RELEVANT TO ACCA QUALIFICATION PAPER F7 AND PERFORMANCE OBJECTIVES 10 AND 11

The need for and an understanding of a conceptual framework

This topic forms most of Section A (and has an influence on Section B) of the syllabus for Paper F7, *Financial Reporting*. A conceptual framework is important to the understanding of the many principles and concepts that underpin International Financial Reporting Standards (IFRS) and is an often-neglected part of candidates' studies.

Questions from these areas regularly appear in Paper F7 exams – usually as Question 4 – and I often comment in my examiner's report that they are the least well-answered question in the exam paper; the questions also have a high incidence of candidates not attempting them at all.

This article is intended to illustrate the relevance and importance of this topic.

What is a conceptual framework?
In a broad sense a conceptual framework can be seen as an attempt to define the nature and purpose of accounting. A conceptual framework must consider the theoretical and conceptual issues surrounding financial reporting and form a coherent and consistent foundation that will underpin the development of accounting standards. It is not surprising that early writings on this subject were mainly from academics.

Conceptual frameworks can apply to many disciplines, but when specifically related to financial reporting, a conceptual framework can be seen as a statement of generally accepted accounting principles (GAAP) that form a frame of reference for the evaluation of existing practices and the development of new ones. As the purpose of financial reporting is to provide useful information as a basis for economic decision making, a conceptual framework will form a theoretical basis for determining how transactions should be measured (historical value or current value) and reported – ie how they are presented or communicated to users.

Some accountants have questioned whether a conceptual framework is necessary in order to produce reliable financial statements. Past history of standard setting bodies throughout the world tells us it is. In the absence of a conceptual framework, accounting standards were often produced that had serious defects – that is:

- they were not consistent with each other particularly in the role of prudence versus accruals/matching
- they were also internally inconsistent and often the effect of the transaction on the statement of financial position was considered more important than its effect on income the statement

- standards were produced on a 'fire fighting' approach, often reacting to a corporate scandal or failure, rather than being proactive in determining best policy.
- Some standard setting bodies were biased in their composition (ie not fairly representative of all user groups) and this influenced the quality and direction of standards
- the same theoretical issues were revisited many times in successive standards – for example, does a transaction give rise to an asset (research and development expenditure) or liability (environmental provisions)?

It could be argued that the lack of a conceptual framework led to a proliferation of 'rules-based' accounting systems whose main objective is that the treatment of all accounting transactions should be dealt with by detailed specific rules or requirements. Such a system is very prescriptive and inflexible, but has the attraction of financial statements being more comparable and consistent.

By contrast, the availability of a conceptual framework could lead to 'principles-based' system whereby accounting standards are developed from an agreed conceptual basis with specific objectives.

This brings us to the International Accounting Standards Board's (IASB) *The Conceptual Framework for Financial Reporting* (the Framework), which is in essence the IASB's interpretation of a conceptual framework and in the process of being updated. The main purpose of the Framework is to:

- assist in the development of future IFRS and the review of existing standards by setting out the underlying concepts
- promote harmonisation of accounting regulation and standards by reducing the number of permitted alternative accounting treatments
- assist the preparers of financial statements in the application of IFRS, which would include dealing with accounting transactions for which there is not (yet) an accounting standard.

The Framework is also of value to auditors, and the users of financial statements, and more generally help interested parties to understand the IASB's approach to the formulation of an accounting standard.

The content of the Framework can be summarised as follows:

- Identifying the objective of financial statements
- The reporting entity (to be issued)
- Identifying the parties that use financial statements
- The qualitative characteristics that make financial statements useful
- The remaining text of the old Framework dealing with elements of financial statements: assets, liabilities equity income and expenses and

when they should be recognised and a discussion of measurement issues (for example, historic cost, current cost) and the related concept of capital maintenance.

The development of the Framework over the years has led to the IASB producing a body of world-class standards that have the following advantages for those companies that adopt them:

- IFRS are widely accepted as a set of high-quality and transparent global standards that are intended to achieve consistency and comparability across the world.
- They have been produced in cooperation with other internationally renowned standard setters, with the aspiration of achieving consensus and global convergence.
- Companies that use IFRS and have their financial statements audited in accordance with International Standards on Auditing (ISA) will have an enhanced status and reputation.
- The International Organisation of Securities Commissions (IOSCO) recognise IFRS for listing purposes – thus companies that use IFRS need produce only one set of financial statements for any securities listing for countries that are members of IOSCO. This makes it easier and cheaper to raise finance in international markets.
- Companies that own foreign subsidiaries will find the process of consolidation simplified if all their subsidiaries use IFRS.
- Companies that use IFRS will find their results are more easily compared with those of other companies that use IFRS. This should obviate the need for any reconciliation from local GAAP to IFRS when analysts assess comparative performance.

