

1

The IASB and its *Conceptual Framework*

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

- 1 describe the organisational structure of the key players in setting International Financial Reporting Standards (IFRS® Standards)
- 2 describe the purpose of a conceptual framework — who uses it and why
- 3 explain the qualitative characteristics that make information in financial statements useful and the constraint thereon
- 4 explain the going concern assumption
- 5 define the basic elements in financial statements — assets, liabilities, equity, income and expenses
- 6 explain the principles for recognising the elements of financial statements
- 7 distinguish between alternative bases for measuring the elements of financial statements
- 8 explain the principles for measuring the elements of financial statements
- 9 explain the difference between presentation and disclosure and the principles for presenting and disclosing information in the financial statements
- 10 explain what is meant by a unit of account and in what context it is used
- 11 outline two concepts of capital and explain the relevance of the term capital maintenance

INTRODUCTION

The purpose of this book is to identify and explain the major concepts and principles of International Financial Reporting Standards (generally referred to as IFRS Standards, or simply IFRSs) and to help you develop skills in applying them in business contexts. You may be familiar with the accounting treatment for various transactions, such as the purchase of inventory. The text will build on that knowledge and consider the principles and techniques required or permitted by IFRS Standards in accounting for a range of transactions, events and circumstances.

This first chapter provides an outline of the International Accounting Standards Board (IASB®) and its role in setting international accounting standards (IFRS Standards). It also explains that the IASB develops those IFRS Standards using certain fundamental concepts and principles, which are set out in the *Conceptual Framework for Financial Reporting* (the *Conceptual Framework*). The *Conceptual Framework's* key concepts and principles will also be outlined in this chapter. Interestingly, although the IFRSs are supposed to be built on the concepts and principles contained in the *Conceptual Framework*, it is possible for an IFRS to not reflect these concepts and principles. This situation may arise when an IFRS was developed prior to the current revision of the *Conceptual Framework* (the latest major revision occurred in 2018), and in situations such as these, the requirements of that IFRS take precedence over the *Conceptual Framework*. IFRS Standards are principles-based standards, rather than rules-based standards, even though the volume of guidance under IFRS Standards might suggest otherwise. Since the IFRS Standards are principles-based, we need *professional judgement* when applying them. An example of needing to apply principles rather than rules is the requirement that investment property be measured either using the cost model or fair value model, where this decision is based on the principle that the model chosen should be the one that provides the most useful information to the user. Identifying the most useful information is frequently a subjective task. To assist in this process, the *Conceptual Framework* establishes the qualitative characteristics financial information must have for it to be considered useful. The *Conceptual Framework* also provides definitions and recognition criteria that must be met before including elements in the financial statements and explains a variety of principles, including, for example, the concepts of recognition and derecognition, measurement, presentation and disclosure as well as concepts of capital. These principles are an important source of guidance to standard setters in the development of new IFRS standards referred to as IFRS Standards or simply IFRSs and to preparers of financial statements in the absence of an applicable IFRS standard. Accordingly, study of the *Conceptual Framework* provides a useful foundation to understanding and applying IFRS Standards.



1.1 THE IFRS FOUNDATION AND THE INTERNATIONAL ACCOUNTING STANDARDS BOARD (IASB)

The purpose of this section is to provide an understanding of the structure of the IFRS Foundation and how the IASB fits into this structure, and in particular, the IASB's role in the determination of IFRS Standards. Much of this information has been obtained from the website of the IASB, www.ifrs.org. To keep up to date with what the IASB is doing, this website should be regularly visited.

1.1.1 Formation of the IASB

In 1972, at the 10th World Congress of Accountants in Sydney, Australia, a proposal was put forward for the establishment of an International Accounting Standards Committee (IASC). In 1973, the IASC was formed by 16 national professional accountancy bodies from nine countries — Canada, the United Kingdom, the United States, Australia, France, Germany, Japan, the Netherlands and Mexico. By December 1998, the membership of the IASC had expanded and the committee had completed its core set of accounting standards.

However, the IASC was seen as having a number of shortcomings:

- It had weak relationships with national standard setters; this was due in part to the fact that the representatives on the IASC were not representative of the national standard setters but rather of national professional accounting bodies.
- There was a lack of convergence between the IASC standards and those adopted in major countries, even after 25 years of trying.
- The board only functioned on a part-time basis.
- The board lacked resources and technical support.

In 1998, the committee responsible for overseeing the operations of the IASC began a review of the IASC's operations. The results of the review were recommendations that the IASC be replaced with a smaller, full-time International Accounting Standards Board. At the same time, the IASC's Standing Interpretations Committee of the IASC was replaced by the IFRS Interpretations Committee of the IASB (commonly referred to as IFRIC). In 1999, the IASC board approved the constitutional changes necessary for the restructuring of the IASC. A new International Financial Reporting Standards Foundation was established and its trustees appointed. By early 2001, the members of the IASB and the Standards Advisory Council (SAC) were appointed, as were technical staff to assist the IASB.

The IASB initially adopted the International Accounting Standards (IAS® Standards), with some modifications, as issued by the IASC (e.g. IAS 2 *Inventories*). As standards were revised or newly issued by the IASB, they were then called International Financial Reporting Standards (e.g. IFRS 8 *Operating Segments*). This means that the term International Financial Reporting Standards (IFRSs) includes both IFRS Standards and IAS Standards. For the sake of brevity, this chapter will refer to all standards as IFRSs, whether prefixed with 'IFRS' or IAS'.

1.1.2 The IFRS Foundation: purpose and governance

The *IFRS Foundation* has a three-tiered governance structure:

- The International Accounting Standards Board (IASB), together with its IFRS Interpretations Committee (IFRIC), and the International Sustainability Standards Board (ISSB)
- The IFRS Foundation Trustees
- IFRS Foundation Monitoring Board

What these levels do and how they interact is explained below.

