CHAPTER 2

THE FRAMEWORK OF INTERNATIONAL ACCOUNTING STANDARD BOARD (IASB)

INTRODUCTION

In order to narrowing the differences in recognition and measurement of elements of financial statements and harmonization of accounting standards and procedures regarding the preparation and presentation of financial statements, The IASB has revised The Framework. The chapters 1, 3 and 4 have been finalized and exposure draft of chapter 2 (Reporting Entity) has also been published.

The financial statements are prepared to provide information to the users regarding their economic decisions. The economic decisions users normally made are: -

(a) to decide when to buy, hold or sell an equity investment.
(b) to assess the stewardship or accountability of management.
(c) to assess the ability of the entity to pay and provide other benefits to its employees.
(d) to assess the security for amounts lent to the entity.
(e) to determine taxation policies.
(f) to determine distributable profits and dividends.
(g) to prepare and use national income statistics.
(h) to regulate the activities of entities.

The new conceptual framework is developed to apply range of accounting models and concept of capital and capital maintenance.

PURPOSE AND STATUS

The purposes of the Framework are: -

a) Assist the board to develop future IFRS and in its review of existing IFRSs
b) Assist the board in harmonization of regulations, accounting standards and procedure relating to the preparation and presentation of Financial Statements
c) Assist national standard setting bodies to develop national standards
d) Assist in preparation of Financial Statements and dealing with items not covered by the IFRS yet
e) Assist auditors in forming opinion whether the FS give a true and fair view
f) Assist users in interpreting the financial information
g) Assist in understanding the approach followed in the preparation of IFRS
h) The Framework and IFRS do not override any individual IFRS.

SCOPE OF FRAMEWORK

The framework deals with the following: -

a) The objective of financial reporting
b) The qualitative characteristics of useful information
c) The definition, recognition and measurement of the elements of Financial Statements
d) Concepts of capital and capital maintenance

Chapter 1

1.1 Objectives, usefulness and limitations of general purpose financial statements

1.1.1 The objective of general purpose financial statements is to provide financial information to existing and potential investors, lenders and other creditors in making above said economic decisions. To make economic decisions existing and potential users require information about the resources the entity controls, claims against the entity and information regarding how effectively and efficiently the management discharging its responsibilities.

1.1.2 Many users cannot require reporting entity for direct information they need and consequently they are the primary users of general purpose financial statements.

1.1.3 The IFRS Framework notes that general purpose financial reports cannot provide all the information that users may need to make economic decisions. They will need to consider pertinent information from other sources as well.

1.1.4 The IFRS Framework notes that other parties, including prudential and market regulators, may find general purpose financial reports useful. However, the Board considered that the objectives of general purpose financial reporting and the objectives of financial regulation may not be consistent. Hence, regulators are not considered a primary user and general purpose financial reports are not primarily directed to regulators or other parties.

1.2 Information about a reporting entity's economic resources, claims, and changes in resources and claims

1.2.1 Information about the nature and amounts of a reporting entity's economic resources and claims assists users to assess that entity's financial strengths and weaknesses; to assess liquidity and solvency, and its need and ability to obtain financing. Information about the claims and payment requirements assists users to predict how future cash flows will be distributed among those with a claim on the reporting entity.

1.2.2 A reporting entity's economic resources and claims are reported in the statement of financial position.

1.2.3 Changes in a reporting entity's economic resources and claims result from that entity's performance and from other events or transactions such as issuing debt or equity instruments. Users need to be able to distinguish between both of these changes.

1.2.4 Changes in economic resources and claims: - Information about a reporting entity's financial performance during a period, representing changes in economic resources and claims other than those obtained directly from investors and creditors, is useful in assessing the entity's past and future ability to generate net cash inflows. Such information may also indicate the extent to which general economic events have changed the entity's ability to generate future cash inflows.

1.2.5 The changes in an entity's economic resources and claims are presented in the statement of comprehensive income.

1.2.6 Financial performance reflected by past cash flows: - Information about a reporting entity's cash flows during the reporting period also assists users to assess the entity's ability to generate future net cash inflows. This information indicates how the entity obtains and spends cash, including information about its borrowing and repayment of debt, cash dividends to shareholders, etc.

1.2.7 The changes in the entity's cash flows are presented in the statement of cash flows.

1.2.8 Changes in economic resources and claims not resulting from financial performance: - Information about changes in an entity's economic resources and claims resulting from events and transactions other than financial performance, such as the issue of equity instruments or distributions of cash or other assets to shareholders is necessary to complete the picture of the total change in the entity's economic resources and claims.

1.2.9 The changes in an entity's economic resources and claims not resulting from financial performance is presented in the statement of changes in equity.

