2 Conceptual framework for financial reporting

Contents

Objectives 36
2.1 Why a conceptual framework? 36
2.2 IASB Framework for the Preparation and Presentation of Financial Statements 37
   2.2.1 The objective of financial statements 38
   2.2.2 Stewardship as an objective of financial statements: the current debate 40
   2.2.3 Underlying assumptions 43
   2.2.4 A note on the ‘going concern’ assumption 43
   2.2.5 Qualitative characteristics of financial reporting information 47
   2.2.6 Constraints on financial reporting 51
2.3 Elements of financial statements 52
2.4 Measurement of the elements of financial statements 57
   2.4.1 Fair value 58
   2.4.2 Alternatives to fair value 61
2.5 Concepts of capital and capital maintenance 63
Appendix to Chapter 2: Use of present value in accounting 65
Summary 68
Research and references 68
Discussion questions 70
Notes 72
2.1 Why a conceptual framework?

The conceptual framework is a recent concept. In fact, many accounting standard setters have historically operated without having a conceptual framework in place. This resulted in accounting standards often being haphazard in nature and largely a response to the issues or scandals of the day – reactive rather than proactive. The lack of an agreed conceptual framework also increases the risk that standards are inconsistent with each other and that there is no overall objective for the preparation of financial statements.

A statement of the functions of financial statements included in a framework document increases the robustness of the standard-setting process, ensures consistency and assists in the development of future standards. The framework can assist users in interpreting information contained within financial statements as it provides an understanding of the principles on which they are prepared. Each national standard-setting body has its own conceptual framework providing the foundations on which its accounting standards are based. Many commentators believe that harmonising these frameworks should be the priority in developing globally accepted standards.

In theory, the conceptual framework should drive the development of accounting standards. In practice, social, economic and political factors often play a role...
and influence the guidance provided by standards. The requirements of capital markets and regulators and the public’s reactions to accounting scandals and the credit crunch, which started in 2007, will continue to influence the standard-setting process.

2.2 IASB Framework for the Preparation and Presentation of Financial Statements

The Framework for the Preparation and Presentation of Financial Statements was issued in 1989 by the IASC and adopted by the IASB in 2001. It deals with:

(a) the objective of financial statements;
(b) the qualitative characteristics that determine the usefulness of information in financial statements;
(c) the definition, recognition and measurement of the elements from which financial statements are constructed; and
(d) concepts of capital and capital maintenance.

In May 2008 the IASB issued an exposure draft (ED) which deals with the objective of financial reporting and qualitative characteristics. In this chapter, we refer to this ED when illustrating the objective and qualitative characteristics of financial reporting.

The Framework is concerned with general purpose financial statements including consolidated financial statements. Such financial statements are prepared and presented at least annually and are directed towards the common information needs of a wide range of users. Some of these users may require, and have the power to obtain, information in addition to that contained in the financial statements. Many users, however, have to rely on the financial statements as their major source of financial information and such financial statements should, therefore, be prepared and presented with their needs in mind.

Financial statements form part of the process of financial reporting. The main components of a complete set of financial statements are listed below (IAS 1 (revised), 2007):

• a statement of financial position as at the end of the period (i.e. balance sheet);
• a statement of comprehensive income for the period (i.e. income statement);
• a statement of changes in equity for the period;
• a statement of cash flows for the period;
• notes, comprising a summary of significant accounting policies and other explanatory information.

Many entities also present a financial review by management that describes and explains the main features of an entity’s financial performance and financial position, and the principal challenges it faces. They also present environmental and social reports particularly in industries in which environmental factors are significant and when employees are regarded as an important user group.
2.2.1 The objective of financial statements

The objective of a general purpose financial report is to provide financial information about the reporting entity that is useful to present and potential investors and creditors in making decisions in their capacity as capital providers. The objective refers to financial reporting as a whole, not just financial statements.

The objective of financial reporting is focused on meeting the information needs of the primary user group. The primary user group is made up of those who have a claim (or potentially may have a claim) on an entity’s resources – its present and potential equity investors, lenders, and other creditors (capital providers).

The primary user group is interested in financial information because that information is useful in making decisions that equity investors, lenders, and other creditors make in their capacity as capital providers.

The decisions made by capital providers include whether and how to allocate their resources to a particular entity and how to protect or enhance their holdings. When making these decisions, capital providers are interested in assessing an entity’s ability to generate net cash inflows and management’s stewardship (see section 2.2.2 for a discussion on stewardship as an objective of financial statements).

Capital providers use information about an entity’s resources, claims to those resources, and changes in resources and claims as inputs into the decision-making process.

Other potential user groups are represented by governmental and regulatory bodies, as shown in Figure 2.1.

Figure 2.1 shows that, according to the IASB Framework the users of financial statements include present and potential investors, employees, lenders, suppliers and other trade creditors, customers, governments and their agencies and the public.

![Figure 2.1 An entity and the users of its financial information according to the IASB Framework](image)
Financial statements satisfy many of their users’ different needs for information. These needs include the following:

(a) **Owners** (or investors) need financial information relating to the entity to assess how effectively the managers are running it and to make judgements about likely levels of risk and return in the future. Shareholders need information to assess the ability of the entity to pay them a return (dividend). The same applies to potential shareholders.

(b) **Employees and their representative groups** are interested in information about the stability and profitability of their employers. They too need information which enables them to assess the ability of the entity to provide remuneration, retirement benefits and employment opportunities.

(c) **Lenders** (such as banks) need financial information about an entity in order to assess its ability to meet its obligations, to pay interest and to repay the amount borrowed.

(d) **Suppliers and other trade creditors** need information that enables them to determine whether amounts owed to them will be paid when due. Trade creditors are likely to be interested in an entity over a shorter period than lenders unless they are dependent upon the continuation of the entity as a major customer.

(e) **Customers** have an interest in information about the continuance of an entity, especially when they have a long-term involvement with, or are dependent on, the entity.

(f) **Governments and their agencies** need information in order to regulate the activities of entities, to assess whether they comply with agreed pricing policies, whether financial support is needed, and how much tax they should pay. They also require information in order to determine taxation policies and as the basis for national income and statistics.

(g) **Public.** Entities affect members of the public in a variety of ways. For example, entities may make a substantial contribution to the local economy in many ways including the number of people they employ and their patronage of local suppliers. Financial statements may assist the public by providing information about the trends and recent developments in the prosperity of the entity and the range of its activities.

Though not mentioned by the IASB Framework, other users and their information needs include the following:

- **Investment analysts** need financial information relating to an entity to assess the risks and returns associated with the entity in order to determine its investment potential and to advise clients accordingly.
- **Competitors** need financial information relating to an entity to assess the threat to sales and profits posed by those businesses and to provide a benchmark against which the competitor’s performance can be measured.
- **Managers** need financial information relating to an entity to help make decisions and plans for the business and to exercise control so that the plans come to fruition.

While all the information needs of these users cannot be met by financial statements, there are needs which are common to all users. As investors are providers of
risk capital to the entity, the publication of financial statements that meet their needs will also meet most of the needs of other users.

*It is unlikely that one piece of information, such as a single profit figure, will meet all of the wide variety of needs which financial accounting is meant to satisfy. For example, it is not necessary that the measure of profit used for tax purposes should be the same as that used for setting an upper limit to the dividends which can be distributed to shareholders: the fact that taxable profit and distributable profit differ under current British legislation is evidence of this.*

(Whittington 1983: 3)

### 2.2.2 Stewardship as an objective of financial statements: the current debate

The IASB and FASB are currently developing a common conceptual framework. This would improve upon the existing conceptual frameworks of each board and provide a sound foundation for the development of accounting standards which might attain global acceptance.¹

In May 2008, IASB and FASB published an exposure draft (ED), *Conceptual Framework for Financial Reporting: The Objective of Financial Reporting and Qualitative Characteristics and Constraints of Decision-Useful Financial Reporting Information*, in which it was proposed that:

- the converged framework should specify only one objective of financial reporting, that of providing information that is useful to users in making investment, credit and similar resource allocation decisions (*the resource allocation decision-usefulness objective*); and
- information relevant to assessing stewardship will be encompassed in that objective.

In this section, we argue that stewardship and decision-usefulness for investors are parallel objectives, which do not necessarily conflict, but which have different emphases and therefore they should be defined as separate objectives. Stewardship, which is linked to agency theory, should be considered as a broader notion than resources allocation as it focuses on both past performance and how the entity is positioned for the future. It should therefore be retained as a separate objective of financial reporting to ensure that there is appropriate emphasis on company performance as a whole and not just on potential future cash flows. As noted by Andrew Lennard (2007):

*Stewardship contributes an important dimension to financial reporting, which should be reflected by specific acknowledgement in the objectives of financial reporting. Moreover, stewardship should not be characterised simply as information to assist an assessment of the competence and integrity of ‘stewards’ (i.e. management, directors) but as the provision of information that provides a foundation for a constructive dialogue between management and shareholders.*

Meaning of ‘stewardship’ and ‘accountability’

The previous IASB *Framework* issued in 1989 referred to ‘stewardship’ as follows:

*Financial statements also [i.e. in addition to providing information that is useful in making economic decisions] show the results of the stewardship of management, or the accountability of
management for the resources entrusted to it. Those users who wish to assess the stewardship or accountability of management do so in order that they make economic decisions; these decisions may include, for example, whether to hold or sell their investment in the entity or whether to re-appoint or replace the management.

