World Academy of Science, Engineering and Technology
International Journal of Economics and Management Engineering
Vol:10, No:5, 2016

Several Aspects of the Conceptual Framework of Financial Reporting

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Open Science Index, Economics and Management Engineering Vol:10, No:5, 2016 publications.waset.org/10004317.pdf

***Abstract*—**The conceptual framework of International Financial Reporting Standards determines the basic principles of accounting. The said principles have multiple applications, with professional judgments being one of those. Recognition and assessment of the information contained in financial reporting, especially so the somewhat uncertain events and transactions and/or the ones regarding which there is no standard or interpretation are based on professional judgments. Professional judgments aim at the formulation of expert assumptions regarding the specifics of the circumstances and events to be entered into the report based on the conceptual framework terms and principles. Experts have to make a choice in favor of one of the aforesaid and simulate the situations applying multi-variant accounting estimates and judgment. In making the choice, one should consider all the factors, which may help represent the information in the best way possible. Professional judgment determines the relevance and faithful representation of the presented information, which makes it more useful for the existing and potential investors. In order to assess the prospected net cash flows, the information must be predictable and reliable. The publication contains critical analysis of the aforementioned problems. The fact that the International Financial Reporting Standards are developed continuously makes the issue all the more important and that is another point discussed in the study.

***Keywords*—**Conceptual Framework for financial reporting, Qualitative characteristics of financial information, Professional judgement, Cost constraints, Financial reporting

I. Introduction

THE objective of financial reporting is to provide information on the reporting entity to existing and potential investors and creditors for the purpose of decision-making on the resources supplied to it. Financial reporting designed for investors is presented in a way that makes it useful in economic decision making and to make net cash flow forecast possible.

Basic principles of accounting defined in the conceptual framework for financial reporting underlie the information-free preparation and presentation of financial statements to the users. Fundamental qualitative indicators, such as relevance and faithful representation, defined by the conceptual framework for financial reporting safeguard the usefulness of the financial information [1].

II. Theoretical Frameworks

Information is appropriate if it can affect the user's decision. Financial Information affects a decision if it is essential and has predictive and confirmatory values or both and is employed by the user for forecasting and assessment.

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For the information to be useful to the user, it should faithfully represent the economic developments, to which end it should have three properties: completeness, neutrality and accuracy.

Aside from the basic qualitative indicators, the conceptual framework sets apart additional ones, such as comparability, verifiability, timeliness and understandability, which add up to the usefulness of the supplied information. The conclusion states that if the financial information is subjective to the extent that it may affect the users' decision making, it is regarded as partial. The international Accounting Standards Board justifies cancellation of substance over form principle by stating that fair presentation of information purports it. The substance over form principle is not specified as a separate component of fair presentation since it would have been verbosity. If the legal form of an economic phenomenon differs from its economic substance, it cannot be regarded as fairly presented.

Within the framework of the draft project for structural framework changes and as a result of the evaluation of critical opinion, consultations and discussions, the International Standards Board developed a draft project for comments to the changes in the Conceptual Framework (26 October 2015). According to the draft project, in financial reporting, the phenomena are to be represented not only in legal but economic terms since representation of information in the form, which differs from the economic substance of the main phenomenon, does not secure faithful representation [2].

The project also involves connection between the neutrality and prudence, for the latter principle supports the former. The principle of prudence/caution reflects the entity tactics regarding risks. Traditionally, prudence implies that assets and incomes should not be assessed optimistically, and that expenses and liabilities should be evaluated pessimistically. For instance, income is recognized only when there is evidence of its obtainment, while loss - at the time of its assumed rise. Special reserves are created to cover the anticipated loss. This kind of approach to assessment is known as asymmetric prudence/caution. Some experts claim that a financial report based on this principle "is not good enough" to portray an entity to investors, which may have an adverse effect on their future financial prospects.

The May 2015 draft changes to the Conceptual Framework suggest exercising cautious prudence in cases of uncertain phenomena. Rationality is defined as the judgment-based prudence in cases of uncertainty. The Board believes that

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prudent caution will be beneficial in terms of neutrality of the accounting policy and secures faithful representation of financial reporting elements to investors.

