACCOUNTING STANDARDS (Micro level: relating to the setting of an individual standard)	
Measurement concepts	
Fair value	The role of measurement concepts in standard setting is to provide a common basis of measurement that is acceptable to all

	users and preparers of financial statements. *Fair value* is a widely recognised and accepted concept. This is demonstrated by the wide scope of IFRS 13 *Fair Value Measurement*. This standard deals with all aspects of fair value measurement where it is required or permitted by other IFRS. It deals with assets, liabilities, equity and revenue. Work on the conceptual Framework was halted in 2010. IFRS 13 was issued in may 2011. As can be seen above work on the measurement phase of the new conceptual framework was not completed by the time IFRS 13 was issued yet standard setters formed judgment on the criteria to be used i) to achieve fair value and comply with the objectives of financial reporting and ii) to meet the qualitative characteristics of financial reports.
Qualitative characteristics	
Relevance	By requiring fair values to be relevant and decision useful IFRS 13 must comply by setting the context in which fair values are relevant. This necessitates setting conditions, exclusions and exceptions. For example, fair values must be determined in the principal market when market participants are acting with the best available information in sufficient time to make rational decisions that reflect orderly market conditions. IFRS 13 requires the fair value of an asset to be based on the *highest and best use* of the asset. This requirement imposes on the entity the need to take into account the assumptions of market participants who may have a wide range of alternative uses for the asset. Thus the fair value would be representative of and therefore relevant to the best use of the asset. This makes for efficient allocation of economic resources and is indicative of the accountant's responsiveness to social and ethical requirements for financial reporting.
Faithful representation	By requiring standards to achieve faithful representation IFRS 13 sets rules of practice (principles) that guide action towards satisfying the objective. For example, the standard sets a valuation hierarchy for input values with quoted prices (unadjusted) being priority level 1, unobserved inputs being priority level 3 and observed inputs being priority level 2. This ensures consistency and comparability in measuring fair values using subjective estimates and different valuation techniques. By requiring fair values to be based on *highest and best use* IFRS 13 ensures fair values faithfully represent what they purport to represent, the maximum amount that can be received to sell the asset in an orderly transaction in the principal market between market participants on the measurement date.
Consistency	The role of consistency in standard setting is to ensure that i) IFRS make sense; ii) IFRS do not contradict each other; iii) IFRS are not intentionally manipulated to give a favourable view; iv) IFRS compliant financial statements produce comparable and reliable results based on which meaningful interpretations and predictions can be made.
Recognition criteria and definitions	
Identification and recognition	The **recognition criteria** and **definitions** of assets and liabilities of the *Framework* impose **rigour** in recognising assets and liabilities. IFRS 13 reflects this rigour in its definitions of key elements. In addition, IFRS 13 imposes rigour in determining fair values in all the different circumstances.

HOW THE CONCEPTUAL FRAMEWORK UNDERPINS THE PRODUCTION OF ACCOUNTING STANDARDS (Macro level: relating to the standard setting process itself)	
IFRS 13	An example of how seeking to produce a unified framework **imposes the need** to clarify certain concepts such as *fair value* which then leads to the development of standards such as IFRS 13 that serve as references for other standards.
IFRS 12	**Integrating** and **harmonising** disclosures **imposes the need** to clarify principles and sharpen the focus on common critical

	elements such as **Significant Assumptions** and **Judgements** in determining whether it controls another entity or not.
IFRS 11	
IFRS 10	
IFRS 15	
IFRS 16	

Assess the success of such a framework in introducing rigorous and consistent accounting standards.[3]

6. Explain what "**rigorous"** means and the effects produced by rigour (good or bad), the sources of rigour in the Framework and how achieving rigour is enhanced (or required) by other properties of the Framework such as objectives, comparability. Explain what "**consistency**" means, the sources of consistency within the Framework and the effects produced by consistency.

7. Rigorous and consistent standards have a (general and specific) purpose: to produce useful information about the entity that investors and other users can use for making economic decisions and monitoring the effects of those decisions: a) evaluate financial position and performance of the entity, b) compare different entities, and c) make decisions.

8. Thus this discussion can be approached: a) identify specific user needs and discuss to what extent standards have met those needs; b) discuss how qualitative characteristics (aimed at producing useful information) have influenced and been influenced by standards; c) discuss how key elements of financial statements have been defined and measured by different standards and evaluate the effectiveness of the respective standards in terms of enabling the production of useful information through the introduction of effective standards (that are cost effective to apply).

9. In each of the discussions it is essential to: i) identify cost versus benefit considerations; ii) highlight the ways in which standards may complement each other (e.g.) iii) highlight the ways in which standards may conflict with each other (e.g. substance over form …); iv) highlight the ways in which standards may be arbitrary (e.g. IAS 23 capitalisation of interest stops after construction is completed even though the loan to finance the construction may still be outstanding) v) trace development: key dates e.g. introduction of the Framework, IFRS convergence, divergent standards e.g. USGAAP and UKGAAP; vi) identify business failures and scandals specifically attributable to accounting and reporting failures e.g. the fact that accounting allowed off-balance sheet accounting and reporting contributed to frauds, misfeasance and defalcations being perpetrated on a grand scale. Think about Enron, financial crises of 2008 (the lack of rigour in determining what is an asset and identifying all of an entity's liabilities). What has the accounting response been? What lessons have been learnt? Provide examples of lessons that have been learnt and how these lessons are making a difference to how standards are set.