(\textit{Framework} para 14)

Thus, the previous \textit{Framework} argued that stewardship accounting is implicit in a decision-relevance objective. Moreover, the previous \textit{Framework} seemed to imply that the terms \textit{stewardship} and \textit{accountability} are synonymous. However, ‘accountability’ refers directly to the fact that, not only do management have the responsibility to use the assets entrusted to them for the benefit of shareholders, they also have the overriding obligation to provide those shareholders with an account of what it has done with those assets.

The view of ‘stewardship’ given in the current ED is somewhat different. It mentions that management are accountable to the entity’s capital providers for the custody and safekeeping of the entity’s economic resources and for their efficient and profitable use, including protecting them from unfavourable economic effects such as inflation and technological changes. Management are also responsible for ensuring compliance with laws, regulations and contractual provisions.

\textbf{Stewardship and agency theory}

In the context of business entities, the need for accounting is often rationalised in terms of agency theory.

The main focus of the agency theory is the conflict that arises when ownership is different from management. Agency theory is concerned with resolving two problems that can occur in an agency relationship. The first problem arises when:

(a) the desires or goals of the principal and agent conflict; and

(b) it is difficult or expensive for the principal to verify what the agent is actually doing.

The problem here is that the principal cannot verify that the agent has behaved appropriately. The second problem is that of risk sharing when the principal and the agent have different attitudes towards risk and therefore prefer different actions.$^2$

When a company is listed (quoted) on the \textit{stock exchange}, control and ownership are separated. The company is controlled, at least on a day-to-day basis, by its management (the directors or management board) but owned by its shareholders (or proprietors). This involves obvious benefits for both parties but also risks. These risks may be controlled or reduced by various means; one of the most obvious, and widely used, strategies is for a requirement on management to provide regular accounts that are available to the shareholders. Financial statements therefore provide a key condition for the existence of a modern company: it is difficult to imagine how companies with widely held and traded shares would be managed if credible accounts were not generally prepared. A stewardship objective emphasises this role of financial reporting as explained below.

Shareholders, in their capacity as owners of the business, make decisions other than to buy, sell or hold. The other decisions include a consideration of whether they, as owners of the business, need to intervene in its management. The shareholders look to financial reporting to access information relating to management’s stewardship of the business. Most accounts of agency theory stress the possibility of
a divergence of interest between management and shareholders, both of which are assumed to be relentlessly pursuing their economic self-interest. Perhaps it is for this reason that the ED characterises stewardship as a demand for information on management’s safe custody of the assets, and compliance with laws and regulations. The stress is on whether management have behaved properly and not for example, unjustly enriched themselves at the company’s expense.

If owners assign stewardship of their company to management, they wish to have the ability to oversee management behaviour to ensure that:

- it is aligned to the owners’ objectives;
- management are devising strategies aimed at making the best use of company assets; and
- no misappropriation of the company assets takes place.

The owners attempt to ensure alignment to their objectives by monitoring the company against some criteria e.g. at its simplest the increase in profits and net assets over the year. However, they also need information that enables them to review the company’s performance in light of the risks management took in order to obtain the results and to assist them in making decisions about the future direction of the business.

Company law in many jurisdictions also interprets what is now commonly known as agency theory as discussed above. Stewardship was originally the primary objective of financial reporting which is why company law initially sought to ensure that management provide an account of their performance over a given period and show how they have utilised the resources entrusted to them by the owners. It was only after the development of capital markets that a further focus for financial reporting developed, i.e. on cash flow generation that would assist in buy, sell or hold decisions (the main focus of the resource allocation decision-usefulness objective as described in the ED).

For many investors in unlisted companies, selling the shares in a readily available, liquid market is not an option (due to a lack of capital markets or otherwise). The only alternatives available to such investors are intervention or removal of management. As a result, the main objective of financial reporting for these investors is stewardship. Such equity investors are interested in the following:

- how management have performed in the past so they can gauge their likely performance in the future;
- ability to gauge the extent to which transactions similar to those already undertaken might recur in the future; and
- how the management performance and transactions undertaken, including related party transactions, might affect the entity’s performance.

Thus, we consider stewardship as a separate objective of financial reporting. In fact, an investor first assesses how an entity has performed in a given period, and secondly to make a judgement about how it is likely to perform in the future (so that he can make resource-allocation decisions). We believe that one of the first assessments an investor makes is to take a view on stewardship and as such this should have equal prominence with the resource-allocation decisions. Therefore, the stewardship objective that financial reporting has is broader than the resource-allocation decision-usefulness objective described in the ED. The stewardship objective is about
providing information about the past (including, for example, the transactions entered into, the decisions taken and the policies adopted) at a level of detail and in a way that enables an entity’s past performance to be assessed in its own right, rather than just as part of an assessment about likely future performance. And it is about providing information about how an entity has been positioned for the future.

2.2.3 Underlying assumptions

There are two assumptions underlying financial statements. These are the accrual basis and the going concern conventions.\(^3\)

Accrual basis

Financial statements of an entity are prepared on an accrual basis of accounting. Under this basis, the effects of transactions and other events are recognised when they occur (and not as cash or its equivalent is received or paid) and they are recorded in the accounting records and reported in the financial statements of the periods to which they relate. Financial statements prepared on an accrual basis inform users not only of past transactions involving the payment and receipt of cash but also of obligations to pay cash in the future and of resources that represent cash to be received in the future. Hence, they provide the type of information about past transactions and other events that is most useful to users in making economic decisions.

Going concern

The financial statements are normally prepared on the assumption that an entity will continue in operation for the foreseeable future. Hence, it is assumed that the entity has neither the intention nor the need to liquidate or curtail materially the scale of its operations; if such an intention or need exists, the financial statements may have to be prepared on a different basis and, if so, the basis used should be disclosed.

The going concern assumption is a fundamental principle in the preparation of financial statements. Under the going concern assumption, an entity is ordinarily viewed as continuing in business for the foreseeable future with neither the intention nor the necessity of liquidation, ceasing trading or seeking protection from creditors pursuant to laws or regulations. Accordingly, unless the going concern assumption is inappropriate in the circumstances of the entity, assets and liabilities are recorded on the basis that the entity will be able to realize its assets, discharge its liabilities, and obtain refinancing (if necessary) in the normal course of business.

(IAASB 2009)

2.2.4 A note on the ‘going concern’ assumption\(^4\)

The assessment of an entity’s ability to continue as a going concern is the responsibility of the entity’s management; and the appropriateness of management’s use of the going concern assumption is a matter for the auditor to consider on every audit engagement. Some financial reporting frameworks contain an explicit requirement
for management to make a specific assessment of the entity’s ability to continue as a going concern, and include guidance regarding matters to be considered and disclosures to be made in connection with going concern. For example, IAS 1 (revised) paras 25 and 26 require management to make an assessment of an entity’s ability to continue as a going concern:

*When preparing financial statements, management shall make an assessment of an entity’s ability to continue as a going concern. An entity shall prepare financial statements on a going concern basis unless management either intends to liquidate the entity or to cease trading, or has no realistic alternative but to do so. When management is aware, in making its assessment, of material uncertainties related to events or conditions that may cast significant doubt upon the entity’s ability to continue as a going concern, the entity shall disclose those uncertainties. When an entity does not prepare financial statements on a going concern basis, it shall disclose that fact, together with the basis on which it prepared the financial statements and the reasons why the entity is not regarded as a going concern.*

Other standards and guidance may also be relevant, such as those relating to disclosures of risks and uncertainties or to supplementary statements such as management discussion and analysis or similar.

Management’s assessment of the going concern assumption involves making a judgement, at a particular point in time, about the future outcome of events or conditions which are inherently uncertain. Where management have made a preliminary assessment, it will be probably necessary to update it at year-end given the speed with which economic conditions are changing as a result of the credit crunch. The information available at the time at which the judgement is made, the size and complexity of the entity, the nature and condition of its business and the degree to which it is affected by external factors all affect the judgement regarding the outcome of events or conditions.

Consideration of the going concern assumption

IAS 1 and International Standard on Auditing (ISA) 570 acknowledge that entities with a history of profitable operations and ready access to financial resources *may not* need a detailed analysis to support the going concern assumptions. However, the effect of the credit crisis and economic downturn is likely to be that such an approach will no longer be appropriate for many entities. In particular, the implicit assumptions behind such an approach may no longer be valid in the current economic environment (2007–10). Issues surrounding liquidity and credit risk may create new uncertainties, or may exacerbate those already existing. Even many well-respected entities with a long-standing history of profits and availability of credit may find it difficult to obtain or renew financing, either at all or on comparable terms. Further, entities that have typically relied on extensions of debt payments...
or waivers of debt covenants at year-end may find that these reliefs are no longer available from their lenders. In addition, the economic crisis may undermine the previous assumptions about profitability.