- The **International Accounting Standards Board (IASB)** is an independent standard-setting board. It is this body that publishes the International Financial Reporting Standards (IFRSs).
- The IASB has a committee called the **IFRS Interpretations Committee (IFRIC)**. This committee reviews newly identified financial reporting issues that are not specifically dealt with in the IFRSs, and issues for which unsatisfactory or conflicting interpretations have emerged or may emerge. The committee endeavours to reach a consensus on appropriate accounting treatment and provides authoritative guidance on the issue concerned. This may take the form of (i) a proposal to the Board to amend a standard; (ii) the issuance of an interpretation of a standard; or (iii) the issuance of an agenda decision explaining why neither is necessary. The latter often implicitly contains guidance on how to apply an IFRS.

Once approved, or not objected to, by the IASB, the interpretations have equivalent status to standards (IFRSs); that is, although they are technically not standards (IFRSs), they are regarded as forming part of the standards (IFRSs) such that stating that there is compliance with the standards (IFRSs) means that there has been compliance with both the standards issued by the IASB (IFRSs) and any guidance issued by IFRIC. More recently the *IFRS Interpretations Committee* has been asked by the IASB to help with the drafting of minor amendments to standards and with the Annual Improvement Projects. The latter are annual packages of changes to standards that are minor or narrow in scope.

- The **International Sustainability Standards Board (ISSB)** was created in 2022, and is the body that will focus on the standard setting for 'sustainability reporting', called IFRS Sustainability Disclosure Standards. Sustainability disclosure standards are not covered in this book. However, the two Boards will work together closely in areas of mutual interest, where uncertainties regarding sustainability may have an impact on financial statements.

The members of the ISSB, the IASB and IFRIC are appointed and overseen by a geographically and professionally diverse group of trustees, referred to as the **IFRS Foundation Trustees**. The trustees are publicly accountable to the **IFRS Foundation Monitoring Board**.

- The trustees appoint an **IFRS Advisory Council (IFRS AC)**, which provides strategic advice to the IASB, the ISSB, and informs the *IFRS Foundation Trustees*.

In addition to the IFRSAC, **other formal advisory bodies** that provide a means for the IASB to consult and engage with interested parties from a range of backgrounds and geographical areas include:

- Capital Markets Advisory Committee
- Emerging Economies Group
- Global Preparers Forum
- SME Interpretations Group.

Furthermore, **working groups** may be established for major projects to provide the IASB with access to additional expertise as required; for example, the Insurance Working Group was set up when the IASB was developing a standard on accounting for insurance contracts.

Further information about advisory bodies and working groups, including reports and summaries of discussions, can be obtained from the IASB's website.

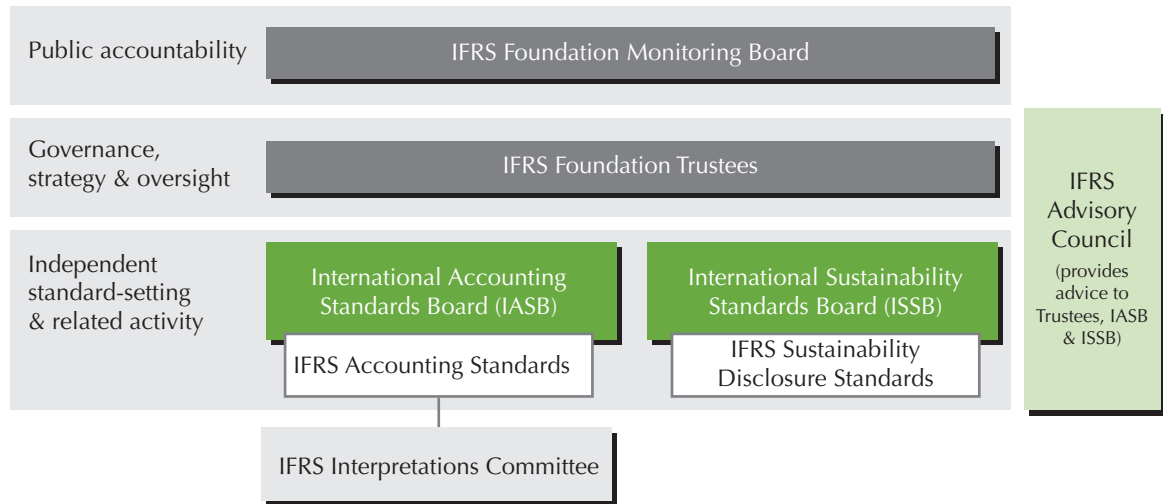


FIGURE 1.1 Institutional structure of international standard setting

Source: IASB (accessed 2024): <http://www.ifrs.org/about-us/our-structure>.

A pictorial view of the structure of the IFRS Foundation is given in figure 1.1.

1.1.3 The IFRS Foundation: due process

The *IFRS Foundation Trustees* approved the publication of the booklet *IASB and IFRS Interpretations Committee Due Process Handbook* (DP Handbook) in 2020 (available on the IASB's website). This handbook sets out the due process to be followed when, for example, publishing a new or revised IFRS Standard, or an IFRS Interpretation. The requirements laid out in the DP Handbook have been carefully crafted to ensure the development process is 'thorough, inclusive and transparent', which, in turn, ensures that the *IFRS Foundation* is successful in its stated aim of developing high-quality standards that will be accepted and adopted globally.

By way of a brief overview, the DP Handbook sets out:

- 'how the Board determines whether to add a project to its work plan;
- the stages of standard-setting and the types of consultation documents and other materials published by the Board and the Interpretations Committee;
- the minimum consultation requirements, including the duration of consultations;
- the advisory bodies and consultative groups established to provide input to the standard-setting process, and when and how they should be consulted;
- the minimum voting requirements for the Board and the Interpretations Committee to advance proposals or finalise documents at different stages in standard-setting; and
- the procedures followed if a stakeholder complains about the due process'.