B.2 CRITICAL EVALUATION OF PRINCIPLES AND PRACTICES

Identify the **relationship** between accounting theory and practice. [2]

The constructivist case for a theory of accounting.

What is a theory of accounting?

10. Accounting theory is a coherent body of knowledge consisting of concepts, principles, and objectives that explain how accounting should be done, what should be accounted for, the scope of accounting, the purpose of accounting and financial reporting, the users of accounting and financial reports, the constraints and limitations of financial reporting and the requirements for financial accounting to be supplemented with other nonfinancial information to enhance the quality of accounting and its information outputs.

11. The theory of accounting examines accounting as a tool shaped by the context in which it is practised. The main entities in that context are the stakeholders and they raise social, ethical, legal, environmental, political and economic issues to which the accounting profession must address itself as a responsible entity.

The benefits of a sound theory of accounting

12. Accounting theory can be a basis for clear thinking, sound and consistent accounting practice and coherent evolution of practice to respond effectively to emerging issues. An example of this can be seen in the conceptual Framework of accounting that underpins the setting of standards of accounting and reporting practice. How does it (accounting theory) make for sound thinking and practice? By identifying the **objectives of financial reporting** and by defining the **recognition criteria** for its basic elements (assets, liabilities, income, expenses, equity) and **measurement concepts** the *Framework* assists standard setters to set standards that apply to transactions, conditions and other events in order to produce relevant and reliable information for users. This sets the benchmark for sound accounting practice and the resolution of accounting issues to the satisfaction of users, preparers, auditors and other standard setters.

13. A*ccounting theory* attempts to explain all issues relevant to accounting and financial reporting in a comprehensive and forward looking way. This has the potential to make the standard setting process efficient because the required standards can be proactively determined and designed to fit the requirements within a structured and rational framework. For example

- More emphasis could be placed on general principles (*principle-based*) rather than specific rules. This would restrict the proliferation of rules of accounting practice in response to regulatory pressures.
- The same issues such as leases, substance over form, deferred tax, revenue and goodwill would not be reassessed over and over again once a coherent body of knowledge has been developed. Inconsistencies and conflicts that have existed would be removed from existing standards and prevented from new ones because standards would have a common reference and the standards would refer to these references where appropriate. For example, goodwill as an intangible asset is not amortised but other intangibles recognised under IAS 38 are amortised. How should earnings be measured? Is it by the balance sheet approach or is it by the income approach? How is the choice made?
- Once it is theoretically determined that accounting has a social function then the Framework has to reflect that function by defining the concepts and principles of social responsibility accounting and reporting. This would make for consistent standards for social responsibility reporting that are integrated with other financial reporting standards.
- The true and fair view would be more clearly explained and the guidance towards achieving it would be clearer and this would enhance practice.
- Certain fundamentals of financial reporting would be addressed in a practical and rational way. **Examples:** What is the reporting entity? Who are the users of reports within those entities? What are their information needs? What type of reports will best satisfy those needs? How is the balance between the needs of preparers and users to be achieved?
- Because accounting theory is aimed at producing decision-useful information required by capital markets and other users it can be an effective

tool for combating interference in the standard-setting process. But its effectiveness must be vindicated in terms of how well standards reflect the commercial reality of transactions, conditions and other events.

14. Convergence is a major stage in the evolution of accounting practice and *accounting theory* facilitates convergence because the separate frameworks of the IASB and the FASB provide a sound working basis for integrating and harmonising the separate (national or regional) accounting regimes. Moreover, the attractiveness of a comprehensive and rational theory would be hard to ignore by standard setters who would find it hard to deviate from it in a justifiable way.

15. If the theory is that accounting **mediates the efficient allocation of resources** then rational performance measurement would require appropriate measurement and capital maintenance concepts. This would be developed and applied consistently to provide benchmarks for monitoring and evaluation of performance including comparison with other firms in the same and other industries.

16. Accounting theory is not a panacea for all accounting problems. Critical thinking and judgement are required in resolving accounting issues. Accounting theory provides the reference for exercising that judgement.

The costs of not having a sound theory of accounting.

17. Without an accounting theory on which accounting standards are based

- There is a risk that an accounting standard would lack conceptual coherence due to the lack of a coherent theoretical reference for its critical elements and arguments in support of an identified practice. This could result in recommended accounting practices that are arbitrary, theoretically baseless and unacceptable to other standard setters, preparers of financial statements and users. The overall effect of this is lack of credibility in the financial statements and frustration on the part of users such as investors who might incur additional costs in trying to supplement the perceived inadequacies in the information outputs from such an accounting regime.
- The standards setting process would be costly and inefficient.
- Standards would be produced on a haphazard and fire-fighting basis with a high risk of inherent conceptual incompatibility and inconsistencies with other standards.
- *Commonly agreed principles of accounting practice* would not necessarily lead to *common practice* without the persuasive force of a coherent theory of accounting.