Consequently, entities that have not previously found the need to prepare a detailed analysis in support of the going concern assumption may need to give the matter further consideration. In many cases, the management of smaller entities may not have historically prepared a detailed assessment of the entity’s ability to continue as a going concern, but instead may have relied on in-depth knowledge of the business and anticipated future prospects.

Disclosures in the financial statements

In addition to specific disclosures that may be required regarding a material uncertainty about the entity’s ability to continue as a going concern, disclosures of risks and uncertainties are required in order to assist users of the financial statements to better understand the entity’s financial position, financial performance and cash flows.

For those entities that are significantly affected by the prevailing economic conditions, management need to consider how to address the risks arising from such economic conditions in their financial statements.

Under IFRS, financial statements should provide sufficient disclosures to enable users to understand the effects of material transactions and events on the information conveyed in the financial statements. Moreover, entities are required to disclose the nature and extent of risks arising from financial instruments to which the entity is exposed during the period and at the reporting date, and how the entity manages those risks (for example, IFRS 7 – Financial Instruments: Disclosures). A combination of qualitative and quantitative disclosures should provide an overview of the entity’s use of financial instruments and the exposures to risks they create.

Historically, when management has concluded that the entity is a going concern without any material uncertainty, this conclusion has not usually been expressly stated in the financial statements. However, even in such cases management may nevertheless consider it appropriate, or in fact may be required by the applicable financial reporting framework, to make disclosures in the financial statements to set out the challenges management are facing in the prevailing economic environment, how this affects the outlook for the entity and any uncertainties that could have an effect on the entity, whether material or not. These could include, for example:

- concerns over availability of credit, in particular if there are facilities due for renewal soon after the issuance of the financial statements;
- developments in the industry and region in which the entity operates;
- uncertainties regarding plans to sell assets or dispose of businesses; and
- potential impairments of fixed assets and intangibles.

Further discussion in an entity’s annual report (such as Management’s Discussion and Analysis section; Business Review section of the Directors’ Report; or equivalent) of management’s assessment of the entity’s funding position will be particularly relevant to users of the financial statements. Such discussion, when combined with required disclosures regarding debt maturities, help to provide a fuller view of an entity’s outlook and risks (see Figure 2.2).
Corporate governance and responsibility (extract)

**Description of directors’ responsibilities in respect of the Annual Report, the Remuneration report and the financial statements**

The directors are responsible for preparing the Annual Report, the Remuneration report and the financial statements in accordance with applicable law and regulations.

Company law requires the directors to prepare financial statements for each financial year that give a true and fair view of the state of affairs of the Company and the Group and of the profit or loss of the Group for that period.

In preparing those financial statements the directors are required to:

- Select suitable accounting policies and then apply them consistently.
- Make judgements and estimates that are reasonable and prudent.
- State that the financial statements conform with IFRSs as adopted by the European Union.
- Prepare the financial statements on a **going concern basis** unless it is inappropriate to presume that the Company will continue in business.

(...)

**Independent auditors’ report to the members of XYZ plc (extract)**

**Emphasis of matter – Going concern**

In forming our opinion on the financial statements, which is not qualified, we have considered the adequacy of the disclosures made in note 1 to the financial statements concerning the ability of the Company to continue as a going concern. There is a risk that the Group may need to renegotiate its financial covenants with its lenders. If the Group needed to but were unable to agree amendments to the covenants and those covenants were breached, the syndicate of lenders would have the right to demand, with a two-thirds majority vote, immediate repayment of all amounts due to them. This right, together with other remedies available to lenders, creates doubt about the future capital funding of the Group. These conditions, along with the other matters explained in note 1 to the financial statements, indicate the existence of a material uncertainty which may cast significant doubt about the Company’s ability to continue as a going concern. The financial statements do not include the adjustments that would result if the company was unable to continue as a going concern.

Notes (extract)

1. **Basis of preparation and consolidation, accounting policies and critical accounting estimates and judgements**

   **Basis of preparation and consolidation**

   XYZ plc (the Company) is a public limited company incorporated, listed and domiciled in the UK. The financial statements have been prepared under the historical cost convention as modified by the revaluation of financial instruments (including derivative instruments) at fair value in accordance with International Financial Reporting Standards (IFRSs) as adopted by the European Union (EU), and the Companies Act 1985. Accordingly, these financial statements have been prepared in accordance with IFRSs as adopted by the European Union and therefore comply with Article 4 of the EU IAS Resolution. A summary of the more important Group accounting policies is set out below.

   (...)

   The financial statements have been prepared on a going concern basis. The Group is currently in full compliance with the financial covenants contained in all of its borrowing agreements. However, as a consequence of the increasingly uncertain trading conditions there is a risk that the Group would need to reset its financial covenants with its lenders. Details of our covenants and our management of the risks associated with meeting those covenants are set out in our risk management disclosures.

   If the Group were required but not able to agree amendments to the covenants such that undertakings to the Group’s lenders were breached, then the syndicate of lenders would have

---

**Figure 2.2** Example of disclosure on going concern
The current economic conditions (2010) are likely to increase the level of uncertainty existing when management make their judgement about the outcome of future events or conditions. However, while the effect of the current market conditions on individual entities requires careful evaluation, it should not automatically be assumed that a material uncertainty exists to cast significant doubt on the ability of the entity to continue as a going concern.

2.2.5 Qualitative characteristics of financial reporting information

Qualitative characteristics are the attributes that make the information provided in financial statements useful to users. According to the IASB ED Conceptual Framework for Financial Reporting: The Objective of Financial Reporting and Qualitative Characteristics and Constraints of Decision-Useful Financial Reporting Information (29 May 2008), for financial information to be useful, it should possess two fundamental qualitative characteristics:
The ED also describes enhancing qualitative characteristics, which are complementary to the fundamental qualitative characteristics. Enhancing qualitative characteristics distinguish more useful information from less useful information. They enhance the decision-usefulness of financial reporting information that is relevant and faithfully represented. They are:

- **comparability**;
- **verifiability**;
- **timeliness**; and
- **understandability**.

These characteristics are shown graphically in Figure 2.3 above and described in detail below.

**Fundamental qualitative characteristics**

**Relevance**. Relevant information is capable of making a difference to a financial statement user’s decisions. Relevant information has *predictive value*, i.e. it helps users to evaluate the potential effects of past, present, or future transactions or other events on future cash flows, and *confirmatory value*, in other words, it helps to confirm or revise their previous evaluations.

**Faithful representation**. To be useful in financial reporting, information must be a faithful representation of the economic phenomena that it purports to represent. Faithful representation is attained when the depiction of an economic phenomenon is complete, neutral, and free from material error. Financial information that faithfully represents an economic phenomenon depicts the economic substance of
the underlying transaction, event, or circumstance, which is not always the same as its legal form.

A single economic phenomenon may be represented in multiple ways. For example, an estimate of the risk transferred in an insurance contract may be depicted qualitatively (e.g. a narrative description of the nature of possible losses) or quantitatively (e.g. an expected loss). Additionally, a single depiction in financial reports may represent multiple economic phenomena. For example, the presentation of the item called plant and equipment in the financial statements may represent an aggregate of all of an entity’s plant and equipment.

Completeness. A depiction of an economic phenomenon is complete if it includes all information that is necessary for faithful representation of the economic phenomena that it purports to represent. An omission can cause information to be false or misleading and thus not helpful to the users of financial reports.

Neutrality. This is the absence of bias intended to attain a predetermined result or to induce a particular behaviour. Neutral information is free from bias so that it faithfully represents the economic phenomena that it purports to represent. Neutral information does not colour the image it communicates to influence behaviour in a particular direction.

Financial reports are not neutral if, by the selection or presentation of financial information, they influence the making of a decision or judgement in order to achieve a predetermined result or outcome. However, to say that financial reporting information should be neutral does not mean that it should be without purpose or that it should not influence behaviour. On the contrary, relevant financial reporting information, by definition, is capable of influencing users’ decisions.

Faithful representation does not imply total freedom from error as most financial reporting measures involve estimates of various types that incorporate management’s judgement.

Completeness and neutrality of estimates are desirable; however, a minimum level of accuracy also is necessary for an estimate to be a faithful representation of an economic phenomenon. For a representation to imply a degree of completeness, neutrality, or freedom from error that is impracticable would diminish the extent to which the information faithfully represents the economic phenomena that it purports to represent. Thus, to attain a faithful representation, it sometimes may be necessary to explicitly disclose the degree of uncertainty in the reported financial information.

Enhancing qualitative characteristics

Comparability. This quality of information enables users to identify similarities in and differences between two sets of economic phenomena. Consistency refers to the use of the same accounting policies and procedures, either from period to period within an entity or in a single period across entities. Comparability is the goal; consistency is a means to an end that helps in achieving that goal.

The essence of decision making is choosing between alternatives. Thus, information about an entity is more useful if it can be compared with similar information about other entities and with similar information about the same entity for
some other period or some other point in time. Comparability is not a quality of an individual item of information but, rather, a quality of the relationship between two or more items of information.

