International Financial Reporting Standards

Framework-based teaching of principle-based standards

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.

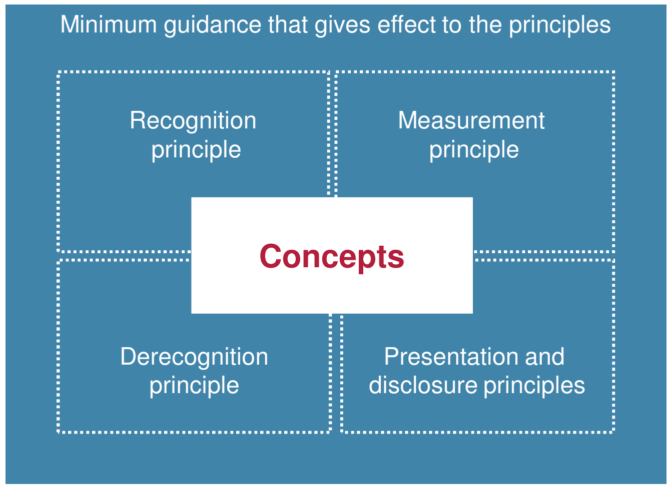
IFRS™

Role of IASB *Framework*

- *Framework* sets out agreed concepts that underlie financial reporting
  - – Objective, qualitative characteristics, element definitions, …
- 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

IFRS™

Structure of a principle-based standard



IFRS

The ideal principle-based standard

- Scope
  - no exceptions
- Principles
  - derived from conceptual framework
  - reliance on professional judgement to apply principles in business context
- Application guidance
  - explains application of principles

IFRS

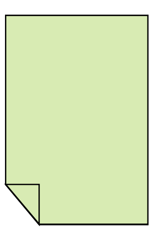
Get rule-based standards if

5

- 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

From concepts to principles to rules

6

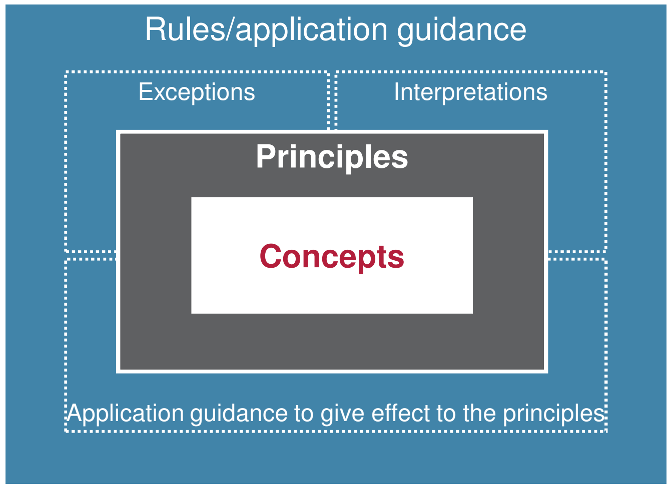


Concepts

Principles

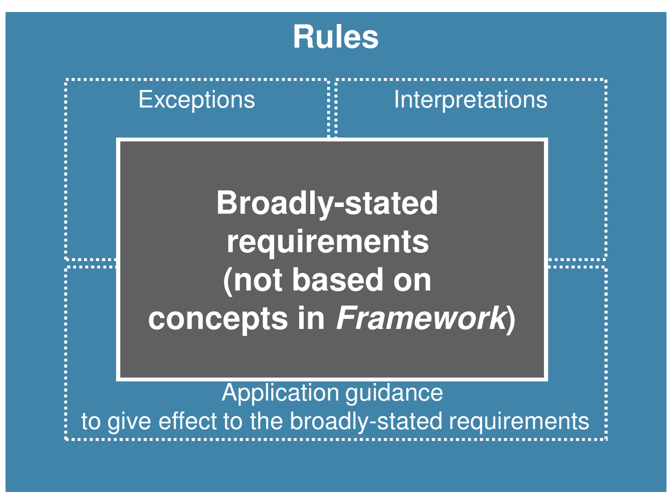
Rules

Structure of some IFRSs



IFRS™

Structure of other IFRSs



IFRS™

Concepts that underlie IFRSs

9

- Objective of **general purpose financial statements**
- Qualitative characteristics
- Elements
- Recognition and measurement
- Presentation and disclosure

Teaching suggestions:
- Identify which concepts are robust (and which are not)
- Relate the requirements back to the robust concepts in *Framework*
- Explain reasons when requirements inconsistent with *Framework*
- Debunk myths, eg myth: *Framework* = IFRS constitution

IFRS™

Objective

10

Objective of IFRS financial statements

- to provide financial information about the reporting entity
- that is useful to existing and potential investors, lenders and other creditors
- in making capital allocation decisions
  – buy, sell or hold debt and equity instruments
  – provide or settle loans and other form of credit

IFRS™

Objective continued

11

Teaching suggestions:

- Contrast objective of IFRS financial statements with other objectives of 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

IFRS™

Qualitative characteristics

12

- fundamental QCs
  - relevance
    - predictive value, feedback value, materiality (entity-specific)
  - faithful representation
    - completeness, neutrality, free from error
- enhancing QCs
  - comparable
  - verifiable
  - timely
  - understandable