Critically evaluate accounting principles and practices used in corporate reporting. [3]

18. The Framework allows useful information to be produced because it requires the substance (commercial effects) of transactions to be reflected in accounting records and financial statements (faithful representation). This increases the relevance of financial information and their reliability. However, it can be argued that because what is substance can be arbitrary and subjective (e.g. finance lease) "**substance over form**" increases the scope for misinterpretation of the effects of certain transactions thereby reducing the reliability of financial information.

19. IAS 37 requires an entity to make a provision for constructive obligations where appropriate. This practice increases the relevance and reliability of financial information but could lead to reduced consistency as amounts based on legal obligations are more precisely determined than amounts

based on subjective assessments of obligations arising from an entity's actions.

20. Comparability is enhanced by standardisation of accounting practice fostered by the Framework leading to convergence. However the same items may be recognised at different amounts e.g. PV of lease contracts for the same assets and amounts when measured using incremental cost of borrowing as a discount rate may result in different measurements due to the differing costs of borrowing of different entities with different risk profiles.

21. Framework ensures common set of criteria and principles are used to produce standards, resolve issues, foster harmony and minimise internal conflict within and between standards. Framework encourages systematic and holistic thinking, development of accounting theory and engenders authority and respect for the profession and the standards. However, in seeking to encompass all businesses across a diverse culture, legislation and economic landscape the Framework allows flexibility, which leads to subjectivity. This increases relevance while increasing the risk that the resulting information would suffer from reduced reliability and comparability, two of the key characteristics to which the Framework aspires. For example, IFRS 13 fair value measurement allows different valuation techniques for measuring fair value depending on the circumstances.

22. **Relevance** (decision usefulness) and **representational faithfulness** may be in direct conflict due to timing. Example, management accounts produced on the first day after the end of the month to which they relate may be more relevant than management accounts produced a few weeks later which could be more reliable because it is more complete.

23. Relevance may also be in conflict with reliability due to different valuation bases. IFRS 13 addresses this issue from the perspective of the user by requiring disclosure of the valuation methods and input levels (Fair value hierarchy). Transaction prices may be highly reliable but fair values may be more relevant as they reflect market participants' assumptions about the highest and best use of an asset.

Exam Insight!
The *Framework* is a crucial part of the convergence process and it must be thoroughly examined for any exam. The likely examiner's approach must be thoroughly assessed and its implications carefully thought through. <u>Likely examiners approach & implications for study and exam preparation</u> i) Because it is so fundamental to the standard setting process the examiner is likely to invite students to refer to the *Framework* in dealing with specific transactions for which there are no specific requirements in existing *standards*, *interpretations* and *guidelines*. The implication of this is that a) a list of transactions for which there are no specific requirements should be kept; b) regular practice discussing how the Framework deals with these transactions is a must. Q2a Dec 2012; Q2c June 2010 ii) The delay in producing a new *Framework* and the reasons for the delay would attract the examiners attention and he would probably invite students to refer to and consider the implications of the delay for standard setting. iii) The **expected benefits** of a new conceptual *Framework*, particularly **its role in promoting convergence,** is a likely examination issue. The

examiner would invite students to think critically about the contents of the proposed Framework. What are the features that make the proposed Framework most likely to promote convergence? What factors would prevent or restrict the Framework from effectively supporting convergence? Discuss these features in relation to the expected benefits, constraints and trade-offs, explaining how the inherent features of the CF make it likely that the expected benefits would be achieved?

Examples of expected benefits: a) achieving consistency in accounting and reporting across different geography and cultures would make financial reports more comparable. This would contribute towards the efficient working of capital markets as information would become more readily available to investors at reduced cost. Transparency of financial information and what it purports to represent would improve. Investors and other users would invest with more confidence and the cost of capital would consequently reduce with overall benefits to national and international economies; b) improving standards of accounting and reporting: increases the likelihood of improving probity, ethical conduct, accountability.

iv) The requirement to balance the needs of the **user** and the **preparer** of accounts whilst reflecting cost and benefit considerations. Give examples of how this is achieved by IFRS 13 and IFRS 12.

v) The requirement to respond to criticisms of the **volume** and **perceived lack** of focus of many current disclosures of IFRSs. For example, IFRS 12 is a response to this criticism being **principle based** and *integrative* of similar and related issues. It functions as a reference standard, reducing the need to repeat similar disclosures in other related standards. IFRS 13 also serves this integrative and harmonisation purpose.

Examiners Track record for the Framework.
What is the examiners track record in examining this topic? This question is not simply about relative frequency of occurrence but critically about the approach and the elements. This provides some useful insights into how the examiner wants students to think about the Framework and related issues.

24. Clarity and quality of discussion Revise the glossary from … and test your knowledge rigorously using i) objective tests; ii) fill in the blanks; iii) match the concept	
Key terms	
Key words	
Key phrases: it is worth memorizing these as **prepared phrases** could potentially save you time in the exams	

and make your answers read more professional.	
25. News digest & Developments	