Comparability should not be confused with uniformity. For information to be comparable, like things must look alike and different things must look different. An overemphasis on uniformity may reduce comparability by making unlike things look alike. Comparability of financial reporting information is not enhanced by making unlike things look alike any more than it is by making like things look different.

Verifiability. This quality helps assure users that information faithfully represents the economic phenomena that it purports to represent. Verifiability implies that different knowledgeable and independent observers could reach general consensus, although not necessarily complete agreement, that either:

(a) the information represents the economic phenomena that it purports to represent without material error or bias; or

(b) an appropriate recognition or measurement method has been applied without material error or bias.

To be verifiable, information need not be a single point estimate. A range of possible amounts and the related probabilities also can be verified.

Verification may be direct or indirect. With direct verification, an amount or other representation itself is verified, such as by counting cash or observing marketable securities and their quoted prices. With indirect verification, the amount or other representation is verified by checking the inputs and recalculating the outputs using the same accounting convention or methodology. An example is verifying the carrying amount of inventory by checking the inputs (quantities and costs) and recalculating the ending inventory using the same cost flow assumption (e.g. average cost or first-in, first-out).

Timeliness. Information should be available to decision makers before it loses its capacity to influence decisions. Having relevant information available sooner can enhance its capacity to influence decisions, and a lack of timeliness can rob information of its potential usefulness. Some information may continue to be timely long after the end of a reporting period because some users may continue to consider it when making decisions. For example, users may need to assess trends in various items of financial reporting information in making investment or credit decisions.

Understandability. This quality of information enables users to comprehend its meaning. Understandability is enhanced when information is classified, characterised, and presented clearly and concisely. Comparability also can enhance understandability. Although presenting information clearly and concisely helps users to comprehend it, the actual comprehension or understanding of financial information depends largely on the users of the financial report. Users of financial reports are assumed to have a reasonable knowledge of business and economic activities and to be able to read a financial report. In making decisions, users also should review and analyse the information with reasonable diligence. However, when underlying economic phenomena are particularly complex, fewer users may understand the financial information depicting those phenomena. In these cases, some
users may need to seek the aid of an adviser. Information that is relevant and faithfully represented should not be excluded from financial reports solely because it may be too complex or difficult for some users to understand without assistance.

2.2.6 Constraints on financial reporting

Two pervasive constraints limit the information provided by financial reporting:

- **materiality**; and
- **cost**

**Materiality.** Information is material if its omission or misstatement could influence the decisions that users make on the basis of an entity’s financial information. Because materiality depends on the nature and amount of the item judged in the particular circumstances of its omission or misstatement, it is not possible to specify a uniform quantitative threshold at which a particular type of information becomes material. When considering whether financial information is a faithful representation of what it purports to represent, it is important to take into account materiality because material omissions or misstatements will result in information that is incomplete, biased, or not free from error.

**Cost.** Financial reporting imposes costs; the benefits of financial reporting should justify those costs. Assessing whether the benefits of providing information justify the related costs will usually be more qualitative than quantitative. In addition, the qualitative assessment of benefits and costs often will be incomplete. The costs of providing information include costs of collecting and processing the information,
costs of verifying it, and costs of disseminating it. Users incur the additional costs of analysis and interpretation. Omission of decision-useful information also imposes costs, including the costs that users incur to obtain or attempt to estimate needed information using incomplete data in the financial report or data available elsewhere.

Preparers expend the majority of the effort towards providing financial information. However, capital providers ultimately bear the cost of those efforts in the form of reduced returns.

Financial reporting information helps capital providers make better decisions, which result in more efficient functioning of capital markets and a lower cost of capital for the economy as a whole. Individual entities also enjoy benefits, including improved access to capital markets, favourable effect on public relations, and perhaps lower costs of capital. The benefits also may include better management decisions because financial information used internally often is based at least partly on information prepared for general-purpose financial reporting.

### 2.3 Elements of financial statements

Financial statements portray the financial effects of transactions and other events by grouping them into broad classes according to their economic characteristics. These broad classes are termed the elements of financial statements (*Framework* para 47). There are two main groups of elements:

- The first is associated with the measurement of an entity’s financial position: assets, liabilities and equity.
- The second is related to the measurement of performance: income and expenses.

Within these main categories there are sub-classifications. For example, assets and liabilities may be classified by their nature or function in the business of the entity in order to display information in the manner most useful to users for purposes of making economic decisions (*Framework* para 48).

**Assets.** 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 (*Framework* para 49(a)).

The following example explains better the above definition.

---

**Example 2.1**

**Recognition of an asset**

Entity X enters into a legal arrangement to act as trustee for entity Y by holding listed shares on entity Y’s behalf. Entity Y makes all investment decisions and entity X will act according to entity Y’s instructions. Entity X will earn a trustee fee for holding the shares. Any dividends or profit/(loss) from the investments belong to entity Y.
Entity X should not recognise the listed shares as its asset even though it is in possession of the shares. Entity X does not control the investment’s future economic benefits. Benefits from the investments flow to entity Y and entity X earns a trustee fee for holding the shares regardless of how the shares perform. The listed shares, therefore, do not meet the criteria of an asset in entity X’s balance sheet.

In assessing whether an item meets the definition of an asset (or a liability or equity), attention needs to be given to its underlying substance and economic reality and not merely its legal form. Thus, for example, in the case of finance leases, the substance and economic reality are that the lessee acquires the economic benefits of the use of the leased asset for the major part of its useful life in return for entering into an obligation to pay for that right an amount approximating to the fair value of the asset and the related finance charge. Hence, the finance lease gives rise to items that satisfy the definition of an asset and a liability and are recognised as such in the lessee’s balance sheet (Framework para 51). Thus, the Framework stresses economic substance over legal form and reminds us that not all assets and liabilities will meet the criteria for recognition.

Many assets, for example, property, plant and equipment, have a physical form. However, physical form is not essential to the existence of an asset; hence patents and copyrights, for example, are assets if future economic benefits are expected to flow from them to the entity and if they are controlled by the entity (Framework para 56).

Many assets, for example, receivables and property, are associated with legal rights, including the right of ownership. In determining the existence of an asset, the right of ownership is not essential; thus, for example, property held on a lease is an asset if the entity controls the benefits which are expected to flow from the property. Although the capacity of an entity to control benefits is usually the result of legal rights, an item may nonetheless satisfy the definition of an asset even when there is no legal control. For example, know-how obtained from a development activity may meet the definition of an asset when, by keeping that know-how secret, an entity controls the benefits that are expected to flow from it (Framework para 57).

The assets of an entity result from past transactions or other past events. Entities normally obtain assets by purchasing or producing them, but other transactions or events may generate assets; examples include property received by an entity from the government as part of a programme to encourage economic growth in an area and the discovery of mineral deposits. Transactions or events expected to occur in the future do not in themselves give rise to assets; hence, for example, an intention to purchase inventory does not, of itself, meet the definition of an asset (Framework para 58).

There is a close association between incurring expenditure and generating assets but the two do not necessarily coincide. Hence, when an entity incurs expenditure, this may provide evidence that future economic benefits were sought but is not conclusive proof that an item satisfying the definition of an asset has been obtained. Similarly the absence of a related expenditure does not preclude an item from satisfying the definition of an asset and thus becoming a candidate for recognition in the balance sheet; for example, items that have been donated to the entity may satisfy the definition of an asset (Framework para 59).
Liabilities. A liability is a present obligation of an entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits (Framework para 49(b)).

Obligations may be legally enforceable as a consequence of a binding contract or statutory requirement. This is normally the case, for example, with amounts payable for goods and services received. However, obligations do not have to be legally binding. If, for example, an entity decides as a matter of policy to rectify faults in its products even when these become apparent after the warranty period has expired, the costs that are expected to be incurred in respect of goods already sold are liabilities. Obligations do not include future commitments (Framework paras 60 to 63).

Some liabilities can be measured only by using a substantial degree of estimation. Some entities describe these liabilities as provisions. In some countries, such provisions are not regarded as liabilities because the concept of a liability is defined narrowly so as to include only amounts that can be established without making estimates. The definition of a liability in paragraph 49 follows a broader approach. Thus, when a provision involves a present obligation and satisfies the rest of the definition, it is a liability even if the amount has been estimated. Examples include provisions for payments to be made under existing warranties and provisions to cover pension obligations (Framework para 64).

Equity. Equity represents the residual amount after all the liabilities have been deducted from the assets of an entity. Although equity is defined as a residual, it may be sub-classified in the balance sheet into various types of capital and reserves, such as shareholders’ capital, retained earnings, statutory reserves, tax reserves, etc. Such classifications can be relevant to the decision-making needs of the users of financial statements when they indicate legal or other restrictions on the ability of the entity to distribute or otherwise apply its equity. They may also reflect the fact that parties with ownership interests in an entity have differing rights in relation to the receipt of dividends or the repayment of contributed capital (Framework paras 65 and 66).

Performance. The income and expense elements of performance are also measured in terms of assets and liabilities. Income is measured by increases in assets or decreases in liabilities, other than those relating to contributions from equity participants. Expenses, on the other hand, are measured by increases in liabilities or decreases in assets (Framework para 70).

