A Framework-based approach to teaching of IFRSs

Michael Wells, Director, IFRS Education Initiative, IFRS Foundation

The views expressed in this presentation are those of the presenters, not necessarily those of the IASB or IFRS Foundation.
Framework-based teaching

Framework-based teaching relates particular IFRS requirements to the concepts in the IASB’s Conceptual Framework

- Because the objective of the Framework is to facilitate the consistent and logical formulation of IFRSs

Framework-based teaching
- develops a cohesive understanding of IFRSs
- prepares individuals to continuously update their IFRS knowledge and competencies
Why *Framework*-based teaching?

To a large extent, IFRS financial statements are based on estimates, judgements and models rather than exact depictions

• Because the *Framework* established the concepts that underlie those estimates, judgements and models it provides a basis for the use of judgement in resolving accounting issues

• The benefits: by relating those concepts to the IFRS requirements *Framework*-based teaching – enhances the ability of individuals to exercise the judgements that are necessary to apply IFRSs
From concepts to principles to rules

Concepts

Principles

Rules
The views expressed in this presentation are those of the presenters, not necessarily those of the IASB or IFRS Foundation.
The IASB’s Conceptual Framework

- Framework sets out agreed concepts that underlie IFRS financial reporting
  - the objective of general purpose financial reporting
  - qualitative characteristics
  - elements of financial statements
  - recognition
  - measurement
  - presentation and disclosure

Other concepts all flow from the objective
Role of the *Framework*

- IASB uses *Framework* to set standards
  - enhances consistency across standards
  - enhances consistency across time as Board members change
  - provides benchmark for judgments
- IFRS teachers/trainers use the *Framework* to teach IFRS
- Preparers use *Framework* to develop accounting policies in the absence of specific standard
  - IAS 8 hierarchy
Objective of financial reporting

“Provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity.”

Those decisions involve buying, selling or holding equity and debt instruments, and providing or settling loans or other forms of credit
Objective of financial reporting

• Primary users
  – provide resources, but cannot demand information
  – common information needs

• Assess the prospects for future net cash inflows
  – buy, sell, hold
  – efficient and effective use of resources
Fundamental qualitative characteristics

• Relevance
  – Predictive value
  – Confirmatory value
  – Materiality, entity-specific

• Faithful representation (replaces reliability)
  – Completeness
  – Neutrality
  – Free from error
Enhancing qualitative characteristics

- Comparability
- Verifiability
- Timeliness
- Understandability
Pervasive constraint

• Cost
  – IASB assesses whether the benefits of reporting particular information are likely to justify the costs incurred to provide and use that information.

Note: It is consistent with the Framework for an IFRS requirement not to maximise the qualitative characteristics of financial information when the costs of doing so would exceed the benefits.
Elements

Asset
• resource controlled by the entity
• result of past event
• expected inflow of economic benefits

Liability
• present obligation
• arising from past event
• expected outflow of economic benefits

Equity = assets less liabilities

Income
• recognised increase in asset/decrease in liability in current reporting period
• that result in increased equity except...

Expense
• recognised decrease in asset/increase in liability in current reporting period
• that result in decreased equity except…
Recognition

• Accrual basis of accounting
  – recognise element (eg asset) when satisfy definition and recognition criteria

• Recognise item that meets element definition when
  – probable that benefits will flow to/from the entity
  – has cost or value that can measured reliably

What does probable mean?
Its meaning is determined at the standards level. Therefore, inconsistent use across IFRSs
Measurement

• Measurement is the process of determining the monetary amounts at which the recognised elements are carried.

