

STUDY GUIDE A1: THE NEED FOR A CONCEPTUAL FRAMEWORK

Get Through Intro

A conceptual framework to financial statements is like a foundation of a building. Without the foundation, a building cannot stand. Similarly, without the basic concepts of accounting that are given in the Framework to International Financial Reporting Standards (IFRSs), the financial statements will not stand.

The Framework provides fundamental principles upon which accounting standards are expected to be based. It gives certain qualitative characteristics that are essential for the statements to serve their purpose.

If financial statements satisfy the requirements of the Framework and the IFRSs, they are likely to present a true and fair view and therefore become acceptable to a wide range of users. As an accountant, you will sometimes be faced with a transaction where there is no accounting standard, so you will need some guidance to follow. The Framework is the guide you will use.



Learning Outcomes

- Describe what is meant by a conceptual framework of accounting.
- Discuss whether a conceptual framework is necessary and what an alternative system might be.

Introduction

An important quote from Sir David Tweedie is as follows:

“There will be more individual transactions and structures that are not explicitly addressed. We hope that a clear statement of the underlying principles will allow companies and auditors to deal with those situations without resorting to detailed rules.”

Accounting standards deal with many individual transactions and structures. However, they may not be able to cover all possible examples. In an increasingly complex business world, there are going to be more kinds of transactions and events which are not covered by the standards.

There should be a set of underlying principles guiding entities and their auditors in such situations. The IFRS Framework is one such set: we present an overview of the Framework in this Study Guide.

1. Describe what is meant by a conceptual framework of accounting.^[2]

[Learning Outcome a]

Meaning of conceptual framework of accounting

The IFRS Framework gives a set of concepts on certain basic points about the why, what and how of the accounting process and the financial statements. In this Study Guide, we take an overview of these concepts, so as to understand what the overall framework is. Many of these important concepts have been covered in separate Study Guides within these materials.

It is to be noted that the Framework is concerned with **general purpose financial statements**. It does not cover special statements such as prospectuses. Similarly, the Framework **is not itself an International Accounting Standard**: it does not define standards for any particular measurement or disclosure issue.

There may be different accounting models depending upon the measurement basis selected and the concept of capital maintenance selected. However, most concepts discussed in the Framework are so fundamental that **they apply irrespective of the model selected**.

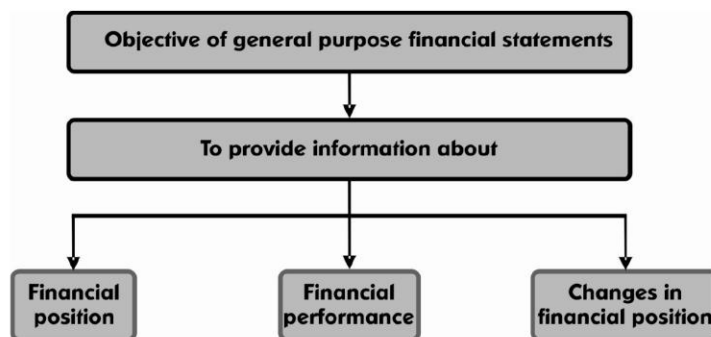
The Framework includes the following matters:

1.1 Objectives of financial statements

This is a fundamental concept. Before we do anything, we need to be clear about why we are doing it. This concept tells us as to why we do accounting.