Source: 'What is Due Process and Why Does it Matter?' by Alan Beller; on the IFRS website: <https://www.ifrs.org/news-and-events/news/2020/08/what-is-the-due-process-and-why-does-it-matter/#:~:text=The%20due%20process%20is%20essential,global%20acceptance%20of%20the%20Standards>.

1.1.4 Due process: publishing an IFRS

By way of an example, the summarised process involved in publishing an IFRS Standard (IFRS) is presented below.

1. *Research programme.* This stage of the process involves analysing 'perceived shortcomings' and assessing possible improvements and remedies to these alleged problems. A wide variety of bodies and interested parties are involved in this step (e.g. national and regional accounting standard-setting bodies, other bodies associated therewith, academics and any other interested persons). The involvement of a wide array of bodies is made possible through the use of the Accounting Standards Advisory Forum (ASAF). Evidence of possible problems and their solutions is put forward through documents such as discussion papers, requests for information or research papers. After a process of deliberation and debate, some of these matters will be considered important enough to progress to stage 2, whereas others may

be dismissed as not sufficiently important to require modifications or revisions to existing standards or pronouncements.

2. *Developing a proposal for publication.* After mandatory consultation with the IFRS Trustees, IFRS Advisory Council (IFRSAC) and the Accounting Standards Advisory Forum (ASAF), the project must then be formally added to the IASB's agenda (this is done by a simple majority vote at a public IASB meeting). If the project is considered major, the IASB must then consider whether a consultative group (e.g. involving a group of expert advisors) needs to be established. Proposals must then be developed and debated in public meetings (this involves reviewing papers prepared by the IASB's technical staff and also the possible feedback from any discussion papers). Then, an exposure draft is prepared and published (sometimes with additional supporting materials). This must be done with a press release, requesting public comment.
3. *Redeliberations and finalisation.* After the exposure draft is published (see prior stage 2), there is a mandatory period during which the public is given time to comment (the period depends on what the exposure draft relates to). When this period ends, the IASB must then consider the feedback. Based on feedback received, the IASB must consider whether a revised exposure draft is necessary and whether additional consultation is necessary (or, if significant negative feedback is received, the IASB may need to consider cancelling the entire project). Unless the project is cancelled, the final draft IFRS will need to be prepared for balloting, whereupon the Due Process Oversight Committee (DPOC) needs to be informed that the balloting milestone has been reached (and, if relevant, the DPOC will need to be told why a revised exposure draft was not necessary). The IFRS is published (normally together with an accompanying document called the 'Basis of Conclusions') if the ballot results yield a supermajority of IASB members (this is 8 votes if there are only 13 members, or 9 votes if there are 14 members). If the IFRS was a new standard or had been subject to major amendments, then the publication of the IFRS will be accompanied by other supporting materials, such as a project summary, feedback statements and possibly even podcasts and Q&As.
4. *Post-implementation reviews.* If the IFRS (published in stage 3) was a new standard or arose due to major amendments to a pre-existing standard, then a post-implementation review must be conducted roughly 2.5–3 years after the IFRS became effective (the review may be deferred in certain circumstances). This review may also be performed for other reasons (e.g. changes to the concerns voiced by stakeholders).

Source: Summarised from ifrs.org website — IASB Due Process

<https://www.iasplus.com/en/resources/ifrsf/due-process/iasb-due-process>

The above is a summary of the Due Process followed by the IASB before publishing IFRS Standards or amendments thereto. A slightly different due process would be followed when publishing an Interpretation or Agenda decision by IFRIC. The detailed Due Process can be found in the Due Process Handbook, which is available on the IFRS Foundation's website (IFRS.Org: <https://www.ifrs.org/content/dam/ifrs/about-us/legal-and-governance/constitution-docs/due-process-handbook-2020.pdf>)



1.2 THE PURPOSE OF A CONCEPTUAL FRAMEWORK

1.2.1 Overview

The first international 'framework' was adopted in 1989, then superseded by a replacement in 2010, and then largely rewritten in 2018. This latest version is called the *Conceptual Framework for Financial Reporting* (CF). Some fairly significant changes were made in this latest revision, including formalising concepts not previously referred to (e.g. derecognition), clarifying concepts that had previously been interpreted in a variety of ways (e.g. prudence) and completely revising the definitions of the elements and their recognition criteria. Before getting into the details, however, it is important to understand a few important points about this CF.

Firstly, the CF is not an IFRS. Instead, the purpose of the CF is:

- to assist the IASB to develop IFRSs;
- to assist preparers of financial statements to develop their own accounting policies in the event there is no suitable IFRS or the existing IFRS allows for an alternative policy to be developed;
- to assist everyone (e.g. the IASB, the preparers of financial statements and users of financial statements) to understand and interpret the application of IFRSs.

The revised CF consists of eight chapters:

- Chapter 1: The objective of general-purpose financial reporting
- Chapter 2: Qualitative characteristics of useful financial information
- Chapter 3: Financial statements and the reporting entity
- Chapter 4: The elements of financial statements
- Chapter 5: Recognition and derecognition

- Chapter 6: Measurement
 - Chapter 7: Presentation and disclosure
 - Chapter 8: Concepts of capital and capital maintenance.
- Aspects of these eight chapters will be explained in the rest of this chapter.

1.2.2 The objective of general purpose financial reporting

The IASB's *Conceptual Framework* deals only with the objective of general purpose financial reporting; that is, financial reporting intended to meet the information needs common to a range of users who are unable to command the preparation of reports tailored to satisfy their own particular needs. For example, IFRSs are not designed to be used in the preparation of special purpose reports for stakeholders such as tax authorities and banking supervisors, both of which are able to demand this information directly.

Paragraph 1.2 of the *Conceptual Framework* states the objective of general purpose financial reporting:

The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions relating to providing resources to the entity. Those decisions involve decisions about (a) buying, selling or holding equity and debt instruments, (b) providing or settling loans and other forms of credit, or (c) exercising rights to vote on, or otherwise influence, management's actions that affect the use of the entity's economic resources.