Income and expenses may be presented in the income statement in different ways so as to provide information that is relevant for economic decision making. For example, it is a common practice to distinguish between those items of income and expenses that arise in the course of the ordinary activities of the entity and those that do not (Framework para 72).

Distinguishing between items of income and expense and combining them in different ways also permit several measures of entity performance to be displayed. These have differing degrees of inclusiveness. For example, the income statement could display gross margin, profit from ordinary activities before taxation, profit from ordinary activities after taxation, and net profit (Framework para 73). We illustrate in depth the income statement layouts in Chapter 3.

Recognition. IASB Framework para 83 calls for recognition of elements when:
(a) it is probable that any future economic benefit associated with the item will flow to or from the entity; and
(b) the item has a cost or value that can be measured reliably.

It is possible for an item to meet the definition of an asset, but not the recognition criteria as illustrated below.

Example 2.2

Asset recognition

Entity W is in the beverage business and its brand name is known throughout the world. Its main products command premium prices and the product names represent considerable future economic benefits. The brand has a market value and may be sold.

Management should not recognise its brand name as an asset, although it meets the definition of one. Management is prohibited from recognising internally generated brands, mastheads, publishing titles, customer lists and items similar in substance (IAS 38 para 63). The recognition criteria for intangible assets are more narrowly defined by IAS 38, limiting recognition of assets for which cost can be measured reliably (IAS 38 para 21(b)). The standard takes the view that the cost of brand generated internally cannot be distinguished from the cost of developing the business as a whole. Such items should not be recognised as intangible assets since the cost cannot be reliably measured.

When similar assets are acquired from a third party, the consideration given to acquire those assets is clearly distinguishable from the general costs of developing the business as a whole and, therefore, should be recognised, provided that they also meet the criteria of control and the probable flow of future economic benefits.

Uncertainty surrounds the meaning of probable. The concept of probability used in the recognition criteria refers to the degree of uncertainty that the future economic benefits associated with the item will flow to or from the entity. The concept is in keeping with the uncertainty that characterises the environment in which an entity operates. Assessments of the degree of uncertainty attaching to the flow of future economic benefits are made on the basis of the evidence available when the financial statements are prepared. For example, when it is probable that a receivable owed by a customer will be paid, it is then legitimate, in the absence of any evidence to the contrary, to recognise the receivable as an asset (Framework para 85). Some see ‘probable’ as representing 51 per cent likelihood, while others consider that a higher threshold is required for asset or income recognition. This is an area where there is little explicit guidance, so professional judgement should be exercised.

The second criterion for recognition is reliability. The Framework notes that the use of reasonable estimates is an essential part of the preparation of financial statements and that estimates in themselves do not undermine the reliability of financial information. Where an item has the characteristics of an element, but does not
meet the recognition criteria, then it may be that disclosure in the notes is required (Framework paras 86 to 88).

The Framework takes an asset and liability approach rather than focusing on matching of income and expenses. This is borne out by the recognition criterion for income and expenses: Income is recognised in the income statement when an increase in future economic benefits related to an increase in an asset or a decrease in a liability has arisen that can be measured reliably. This means, in effect, that recognition of income occurs simultaneously with the recognition of increases in assets or decreases in liabilities (for example, the net increase in assets arising on a sale of goods or services or the decrease in liabilities arising from the waiver of a debt payable) (Framework para 92). The example below illustrates this concept.

Example 2.3

Accrued revenue

Entity T, a telecom company, invoices its customers for call charges on a monthly basis. At the beginning of March the total value of invoices that entity T sent out to its customers was EUR 1m. The invoices relate to calls customers made during the month of February. The invoices are payable by customers by the end of April.

Entity T should recognise revenue of EUR 1m in the income statement of February. A corresponding increase in assets (Sales invoice to be issued, under Other receivables, or Trade receivables) should be recognised in the balance sheet.

The effects of transactions and other events are recognised as they occur. They are reported in the financial statements of the periods to which they relate (Framework para 22). Revenue is not deferred to match the timing of the receipt of cash or the raising of the invoices.

The recognition criterion for expenses is the mirror of the recognition criterion for income. Expenses are recognised in the income statement when a decrease in future economic benefits related to a decrease in an asset or an increase in a liability has arisen that can be measured reliably. This means, in effect, that recognition of expenses occurs simultaneously with the recognition of an increase in liabilities or a decrease in assets (for example, the accrual of employee entitlements or the depreciation of equipment) (Framework para 94).

Expenses are recognised in the income statement on the basis of a direct association between the costs incurred and the earning of specific items of income. This process, commonly referred to as the matching of costs with revenues, involves the simultaneous or combined recognition of revenues and expenses that result directly and jointly from the same transactions or other events; for example, the various components of expense making up the cost of goods sold are recognised at the same time as the income derived from the sale of the goods. However, the application of the matching concept under this framework does not allow the recognition of
items in the balance sheet which do not meet the definition of assets or liabilities (Framework para 95).

When economic benefits are expected to arise over several accounting periods and the association with income can only be broadly or indirectly determined, expenses are recognised in the income statement on the basis of systematic and rational allocation procedures. This is often necessary in recognising the expenses associated with the using up of assets such as property, plant, equipment, patents and trade marks; in such cases the expense is referred to as depreciation or amortisation. These allocation procedures are intended to recognise expenses in the accounting periods in which the economic benefits associated with these items are consumed or expire (Framework para 96).

An expense is recognised immediately in the income statement when an expenditure produces no future economic benefits or when, and to the extent that, future economic benefits do not qualify, or cease to qualify, for recognition in the balance sheet as an asset. An expense is also recognised in the income statement in those cases when a liability is incurred without the recognition of an asset, as when a liability under a product warranty arises (Framework paras 97 and 98).

Measurement of the elements of financial statements

Measurement is the process of determining the monetary amounts at which the elements of the financial statements are to be recognised and carried in the balance sheet and income statement. This involves the selection of the particular basis of measurement (Framework para 99).

The IASB Framework para 100 lists a number of different measurement bases which are employed in different degrees and in varying combinations in financial statements:

(a) **Historical cost.** Assets are recorded at the amount of cash or cash equivalents paid or the fair value of the consideration given to acquire them at the time of their acquisition. Liabilities are recorded at the amount of proceeds received in exchange for the obligation, or in some circumstances (for example, income taxes), at the amounts of cash or cash equivalents expected to be paid to satisfy the liability in the normal course of business.

(b) **Current cost.** Assets are carried at the amount of cash or cash equivalents that would have to be paid if the same or an equivalent asset was acquired currently. Liabilities are carried at the undiscounted amount of cash or cash equivalents that would be required to settle the obligation currently.

(c) **Realisable (settlement) value.** Assets are carried at the amount of cash or cash equivalents that could currently be obtained by selling the asset in an orderly disposal. Liabilities are carried at their settlement values; that is, the undiscounted amounts of cash or cash equivalents expected to be paid to satisfy the liabilities in the normal course of business.

(d) **Present value.** Assets are carried at the present discounted value of the future net cash inflows that the item is expected to generate in the normal course of
business. Liabilities are carried at the present discounted value of the future net cash outflows that are expected to be required to settle the liabilities in the normal course of business.\(^7\)

The measurement basis most commonly adopted by entities in preparing their financial statements is historical cost. This is usually combined with other measurement bases. For example, inventories are usually carried at the lower of cost and net realisable value, marketable securities may be marked-to-market and pension liabilities are carried at their present value. Furthermore, some entities use the current cost basis as a response to the inability of the historical cost accounting model to deal with the effects of changing prices of non-monetary assets (\textit{Framework} para 101).

### 2.4.1 Fair value\(^8\)

A major feature of IFRS is the extent to which they are imbued with fair value accounting or mark-to-market accounting. Notably:

- IAS 16 provides a fair value option for property, plant and equipment (see Chapter 7).
- IAS 36 requires asset impairments (and impairment reversals) adjusted to fair value (see Chapter 10).
- IAS 38 requires intangible asset impairments adjusted to fair value (see Chapter 10).
- IAS 38 provides for intangibles to be revalued to market price, if available (see Chapter 9).
- IAS 39 requires financial instruments other than loans and receivables that are not held for trading, securities held to maturity to be accounted for at fair value (see Chapter 15).
- IAS 40 provides a fair value option for investment property (see Chapter 7).
- IFRS 2 requires share-based payments (stock, options, etc.) to be accounted for at fair value.
- IFRS 3 requires minority interest to be recorded at fair value (see Chapters 18 and 19).

As pointed out by Ball (2006), there are mixed views on fair value accounting. The fundamental case in favour of fair value accounting seems obvious to most economists: fair value incorporates market information into the financial statements. Incorporating more information in the financial statements by definition makes them more informative, with potential advantages to investors, and other things being equal it makes them more useful for purposes of contracting with lenders, managers and other parties.

Moreover, fair value meets the conceptual framework criteria in terms of qualitative characteristics of accounting information better than other measurement bases. In fact, fair values are relevant, can be faithful representations of assets and liabilities, are neutral, timely and comparable (see Table 2.1, below).

