A Commentary on the Conceptual Framework for Financial Reporting

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1. Introduction

In April 2018, the MASB issued a revised *Conceptual Framework for Financial Reporting*. This is equivalent to the revised *Conceptual Framework for Financial Reporting* issued by the IASB in March 2018. This marks the completion of the project to replace the original *Framework for the Preparation and Presentation of Financial Statements (2007)* in its entirety. This revised *Conceptual Framework (2018)* rearranges certain chapters of the original *Conceptual Framework (2010)* and there are now eight chapters, including a chapter on "Financial Statements and the Reporting Entity" and a chapter on "Presentation and Disclosure".

2. The Salient Features of the revised Conceptual Framework

When compared to the 2010 Conceptual Framework, the salient features and changes in the revised Conceptual Framework (2018) are summarised as follows:

(a) Defining and explaining the concept of the "*reporting entity*" (an entity that is required, or chooses, to prepare financial statements) which may be a single entity, a group of entities, or a combined reporting unit. Along with this, a new set of financial statements, known as *combined financial statements*, is introduced for the first time in the Conceptual Framework to cater for circumstances in which financial statements need to be prepared, for example, for businesses or units operating under common control but for which the legal status has not yet been determined.

(b) Refining the definition of an asset as an economic resource (being *"rights"* that have the potential to produce economic benefits) controlled by the entity as a result of past events and removing the notion of "expected flow". This means an asset can exist even if the probability of an inflow of economic benefits is low. Some of the more recent MFRSs have used this "rights" condition to require reporting entities to recognise intangible assets (in MFRS 138 *Intangible Assets*) and right-of-use assets (in MFRS 16 *Leases)*.

(c) Introducing the "no *practical* ability to avoid" criterion to the liability definition. It discusses how the criterion is applied if a duty or responsibility arises from the entity's customary practices, published policies or specific statements or if a duty or responsibility is conditional on a particular future action that the entity itself may take.

(d) Introducing the concept of "*unit of account*" for assets and liabilities to facilitate a thought process to follow in selecting and identifying the unit of account when setting the recognition and measurement requirements in the MFRSs. This concept requires judgements to be applied in deciding whether the recognition and measurement principles in the MFRSs shall be applied individually to each asset or liability, grouped into portfolios of assets or liabilities, or grouped in a single unit.

(e) Revising the *recognition principles* for elements of financial statements by aligning the recognition criteria to the objective of providing useful information that meets the fundamental qualitative characteristics of relevance and faithful representation. Thus, some items of assets and liabilities may qualify for recognition even if the probability of an inflow or outflow of economic benefits is low or the measurement is subject to significant uncertainties. These differ from the criteria of the former Frameworks that required high probability of future economic benefits and cost or value that can be measured with reliability.

(f) Adding a separate section on *measurement* which describes various measurement bases and discusses factors to be considered when selecting a measurement basis.

(g) Adding a separate chapter on presentation and disclosure to explain the objectives and principles of presentation and disclosure, classification of items of assets, liabilities, equity, income and expenses, and aggregation of items.

3. Commentaries

There are no significant changes to the objective of financial reporting, qualitative characteristics of financial reports, accrual basis, elements, concepts and pervasive principles. The revised Conceptual Framework has reintroduced the prudence concept to support the neutrality principle for faithful representation. It also reintroduced the term 'stewardship' to give prominence to the importance of providing information to help users to assess the prospects for future net cash inflows to the entity, and that extra prominence contributes to highlighting management's accountability to users for economic resources entrusted to their care.

The 2018 Conceptual Framework defines a reporting entity as "*an entity that is required, or chooses, to prepare financial statements*". A reporting entity can be a single entity (such as a reporting company) or a portion of an entity (such as a reporting cash-generating unit if it so chooses to prepare financial statements) or can comprise more than one entity (such as a reporting group). A reporting entity is not necessarily a legal entity. It can be a combined unit of business segments operating under common control.

For asset recognition, the criteria to determine the existence of an asset are: (i) right to; (ii) potential to produce economic benefits from, and (iii) control of, an economic resource, which implies that an asset need not necessarily take a particular form, like being tangible or physical. Many of the more recent MFRSs have required that other than legal ownership, rights arising from contractual arrangements, including rights to access intellectual property and right to use particular assets meet the requirements of a resource controlled by an entity. Also, an entity might obtain rights in other ways, for example: (b) by acquiring or creating know-how that is not in the public domain; or (b) through an obligation of another party that arises because that other party has no practical ability to act in a manner inconsistent with its customary practices, published policies or specific statements.

For a liability to exist, the three criteria that must all be satisfied are: (a) the entity has an obligation; (b) the obligation is to transfer an economic resource; and (c) the obligation is a present obligation that exists as a result of past events. The 2018 *Conceptual Framework* defines an obligation as a duty or responsibility, as did the 2010 *Conceptual Framework*. In applying the 2010 definition, it was generally accepted that an entity has a present obligation when that obligation is unconditional and legally enforceable—in such situations, the entity clearly has no ability to avoid the transfer. However, in some other situations an entity has some limited ability to avoid a future transfer and problems had arisen because it was unclear how limited that ability must be for an entity to have a ‘present obligation’. To provide clarity, the 2018 *Conceptual Framework* states that an entity has an obligation if it has a duty or responsibility that it has no practical ability to avoid. Applying the criterion of ‘no practical ability to avoid’ will require judgment as the factors used to make the assessment may depend on the nature of the entity’s obligation.

3.1 Unit of Account

A unit of account is defined as “the right or the group of rights, the obligation or the group of obligations, or the group of rights and obligations, to which recognition criteria and measurement concepts are applied”.