• IFRS measurements are largely based on estimates, judgements and models

• The measurement part of the Framework is weak and IASB has a project to replace it

• Measurement determined at the standards level. Therefore, inconsistent use across IFRS (see next 2 slides)
Asset

Classification, recognition and measurement

- PP&E
- Intangible
- Inv Property
- Financial
- FV plan assets less PUC plan obligation & arbitrary rules
- Defined Benefit
- Deferred Tax
- Tax rates & undiscounted
- Tax rates & undiscounted
- CM or RM
- Cost
- CM or RM
- Nil
- Cost
- CM or FVM
- CM or RM
- Cost
- CM or FVM
- CM or RM
- Cost
- CM or FVM
- CM or RM
- Cost
- CM or FVM
- CM or RM
- Cost
- CM or FVM
Liability

Classification, recognition and measurement

Liabilities

Leases

Defined Benefit

PUC plan obligation less FV plan assets and arbitrary rules

Contingent

Deferred Tax

PUC plan obligation less FV plan assets and arbitrary rules

etc

Various

Various

Nil

Nil

Best est. to settle @ BIS date

Best est. to settle @ BIS date

Fair value

AmC, FVM & other

Tax rates & undiscounted

Tax rates & undiscounted

© 2010 IFRS Foundation. 30 Cannon Street | London EC4M 6XH | UK. www.ifrs.org
Presentation and disclosure

• Objective of financial reporting

• Presentation: financial statements portray financial effects of transactions and events by:
  – group into broad classes (the elements, eg asset)
  – sub-classify elements (eg assets sub-classified by their nature or function in the business)

• IAS 1
  – application of IFRSs with additional disclosures when necessary results in a fair presentation (faithful representation of transactions, events and conditions)
  – don’t offset assets & liabilities or income & expenses
Structure of a principle-based standard

Minimum guidance that gives effect to the principles

- Recognition principle
- Measurement principle
- Derecognition principle
- Presentation and disclosure principles

Concepts
The ideal principle-based standard

• Scope
  – no exceptions

• Principles
  – derived from the Framework
  – reliance on professional judgement to apply principles in business context

• Application guidance
  – explains application of principles
Get rule-based standards if

- Preparers and auditors
  - refuse to exercise professional judgement
  - don’t act with integrity
  - ask for detailed interpretations
  - refuse to accept raw economic facts
- Regulators
  - want one answer in spite of different economic facts
- Courts
  - lawyers fail to defend reasonable judgements
Structure of some IFRSs

- Rules/application guidance
  - Rules (exceptions)
  - Rules (interpretations)
- Principles
- Concepts
  - Application guidance to give effect to the principles
Structure of other IFRSs

Rules

Exceptions

Interpretations

Broadly stated requirements (not based on concepts in *Framework*)

Application guidance to give effect to the broadly stated requirements
### Common misunderstandings

<table>
<thead>
<tr>
<th>The <em>Framework</em> does <strong>not</strong>...</th>
<th>Clarification—the <em>Framework</em> includes</th>
</tr>
</thead>
<tbody>
<tr>
<td>include a matching concept</td>
<td>accrual basis of accounting—recognise elements when satisfy definition and recognition criteria</td>
</tr>
<tr>
<td>include prudence/conservatism concept</td>
<td>neutrality concept</td>
</tr>
<tr>
<td>include an element other comprehensive income (or a concept for OCI)</td>
<td>only the following elements—asset, liability, equity, income and expense</td>
</tr>
<tr>
<td>mention management intent or business model</td>
<td></td>
</tr>
</tbody>
</table>
# Common misunderstandings continued

<table>
<thead>
<tr>
<th>Misunderstanding</th>
<th>Clarification</th>
</tr>
</thead>
<tbody>
<tr>
<td>Principles are necessarily less rigorous than rules</td>
<td>Rules are the tools of financial engineers</td>
</tr>
<tr>
<td>There are few judgements and estimates in cost-based measurements</td>
<td>Inventory, eg allocate joint costs and production overheads</td>
</tr>
<tr>
<td></td>
<td>PP&amp;E, eg costs to dismantle/restore site, useful life, residual value,</td>
</tr>
<tr>
<td></td>
<td>depreciation method</td>
</tr>
<tr>
<td></td>
<td>Provisions, eg uncertain timing and amount of expected future cash flows</td>
</tr>
</tbody>
</table>
Role of the *Framework* in interpreting IFRS and applying IFRSs

Michael Wells, *Director, IFRS Education Initiative*, IFRS Foundation

The views expressed in this presentation are those of the presenter, not necessarily those of the IASB or IFRS Foundation.
Framework’s role in interpreting IFRSs

Does the *Framework* help me apply/interpret IFRSs?