Prudence means envisaging conditions of uncertainty in an enterprise in assessment of the phenomena. Prudence also implies that available data should underlie the incomes and assets, which should not be overstated, neither should the costs and liabilities be understated. This principle should be strictly observed, as its disregard is likely to affect subsequent periods. At the same time, prudence (caution) does not mean formation of undisclosed reserves and misstatement of enterprise-related information.

Neutral representation of information calls for accurate and conservative assessment of phenomena in order not to influence the user's decisions. Therefore, we may say that neutrality relies on prudence and includes it.

The conceptual framework explicates that faithful representation of information in the financial statement does not always mean accuracy in all aspects and relies more on estimation, judgment and modeling rather than accurate values. The Conceptual Framework also defines the principles of estimation, judgment and modeling.

In the financial statement, professional judgment should be employed in the recognition and estimation of information, especially those concerning the phenomena and transactions associated with uncertainty and/or regarding which there is no standard and interpretation.

The purpose of professional judgment is the formation of expert opinion on accounting and representing the phenomena and circumstances in the financial statement using the Conceptual Framework terms and principles. To this end, experts should model the situations with multivariant estimation values and make a judgment-based choice in favor of one of those. In making the choice, all the factors that may represent the financial information in the best way possible, should be taken into account.

Uncertainties and uncommon situations characteristic to economic phenomena, rules of accounting of which are not determined in IFRS. To this end, the IFRS Conceptual Framework should be employed. Based on professional judgment, management develops accounting policy for the phenomena, transactions or conditions for which no standards are available. Professional judgment relies on the Conceptual Framework principles and regulations securing relevance and reliability of the enterprise-related financial information.

The professional judgment determines relevance and fairness of the presented financial information and therefore, increases its usefulness to the existing and potential investors who need the predictable and reliable information in order to estimate the net cash flow prospects. Consequently, representation of uncommon phenomena, conditions and transactions calls for professional judgment relying on the IFRS conceptual grounds. However, there is no interpretation for professional judgment itself [3].

Summing up the views presented in economic literature, we may say that professional judgment aims at the formation of expert opinions on accounting and representing phenomena in financial statement in case of uncertainty and uncommon conditions. To this end, an expert should model a situation with due regard to multiple results and make a choice in favor of one of those, with all the objective factors influencing the decision taken into account. Hence, professional judgment is an expert opinion (evaluation, conclusion) on recognition and assessment of the accounting units in uncertain and uncommon conditions.

Under IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors: In the absence of an IFRS that specifically applies to a transaction, other event or condition, management shall use its judgement in developing and applying an accounting policy that results in information that is relevant and reliable [4].

Professional judgment largely determines usefulness of the financial reporting information. Therefore, professional judgment, which must rely on conceptual grounds of financial reporting, requires high professional qualification, experience and awareness of economic practice [5].

In the initial recognition and subsequent estimation of the financial reporting components, the principles and regulations determined by the Conceptual Framework are used as a means of professional judgment. Two kinds of uncertainties in the governing regulations and normative acts have been singled out: first - uncertainties, which make it possible to choose the most optimal from the suggested options in a certain situation; second - uncertainties where there is no regulation or it is inadequate and a professional has to make independent decisions and assume responsibility [6].

Professional judgment underlies estimation of the economic resources of an enterprise, its due assessment models and processes, recognition principles, and accounting issues, etc.

Qualitative indicators supply a professional judgment criterion of relevance and faithful presentation of information. It is those qualitative indicators that make the information on the economic resources of an accounting unit useful, predictable or/and confirmable.

As mentioned above, financial reporting is designed for supply of information to users in order to help them in making predictions and decisions. To this end, the information is to have predictive or confirmatory values or both, in which case it is relevant, i.e. affects the user's decision-making. Relevance of financial reporting is one of the main qualities covered within the Conceptual Framework.

According to the Conceptual Framework, predictive and confirmatory values make the information relevant. The financial information is predictive if the user may refer to it in predicting the results, while it has the confirmatory value if it provides evidence of the earlier assessments, confirms or changes them.

The fact is that most of the information users' decisions rely on the anticipated return from the equity, bond and credit instruments. Consequently, the information may change the decisions only in case it helps the user make new predictions, confirms or adjusts them.

