Questions

- What do ‘principle-based’ and ‘Framework-based’ mean?
- What is the Framework?
- Are IFRSs principle-based?
- Framework-based IFRS teaching
- Common misunderstandings
What does principle-based mean?

• There is overwhelming support for principle-based accounting standards

• But
  – what does principle-based mean?
  – are IFRSs principle-based?

• In this presentation
  – an IFRS requirement is principle-based only when it is consistent with the concepts in the IASB’s Conceptual Framework

What is Framework-based teaching?

In the context of IFRSs, Framework-based teaching relates the concepts in the IASB’s Conceptual Framework to the particular IFRS requirements being taught
What is the Framework?

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
- Preparers use Framework to develop accounting policies in the absence of specific standard
  - IAS 8 hierarchy

This presentation describes the role of the Framework in IFRS teaching

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
Enabling 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**
\[ \text{Equity} = \text{assets} - \text{liabilities} \]

**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, liability, etc) 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 to be 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)
**Liability**

**Classification, recognition and measurement**

<table>
<thead>
<tr>
<th>Liabilities</th>
<th>Nil</th>
<th>Various</th>
</tr>
</thead>
<tbody>
<tr>
<td>Leases</td>
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<tr>
<td>Defined Benefit</td>
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<td>Deferred Tax</td>
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<td>Fair value</td>
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<td>Provisions</td>
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<td>Financial</td>
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<td>Tax rates &amp; undiscounted</td>
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<tr>
<td>PUC plan obligation less FV plan assets and arbitrary rules</td>
<td></td>
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<tr>
<td>FL ~ rules</td>
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<td>OL ~ nil</td>
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</tbody>
</table>

**Framework-based teaching**

- Because
  - the *Framework* sets out agreed concepts that underlie IFRS financial reporting, and
  - *Framework*-based teaching relates the concepts in the *Framework* to the particular IFRS requirements being taught

IFRS teachers should first teach their students
- the objective of general purpose financial reporting
- the concepts that flow from the objective
- which concepts are robust (and which are not)
Teaching suggestions—objective

• Contrast objective of IFRS financial statements with objectives of other financial statements

• Debunk myths
  – Myth 1: objective = record of historical costs
  – Myth 2: objective = support tax return
  – Myth 3: financial statements are designed to meet all the information needs of all users

• Before teaching the class the IFRS requirements for a transaction or event, discuss what information about that transaction or event would best meet the objective

Are IFRSs principle-based?
Structure of a principle-based standard

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

- Concepts
- Principles
- Rules (interpretations)
- Rules (exceptions)
- Rules/application guidance
Structure of other IFRSs

Rules

- Broadly-stated requirements (not based on concepts in Framework)
- Application guidance to give effect to the broadly-stated requirements

Exceptions

Interpretations

Framework-based IFRS teaching
**Framework-based IFRS teaching**

- *Framework*-based teaching relates the concepts in the *Framework* to the particular IFRS requirements being taught
- Because the objective of the *Framework* is to facilitate the consistent and logical formulation of IFRSs
  - *Framework*-based teaching
    - provides students with a cohesive understanding of IFRSs
    - prepares students to continuously update their IFRS knowledge and competencies

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**Framework-based IFRS 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
- By relating those concepts to the IFRS requirements
  - *Framework*-based teaching
    - enhances the ability of students to exercise the judgements that are necessary to apply IFRSs
    - prepares students to continuously update their IFRS knowledge and 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
Examples 1a, b and c: continued

Teaching suggestions:
– build from objective to concepts to principles and rules
– explain 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
– test understanding, eg use integrated case studies

What if requirement not principle-based

• When teaching the requirement
  – explain why IASB deviated from the Framework
    (see Basis for Conclusions (BfC). If no BfC then
    requirement could predate Framework (eg IAS 20)
    etc)
  – discuss what a more principle-based requirement
    could be (consider rejected alternatives, subsequent
    IASB DPs and EDs, etc)
  – prepare students to continuously update their 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
- 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

Teaching suggestions:
- explain broadly-stated requirement is inconsistent with the Framework (see BfC ED Leases)
- discuss what a principle-based lease classification principle could be (eg see ED Leases)
- focus on judgements (eg use lease classification case studies)
- test understanding (eg use integrated case study)
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
Example 3: Business combinations continued

Teaching 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)

Teaching suggestions (continued):
Focus on judgements, eg
– identifying a business, measuring fair value in
  the absence of an active market etc
Test understanding, eg:
– integrated case studies
– discuss with reference to the objective and QCs whether
  uncertainty should enter recognition or measurement
  (for business combinations and then extend the
discussion to other transactions and elements)
Range of IFRS classes

Can I use Framework-based teaching in my IFRS class?

• Yes, the starting point for all IFRS teaching should be the objective of IFRS financial information and the concepts that flow logically from that objective

• However, the extent of IFRS requirements taught are likely to vary by course level and to suit the objectives of the course

Common misunderstandings?
## Common misunderstandings

<table>
<thead>
<tr>
<th>The Framework does not…</th>
<th>Clarification—the Framework 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>

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## Common misunderstandings continued

<table>
<thead>
<tr>
<th>Misunderstanding</th>
<th>Clarification</th>
</tr>
</thead>
<tbody>
<tr>
<td>Principle 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 etc PP&amp;E, eg costs to dismantle/restore site, useful life, residual value, depreciation method etc Provisions, eg uncertain timing and amount of expected future cash flows</td>
</tr>
</tbody>
</table>
Conclusion

Benefits of Framework-based teaching

- Because the objective of the Framework is to facilitate the consistent and logical formulation of IFRSs, Framework-based teaching provides students with a cohesive understanding of IFRSs by relating the requirements to the objective of IFRS financial information and the concepts that underlie and inform its development.

- That cohesive understanding of IFRSs also
  - enhances the ability of students to exercise the judgements that are necessary to apply IFRSs
  - prepares students to continuously update their IFRS knowledge and competencies
Benefits of *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
- By relating those concepts to the IFRS requirements
  - *Framework*-based teaching
    - enhances the ability of students to exercise the judgements that are necessary to apply IFRSs
    - prepares students to continuously update their 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.