- Yes, Framework is in IAS 8 hierarchy (see slide 29)
  - IFRS Interpretations Committee uses *Framework* when developing official IFRS Interpretations
  - Preparers use the *Framework* to make the judgements that are necessary to apply IFRSs
  - Auditors and regulators assess those judgements
  - Investors, lenders and others consider those judgements when using IFRS financial information to inform their decisions
IFRS Interpretations Committee (IC)

• Interpret the application of IFRSs and provide timely guidance on financial reporting issues not specifically addressed in IFRSs, in the context of the IASB’s Framework

(see paragraph 43(a) of the IFRS Foundation Constitution)

• Provide interpretative guidance applying a principle-based approach founded on the Framework
Applying IFRSs (IAS 8)

- When an IFRS specifically applies to a phenomenon, apply that IFRS
- If no specific IFRS requirement, use judgement to
  - develop a policy that results in relevant information that faithfully represents (ie complete, neutral and error free)
  - Hierarchy:
    1st IFRS dealing with similar and related issue
    2nd Framework definitions, recognition crit. etc

Can also in parallel refer to GAAPs with similar Framework
In other words, if no IFRS requirement...

Framework-based approach would ask:

• What are the economics of the phenomenon (eg transaction or event)?

• What relevant information using the accrual basis of accounting faithfully present that economic phenomenon to inform decisions of investors and lenders (potential and existing)?

• Is there anything in IFRSs that prevents me from providing that information?
Example — non-cash distribution

Before IFRIC 17, entity distributes non-cash asset (eg land or shares in another) whose fair value = CU1 mill. Carrying amount of asset = cost = CU1K

• Economics = reduce owners’ claims against the entity by distributing to them an asset worth CU1 million.

• Relevant information for investors and lenders that faithfully represents the economics:
  – investors received distribution worth CU1 million.
  – value of assets available to meet lenders’ claims reduced by CU1 million.
Example — non-cash distribution

Before IFRIC 17… (continued)

• Does IFRSs prevent providing that information? No. Therefore:
  – recognise CU999K income (previously unrecognised increase in the value of the asset derecognised).
  – recognise CU1 million distribution to owners.
Example — share-based payment

Before IFRS 2, entity pays employee in own shares. Par value of shares issued = CU1K. Fair value of services provided = CU1 million = fair value of shares.

- Economics = entity paid employees CU1 million for services. Employees invested CU1 million in entity.

- Relevant information for investors and lenders that faithfully represents the economics:
  - CU1 million services received = staff cost.
  - CU1 million invested = increased owner equity.

- Does IFRSs prevent providing that information? No. Therefore, recognise CU1 million expense and recognise CU1 million increase in owners’ equity.
The views expressed in this presentation are those of the presenters, not necessarily those of the IASB or IFRS Foundation.
Framework-based teaching...

- relates the IFRS requirements being taught to the concepts in the *Conceptual Framework*
- explains why some IFRS requirements do not maximise those concepts (e.g., application of the cost constraint or inherited requirements)
Framework-based teaching provides…

• a cohesive understanding of IFRSs
  – *Framework* facilitates consistent and logical formulation of IFRSs

• a basis for judgement in applying IFRSs
  – *Framework* established the concepts that underlie the estimates, judgements and models on which IFRS financial statements are based

• a basis for continuously updating IFRS knowledge and IFRS competencies
Examples 1a, b and c: Errors and changes in policies and estimates