Chapter 2

The Reporting Entity

The chapter on the Reporting Entity will be inserted once the IASB has completed its re-deliberations following the Exposure Draft ED/2010/2 issued in March 2010.

2.1 Reporting entity concept

This deals with the general issues relating to the reporting entity concept. For example, it considers whether a precise definition of a reporting entity is necessary and whether a reporting entity must be a legal entity.

2.2 The Board's conclusion at this stage is that conceptual framework should broadly describe rather than precisely define a reporting entity as a circumscribed area of a business activity of interest to present and potential equity investors, lenders and other creditors who cannot directly obtain the information they need in making decisions about providing resources to the entity and in assessing whether management and governing board of the entity have made efficient and effective use of the resources provided. Examples of reporting entity includes a sole trader, corporation, trust, partnership, association and group.

2.3 Even a portion of an entity can qualify as a reporting entity if economic activities of that portion can be distinguished objectively from the rest of the entity and financial information about that portion of the entity has the potential to be useful in making decisions about providing resources to that portion of the entity. (Example include SILO)

Chapter 3

3.1 Qualitative characteristics of useful financial information: - The qualitative characteristics of useful financial reporting identify the types of information are likely to be most useful to users in making decisions about the reporting entity on the basis of information in its financial report. The qualitative characteristics apply equally to financial information in general purpose financial reports as well as to financial information provided in other ways.

3.2 Financial information is useful when it is relevant and represents faithfully what it purports to represent. The usefulness of financial information is enhanced if it is comparable, verifiable, timely and understandable.

3.3 Fundamental qualitative characteristics: - Relevance and faithful representation are the fundamental qualitative characteristics of useful financial information.

3.3.1 Relevance: - Relevant financial information is capable of making a difference in the decisions made by users. Financial information is capable of making a difference in decisions if it has predictive value, confirmatory value, or both. The predictive value and confirmatory value of financial information are interrelated.

3.3.2 Materiality is an entity-specific aspect of relevance based on the nature or magnitude (or both) of the items to which the information relates in the context of an individual entity's financial report.

3.3.4 Faithful representation: - General purpose financial reports represent economic phenomena in words and numbers, to be useful, financial information must not only be relevant, it must also represent faithfully the phenomena it purports to represent. This fundamental characteristic seeks to maximize the underlying characteristics of completeness, neutrality and freedom from error. Information must be both relevant and faithfully represented if it is to be useful. Information is faithfully represented when it is neutral, free from error and complete.

3.4 Enhancing qualitative characteristics: - Comparability, verifiability, timeliness and understandability are qualitative characteristics that enhance the usefulness of information that is relevant and faithfully represented.

3.4.1 Comparability: - Information about a reporting entity is more useful if it can be compared with similar information about other entities and with similar information about the same entity for another period or another date. Comparability enables users to identify and understand similarities in, and differences among, items.

3.4.2 Verifiability: - Verifiability helps to assure users that information represents faithfully the economic phenomena it purports to represent. Verifiability means that different knowledgeable and independent observers could reach consensus, although not necessarily complete agreement, that a particular depiction is a faithful representation.

3.4.3 Timeliness: - Timeliness means that information is available to decision-makers in time to be capable of influencing their decisions.

3.4.4 Understandability: - Classifying, characterizing and presenting information clearly and concisely make it understandable. While some phenomena are inherently complex and cannot be made easy to understand, to exclude such information would make financial reports incomplete and potentially misleading. Financial reports are prepared for users who have a reasonable knowledge of business and economic activities and who review and analyze the information with diligence.

3.5 The cost constraint on useful financial reporting: - Cost is a pervasive constraint on the information that can be provided by general purpose financial reporting. Reporting such information imposes costs and those costs should be justified by the benefits of reporting that information. The IASB assesses costs and benefits in relation to financial reporting generally, and not solely in relation to individual reporting entities. The IASB will consider whether different sizes of entities and other factors justify different reporting requirements in certain situations.

Chapter 4

The Framework remaining text

Chapter 4 contains the remaining text of the Framework approved in 1989. As the project to revise the Framework progresses, relevant paragraphs in Chapter 4 will be deleted and replaced by new Chapters in the IFRS Framework. Until it is replaced, a paragraph in Chapter 4 has the same level of authority within IFRSs as those in Chapters 1-3.

4.1 UNDERLYING ASSUMPTIONS

Going Concern

The financial statements are normally prepared on the assumption that an enterprise is a going concern and will continue its operation in the foreseeable future. It is assumed that neither the enterprise has intention to liquidate nor the circumstances are such that the entity will discontinue it operations in the foreseeable future.

4.2 ELEMENTS OF FINANCIAL STATEMENTS

Financial statements portray the financial effects of transactions and other events by grouping them into broad classes according to their economic characteristics. These broad classes are termed the elements of financial statements.