In order to achieve the objective of general purpose financial reporting (i.e. to provide useful information), the CF specifies certain qualitative characteristics of financial reporting information, defines the elements (assets, liabilities, income, expenses and equity), clarifies the concepts to be used when deciding whether to recognise (and derecognise) them, how to measure them and how to present and disclose them.



1.3 QUALITATIVE CHARACTERISTICS OF USEFUL FINANCIAL INFORMATION

What characteristics should financial information have in order to be included in general purpose financial reporting? The following section discusses both the qualitative characteristics of useful information and the constraint on providing useful information. The qualitative characteristics are divided into fundamental qualitative characteristics and enhancing qualitative characteristics.

1.3.1 Fundamental qualitative characteristics

For financial information to be decision-useful, it must possess two fundamental qualitative characteristics:

- relevance
- faithful representation.

Relevance

Paragraphs 2.6–2.11 of the IASB's *Conceptual Framework* elaborate on the qualitative characteristic of *relevance*.

Information is relevant if:

- it is capable of making a difference in the decisions made by users of financial information.
- Information is considered to have the ability to make a difference in a user's decision-making if the information provides predictive value, confirmatory value or both.
- *Predictive value* occurs where the information is useful as an input into the users' decision models and affects their expectations about the future.
 - *Confirmatory value* arises where the information provides feedback that confirms or changes past or present expectations based on previous evaluations

Notice that the information needs merely to be *capable* of making a difference. It is not necessary that the information has actually made a difference in the past or will make a difference in the future.

Information about the financial position and past performance is often used as the basis for predicting future financial position and performance and other matters in which users are directly interested, such as future dividends and wage payments, future share prices, and the ability of the reporting entity to pay its debts when they fall due. The predictive ability of information may be improved if unusual or infrequent transactions and events are reported separately in the statement of profit or loss and other comprehensive income.

Materiality is not a qualitative characteristic, but is a concept used when assessing the relevance of information. Simply put, if something is *immaterial*, it would be *irrelevant* to the users. Information is *material*

if it is reasonable to expect that a primary user's decisions relating to the specific reporting entity might change if the information were to be omitted, misstated or obscured (paragraph 2.11).

Small expenditures for non-current assets (e.g. tools) are often expensed immediately rather than depreciated over their useful lives to save the clerical costs of recording depreciation and because the effects on performance and financial position over their useful lives are not large enough to affect decisions. Another example of the application of materiality is the common practice by large companies of rounding amounts to the nearest thousand units of currency (e.g. euros or dollars) in their financial statements.

An important aspect of materiality is that it is *entity-specific*. In other words, materiality is a relative matter — what is material for one entity may be immaterial for another. A \$10,000 error may not be important in the financial statements of a multimillion-dollar company, but it may be critical to a small business. The materiality of an item may depend not only on its relative size but also on its nature. For example, the discovery of a \$10,000 bribe may be a material event even for a large company. Professional judgements as to the materiality of an item or event are often difficult.

Faithful representation

Paragraphs 2.12–2.19 of the IASB's *Conceptual Framework* elaborate on the concept of faithful representation. Faithful representation is attained when the depiction of an economic phenomenon is complete, neutral, and free from material error. This results in the depiction of the economic substance of the underlying transaction. Note the following in relation to these characteristics:

- A depiction is *complete* if it includes 'all information necessary for a user to understand the phenomenon being depicted'. (Paragraph 2.14).
- *Neutrality* is the absence of bias. Bias refers to the manipulation of information to achieve a response, whether it be favourable or unfavourable. In order to achieve neutrality, we must exercise prudence. Prudence requires preparers to be cautious whenever dealing with information that has a level of uncertainty so that they do not prepare financial information with a favourable bias (e.g. overstating assets or understating liabilities), or unfavourable bias (e.g. understating assets or overstating liabilities). (Paragraphs 2.15–2.17).
- Information that is *free from error* does not mean accurate in all respects. Instead, it means that there is no error or omission either in the description thereof or in the selection and application of processes used to produce it. By way of an example, including an estimated amount in a set of financial statements does not render the information erroneous and thus no longer a faithful representation. Although measurement uncertainty has now been introduced into the financial statements, the amount is still a faithful representation of the phenomena 'if the amount is described clearly and accurately as being an estimate, the nature and limitations of the estimating process are explained and no errors have been made in selecting and applying an appropriate process for developing the estimate'. (Paragraphs 2.18–2.19).

It should be noted that the term 'faithful representation' has replaced the previous term 'reliability'. As explained in the *Basis for Conclusions*, the boards noted that there were various notions as to what is meant by reliability. The boards believed that the term 'faithful representation' provided a better understanding of the quality of information required. (Paragraphs BC 2.22–2.30).

The two fundamental qualitative characteristics of financial information (relevance and faithful representation) may give rise to conflicting guidance on how to account for phenomena. For example, the measurement base that provides the most relevant information about an asset will not always provide the most faithful representation. The *Conceptual Framework* (paragraphs 2.21–2.22) explains how to balance the fundamental qualitative characteristics. First, the criterion of relevance is applied to information to determine which economic information should be contained in the financial statements. Thereafter, the criterion of faithful representation is applied to determine how to depict those phenomena in the financial statements. The two characteristics work together. Either irrelevance (the economic phenomenon is not going to make a difference to the users' decision-making) or unfaithful representation (the depiction of the phenomenon is incomplete, biased or contains error) will result in information that is not useful to users in their decision-making.

1.3.2 Enhancing qualitative characteristics

The *Conceptual Framework* (paragraphs 2.23–2.36) identifies four enhancing qualitative characteristics. These four enhancing characteristics, expanded upon below, are *complementary* to the two fundamental characteristics. These enhancing characteristics distinguish *more useful* information from *less useful* information.