Despite these advantages, fair value measurement is not a panacea. There are many potential problems with fair value in practice, including market illiquidity
Measurement of the elements of financial statements

as emerged during the recent credit crunch. Other concerns include the lack of a clear definition of fair value, lack of verifiability, the ability of management to determine fair value estimates, and the potential circularity of reflecting fair values in financial statements when the objective is to provide financial statement users with information to make economic decisions that include assessing the value of the entity (see Table 2.1 and Exhibit 2.1, below).

Exhibit 2.1

If a prospective house buyer were asked the question: ‘What would be the more meaningful information – the best estimate of the market value of the property you are considering buying today, the best estimate last year, or some sort of hybrid number?’, few would disagree with the answer, no matter how painful economic reality may feel to the seller.

While fair value accounting for financial instruments may not be perfect, its suspension would diminish transparency at a time when investors badly need less opacity, not more.

Michael Izza, Chief Executive, ICAEW, London

Fair value is defined as ‘the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm’s length transaction’

Table 2.1 Fair values and qualitative characteristics of accounting information

<table>
<thead>
<tr>
<th>Advantages</th>
<th>Disadvantages</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair values are <strong>relevant</strong> because they reflect present economic conditions relating to economic resources and obligations, i.e., the conditions under which financial statement users will make their decisions?</td>
<td>Lack a clear definition of fair value</td>
</tr>
<tr>
<td>Fair values can be <strong>faithful representation</strong> of assets and liabilities, because they reflect risk and probability-weighted assessments of expected future cash inflows and outflows</td>
<td>Lack verifiability</td>
</tr>
<tr>
<td>Fair values are unbiased and therefore <strong>neutral</strong></td>
<td>Management competence to determine fair value estimates</td>
</tr>
<tr>
<td>Fair values are <strong>timely</strong> because they reflect changes in economic conditions when those conditions change</td>
<td>Potential circularity of reflecting fair values in financial statements when the objective is to provide financial statement users with information to make economic decisions that include assessing the value of the entity</td>
</tr>
<tr>
<td>Fair values are <strong>comparable</strong> because the fair value of any particular asset or liability depends only on the characteristics of the asset or liability, not on the characteristics of the entity that holds the asset or liability or when it was acquired. Fair values enhance consistency because they reflect the same type of information in every period</td>
<td></td>
</tr>
</tbody>
</table>

Source: This table is based on Barth (2007).
Although this definition states the measurement objective, it lacks sufficient specificity to ensure consistent application.

As regards verifiability of fair value, verifiability is a component of faithful representation. A concern over verifiability of fair value often is expressed in relation to assets and liabilities that do not have observable market prices. For such assets and liabilities, fair value must be estimated, which raises the possibility that the estimates may not be verifiable.

The effect of incentives on fair value estimates by management is also of concern when observable market prices are unavailable.

Lastly, concerning potential circularity, it is unlikely that even if all recognised assets and liabilities are measured at fair value, recognised equity would equal the market value of equity. This is because only assets and liabilities that meet the Framework definitions are candidates for recognition. Market value of equity reflects investors’ assessments of, among other things, growth options and managerial skill that do not meet the asset definitions (Barth 2007).

Notwithstanding the above, the use of fair value would minimise the undesirable effects of the mixed measurement approach to financial reporting that we have today (Barth 2007). Presently, financial statement amounts are determined using a variety of measurement bases. These include, for example, historical cost (used for cash), amortised historical cost (used for loans receivable and long-term debt), impaired amortised historical cost (used for purchased property, plant, and equipment), accumulated amortised and impaired historical cost (used for self-constructed property, plant, and equipment), fair value (used for derivatives and asset revaluations), and entity-specific value (used for impaired inventories and impaired property, plant, and equipment). These differences in measurement bases do not result from differences specified in the Framework. Rather, they result from conventions and differences in practice that have evolved over time. Thus, when viewed in terms of the Framework, these differences cause financial statements to be internally inconsistent. Not only is use of multiple measurement bases conceptually unappealing, but it also creates difficulties for financial statement users. Measuring financial statement amounts in different ways complicates the interpretation of accounting summary amounts such as profit or loss (Barth 2007).

Support for fair value accounting is also backed by a study on mark-to-market accounting standards carried out in the last quarter of 2008 by the US SEC. Most investors and other users of financial reports indicated a view that fair value accounting transparently reflects, under the prevailing economic conditions, the value of assets and liabilities of the companies in which they invest. Most indicated that suspending fair value accounting would result in a loss of information and investor confidence: fair value is the most relevant measurement attribute for financial instruments in the prevailing market environment. However, fair value reporting can pose challenges, particularly in the absence of active markets. Users also
expressed the need to supplement fair value accounting with robust disclosure on the methods used, of the underlying assumptions and sensitivities, particularly when fair value estimates are necessary in the absence of quoted prices. There is little evidence to suggest investors and other users generally believe an alternative to fair value, such as amortised cost, would be a superior approach. Preparers of financial statements held mixed views about the usefulness of fair value accounting in the prevailing market conditions. Preparers that manage their businesses based on fair values, such as investment banks and mutual funds, indicated that fair value for financial instruments is always the most relevant measure. Preparers whose business activities include managing financial assets based on a longer-term profit expectation, for instance insurance companies and commercial banks, questioned the relevance of measuring securities based on current illiquid prices when those prices do not reflect the company’s ultimate cash flow expectations (see US SEC 2008).

2.4.2 Alternatives to fair value

As mentioned earlier, there are opponents to a more comprehensive use of fair value especially in the economic climate of 2007–10. As pointed out in the article from the Financial Times (Exhibit 2.2), fair values sometimes are the output of such complex mathematical models, that not only are they not verifiable, but are also so abstract and practically incomprehensible.

Exhibit 2.2

[... ] Another problem was at play: the extraordinary complexity and opacity of modern finance. During the past two decades, a wave of innovation has reshaped the way markets work, in a manner that once seemed able to deliver huge benefits for all concerned. But this innovation became so intense that it outran the comprehension of most ordinary bankers – not to mention regulators.

As a result, not only is the financial system plagued with losses of a scale that nobody foresaw, but the pillars of faith on which this new financial capitalism were built have all but collapsed. That has left everyone from finance minister or central banker to small investor or pension holder bereft of an intellectual compass, dazed and confused. [ ... ] The current crisis stems from changes that have been quietly taking root in the west for many years. Half a century ago, banking appeared to be a relatively simple craft. When commercial banks extended loans, they typically kept those on their own books – and they used rudimentary calculations (combined with knowledge of their customers) when deciding whether to lend or not.

From the 1970s onwards, however, two revolutions occurred: banks started to sell their credit risk on to third-party investors in the blossoming capital markets; and they adopted complex computer-based systems for measuring credit risk that were often imported from the hard sciences. [ ... ] In reality, many of the new products were so specialized that they were never traded in ‘free’ markets at all. An instrument known as ‘collateralised debt obligations of
Some opponents of comprehensive use of fair value advocate historical cost. However, we do not use historical cost comprehensively in financial statements today. Items initially recognised at cost typically are subsequently measured at amortised and impaired amounts; these are not historical cost. Thus, one would need to specify how these items should be measured subsequent to initial recognition. Also, it is unclear whether historical cost has the qualitative characteristics of accounting information specified in the Framework. For example, although an historical cost measure can be a faithful representation, historical cost may not be as relevant for users making economic decisions. However, cost is not always clearly identifiable, for example for self-constructed assets or assets acquired in a basket purchase, which raises concerns about verifiability. Also, the present convention of recognising decreases in asset values, i.e. impairments, but not increases in asset values, is inconsistent with neutrality. Moreover, some assets and liabilities have no cost – notably derivatives. This raises the question of how such assets and liabilities should be reflected in historical cost financial statements without either leaving them unrecognised or creating a mixed measurement approach.

Value in use, or entity-specific value, is another possible measurement alternative. Value in use requires inclusion of future cash flows that the entity expects to receive, discounted at a rate that reflects the entity’s cost of capital, even if these differ from those of other entities. Thus, entity-specific value differs from fair value in that entity-specific value includes cash inflows or outflows expected by the entity that would not be expected by other market participants, such as expected inflows related to superior management talent. Thus, entity-specific value can result in embedding the measure of an intangible asset, e.g. superior management talent, in the measure of another asset, e.g. property, plant, and equipment. As with all measurement bases, measuring assets and liabilities at entity-specific value also has
implications for profit or loss measurement. Because entity-specific value measures, assets and liabilities are based on what the entity expects to accomplish with the assets, the value of the entity’s special rights or skills are recognised when the assets are recognised, not when the entity realises the benefits associated with those special rights or skills. In contrast, using fair value would result in profit or loss reflecting how the entity performed during the period given the assets at its disposal relative to other market participants’ expected performance. If the entity makes better use of the assets, profit will be greater than the return expected based on the risk of its net assets; if it makes worse use of the assets, profit will be less than the expected return (Barth 2007).

2.5 Concepts of capital and capital maintenance

All accounting systems depend on the capital maintenance concept adopted, the basis used to value assets and the unit of measurement used.