The elements directly related to financial position (balance sheet) are:

Assets

- A resource controlled by the enterprise
- As a result of past event
- From which future economic benefits are expected to flow

Liabilities

- A present obligation of the enterprise
- Arising from past event
- Settlement of which is expected to result in an outflow of resources embodying economic benefits

Equity

The residual interest in the assets of the enterprise after deducting al its liabilities

The elements directly related to performance (income statement) are:

Income

- Increase in economic benefits during the accounting period
- In the form of inflows (or enhancements of assets or decreases in liabilities)
- That result increases in equity
- Other than those relating to contribution from equity participants

The definition of income encompasses both revenue and gains. Revenue arises in the course of the ordinary activities of an entity and is referred to by a variety of different names including sales, fees, interest, dividends, royalties and rent. Gains represent other items that meet the definition of income and may, or may not, arise in the course of the ordinary activities of an entity. Gains represent increases in economic benefits and as such are no different in nature from revenue. Hence, they are not regarded as constituting a separate element in the IFRS Framework.

Expenses

- Decreases in economic benefits during the accounting period
- In the form of outflows (or depletion) of assets or incurrence of liabilities)
- That results in decreases in equity
- Other than those relating to distribution to equity participants

The definition of expenses encompasses losses as well as those expenses that arise in the course of the ordinary activities of the entity. Expenses that arise in the course of the ordinary activities of the entity include, for example, cost of sales, wages and depreciation. They usually take the form of an outflow or depletion of assets such as cash and cash equivalents, inventory, property, plant and equipment. Losses represent other items that meet the definition of expenses and may, or may not, arise in the course of the ordinary activities of the entity. Losses represent decreases in economic benefits and as such they are no different in nature from other expenses. Hence, they are not regarded as a separate element in this Framework.

1.12 RECOGNITION OF ELEMENTS OF FINANCIAL STATEMENTS

Recognition is the process of incorporating in the statement of financial position or statement of comprehensive income an item that meets the definition of an element and satisfies the criteria set out as below: -

a) It is probable that any future economic benefits associated with the item will flow to or from the enterprise; and

b) The item has a cost or value that can be measured with reliability

1.13 MEASUREMENT OF ELEMENTS OF FINANCIAL STATEMENTS

Measurement is the process of determining the monetary value at which the elements of Financial Statements are to be recognized.

1.13.1 Measurement Basis

	Assets	**Liabilities**
Historic cost	The amount paid or the fair value of consideration given to acquire them at the time of their acquisition.	The amount received in exchange for the obligation or the amount of cash and cash equivalents to satisfy the liability e.g. Income taxes
Current cost	The amount that have to be paid if the same or an equivalent asset was acquired currently	The undiscounted amount that would be required to settle the obligation currently
Realizable value	The amount that could currently be obtained by selling the asset in ordinary course of disposal	At settlement value i.e. the un-discounted amounts expected to be paid to satisfy the liabilities in the normal course of business
Present value	Present discounted value of the future net cash flows that the item is expected to generate in the normal course of business	Present discounted value of the future net cash outflows that one expected to be acquired to settle the liabilities in the normal course of business.

1.13.2 Advantages of historic cost

i) records are based on objectively verifiable data

ii) it is simple and cheap

iii) provide basis for comparison with other companies

1.13.3 Disadvantages of historic cost

i) it overstates profit when prices are rising

ii) it maintains financial capital and does not maintain physical capital

iii) the statement of financial position does not show the actual worth

iv) provide poor basis for assessing performance

v) It does not recognize the loss suffered through holding monetary assets while prices are rising.

1.14 CONCEPTS OF CAPITAL AND CAPITAL MAINTENANCE

1.14.1 Financial concept of capital is the invested capital or invested purchasing power this is synonymous with the net asset or equity normally followed when the user is concerned with the maintenance of nominal amount of capital or purchasing power of capital.

1.14.2 Physical concept of capital is the operating capability. Capital is regarded as the productive capacity of the enterprise based on e.g. units of out put per day, normally followed when the user is concerned with operating capability of the enterprise.

1.14.3 Maintenance of Capital and the Determination of Profit

a) **Financial capital maintenance**: Under this concept a profit is earned only if the financial (money) amount of the net assets at the end of the period exceeds the net amount of assets at the beginning of the period after excluding any distributions to and contributions from owners during the period. Financial capital maintenance can be measured in either nominal monetary units or units of constant purchasing power.

b) **Physical capital maintenance: -** Under this concept a profit is earned only it the physical productive capacity (or operating capability) of the enterprise (or resources or funds needed to achieve that capacity) at the end of the period exceeds the physical productive capacity at the beginning of the period, after excluding any distributions to, and contributions from, owner during the period.