Comparability

Comparability is the quality that enables users to identify similarities in and differences between two or more sets of economic phenomena. Effective decision-making about an entity is enhanced when it is

possible to compare current year financial information with that of the prior year/s (enabling the identification of trends within the entity). Similarly, decision-making is enhanced when it is possible to compare an entity's information with that of other similar entities.

It is important to note the difference between the terms comparability and consistency. For effective comparisons to be possible, there needs to be an appropriate level of consistency e.g. there needs to be a consistent method of calculating earnings per share across the various entities being compared, or from one year to the next, if we are simply comparing the earnings per share of a single entity across a period of years. *Consistency* enables or enhances *comparability*.

Note that the need for consistency does not require a given accounting method to be applied throughout an entity. For example, an entity may well use different methods to account for different types of inventory. (*These inventory costing methods are discussed in chapter 4.*) Similarly, a variety of different measurement techniques may be appropriate; for example, land may need to be measured at cost, plant may be best measured at depreciated cost and investment property may be best measured at fair value.

Consistency from year to year, or entity to entity, enhances comparability in the presentation of financial information but the need for such consistency should not be allowed to hinder the change to better accounting methods. The need for comparability should not demand blind uniformity or consistency. For example, it would not be appropriate for an entity to continue to apply an accounting policy if the policy ceases to meet the fundamental qualitative characteristics of relevance and faithful representation.

Verifiability

Verifiability is the quality that helps assure users that information faithfully represents the economic phenomena that it purports to represent. Verifiability is achieved if different knowledgeable and independent observers would reach the same general conclusions that a particular description or amount is a faithful representation. That said, and as explained in the Basis of Conclusions, information that is not verifiable is not useless. In fact, many forward-looking estimates cannot be verified, and yet the financial statements would be far less useful without them, which is why verifiability is 'very desirable but not necessarily required'. (BC2.62)

Timeliness

Timeliness means having information available to users before it loses its capacity to influence their decisions. If such capacity is lost, then the information loses its relevance. Information may continue to be timely after it has been initially provided, for example, in trend analysis.

Understandability

Understandability is the quality that enables users to comprehend the meaning of the information. Information may be more understandable if it is 'classified, characterised and presented clearly and concisely'. In this regard, preparers of financial information may assume that the users thereof 'have a reasonable knowledge of business and economic activities', that they will 'review and analyse the information diligently' and will obtain the 'aid of an advisor' to understand complex issues.

1.3.3 Cost constraint on useful financial reporting

Paragraphs 2.39 to 2.43 of the *Conceptual Framework* note that cost is the constraint that limits the information provided by financial reporting. The provision of information incurs *costs*. The benefits of supplying information should always be greater than the costs. Costs include costs of collecting and processing information, costs of verifying information, and costs of disseminating information. The non-provision of information also imposes costs on the users of financial information as they seek alternative sources of information.

1.4 GOING CONCERN ASSUMPTION

Financial statements are prepared under the assumption that the entity will continue to operate for the foreseeable future. Thus, it is assumed that an entity will continue to operate at least long enough to carry out its existing commitments. This assumption is called the *going concern assumption* or sometimes the *continuity assumption*.

Adoption of the going concern assumption has important implications in accounting. For example, it is an assumption used by some to justify the use of historical costs in accounting for non-current assets and for the systematic allocation of their costs to depreciation expense over their useful lives. Because it is assumed that the assets will not be sold in the near future but will continue to be used in operating activities, current market values of the assets are sometimes assumed to be of little importance. If the entity continues to use the assets, fluctuations in their market values cause no gain or loss; nor do they increase or decrease the usefulness of the assets. The going concern assumption also supports the inclusion of

some assets, such as prepaid expenses and acquired goodwill, in the statement of financial position (balance sheet) even though they may have little, if any, sales value.

If management intends to liquidate the entity or to cease trading, or has no realistic alternative than to do so, the going concern assumption is set aside. In that case the financial statements are prepared on a different basis, but the *Conceptual Framework* provides no guidance on what that basis would be. However, paragraph 25 of IAS 1 *Presentation of Financial Statements* prescribes disclosures when an entity does not prepare financial statements on a going concern basis, including the basis on which it prepared the financial statements (see chapter 16).



1.5 DEFINITION OF ELEMENTS IN FINANCIAL STATEMENTS

The *Conceptual Framework* (CF) identifies and defines the elements of financial statements; namely assets, liabilities, equity, income and expenses. The 2018 CF introduced some fairly significant changes to these definitions.

1.5.1 Assets

An *asset* is defined in paragraph 4.3 of the *Conceptual Framework* as:

A present economic resource controlled by the entity resulting from past events.

This definition refers to an *economic resource*, which is defined in paragraph 4.4 as:

A right that has the potential to produce economic benefits.

Applying these two definitions means that, for an item to represent an asset to an entity, an assessment needs to be made as to:

1. whether it is an economic resource, being a *right* that has the *potential* to produce economic benefits;
2. whether this right is *controlled* by the entity; and
3. whether the right exists at reporting date as a result of a *past event*.

Each of these characteristics will now be explained in a little more depth.

Rights with potential

One of the most significant changes to the asset definition brought about by the publication of the latest *Conceptual Framework* in 2018 was the notion that assets represent *rights*. This means that, for example, when considering an entity's manufacturing plant, we 'look past' the physical object and, instead, we 'look into' it in order to identify whether that physical object contains any rights; for example, the plant gives the entity both the right to use it to manufacture certain items and the right to benefit from it by selling the plant's output. This example (of a physical plant) raises another important point in that some resources (e.g. a plant) contain multiple rights (e.g. the right to use and the right to benefit). In such situations, the multiple rights are often accounted for as a single asset, being a *set* of rights. In other words, we do not record the 'right to use the plant' and 'right to benefit from the plant' as two separate assets on our statement of financial position. Another important point is that, where an asset is conceptually a 'set of rights' (consider the example of the plant, which represented two rights: a right to use and a right to benefit), the set of rights will often be described as the physical object to which they relate. This is because describing it as the physical object would be a faithful representation and often the most concise and understandable method of describing the rights.

