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14. Reforming the Conceptual Framework for Financial Reporting

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The objective of financial reporting is to provide financial information that is useful to investors and creditors in making their decisions about allocating their resources. Intangible assets are very difficult to integrate into current financial reporting framework due to some of their specific characteristics. The preparers of the most widely used International Financial Reporting Standards (IFRS) set the most important definitions and recognition criteria in the Conceptual Framework for Financial Reporting. However, the application of these definitions and recognition criteria lead to a very limited set of intangible assets presented in financial statements.

The IASB is currently running a project with the aim of reforming the Conceptual Framework. Revising the definition of an asset constitutes a part of this project. The standard setters (as always) place great emphasis on addressing the public and asking for the opinion of the profession during the course of the project of great importance. Opinions given by accounting professionals show great differences, but the fact is that financial reporting paradigm is presently undergoing essential changes.

The significance of the Conceptual Framework project is that it affects such topics that are embedded in the core of the system (such as the definition of assets and recognition criteria). What is more, the process demonstrates such a new way of creating standards that incorporates the active role of the global audience of financial reporting. The aim of this paper is to summarize the reasons of why the reforming of the Conceptual Framework has become inevitable and to present the most recent development related to this field.

Keywords: financial reporting, intangible resources, paradigm shift

1. The heart of the problem

Financial reports are in theory designed to provide all relevant information that is necessary for the users to make their financial decisions. However, present financial accounting regulations seem to provide narrow space for intangibles on balance sheets compared to their significance in economy. International Financial Reporting Standards issued by the International Accounting Standards Board (IASB) are applied in more than a hundred countries including the member states of the European Union. IFRS define recognition criteria that lead to a very limited set of intangible assets presented in financial reports, which seems to be a great contradiction. Lev (2003) summarizes the consequences of the mismeasurement or deficient reporting of intangibles:

1. significant deterioration in the information content of key financial statement items
2. managers looking for alternate measures of corporate performance for internal purposes

3. systematic undervaluation of companies that are intensive in intangibles (excessive cost of capital)
4. gains are misallocated to insiders because of the great information asymmetry.

Mortensen (2012) argues that there is a large and increasing need for improving the insight into the role of intangibles in the economy because we know that intellectual capital is a decisive factor of economic growth, but our knowledge of the process is far from satisfactory. The incompleteness of the data affects the system of financial reporting as well.

The IFRS Conceptual Framework for Financial Reporting is an underlying document of the standards. It sets the basic definitions for the elements of financial reporting (asset, liability, equity, income, expense) to ensure a uniform understanding of these. It explains the meaning of those concepts that are commonly used and accepted by the preparers of IFRS financial statements, such as the recognition criteria for the items. The Framework describes the fundamental qualitative characteristics of useful financial information as relevance and faithful representation. Comparability, verifiability, timeliness, and understandability are the enhancing qualitative characteristics (IASPlus (a), n.d.).

Relevance and faithful representation are basic qualitative characteristics of financial information according to the Framework. This means that financial reports need to contain all relevant information that could affect the decision-making process of the users (the cost constraint must also be considered). One could argue that the complete set of intangible resources carry relevant information about the financial position of the reporting entity, so it should be included in the financial statements. However, faithful representation requires information to be complete, neutral and free from error. The greatest challenge regarding intangible reporting is creating a balance between relevance and faithful representation, because information on intangibles is sometimes regarded highly subjective. Present regulations are rather conservative and give more emphasis to faithful representation (or reliability) (Gröjer 2001).

The recognition criteria set by the Framework define rules that specify which items are incorporated into financial reports. Items that satisfy the recognition criteria are presented on the balance sheet or the income statement. According to the Framework an asset is recognized when *'it is probable that the future economic benefits will flow to the entity and the asset has a cost or value that can be measured reliably"* (IASPlus (a), n.d.).

The Conceptual Framework for Financial Reporting also defines the basic concepts of reporting and states the following definition for asset:

"An asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity" (IASPlus (a), n.d.).

The definition of intangible assets is included in International Accounting Standard 38 *Intangible Assets*:

"An intangible asset is an identifiable non-monetary asset without physical substance" (IASPlus (b), n.d.).