A unit of account is selected for an asset or liability when considering how recognition criteria and measurement concepts will apply to that asset or liability and to the related income and expenses. In some circumstances, it may be appropriate to select one unit of account for recognition and a different unit of account for measurement. For example, contracts may sometimes be recognised individually but measured as part of a portfolio of contracts (e.g. this may be applicable to the telecommunications industry as they have a large volume of similar contracts with similar classes of customer if the entity reasonably expects that the effects on the financial statements would not differ materially whether the contracts are measured individually or as part of a portfolio).

A unit of account may include an individual asset or liability, a group of assets or liabilities, a portfolio of similar items. In applying a particular MFRS, a reporting entity must first decide on and select the unit of account as specified or provided for in the MFRS. That is the starting point for recognition. For example, in a contract to lease a vehicle, the right to use (right-of-use) the vehicle is usually a unit of account for a single asset. However, if there are similar contracts to lease vehicles of the same terms and conditions, all the leases, as a practical expedient, may be grouped as a single unit of account. For biological assets in MFRS 141 *Agriculture*, the plants or animals may be grouped into units of accounts using age attributes for recognition and measurement purposes rather than to account for each plant or animal separately.

3.2 Recognition Criteria

In the original Framework, an item that meets the definition of an element should be recognised if: (i) it is probable that any future economic benefit associated with the item will flow to or from the entity, and (ii) the item has a cost or value that can be measured with reliability. These were high thresholds that emphasised on probable inflows or outflows of future economic benefits (probability recognition criterion) and whose cost or fair value can be measured reliably (measurement reliability criterion). However, the recognition criteria created problems. For example, some Standards did not apply the probability criterion consistently (they used different probability thresholds which included ‘probable’, ‘more likely than not’, ‘virtually certain’ and ‘reasonably possible’) while the reference to reliability was unclear and could result in inappropriate outcomes as it could be interpreted as one prohibiting recognition of any item that has a high level of measurement uncertainty, even if recognising such an item would provide useful information.

The Conceptual Framework (2018) does not have these thresholds. It assesses the link between providing useful information and the fundamental qualitative characteristics of relevance and faithful representation for the recognition of an element. It clarifies that only items that meet the definition of an asset, a liability or equity are recognised in the statement of financial position. Similarly, only items that meet the definition of income or expenses are recognised in the statement(s) of financial performance.

An asset or liability can exist even if the probability of an inflow or outflow of economic benefits is low. If the probability of an inflow or outflow of economic benefits is low, the most relevant information about the asset or liability may be information about the magnitude of the possible inflows or outflows, their possible timing and the factors affecting the probability of their occurrence. For an asset or liability to be recognised, it must be measured. In many cases, such measures must be estimated and are therefore subject to measurement uncertainty. A high level of measurement uncertainty does not necessarily prevent such an estimate from providing useful information.

3.3 Measurement Bases

The Conceptual Framework acknowledges that there are a number of different measurement bases being employed to different degrees and in varying circumstances in financial statements. These bases include: (a) historical cost and (b) current value (which may be fair value, value in use for assets and fulfilment value for liabilities or current cost).

On capital maintenance, two concepts are explained: the physical capital and the financial capital. The Conceptual Framework does not identify a preference for a particular concept of capital and capital maintenance. Certain MFRSs standards, such as MFRS 116 *Property, Plant and Equipment* and MFRS 138 *Intangible Assets*, use the physical capital maintenance concept, which requires gains on revaluation to be credited to an OCI revaluation reserve (capital maintenance adjustment). Others like, MFRS 9 *Financial Instruments*, MFRS 140 *Investment Property*, and MFRS 141 *Agriculture*, adopt the financial capital maintenance concept, which requires changes in fair value be recognised as gains or losses in profit or loss.

4. Conclusions

This 2018 document is a complete version of the *Conceptual Framework for Financial Reporting* in Malaysia. The overall objective of financial reporting, qualitative characteristics and key reporting principles are largely unchanged when compared to the 2010 Conceptual Framework. Just as in the original Frameworks, the 2018 Conceptual Framework does not have a preference for any particular measurement model, which means that measurement bases for assets, liabilities, income and expenses would continue to be of mixed attributes of historical cost and current value (which may be fair value, value in use, fulfilment value or current cost).

The 2018 Conceptual Framework improves on the recognition and measurement principles in the original Frameworks by aligning those principles with some of the more recent MFRSs issued by the MASB and the emerging development and advancement in the business environment. There are no longer high thresholds of probable recognition criterion and measurement reliability criterion for the recognition of assets and liabilities.

Rights to use resources and obligations to transfer resources are recognised as assets and liabilities respectively even if the probability of future flows of economic resources is low or the measurement is subject to significant uncertainties. The key test is whether they exist. In the fast changing business environment, new technologies, mass marketing networking and advancement of artificial intelligence are being created as valuable resources of business entities. These “intangibles” create values to the reporting entities and with lower thresholds for recognition and measurement, some of these may qualify for recognition. However, it remains a challenge for the standard setters to bring these valuable resources for financial reporting. Also, the concept of contingent liabilities and contingent assets currently applied in MFRS 137 *Provisions, Contingent Liabilities and Contingent Assets* may become redundant in financial reporting with the new Conceptual Framework because there are no longer thresholds of "probable, possible and remote" applied in the recognition of liabilities.

With these improvements and changes, some of the existing MFRSs, (such as MFRS 137 *Provisions, Contingent Liabilities and Contingent Assets*) may need revision or update to be consistent with the new Conceptual Framework. Other than these concerns, the new Conceptual Framework is more likely to affect new MFRSs that may be issued in the future.

References:

1. MASB, Conceptual Framework for Financial Reporting, 2010.
2. MASB, Conceptual Framework for Financial Reporting, 2018.
3. MASB, Framework for the Preparation and Presentation of Financial Statements, 2007.

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