The next aspect related to the right is that, for a *right* to meet the definition of an *economic resource*, it must also have the *potential* to produce economic benefits for the entity. These economic benefits could come in many forms; for example, they could be cash inflows (e.g. a plant that represents the right to manufacture items would lead to a potential cash inflow from the sale of these items) or the avoidance of cash outflows (e.g. electricity prepaid represents a right that avoids future cash outflows for electricity). Other examples of ways in which a right could economically benefit an entity (whether the right is used singly or in combination with other rights) include the ability to:

- exchange it for another right under favourable conditions,
- extinguish a liability, and
- use it to create goods or services.

Finally, although the right must have the potential to create economic benefits for the entity, this potential does not need to be probable or even likely. Instead, the level of probability that the potential economic benefits would occur is built into the next stage, being the assessment of the recognition criteria (in other words, the conclusion may be made that an asset exists but because it does not meet the recognition criteria, it is not recognised) and/or into the measurement of the asset.

Control

The entity must have *control* over the right if it is to meet the definition of an asset. This does not mean legal ownership is necessary. Instead, control arises through either:

- the ability to enforce legal rights (e.g. through a legal contract); or
- the ability to both 'direct the use' of the resource (meaning that the entity can decide how it is to be used) and 'obtain the benefits' from it.

Past event

For a right to meet the definition of an asset, it must have arisen by way of a past event on or before reporting date, such that it exists at reporting date.

1.5.2 Liabilities

A *liability* is defined in paragraph 4.26 of the *Conceptual Framework* as:

a present obligation of the entity to transfer an economic resource as a result of past events.

This definition refers to a *present obligation*, which is defined in paragraph 4.29 as:

a duty or responsibility that an entity has no practical ability to avoid.

Applying these two definitions means that, for an item to represent a liability to an entity, an assessment needs to be made as to:

1. whether there is a *present obligation*, being a duty or responsibility that the entity has no practical ability to avoid;
2. whether a transfer of *economic benefits* is possible; and
3. whether the present obligation at reporting date results from a *past event*.

Each of these characteristics will now be explained in a little more depth:

Present obligation

A duty or responsibility the entity has no practical ability to avoid

One of the most significant changes to the liability definition brought about by the publication of the latest *Conceptual Framework* in 2018, is that the term '*present obligation*' has now been clarified to mean there must be a 'duty or responsibility that an entity has *no practical ability to avoid*'. Thus, if an entity could avoid the duty or responsibility only through, for example, the cessation of trading, it would meet the definition of a present obligation because, unless the entity is not applying the going concern assumption, the cessation of trade is not a practical option.

The obligation is a duty or responsibility that always involves a third party

Another important point is that obligations always involve a *duty or responsibility owed to a third party* but that it is not necessary to know who the third party is. (Paragraph 4.29)

The obligation can be legal, constructive or conditional

Legal obligations are duties or responsibilities that cannot practically be avoided because the third party can legally force the entity to fulfil its obligations (e.g. through a legally enforceable contract).

Constructive obligations are duties or responsibilities that cannot practically be avoided due to the entity's own 'customary practices, published policies or specific statements' that will have caused third parties to have certain expectations of the entity (e.g. an entity may have a policy of rectifying faults in its products even after the warranty period has expired, in which case, amounts expected to be spent on repairs in respect of goods already sold are liabilities).

Conditional obligations are duties or responsibilities that will arise due to an entity's own future actions, but where these future actions cannot practically be avoided (e.g. a duty to rehabilitate a specific area if it gets damaged due to mining would be a conditional obligation of a mining company that has been granted a licence to mine in that area, since a mining company has no practical ability to avoid mining).

Present obligations are not the same as future commitments

A future commitment, or intention to sacrifice economic resources in the future, would not meet the definition of a present obligation because the entity has the ability to avoid the future outflow. For example, a decision by management to buy an asset in the future does not give rise to a present obligation. Instead, an obligation would arise when, for example, the entity has entered into an irrevocable agreement to buy the asset, with a substantial penalty if the agreement is revoked.

Transfer of economic resources

The *economic resource* that the entity may need to transfer can be anything, for example, paying in cash, providing the right to cash, providing goods or services or other assets or even converting the obligation to equity.

Past event

The liability definition requires that the obligation be *present* at reporting date, having arisen from a *past event*. Although the asset definition used the term 'past event', it did not explain it. From the perspective of the liability definition, however, two criteria must be met for a *past event* to have occurred (the cause and effect criteria):

- the entity must have either obtained a benefit or taken an action (the cause); and
- as a result, the entity may have to transfer an economic benefit (the effect).

For example, work done by staff gives rise to wages payable. By contrast, wages to be paid to staff for work they will do in the *future* is not a liability as there is no past transaction or event and thus no present obligation.

1.5.3 Income

The *Conceptual Framework* defines *income* in paragraph 4.68 as:

Increases in assets, or decreases in liabilities, other than those relating to contributions from holders of equity claims.

The definition of income is directly linked to the definitions of assets and liabilities: if assets increase, we have income. . . if liabilities decrease, we have income. The only exception is if the assets or liabilities changed due to a contribution made to the entity by 'a holder of an equity claim', in which case the movement in the asset or liability is *not* income, but an *equity movement* instead. For example, if an investor buys shares in the entity in exchange for cash, the entity's bank account, an asset, will increase. However, by definition, this is not income because the cash contribution came from a person in his role as a 'holder of an equity claim' (i.e. a shareholder). Thus, the only option is to record the contra entry to the increase in assets (i.e. cash in bank) as a direct increase in equity (i.e. share capital). In other words, the entity's assets increased with no change to its liabilities, with the result that equity, as defined, has increased and since it is not income, the equity must be increased directly.