Internally generated intangible items hardly meet the recognition criteria because the economic benefits they incorporate are associated with high risk (i.e. the case of research costs). Measurement is another issue that brings a great challenge in case of these types of resources. Furthermore, intangible resources like competence, experience and ideas of the workforce or technological expertise are not assets *controlled* by the companies. Under current regulations, the only types of internally-generated intangible resources that appear on the balance sheet are development costs and know-how (protected by contract). Intangible assets that are of external origin (purchased, acquired as part of a business combination or by way of government grant) are much easier to place in financial reports as they are traded on the market, which makes them easy to identify, control and measure (i.e. brands, patents, trademarks, customer lists). However, entities are entitled (sometimes required) to enclose information on all items that are essentially assets but fail to meet the recognition criteria in case knowledge of the item is relevant to the evaluation of the financial position.

2. The new framework

Failing to recognize internally generated intangible assets causes difficulties in the measurement of the entities' performance and impedes the accurate assessment of returns related to these resources. Investors on capital markets need financial statements that give more relevant and complete information. To achieve this, the reporting Framework needs to be modified by the accounting profession:

"*Failure to do so will see it taking on the responsibility to develop and maintain standards and reporting that increasingly deal with a smaller and smaller share of an investor's value – not a prescription for a healthy and growing profession"* (IMA 2010, p. 3).

There are of course opponents to the modifications of financial reporting regulations. Upton (2001) quotes several professionals who emphasize the dangers of reforms. Some

consider that standards do not allow the recognition of certain items because this does not correspond with the objective of financial reporting. From this point of view, putting (internally generated) intangibles on the balance sheet would confuse users and lead to a greater uncertainty and deterioration of the usefulness of financial reports:

„*Monkeying with financial statements… is a terrible idea. Investors have 500 years of practice interpreting financial statements while learning to understand…and value our more than $60 trillion in total assets. In doing so, they have developed methods to adjust for many of the anomalies…that emerge from our archaic double-entry bookkeeping practices from time to time… Balance sheets are for stuff…not people or ideas*" (Rutledge 1997).

Skinner (2008) also concludes that proposals for reforming accounting and disclosure practices for intangibles are based on claims that are unfounded. He argues that financial markets are currently doing well financing knowledge-based enterprises and there is no need to mandate any further disclosure on intangibles. Standard setters are well aware of the danger of manipulation in case of valuing such items that does lack an active market or trading transactions as helping tools in estimates. What is more, the supporters of the prevailing system can also argue that there are already several types on reports other than financial statements elaborated to cover the invisible intangible property of entities. However, disclosure in the notes about some items that provide relevant information on the financial position of the entity does not compensate the failure to recognize them on the balance sheet. Notes are deemed to provide additional information on capitalized items.

Reforming of underlying financial reporting regulations is now on the agenda of standard-setters. According to Shortridge and Smith (2009), financial reporting is undergoing one of the greatest revolutions ever since Pacioli invented double-entry bookkeeping. The process is triggered by the transition of the industrial economy to information economy, with intangible assets in the spotlight. Reform is inevitable as traditional accounting and reporting systems are lagging behind the rapid change of business environment. The basis of the prevailing accounting paradigm of IFRS is embraced by the Conceptual Framework for Financial Reporting, which was first issued in 1989 and remained unchanged until 2010.

The IASB is currently running a project with the aim of reforming the Conceptual Framework. Chapters regarding the objective of financial reporting and the qualitative characteristics of useful information were renewed and published in 2010. The remaining chapters are currently being revised in a running project. Revising the definition of an asset constitutes a part of this project. The standard setters (as always) place great emphasis on addressing the public and asking for the opinion of the profession during the course of such a

project of great importance. A Discussion Paper (DP) has been published in 2013 which presents the directions of possible new approaches. The DP has been followed by an Exposure Draft in 2015 (Orrell 2015). Separate sections discuss the definitions for the elements of financial statements (asset, liability, equity etc.), recognition and measurement – those topics that are of great importance when taking intangibles into consideration (Table 1).

Table 1 Original and proposed definitions

	Existing Definitions	**Proposed Definitions**
Asset	An asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.	An asset is a present economic resource controlled by the entity as a result of past events.
Liability	A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.	A liability is a present obligation of the entity to transfer an economic resource as a result of past events.
Economic Resource	[no existing definition]	An economic resource is a right that has the potential to produce economic benefits.