It is not the purpose of this article to go through the detailed content of the Framework; this is well documented in many textbooks.

At this point I would stress that it is important to think about what the content of the Framework really means; it is not enough merely to rote learn the principles/definitions. This is because an understanding and application of these topics will be tested in exam questions and it is on these aspects that candidates perform rather poorly.

As previously mentioned, this topic is generally examined as Question 4 (worth 15 marks). Typically, the question will identify two or three areas of the Framework and ask for a definition or explanation of them – for example, the definition of assets and liabilities, an explanation of accounting concepts such as substance over form or materiality, or qualitative characteristics such as relevance and reliability. This section will usually be followed by short scenarios intended to test candidates' understanding and their ability to apply the above knowledge.

Here are a few examples of past questions.

June 2008 exam
(a) The IASB's *Framework for the Preparation and Presentation of Financial Statements* requires financial statements to be prepared on the basis that they comply with certain accounting concepts, underlying assumptions and (qualitative) characteristics. Five of these are:

- Matching/accruals
- Substance over form
- Prudence
- Comparability
- Materiality

Required
Briefly explain the meaning of each of the above concepts/assumptions.
(5 marks)

(b) For most entities, applying the appropriate concepts/assumptions in for inventories is an important element in preparing their financial statements.

Required
Illustrate with an example how each of the concepts/assumptions in (a) may be applied to accounting for inventory.
(10 marks)

(15 marks)

Observations
This question illustrates the progression of the topic from Paper F3 to F7. Part (a) is not much more than expected knowledge from F3, however Part (b) progresses this knowledge. It requires the application of each of the concepts, not to just any situation, but specifically to inventory thus illustrating how a single transaction (inventory in this case) can be subject to many different accounting concepts.

June 2010 exam
(a) An important aspect of the International Accounting Standards Board's (IASB) *Framework for the Preparation and Presentation of Financial Statements* is that transactions should be recorded on the basis of their substance over their form.

Required
Explain why it is important that financial statements should reflect the substance of the underlying transactions and describe the features that may

indicate that the substance of a transaction may be different from its legal form.

Observations
Part (a) is based on the important topic of substance over form. Note the question does not ask for a definition of the concept (this would be more for Paper F3); instead it asks why the concept is important and what features may indicate that the substance of a transaction may be different to its legal form. In other words, how do we identify such transactions?

Most answers to this question merely gave a definition of substance and an example (inevitably leasing) of its use in financial statements.

Part (b) consisted of a numerical example related to a sale and re-purchase agreement to illustrate the difference that the application of substance has on financial statements (compared to the legal form).

June 2011 exam
(a) Your assistant has been reading the IASB's *Framework for the Preparation and Presentation of Financial Statements* (the Framework) and, as part of the qualitative characteristics of financial statements under the heading of 'relevance', he notes that the predictive value of information is considered important. He is aware that financial statements are prepared historically (ie after transactions have occurred) and offers the view that the predictive value of financial statements would be enhanced if forward-looking information (for example, forecasts) were published rather than backward-looking historical statements.

Required
By the use of specific examples, provide an explanation to your assistant of how IFRS presentation and disclosure requirements can assist the predictive role of historically prepared financial statements.
(6 marks)

Observations
Again Part (a) is themed on the Framework: the important characteristic of relevance. This is such an import characteristic that the Framework says (implicitly) that if information is not relevant, it is of no use. This question focuses on a particular aspect of relevance; that of predictability. Predictability recognises that users of financial statements are very interested the future performance of an entity. The core of this question was about how historical information can be presented, such that it enhances the predictive value of financial statements.

From memory I would say that this (section) question had the highest number of candidates that did not give any answer; and of those that did, very few scored more than half of the available marks.

Part (a) was followed by a section on continuing and discontinued operations, and a calculation of diluted earnings per share. If these topics had been mentioned in Part (a) alone, it would have gained two of the six marks available.

Conclusion
Simply look out for more of this type of question – it is an important area and should not be neglected.

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