Income arises once there is an increase in an asset, provided there is no equivalent increase in liabilities. For example, in the case of magazine subscriptions received in advance, although the bank account has increased (i.e. an asset has increased) no income exists on receipt of the cash because an equivalent obligation has also arisen for services to be performed through the obligation to supply magazines to subscribers in the future (i.e. a liability has increased). Thus, there is no *net* increase in assets and thus no income.

Income can also exist through a reduction in liabilities. An example of a liability reduction is the forgiveness of an entity's loan liability. Income arises from that forgiveness, unless it is a contribution by a holder of an equity claim (e.g. if the party who forgives the entity's debt is given shares in the entity in return, in which case the decrease in the liability is not income but a direct increase in equity, instead).

Under the *Conceptual Framework*, income encompasses both revenue and gains. A definition of *revenue* is contained in paragraph 7 of IAS 18 *Revenue* as follows:

[T]he gross inflow of economic benefits during the period arising in the course of the ordinary activities of an entity when those inflows result in increases in equity, other than increases relating to contributions from equity participants.

Thus, *revenue* represents income that has arisen from 'the ordinary activities of an entity'. Income that does not arise from the entity's ordinary activities (i.e. it does not meet the definition of revenue) is referred to as a *gain* (e.g. income made from the sale of a non-current asset). Gains are usually disclosed in the statement of profit or loss and other comprehensive income *net* of any related expenses, (e.g. when selling an item of plant, we would deduct its carrying amount from the proceeds on sale thereof and show as income the net 'gain on sale of plant'). Revenue, on the other hand, is reported at a gross amount. Revenues and gains are both income, meaning that they are not separate elements under the *Conceptual Framework*.

1.5.4 Expenses

The *Conceptual Framework* defines *expenses* in paragraph 4.69 as:

Decreases in assets, or increases in liabilities, other than those relating to distributions to holders of equity claims.

The definition of expenses is directly linked to the definitions of assets and liabilities: if assets decrease, we have an expense . . . if liabilities increase, we have an expense. The only exception is if the assets or

liabilities changed due to a distribution made by the entity to 'a holder of an equity claim'. For example, if the entity paid a cash dividend to its shareholders, the entity's bank account, an asset, would decrease. However, by definition, this would not be regarded as an expense because a shareholder is a 'holder of an equity claim'. Therefore, in this case, the only option would be to regard this decrease in assets as a direct decrease in equity (the entity's assets decreased with no change to its liabilities, with the result that equity, as defined, has decreased and since it was a payment to a holder of an equity claim (e.g. a shareholder), the decrease is a direct reduction in equity).

A transaction that involves the payment for electricity credits (e.g. electricity prepaid) will not create an expense. This is because the net effect on assets and liabilities is nil since one asset decreases and another asset increases: the payment decreases the 'cash in bank' asset but it increases the 'electricity prepaid' asset ('electricity prepaid' is an asset to the entity because it represents an economic resource, being a right to use electricity in the future and where this right has the potential to lead to economic benefits). Conversely, a transaction that involves the payment for electricity that has already been used would result in an expense. This is because there is a net decrease in the entity's assets (the payment decreases the 'cash in bank' asset but since it is a payment for electricity that has already been used, it has not created an economic resource that can be used by the entity — in other words, the payment has not created an asset).

1.5.5 Equity

Paragraph 4.63 of the *Conceptual Framework* defines *equity* as:

the residual interest in the assets of the entity after deducting all its liabilities.

Defining equity in this manner shows clearly that it cannot be defined independently of the other elements in the statement of financial position. The characteristics of equity are as follows:

- Equity is a residual, that is, something left over. In other words:

$$\text{Equity} = \text{Assets} - \text{Liabilities}$$

- Equity is increased by profitable operations, that is, the excess of income over expenses, and by contributions by owners (e.g. investing in the entity through the purchase of equity shares). Similarly, equity is diminished by unprofitable operations and by distributions to owners (drawings and dividends). The proof of the connection between 'equity' and 'income and expenses' is contained within the definitions. In this regard, like equity, the definitions of income and expenses (see the sections below) are linked directly to assets and liabilities, although income and expenses are defined by the *movement* in assets and liabilities. Thus, since the income definition states that income arises from, for example, an increase in assets, and since the equity definition states that total equity increases through increased assets, it can be seen that increased income leads to increased equity.
- Since equity is the residual of assets and liabilities, equity will clearly also be affected by how those assets and liabilities are measured and by the concepts of capital and capital maintenance adopted in the preparation of general purpose financial statements. (Concepts of capital and capital maintenance are discussed later in the chapter.)
- Equity may be subclassified in the statement of financial position, for example, into contributed funds from owners, retained earnings, other reserves representing appropriations of retained earnings, and reserves representing capital maintenance adjustments.



1.6 RECOGNITION OF ELEMENTS OF FINANCIAL STATEMENTS

1.6.1 Overview

Recognising an item as an element refers to the process of incorporating it into the accounting records such that it will eventually be included in either the statement of financial position or statement of profit or loss and other comprehensive income, where it will either be presented separately, or aggregated with other items.

Before an item may be recognised as one of the five elements (e.g. an asset, liability, income, expense or equity), it must:

- Meet the definition of that element; and
- Meet the recognition criteria.

1.6.2 Recognition criteria

Regarding recognition criteria, the 2018 *Conceptual Framework* states, in paragraph 5.7, that elements should only be recognised in the financial statements if it means providing information that is both:

- relevant; and
- a faithful representation.

Interestingly, these are the two *fundamental qualitative characteristics* of *useful* financial information and thus the essence of the two recognition criteria is simply that, by recognising an element, we must be providing useful information.

These recognition criteria are used for all five elements. This represents a significant departure from the previous *Conceptual Framework* of 2010, in which there were different recognition criteria relevant to each of the five elements.