Capital maintenance is central to the measurement of total accounting profit. Disregarding additions to capital or repayments of capital and distributions, accounting profit is the difference between a company’s capital at the start of the period and at the end of the period. A company can only be considered to have made a profit if it has increased its net assets, which are represented by its capital, over and above that necessary to maintain its opening capital. Thus, total accounting profit can be measured only once a definition has been established as to what capital is to be maintained.

There are at least two different concepts of capital maintenance:

• operating (or physical) capital maintenance; and
• financial capital maintenance.

Operating capital maintenance, although it can be measured in a variety of different ways, generally seeks to ensure that the business’s physical operating capacity is preserved.

Financial capital maintenance attempts to conserve the value of the funds that shareholders have invested in the business. Financial capital maintained can either be the monetary value of capital attributable to shareholders or a value adjusted by a general purchasing power index to maintain capital as a fund of real purchasing power.

The principal difference between the two concepts of capital maintenance is the treatment of the effects of changes in the prices of assets and liabilities of the entity. In general terms, an entity has maintained its capital if it has as much capital at the end of the period as it had at the beginning of the period. Any amount over and above that required to maintain the capital at the beginning of the period is profit (Framework para 107).

Under the concept of financial capital maintenance where capital is defined in terms of nominal monetary units, profit represents the increase in nominal money capital over the period. Thus, increases in the prices of assets held over the period, conventionally referred to as holding gains, are, conceptually, profits. They may not
be recognised as such, however, until the assets are disposed of in an exchange transaction. When the concept of financial capital maintenance is defined in terms of constant purchasing power units, profit represents the increase in invested purchasing power over the period. Thus, only that part of the increase in the prices of assets that exceeds the increase in the general level of prices is regarded as profit. The rest of the increase is treated as a capital maintenance adjustment and, hence, as part of equity (Framework para 108).

Under the concept of operating capital maintenance when capital is defined in terms of the physical productive capacity, profit represents the increase in that capital over the period. All price changes affecting the assets and liabilities of the entity are viewed as changes in the measurement of the physical productive capacity of the entity; hence, they are treated as capital maintenance adjustments that are part of equity and not as profit (Framework para 109).

The selection of the measurement bases and concept of capital maintenance will determine the accounting model used in the preparation of the financial statements. Different accounting models exhibit different degrees of relevance and reliability and, as in other areas, management must seek a balance between relevance and reliability (Framework para 110).

Consider the following example.

**Example 2.4**

**Capital maintenance concepts**

A sole trader starts a business buying and selling second-hand cars. In his first year of trading he buys one car for EUR 4,000 and sells it for EUR 8,000. At the time he sells the car, the cost of buying an equivalent car is EUR 4,800 and general inflation between the dates of buying and selling is 10 per cent.

Under financial capital maintenance (in monetary and in real terms) and operating capital maintenance the trader’s income statement would be as shown in Table 2.2, below.

**Table 2.2 Income statement under different capital maintenance concepts**

<table>
<thead>
<tr>
<th>Capital maintenance concepts</th>
<th>Financial capital maintenance</th>
<th>Operating capital maintenance</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Monetary capital</td>
<td>General purchasing power</td>
</tr>
<tr>
<td>Sales</td>
<td>8,000</td>
<td>8,000</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>(4,000)</td>
<td>(4,000)</td>
</tr>
<tr>
<td>Operating profit</td>
<td>4,000</td>
<td>4,000</td>
</tr>
<tr>
<td>Inflation adjustment to opening capital</td>
<td>–</td>
<td>(400)</td>
</tr>
<tr>
<td>Total profit</td>
<td>4,000</td>
<td>3,600</td>
</tr>
</tbody>
</table>
Monetary financial capital maintenance, which is the basis most commonly used in accounting, takes no account of the effects of inflation. The profit of EUR 4,000 is the amount in excess of the business’s original capital. In the second column the inflation adjustment shows the effect of the general increase in prices on the opening financial capital of EUR 4,000 and seeks to ensure that profit is measured only after preserving the opening capital in the business in terms of its general purchasing power. The profit of EUR 3,600 leaves capital of EUR 4,400 in the business to maintain its purchasing power.

Operating capital maintenance, on the other hand, is concerned with preserving the productive capacity of the business. In this example, this is the trader’s ability to replace the item of stock sold. Under operating capital maintenance, the trader has a profit of EUR 3,200 and operating capital in the business of EUR 4,800 which is sufficient to purchase a car for the next period’s trade.

Appendix to Chapter 2: Use of present value in accounting

Present value is a pervasive concept that has many applications in accounting. Currently, IFRS do not provide specific guidance to this subject matter, but in recognition of its importance, guidance drawn from US GAAP’s Concept Statement 7 (CON 7) is summarised below.

CON 7 provides a framework for using estimates of future cash flows as the basis for accounting measurements either at initial recognition or when assets are subsequently remeasured at fair value (fresh-start measurement). It also provides a framework for using the interest method of amortisation. It provides the principles that govern measurement using present value, especially when the amount of future cash flows, their timing, or both are uncertain. However, it does not address recognition questions, such as which transactions and event should be valued using present value measures or when fresh-start measurements are appropriate.

Fair value is the objective for most measurements at initial recognition and for fresh-start measurements in subsequent periods. At initial recognition, the cash paid or received (historical cost or proceeds) is usually assumed to be fair value, absent evidence to the contrary.

Application of present value tables and formulas

To take the present value of a single amount that will be paid in the future, apply the following formula; where \( PV \) is the present value of EUR 1 paid in the future, \( r \) is the interest rate per period and \( n \) is the number of periods between the current date and the future date when the amount will be realised.

\[
PV = \frac{1}{(1 + r)^n}
\]
The results of this formula are summarised in a present value factor table:

<table>
<thead>
<tr>
<th>(n) Periods</th>
<th>2%</th>
<th>3%</th>
<th>4%</th>
<th>5%</th>
<th>6%</th>
<th>7%</th>
<th>8%</th>
<th>9%</th>
<th>10%</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>0.9804</td>
<td>0.9709</td>
<td>0.9615</td>
<td>0.9524</td>
<td>0.9434</td>
<td>0.9346</td>
<td>0.9259</td>
<td>0.9174</td>
<td>0.9091</td>
</tr>
<tr>
<td>2</td>
<td>0.9612</td>
<td>0.9426</td>
<td>0.9246</td>
<td>0.9070</td>
<td>0.8900</td>
<td>0.8734</td>
<td>0.8573</td>
<td>0.8417</td>
<td>0.8265</td>
</tr>
<tr>
<td>3</td>
<td>0.9423</td>
<td>0.9151</td>
<td>0.8890</td>
<td>0.8638</td>
<td>0.8396</td>
<td>0.8163</td>
<td>0.7938</td>
<td>0.7722</td>
<td>0.7513</td>
</tr>
<tr>
<td>4</td>
<td>0.9239</td>
<td>0.8885</td>
<td>0.8548</td>
<td>0.8227</td>
<td>0.7921</td>
<td>0.7629</td>
<td>0.7350</td>
<td>0.7084</td>
<td>0.6830</td>
</tr>
<tr>
<td>5</td>
<td>0.9057</td>
<td>0.8626</td>
<td>0.8219</td>
<td>0.7835</td>
<td>0.7473</td>
<td>0.7130</td>
<td>0.6806</td>
<td>0.6499</td>
<td>0.6209</td>
</tr>
</tbody>
</table>

Example

Suppose one wishes to determine the amount needed to invest today to have EUR 10,000 in five years if the sum invested would earn 8 per cent.

Looking across the row with \( n = 5 \) and finding the present value factor for the \( r = 8\% \) column, the factor of 0.6806 would be identified. Multiplying EUR 10,000 by 0.6806 results in EUR 6,806, the amount needed to invest today to have EUR 10,000 at the end of five years.

Alternatively, using a calculator and applying the present value of a single sum formula, one could multiply EUR 10,000 by \( 1 \div (1 + 0.08)^5 \), which would also give the same answer, EUR 6,806.

Present value of a series of equal payments (an annuity)

Often in business transactions a series of equal payments paid at equal time intervals is required. Examples of these include payments of semiannual bond interest and principal or lease payments. The present value of each of these payments could be added up to find the present value of this annuity, or alternatively a much simpler approach is available. The formula for calculating the present value of an annuity of EUR 1 payments over \( n \) periodic payments, at a periodic interest rate of \( r \) is:

\[
P V \text{ Annuity} = 1 - \frac{1}{(1 + r)^n}
\]

The results of this formula are summarised in an annuity present value factor table.