The original states that the information in a financial report is to be material, which means that its omission or

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misstatement could influence the decisions of the primary users of general purpose who make decisions relying on the financial information supplied by a specific reporting entity. Since each entity is specific, materiality of the information is to be considered within the context of the financial reporting. Therefore, the Conceptual Framework states that materiality is an entity-specific aspect based on the nature or magnitude of the financial reporting element. Consequently, the Conceptual Framework could not provide a uniform definition of the materiality or regulations for that matter. Once again, the principle of judgment should be applied while assessing the information materiality for specific entity in specific circumstances. Judgment is to be based on interpretation of the materiality. The materiality of information is interpreted as the magnitude or quality of the report items, which if unrepresented or misstated will affect the information users' decisions.

The conclusion of the Conceptual Framework states that the materiality is a relevant aspect since irrelevant information cannot influence the user's decision. The materiality is an entity-specific assumption, which should be applied on an individual level.

To define the materiality means to determine the level or threshold of influence made on the users' decisions. A major item of an entity's financial report will be material. However, materiality of some of the items may be associated with their economic nature. Consequently, in determining the materiality level/threshold, one takes into account both the magnitude and economic nature, of the items i.e. the quantitative and qualitative aspects thereof. As is known, the materiality in accounting is defined as percentage of the balance items or revenue within range of 0.5 % to 25 % of the total. The accounting policy should allow for the approaches and methods of defining the materiality level.

For the financial report information to be useful, not only does it have to be material but faithfully represented, too. Under the Conceptual Framework, faithful representation of the information means faithful representation of the economic phenomena to which end it is to be complete, unbiased and error-free. In this regard, the 2015 draft changes state that a factor influencing relevance of the financial information is its uncertainty level. Therefore, assessment is crucial in preparation of the financial report. It should duly describe the assessment procedures and explain uncertainty, which may materially affect it.

One factor affecting the relevance of financial information is the level of measurement uncertainty. Measurement uncertainty arises when a measure for an asset or liability cannot be observed directly and must be estimated, instead.

The use of estimates is an essential of the preparation of the financial information and does not necessarily undermine its relevance but the estimate needs to be properly described and disclosed.

It is important to describe the stages in which the Conceptual Framework determines the key qualitative characteristics of the information. First - the economic phenomena, which may be useful to the user of the financial information of a reporting entity; second - the definition of the information (if any), which is the most relevant to the economic phenomena on condition of its faithful representation, and third – availability of such information and possibility of its faithful representation. If so, the Conceptual Framework states that at this stage, the information complies with the key qualitative characteristics. Otherwise, the procedure will have to be repeated regarding different type information.

Financial reporting has to do with costs. The Conceptual Framework imposes stringent requirements regarding the information supply costs, which mean that those accrued by the owners', etc., and interested parties for the preparation of the financial report, should not go over the prospected benefit. The framework states that it is important that the costs should be justified in terms of the anticipated benefit.

Preparation and supply of the information relevant to the financial report (collection, processing, verification and dissemination) call for considerable labor and financial costs. The Board believes that it is the users of the information that eventually bear the financial report preparation costs since it reduces their investment return. The fact is that relevant and accurate financial information helps the suppliers of capital in making justified decisions, which is crucial to efficient operation of the capital market and, moreover, diminishes the capital value for the national economy. Also, by making lower value capital accessible, sufficient information may be beneficial to a wide range of the other information users, such as individual investors, creditors and lenders. Apart from that, sufficient information has a positive effect in terms of PR. The relevant information is no less important in terms of top management decision-making, since insider financial information to a certain extent relies on the financial report designed for external users [7].

The Conceptual Framework does not provide instructions as to the assessment of the information supply benefit and striking a cost-benefit balance, since it is impossible to allow for all the possible scenarios. Given the subjectivity of the procedure, assessment of individual items of the financial reports prepared by different entities will inevitably differ. Therefore, the Financial Reporting Board concludes that the cost-benefit ratio should be assessed not only in terms of an individual reporting entity, but the entire reporting, i.e. from the information users' standpoint.

The Framework states that it does not mean that uniform financial information supply requirements should be applied for the purpose of cost-benefit assessment. Factors, such as the size, capital attraction potential of a business, the information users' requirements etc. should be taken into account.

In practice, the cost-benefit test or determination of justified costs is a complex task. Conclusion to the Conceptual Framework states that the cost is not a qualitative index of information but that of the information supply process. Since the cost-benefit ratio principle is essentially more organizational rather than methodological, we believe that sound accounting and reporting practices make it possible to observe it. Moreover, the principle helps in meeting the

relevant and fair information reporting standard set by the Conceptual Framework. For that reason, in the preparation of the financial report, professional judgment should be applied in terms of expediency of the costs and the information users' presumed benefit, with due consideration of ranking the information's qualitative indexes.