- Objective
- Concepts
  - faithful representation
  - comparability
- Principle
  - 1a Prior period error: retrospective restatement
  - 1b Change in policy: retrospective application
  - 1c Change in estimate: prospective application
- Rules
  - impracticable exception
  - specified disclosures
Suggestions:
– build from objective to concepts to principles and rules
– understand how specified disclosures give effect to principle
– focus on judgements
  eg differentiating changes in accounting estimates from changes in accounting policies and correction of prior period errors
– develop understanding, eg use integrated case studies
What if requirement not principle-based

- Explain why the IASB deviated from the main concepts in the *Framework*
  - see Basis for Conclusions (BfC).
  - if no BfC then requirement could predate *Framework* (eg IAS 20))

- Discuss what a more principle-based requirement could be
  - consider rejected alternatives, subsequent IASB DPs and EDs, etc
  - will facilitate continuously updating IFRS knowledge and competencies

*A Guide through IFRSs* cross-references all IFRS requirements to the Basis for Conclusions
Example 2: Lease classification

• Objective

• Concepts
  – faithful representation
  – element definitions

• Broadly stated lease classification requirement
  – capitalise in-substance purchases (finance leases)
  – other leases = executory contracts (operating leases)
  – is this requirement principle-based?

• Rules
  – guidance (eg contingent rentals)
  – specified disclosures
Suggestions:
– explain broadly stated requirement is not consistent with Framework (see BfC ED Leases)
– discuss what a principle-based lease classification principle could be (eg see ED Leases)
– develop ability to make judgements necessary to apply the requirements (eg use lease classification case studies)
Example 3: Business combinations

- **Objective**
- **Concepts**
  - elements definitions
  - representational faithfulness
- **Core principle**
  - an acquirer of a business (scope)
  - recognises assets acquired and liabilities assumed (recognition principle)
  - at their acquisition-date fair values (measurement principle)
  - discloses information that enables users to evaluate the nature and financial effects of the acquisition (disclosure principle)
Example 3: Business combinations continued

• Rules
  – exceptions to the recognition principle
  – exceptions to the measurement principle
  – specified disclosures
Suggestions:

– build from objective through concepts to core principle and rules

– recognition—explain reason for removing
  (i) the probability criterion; and
  (ii) the explicit reliability of measurement criteria
  (see Basis for Conclusions on IFRS 3 paragraphs BC125–BC130)

– explain reasons for exceptions to IFRS 3:
  – recognition principle
  – measurement principle
  (see Basis for Conclusions on IFRS 3)
Suggestions (continued):
Teach students to make judgements, eg
– identifying a business, measuring fair value in
  the absence of an active market etc
Class discussion:
– with reference to the objective and QCs consider whether
  uncertainty should enter recognition or measurement
  (for business combinations and then extend the
discussion to other transactions and elements)
What we hear…

• Very few use *Framework*-based teaching
  – few changes made from the way we taught our previous GAAP

• Many say *Framework*-based teaching is a great way to teach principle-based standards  
  But
  – how do we implement it?
  – where do we find *Framework*-based teaching material?
Support for *Framework*-based teaching

- IFRS Foundation education initiative works with others to support *Framework*-based teaching
  - create awareness
  - develop material (starting with PPE)
  - hold workshops (in 2011: today with World Bank, Boston, Bucharest, George and Venice with IAAER and Rio with BNDES)
  - encourage those certifying accountants to examine their students ability to make the judgements that are necessary to apply IFRSs
Benefits of *Framework*-based teaching of IFRSs

- a cohesive understanding of IFRSs
- a basis for the *use of judgement* in applying IFRSs
- a basis for *continuously updating* IFRS knowledge and competencies
Questions or comments?

Expressions of individual views by members of the IASB and their staff are encouraged. The views expressed in this presentation are those of the presenter. Official positions of the IASB on accounting matters are determined only after extensive due process and deliberation.