



# Conceptual Framework for financial reporting



## Focus:

- ▶ Financial accounting concepts and principles and the Conceptual Framework in the preparation and presentation of financial statements.
- ▶ Purpose of the Conceptual Framework
- ▶ Basic objectives and users of financial statements
- ▶ Assumptions underlying financial statements
- ▶ fundamental qualitative characteristics:
- ▶ enhancing qualitative characteristics:
- ▶ Elements of financial statements
- ▶ Use of capital and capital maintenance in accrual basis financial statements
- ▶ Contribution and inherent limitations of financial statements, including key ethical issues
- ▶ The use of the business model concept in financial reporting

# The Conceptual Framework

- Provides the **fundamental principles and guidelines** that underpin the preparation and presentation of financial statements.
- It establishes the theoretical foundation for financial accounting and standard-setting ensuring:
  - Consistency,
  - Transparency, and
  - Comparability in financial reporting

## Financial Accounting Concepts and Principles in the Preparation and Presentation of Financial Statements

- F/A is governed by fundamental concepts and principles that ensure accuracy, reliability, and relevance in financial reporting eg.,
- **Accrual Basis** – Revenues earned and expenses incurred
- **Going Concern**
- **Consistency** – Accounting policies should be applied consistently across periods for comparability.
- **Materiality** - disclose all material aspects that influence decision-making.
- **Faithful Representation** – **complete, neutral, and free from error.**
- **Relevance** – Information should influence economic decisions and be timely.

## Purpose of the Conceptual Framework

- serves as a **guiding structure** for standard-setters, preparers, and users of financial statements.

### *Its key purposes include:*

- Providing a **foundation for developing financial reporting standards** (IFRS, IAS).
- Assisting **preparers** in applying consistent accounting policies.
- Helping **users** understand and interpret financial statements effectively.
- Enhancing **comparability** across industries and reporting periods

## Basic Objectives and Users of Financial Statements

- To provide **useful financial information** about an entity's financial position, performance, and cash flows to aid economic decision-making.

Category	Key Users	Purpose
Primary Users	Investors, Creditors, Lenders	Assess profitability, risks, and growth potential.
Management	Directors, Executives, Internal Decision Makers	Evaluate financial health, strategic planning.
Regulators	Government Agencies, Tax Authorities	Ensure compliance, taxation, and industry regulations.
Other Users	Employees, Customers, Suppliers, Public	Assess stability, job security, and partnerships.

## Assumptions Underlying Financial Statements

Financial statements are based on **four key assumptions**:

- **Accrual Basis** – Transactions are recorded when they occur, not when cash is exchanged.
- **Going Concern** – Assumes the business will continue operating unless evidence suggests otherwise.
- **Stable Monetary Unit** – Financial data is recorded in a stable currency without inflation adjustments.
- **Periodicity** – Financial information is reported over defined periods (monthly, quarterly, annually).

## Fundamental Qualitative Characteristics

Fundamental qualitative characteristics ensure financial statements provide meaningful and reliable information.

*The two main characteristics are:*

- **Relevance** – Information must **impact decisions** by being timely and predictive or confirmatory in nature.
- **Faithful Representation** – Information must be **complete, neutral, and free from error** to ensure credibility.

## Enhancing Qualitative Characteristics

- These characteristics improve the usefulness of financial statements

Characteristic	Description
<b>Comparability</b>	Allows users to compare financial statements across periods and entities.
<b>Verifiability</b>	Ensures reported figures can be audited and verified for accuracy.
<b>Timeliness</b>	Financial information should be provided in a timely manner for decision-making.
<b>Understandability</b>	Information should be clearly presented and structured for easy interpretation.

## Elements of Financial Statements

Element	Definition
<b>Assets</b>	Resources controlled by an entity expected to generate future economic benefits.
<b>Liabilities</b>	Obligations that require economic resources to settle.
<b>Equity</b>	Residual interest of shareholders in assets after liabilities are deducted.
<b>Revenue/Incomes</b>	Income generated from normal business operations.
<b>Expenses</b>	Costs incurred in generating revenue, reducing equity.

## Use of Capital and Capital Maintenance in Accrual Basis Financial Statements

- ➔ **Capital Maintenance Concept** ensures that an entity maintains its capital before recognizing profit.

### Types of Capital Maintenance:

- ➔ **Financial Capital Maintenance** – Profit is recognized when net assets increase beyond the capital invested.
- ➔ **Physical Capital Maintenance** –a Profit is recognized after maintaining the operating capability of assets



## Contribution and Limitations of Financial Statements, Including Ethical Issues

### Contributions:

- Provide a structured **summary of financial performance** and position.
- Enhance **transparency and accountability** in financial management
- Enable informed **investment and lending decisions**.
- Support regulatory and compliance requirements.



## Limitations:

- **Historical in Nature** – Financial statements reflect past performance, not future predictions.
- **Exclusion of Non-Financial Factors** – Does not capture elements like employee skills, customer loyalty, or brand value.
- **Subject to Estimates and Judgments** – Certain elements (e.g., depreciation, provisions) require subjective judgment, impacting reliability.