The Board is trying to develop the methods that will enable it to obtain information on the collection and processing costs of the duly requested information. To this end, the Board has been using the respondents' feedback about the costs and benefit in order to develop proposals, which to a certain extent can be represented in quantitative terms. Relying on the said information and seeking to cut costs without a significant diminution of the benefit, the Board made changes to the proposed requirements.

The small and medium-size entities do not effect transactions and operations, which the Stock Exchange-quoted companies do. Therefore, their users' interests differ, too. For them preparation of the financial reports in line with the IFRS is a costly and laborious task, which stands against the IFRS envisaged "cost benefit" ratio guideline. It can be said that the costs incurred by SME for preparation of the financial reports under the IFRS conceptual framework are unjustified.

The SME effects foreign trade transactions and are the capital market players. Understandingly, the other market players, such as the banks, creditors and potential investors need information on them in order to assess their standing and prospects.

The IASB decided to develop the reporting standards for the SME, which would supply the relevant information to all the market players useful for decision making. The IASB aimed at simplification of accounting; cutting the financial reporting costs and supply of the business-specific information to help a wide range of users in making economic decisions and the one that would make it possible to determine how efficiently the Management disposes of the available resources.

Given the said objectives, IASB developed the IFRS for SMEs relevant to their operations and transactions, as well as the information users.

According to the IFRS, small and medium-sized enterprises are not publicly accountable and publish common use financial reports designed for external users. Users of their financial reports are more interested in their short-term cash flows, liquidity and solvency rather than their market value. Banks, suppliers, credit-rating agencies, clients and stockholders [8] are the external users of the SME financial reports.

As a result, simpler IFRS allowing slashing of the financial report preparation costs and making the user-designed information more useful were developed. The IFRS for the SME is a separate, global IFRS-based standard created with due regard to their capacity and characteristic events and transactions. The new standards are simpler and do not necessarily require comprehensive application of the global IFRS [9].

The abovementioned simplification resulted from disregard to the issues irrelevant to the SME; the recognition criteria of financial reporting components are simpler; the alternative accounting methods are limited and there are much fewer explanatory notes. All these make financial reporting simpler and cheaper.

Employment of uniform methods in preparation of the SME financial reports make them comprehensible, transparent and comparable to the interested parties and increase their chances of getting loans, attracting investments and ultimately involvement in foreign trade. It should be said though that there is a number of SME operating at the domestic markets solely, their securities are not quoted and they do not issue bonds and equity instruments. Those SMEs have "simplified" their accounting by selecting the most appropriate from the global IFRS or disregarding some issues, such as deferred profit taxes, financial lease, etc. Such SMEs will have to develop accounting policies relying on the IFRS for the SME and make adjustments for the sake of reconciliation of the reporting information for the previous periods.

Upgrading the IFRS for the SME has been and still remains at the top of the International Accounting Standards Board (IASB) agenda as the draft modifications [10] made on the grounds of the hands on experience exchange and discussion of the respondents' feedback make it evident.

III. Conclusion

- With the new requirements of the market economy, critical expert opinions, possibilities of actual employment of the IFRS taken into account, the International Standards Board regularly refines the conceptual framework of financial reporting;
- The draft changes to the Conceptual Framework made it obvious that in estimating the phenomena and conditions, prudence and economic substance of a transaction were to be taken into account. However, without setting those apart as the qualitative indicators of information the Board places them within a single context of the indicators and principles;
- Draft changes to the Conceptual Framework suggest exercise of cautious prudence in case of uncertain phenomena, which will be beneficial in terms of neutrality of the accounting policy and, consequently, faithful representation of the financial information.
- The Conceptual Framework does not interpret the professional judgment. However, we believe it has to be categorized and its requirements defined.
- It is important to describe the way the Conceptual Framework treats the key qualitative characteristics and request describe the assessment-related uncertainties affecting relevance of the information;
- The Conceptual Framework states that the incurred costs to be justified in terms of the information reporting benefit, while the cost-benefit ratio should be assessed not only in terms of an individual reporting entity but the entire reporting.

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