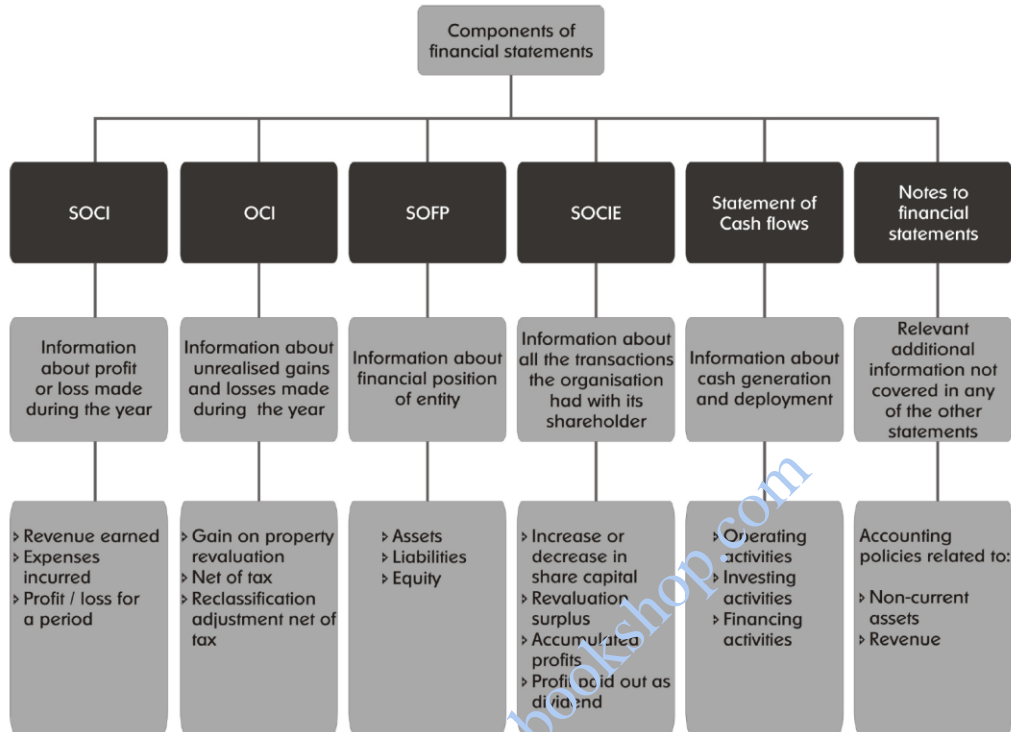
The objective of financial statements is to provide information about the **financial position, performance and changes in financial position of an entity**.

Diagram 1: Objective of financial statements



Which components of the financial statements provide for this?

Diagram 2: Components of financial statements



The SOFP gives us information about financial position. It tells us what the assets of the business are, and how they have been financed at a particular date.

The SOCI informs us about how much profit or loss has been earned during the given period. The OCI informs about the unrealised gains and losses. Similarly, the statement of cash flow (cash flow statement), gives us information about how cash and cash equivalents were generated during the period, and how they were deployed.

1.2 Qualitative characteristics

In order to fulfil their purpose, the statements must have certain qualities. These essential qualities, without which the statements will lose their value, are listed below:

- Understandability
- Relevance
- Reliability
- Comparability

Diagram 3: Characteristics of financial statements



These are covered in detail in Study Guide A2.

1.3 The elements of financial statements

The items reflected in the financial statements are the financial effects of transactions and events. Based on their economic characteristics, they need to be grouped into broad classes for presentation in the financial statements. These broad classes are called the 'elements' of financial statements. They are as follows:

1. Elements related to financial position

- a) Assets
- b) Liabilities
- c) Equity

2. Elements related to performance or profit

- a) Income
- b) Expenses

All definitions below are taken from the Framework.

Definition

An asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.

Definition

A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

Definition

Equity is the residual interest in the assets of the entity after deducting all its liabilities.

Definition

Income is increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.

Definition

Expenses are decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrence of liabilities that result in decreases in equity, other than those relating to distributions to equity participants.

These concepts have been discussed in Paper F3 Financial Accounting and are explained in Study Guide A3 of this book.

As well as giving these definitions of the elements, the Framework also explains the recognition criteria i.e. the conditions subject to which items may be shown in the financial statements.

The Framework also tells us about the manner of determining the value of the different elements i.e. measurements of the elements. These are the following **measurement bases**:

- i. Historical cost
- ii. Current cost
- iii. Realisable (settlement) value
- iv. Present value

The concepts of recognition and measurement are discussed in Study Guide A3.