## Ethical Issues in Financial Reporting

- **Misrepresentation** – Deliberate manipulation of figures to mislead stakeholders.
- **Earnings Management** – Adjusting financial results to meet investor expectations.
- **Fraudulent Reporting** – False disclosures leading to financial scandals (e.g., Enron, WorldCom).
- **Conflicts of Interest** – Accountants prioritizing personal or corporate interests over fairness.

# The Use of the Business Model Concept in Financial Reporting

The **business model concept** describes how an entity **creates, delivers, and captures value**. In financial reporting, it affects:

- ▶ **Revenue Recognition** – Defines when and how income is earned.
- ▶ **Asset Valuation** – Determines the valuation method based on business operations (e.g., cost vs. fair value).
- ▶ **Risk Assessment** – Influences how financial risks and uncertainties are reported.
- ▶ **Decision-Making** – Guides financial disclosures based on business sustainability and performance.

Regulators and standard-setters increasingly incorporate the **business model approach** to ensure that financial reports align with an entity's **strategic objectives and economic reality**.

# Key Components of a Business Model

Component	Description
<b>Value Proposition</b>	Defines what the company offers to customers and how it differentiates itself.
<b>Revenue Streams</b>	Identifies how the business generates income (e.g., sales, subscriptions, licensing).
<b>Key Activities</b>	Core operations required to deliver value (e.g., manufacturing, service delivery).
<b>Cost Structure</b>	Breakdown of operational costs (fixed and variable costs).
<b>Customer Segments</b>	Identifies target market groups and customer needs.
<b>Key Resources</b>	Essential assets needed to operate (financial, human, technological, etc.).
<b>Key Partnerships</b>	Collaborations that enhance efficiency (suppliers, distributors, investors).
<b>Distribution Channels</b>	How products/services are delivered to customers (online, physical stores, etc.).



# The Role of the Business Model in Financial Reporting

Enhances transparency, relevance, and strategic decision-making:

Example:

➤ **Revenue Recognition**

➤ Different business models recognize revenue differently based on IFRS 15 (**Revenue from Contracts with Customers**).

➤ Example:

➤ A **subscription-based model** (e.g., Netflix) recognizes revenue **over time** as customers consume the service.

➤ A **retail business model** (e.g., a supermarket) recognizes revenue **at the point of sale**.



## ➤ **Asset Valuation**

➤ The business model determines how assets are measured, either at **cost or fair value**.

➤ Example:

➤ A company using a **manufacturing model** may **value inventory at cost** (IAS 2 – Inventories).

➤ A **real estate firm** may use **fair value** for property valuation under **IAS 40 – Investment Property**.



## Risk and Financial Sustainability

- ▶ The business model impacts how financial risks are disclosed and managed.

Example:

- ▶ A **tech-based business model** faces cybersecurity and innovation risks.
- ▶ A **traditional manufacturing model** may have risks related to supply chain disruptions.



## Non-Financial Reporting and ESG (Environmental, Social, Governance)

- ▶ The business model also influences **non-financial disclosures**, such as:
- ▶ **Sustainability reporting (IFRS S1 & S2)** – Companies engaged in environmentally sensitive industries disclose their **climate-related risks**.
- ▶ **Corporate Social Responsibility (CSR)** – Businesses focused on social impact report their engagement in **community development and ethical sourcing**.



## The Shift Towards Business Model-Based Reporting

- ▶ Traditionally, financial reporting focused primarily on **historical cost accounting**, but modern frameworks are increasingly incorporating **business model perspectives** to enhance relevance. Key developments include:
- ▶ **Integrated Reporting (IR) Approach:**
- ▶ The **International Integrated Reporting Council (IIRC)** encourages disclosure of **how the business model drives value creation over time**.
- ▶ This approach links **financial** and **non-financial performance**, including **ESG factors**.



## ➤ IFRS and Business Model Alignment:

- New accounting standards such as **IFRS 9 (Financial Instruments)** require classification of assets based on **business model assessment**.
- **IFRS 15 (Revenue Recognition)** aligns revenue recognition with the company's business model structure.

## ➤ Stakeholder Demand for Transparency:

- Investors and regulators now expect companies to **explain their business model risks and strategies** in financial disclosures.
- Example: A company dependent on **third-party suppliers** must disclose **supply chain risks**.

# Limitations of the Business Model in Financial Reporting

- While integrating the business model into financial reporting improves decision-making, challenges exist:

Limitation	Explanation
<b>Lack of Standardization</b>	Business models vary widely, making comparability across industries difficult.
<b>Subjectivity in Disclosure</b>	Some aspects (e.g., intangible assets, brand value) are difficult to measure and report consistently.
<b>Dynamic Business Environments</b>	Frequent model changes (e.g., due to technology shifts) make reporting complex.
<b>Potential for Manipulation</b>	Companies may shape business model disclosures to present a more favorable financial outlook.