IFRS™

Elements

13

Current framework

- 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

Framework project

- Asset
  - a present
  - economic resource
  - to which the entity has a right or other access that others do not have
- Liability
  - a present
  - economic obligation
  - for which the entity is the obligor

IFRS™

Elements continued

14

Current framework

- Equity = Assets – Liabilities (ie a residual)
- Income and expenses = changes in assets and liabilities…

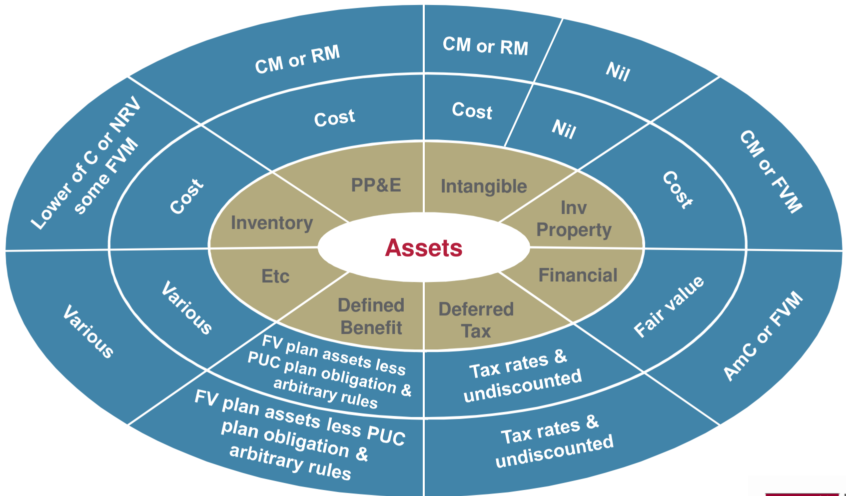
Teaching suggestions:

- asset is the cornerstone of element
- defining income and expenses with reference to assets & liabilities = robust framework for measuring performance

IFRS™

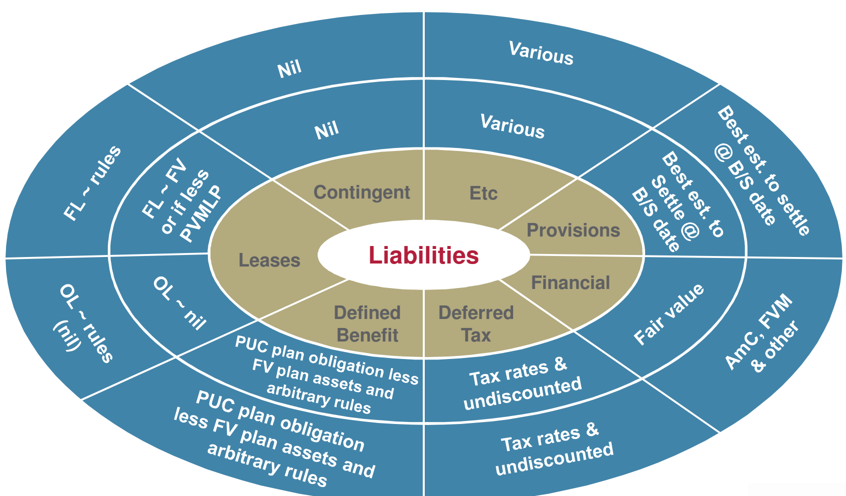
Asset

Classification, recognition and measurement



Liability

Classification, recognition and measurement



Keys to teaching IFRSs

17

- Students need to understand IFRSs, not simply memorise their requirements (open-book exams might help)
- Most requirements in IFRSs are based on the concepts in the *Framework* and require judgment to apply
- Develop capacity to make judgments
  – first step is to understand the *Framework*
  – then need practice – Case method teaching?
- Basis for Conclusions can be instructive
  – explains IASB's reasoning
  – describes rejected alternatives and explains why they were rejected

IFRS

From concepts to principles to rules

18

Teaching suggestions

– build from concepts to principles

– explain

  – need for judgement in applying principles
  – how application guidance gives effect to principles
  – how other rules create exceptions and other departures from the principles
  – how interpretations can create more rules

– test understanding, eg use integrated case studies

IFRS

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

Example 2:
Lease classification

21

- 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

Example 2:
Lease classification continued

22

Teaching suggestions:

– explain broadly-stated requirement is weak/inconsistent with the framework

– discuss what a principle-based leased classification principle could be,
eg see ED *Leases*

– focus on judgements,
eg classification operating or finance lease

– test understanding,
eg use an 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)

Example 3: Business combinations continued

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)

Common misunderstandings

The *Framework* does **not**…	Clarification—the *Framework* includes
include a matching concept	accrual basis of accounting—recognise elements when satisfy definition and recognition criteria
include prudence/conservatism concept	neutrality concept
include an element other comprehensive income (or a concept for OCI)	Only the following elements—asset, liability, equity, income and expense
mention management intent or business model	

Common misunderstandings continued

Misunderstanding	Clarification
Principle are necessarily less rigorous than rules	Rules are the tools of financial engineers
There are few judgements and estimates in cost-based measurements	Inventory, eg allocate joint costs and production overheads etc PP&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

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.

IFRS