Source: Orrell (2015)

One significant change in case of the asset definition is that ‘expected future economic benefits’ have been removed from the definition. This way, it emphasizes that the asset is the economic resource itself, not the imbedded benefits. The only thing that matters in case of an ‘economic resource’ (proposed new definition) is that it has the potential of providing benefits, there is no probability criterion included. The recognition criteria are to be reformed as well, requiring entities to recognize assets and liabilities when certain criteria are met. These criteria are defined based on the principles of relevance, faithful representation and the cost constraint – meaning that benefits should exceed the cost of providing information (Orrell – Streaser 2013, p. 7).

Will more internally generated intangible assets be recognized under the new definitions and criteria? These resources still need to be controlled by the entity, which is not true in case of human resource, for example. The fact that future economic benefits do not need to be ‘probable’ only ‘potential’ does not widen the scope in case of intangibles because still, these resources should be identifiable (tradable) and entities should find reliable measurement methods in order to place them on the balance sheet. However, the new focus will clearly be measurement in the debate regarding intangible reporting. In case of some assets it could

occur that they correspond to the new asset definition but traditional measurement methods (e.g. historical cost) do not provide an accurate base for determining the value they represent for the entity. The conclusion is that although there will be new recognition criteria, the result will probably be the same for the case of internally generated intangible assets.

3. The significance of the modifications

Introducing fundamental changes in the prevailing financial accounting paradigm is a great challenge for all participants of the process. The standard setting bodies are constantly encouraged and sometimes criticized by the public to resolve the reporting anomalies that encumber the preparation of financial statements. On the other hand, reporting entities themselves and also financial analysts, investors and other users of the financial statements require stability and predictable regulatory surroundings. Consequently, decision-makers always act with great cautiousness and diligence when moving on in the process of standard-setting.

What will the above described modifications achieve? Many researchers draw attention to those intangible resources that are missing from the balance sheets currently. Entities' expenditures on acquiring, maintaining and developing these are charged against the income of the current financial year in most cases, even if these expenditures are performed in order to achieve benefits during several future financial years. Some argue that the growing gap between the book value and market value of enterprises somehow indicates the magnitude of these missing resources or 'intangible capital' (Sveiby 2001).

Skinner gives an extensive list of reasons why intangible resources fall out of the scope of traditional financial accounting (Skinner 2008, p. 203):

1. Many intangibles are not separate, saleable or discrete items;
2. Well-defined property rights associated with tangible and financial resources often do not extend to intangibles;
3. There are no liquid secondary markets for many intangibles, making it difficult to reliably measure the value of these resources;
4. It is often difficult to write fully-specified contracts for intangibles.

Internally generated intangible capital (i.e. human resource, processes, customer lists, research costs) will certainly not be presented in the future either on the balance sheet except for those items that have been recognized under the original definitions (development cost or

know-how that is protected by the law). The significance of the Conceptual Framework project lies in that it affects such topics that are embedded in the core of the system (such as the definition of assets and recognition criteria). What is more, the process demonstrates such a new way of creating standards that incorporates the active role of the global audience of financial reporting. The outcome will probably be a new Framework that reflects the opinion of a very wide range of standard users. We can expect new regulations that are more user-friendly, and easier to apply consistently. This leads to a higher level of comparability of financial statements, which is the overall objective of international standard-setting.

4. Conclusion

The Board is taking small steps in the course of the reform, which is understandable taking into consideration that they are about to change a Framework that is built on traditions followed for centuries. Yet business has gone through such significant changes that leave them with no other option but to make some kind of reform.

The new forum of controversy regarding intangibles will be the measurement process. No definition or recognition criteria will exclude explicitly internally generated intangible items, the key issue will be measurement. Historical cost approach is not a real option in case of these resources, so fair value measurement will again be one of the focus areas. The new challenge for financial reporting will be the invention of such measurement methods that are applicable for intangibles and provide stakeholders with information that is not only relevant but faithful and free from bias.

The accounting profession is indeed in the middle of a crisis as the reporting Framework is strained by accounting anomalies deriving from information economy. Standard-setters are in the process of seeking new alternatives, but few rather cautious steps have been taken. The process could be described as an evolutionary change but as demand for more relevant financial reports grow, the possibility of an emerging new reporting paradigm cannot be excluded.

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