<table>
<thead>
<tr>
<th>(n) Periods</th>
<th>2%</th>
<th>3%</th>
<th>4%</th>
<th>5%</th>
<th>6%</th>
<th>7%</th>
<th>8%</th>
<th>9%</th>
<th>10%</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>0.9804</td>
<td>0.9709</td>
<td>0.9615</td>
<td>0.9524</td>
<td>0.9434</td>
<td>0.9346</td>
<td>0.9259</td>
<td>0.9174</td>
<td>0.9091</td>
</tr>
<tr>
<td>2</td>
<td>1.9416</td>
<td>1.9135</td>
<td>1.8861</td>
<td>1.8594</td>
<td>1.8334</td>
<td>1.8080</td>
<td>1.7833</td>
<td>1.7591</td>
<td>1.7355</td>
</tr>
<tr>
<td>3</td>
<td>2.8839</td>
<td>2.8286</td>
<td>2.7751</td>
<td>2.7233</td>
<td>2.6730</td>
<td>2.6243</td>
<td>2.5771</td>
<td>2.5313</td>
<td>2.4869</td>
</tr>
</tbody>
</table>
Example
Suppose four annual payments of EUR 1,000 are needed to satisfy an agreement with a supplier. What would be the amount of the liability today if the interest rate the supplier charges is 6 per cent per year?

Using the table to get the present value factor, \( n = 4 \) periods row, and the 6 per cent column, gives you a factor of 3.4651. Multiply this by EUR 1,000 and you get a liability of EUR 3,465.10 that should be recorded. Using the formula would also give you the same answer with \( r = 6\% \) and \( n = 4 \).

Caution should be exercised when payments are not to be made on an annual basis. If payments are on a semiannual basis \( n = 8 \), but \( r \) is now 3 per cent. This is because \( r \) is the periodic interest rate, and the semiannual rate would not be 6 per cent, but half of the 6 per cent annual rate. Note that this is somewhat simplified, since due to the effect of compound interest 3 per cent semiannually is slightly more than a 6 per cent annual rate.

Present value of a perpetuity
An important, special type of annuity is a perpetual annuity or perpetuity. A perpetuity is a stream of cash flows that lasts forever. The classic example is the ‘consol’ bonds issued by the British government or Rendita Italiana issued by the Italian Treasury in the nineteenth century which pay interest each year on the stated face value of the bonds but have no maturity date. Another example is a preference share that pays a fixed cash dividend each year and never matures.

A feature of any perpetual annuity is that you cannot compute the future value of its cash flows because it is infinite. Nevertheless, it has a perfectly well-defined and determinable present value. Consider a perpetual stream of EUR 100 per year: if the interest rate is 10 per cent per year, how much is this perpetuity worth today? The answer is EUR 1,000. To see why, consider how much money you would have to put into a bank account offering interest at 10 per cent per year in order to be able to take out EUR 100 every year for ever. If you put EUR 1,000 then at the end of the first year you would have EUR 1,100 in the account. You would take out EUR 100, leaving EUR 1,000 for the second year. Clearly, if the interest rate stayed at 10 per cent per year, you could go on doing this forever.

More generally, the formula for the present value for a perpetual annuity is:

\[
PV_{\text{perpetuity}} = \frac{C}{r}
\]

where \( C \) is the periodic payment and \( r \) is the interest rate. This is the present value of an ordinary annuity with \( n = \infty \).
Summary

- The IASB Framework describes the basic concepts that underlie financial statements prepared in conformity with International Financial Reporting Standards.

- The Framework, which identifies the principal classes of users of an entity’s general-purpose financial statements, states that the objective of financial statements is to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions; and to show the results of management’s stewardship (i.e. accountability for resources entrusted to them).

- The Framework specifies the qualities that make financial information useful; namely, understandability, relevance, reliability and comparability. It also defines the basic elements of financial statements (assets, liabilities, equity, income and expenses) and discusses the criteria for recognising and measuring them.

- The IASB and FASB are jointly working on a project to revise and conform their conceptual Frameworks. It has been proposed that the converged framework should specify only one objective of financial reporting, that of providing information that is useful to users in making investment, credit and similar resource allocation decisions (‘the resource allocation decision-usefulness objective’). We consider that stewardship and decision-usefulness for investors are parallel objectives, which do not necessarily conflict, but which are equally important and therefore they should be defined as separate objectives.

- The elements of financial statements are assets, liabilities, equity, income and expenses. Each of these elements is defined in the IASB Framework.

- An element is recognised in the financial statements if it is probable that any economic benefits associated with the element will flow to or from the entity and if the element has a cost or value which can be reliably measured.

- Elements may be measured at their historical cost, current cost, realisable value, present value and fair value. The measurement basis most commonly adopted by entities in preparing their financial statements is historical cost, which is usually combined with other measurement bases.

- Profits and losses may be measured in terms of changes in the amount of an entity’s net assets (financial capital maintenance) or in terms of changes in the entity’s physical operating capability (physical capital maintenance).

Research and references

The IASB documents relevant for this chapter are:


The following are examples of books, research and discussion papers that take the issues of this chapter further:


2: Conceptual framework for financial reporting


Discussion questions

2.1 Conceptual framework

(a) Why do we need a conceptual framework when we have a comprehensive set of accounting standards such as IFRS?
(b) Who are the primary users of general-purpose financial statements?
(c) IASB does not include management of a company as one of the primary users of general-purpose financial statements. Why do you suppose that is?
(d) Should financial information be only ‘decision useful’? Explain why.

2.2 Qualitative characteristics of financial information

(a) Illustrate the qualitative characteristics of useful financial information. Describe the factors which contribute to the achievement of each characteristic.
(b) Relevance is one of the key qualities of the information in financial statements. What does relevance mean?
(c) What is the difference between consistency of accounting information and comparability of accounting information?

2.3 Probable future economic benefits

Under the IASB *Framework*, an asset is recognised ‘when it is probable that the future economic benefits will flow to the entity’.

(a) Which future economic benefits does that principle refer to? Illustrate your answer with examples.
(b) How would you interpret ‘probable’ in this context?

2.4 Recognition of asset

A company buys a costly item of electronic equipment that it expects will have a useful life of eight years, and it depreciates the asset over that period.
By the end of the fourth year, the item of equipment is obsolete and the company is no longer using it. It is still in the company’s balance sheet at the remaining undepreciated one-half of original cost, which the company says (i) is a faithful representation of its circumstances since the company still owns the asset, and (ii) is a reliable measure of the asset.

Comment on the company’s view.

2.5 General-purpose financial statements

In some countries, income tax authorities require companies to prepare accounts that conform to national laws for measuring taxable income.

Are those financial statements ‘general-purpose financial statements’? Why?

2.6 Conceptual framework and IFRS

A company’s senior financial officer says, ‘I always follow IFRSs in preparing my company’s financial statements. But the IASB Framework is a lot of conceptual theory that doesn’t affect me directly. It is not an accounting standard, so I have never read it.’

Is the IASB Framework a standard? Is it relevant to preparing IFRS financial statements? If so, how?

2.7 Going concern assumption

An entity has incurred losses during the last four years and its current liabilities exceed its total assets. The entity was in breach of its loan covenants and has been negotiating with the related financial institutions in order to ensure their continuing support. These factors raise substantial doubt that the entity will be able to continue as a going concern.

How should management deal with this matter?

2.8 Definition and recognition of an asset

(a) Give examples of resources that might be treated as assets in a balance sheet but normally are not. How helpful is the Framework definition of assets in making clear that they are not included?

(b) Give examples of resources that are normally treated as assets in a balance sheet. How helpful is the Framework definition of assets in deciding the monetary amount at which they should be recorded?

2.9 Definition and recognition criteria for an asset

Chemco Ltd. is engaged in the production of chemical products and selling them locally. The company wishes to extend its market and export some of its products. It has come to the attention of the financial director that compliance with international environmental requirements is a significant precondition if it wishes to sell products overseas. Although Chemco Ltd. has during the past put in place a series of environmental policies, it is clear that it is also common practice to have an environmental audit done from time to time, which will cost approximately EUR 120,000. The audit will encompass the following:
• a full review of all environmental policy directives;
• a detailed analysis of compliance with these directives;
• a report containing in-depth recommendations of those physical and policy changes that would be necessary to meet international requirements.

The financial director of Chemco Ltd has suggested that the amount be capitalised as an asset and then written off against the revenues generated from export activities so that the matching of income and expense will occur.

Do you agree with the financial director? Explain why.

Notes

1 The progress of this project may be followed on the website www.iasb.org.
3 The IASB’s ED of 2008 proposes to remove the concept of ‘underlying assumptions’. The accruals concept becomes part of relevant information. The going concern convention is not mentioned in the ED, but it is dealt with in the revised version of IAS 1 – *Presentation of Financial Statements*, para 17.
4 This section is based on IASB (2009).
5 The standard incorporates simple financial instruments, such as *trade receivables* and *trade payables*, as well as more complex instruments, such as *derivatives*.
6 For a different opinion see Jim Leisenring’s presentation (Conceptual Framework CD-Rom 2004, IASB: London). Jim Leisenring, IASB member, compares the IASB *Framework* with the FASB’s conceptual framework for financial accounting and reporting. He argues that the IASB *Framework* has an income statement approach.
7 Readers who are not familiar with the concepts of discounting and present value should refer to the appendix at the end of this chapter where these concepts are explained.
8 This section is based on Ball (2007) and US SEC (2008).
9 See Barth *et al*. (2001), Landsman (2005), Landsman (2006) and Barth (2007) for summaries of empirical research relating to the value relevance of fair values.