1.6.3 The three uncertainties: Impact on recognition criteria and the balancing act

When deciding whether a definition is met, and thus that an element exists, there are uncertainties that were ignored. These uncertainties, however, are considered when deciding whether to recognise the element. For example, when deciding if an asset exists (i.e. whether it meets the asset definition), we consider only whether it has the potential to produce economic benefits and ignore the fact that the potential for economic benefits may be only a remotely possible outcome. This is referred to as *outcome* uncertainty. Other uncertainties include *measurement* uncertainty and *existence* uncertainty.

Existence uncertainty affects *relevance*. For example, the existence of an obligation may be dependent on future actions that may or may not be avoidable, such as an entity's obligation to rehabilitate land that will only arise if a certain level of activity on the land is exceeded. If, on balance, the obligation (the liability element) probably won't eventuate because the entity does not plan to exceed the level of activity beyond which rehabilitation would become necessary, information about this element may be considered irrelevant and would thus not be recognised.

Outcome uncertainty also affects *relevance*. Outcome uncertainty refers to the uncertainty regarding the amount and timing of the potential flow of economic benefits. For example, if an entity is aware that there is a present obligation due to the fact that it is being sued for something that has already happened, but is unsure of the amount of the obligation or when the amount will become payable, there is outcome uncertainty regarding the obligation. If, for example, it is virtually certain that the amount measured will be insignificant, information about this obligation would probably be regarded as irrelevant and not recognised.

Measurement uncertainty affects *faithful representation*. Measurement uncertainty arises when the amount attributed to an element cannot be directly observed and thus has to be estimated. Financial information contains many estimates and thus the mere fact that an amount is estimated does not mean the financial information is not useful. The level of measurement uncertainty must simply be considered acceptable.

Measurement uncertainty may also impact *relevance*. For example, the most relevant information regarding an asset may be its fair value rather than its cost. However, the fair value may involve such a high degree of estimation that the measurement uncertainty reaches an unacceptable level. In such a case, it may be necessary to measure the asset at cost (being information that is a faithful representation although possibly less relevant to the users) instead of at fair value (being information that would be more relevant but information that is not a faithful representation). In other words, in order to achieve useful information, there is a necessary and natural balancing act between the two requirements of relevance and faithful representation. In this example, the most relevant information (fair value) was not able to be faithfully represented and thus the next most relevant information (cost) was substituted instead.

1.6.4 Items that may not be recognised

If an item does not meet the definition or recognition criteria, the item must not be recognised in the statement of financial position or statement of profit or loss and other comprehensive income. Information about the item may, however, be useful to the users of the financial statements and thus it may be necessary to include this information in the notes to the financial statements. If an item is not recognised in the current period because the recognition criteria are not currently met, this item may be recognised in a future period when the recognition criteria are met.

1.7 DERECOGNITION

Although derecognition has always existed (involving the removal of an asset or liability from the accounting records), the 2018 *Conceptual Framework* introduced a new section to clarify the meaning of derecognition, which it describes as the:

- 'removal of all or part of
- a recognised asset or liability
- from the statement of financial position'.

Derecognition normally occurs when an asset or liability, which was previously recognised, subsequently fails to meet the relevant definition. For example, an entity may 'lose control' over the asset (or part of the asset), in which case all of (or part of) an asset would be derecognised. Similarly, a liability will be derecognised if the entity 'no longer has a present obligation for all or part of the recognised liability'.

When part of an asset or liability is derecognised, care must be exercised to ensure that the financial statements faithfully represent both:

- the portion of the asset or liability that remains; and
- the change in the asset or liability arising from the transaction or event that led to the derecognition.

1.8 MEASUREMENT OF THE ELEMENTS

1.8.1 Overview

Chapter 6 of the 2018 *Conceptual Framework* deals with measurement. This chapter explains and describes various measurement bases and the factors to consider when deciding which would be the most appropriate. Interestingly, however, this chapter is one that is designed largely for use by the IASB in preparing IFRSs. Preparers of financial statements, on the other hand, generally do not need to refer to chapter 6 because they simply need to comply with the relevant IFRSs, which are normally quite prescriptive in terms of which measurement bases may be used. That said, however, where an IFRS provides a preparer with measurement options (e.g. IAS 40 *Investment property* allows the choice between the cost model and fair value model), preparers who are battling to decide which option to use would find it helpful to refer to the explanations behind the various measurement bases and factors to consider when choosing which to use.

1.8.2 Measurement and the measurement bases

According to paragraph 6.1 of the *Conceptual Framework*, measurement refers to the quantification, using monetary terms, of the elements recognised in the financial statements. This requires the 'selection of a measurement basis'.

Since equity, income and expenses are elements that, by definition, flow from assets and liabilities, the *Conceptual Framework* tends to focus on how the measurement basis is applied to assets and liabilities. In other words, the measurement of the asset or liability will tend to automatically affect the measurement of the related income and expenses and ultimately equity.

Since the objective is to produce useful information, which requires balancing the qualitative characteristics against the cost constraint, it is generally necessary to use different measurement bases for different assets, liabilities, income and expenses.

1.8.3 Various measurement bases

The *Conceptual Framework* provides various examples of measurement bases, which are categorised under the following headings:

- historical cost; or
- current value.

The *Conceptual Framework* emphasises that both are useful measurements, but that, in particular situations, one method may provide more useful information than the other.

Historic cost

Historic cost refers to measurement bases that are based upon 'the price of the transaction or other event that gave rise to the asset or liability'. (Paragraph 6.24)

A measurement at historic cost will normally include transaction costs, and may involve reductions in cost to reflect usage (e.g. depreciation or amortisation) and impairments. Historic cost is an example of an *entry price* (in other words, it is a measurement that reflects the cost of acquisition).

Examples of IFRSs that utilise the historic cost measurement include:

- IAS 16 *Property, plant and equipment*: Land, which generally does not diminish in value through usage, is often measured at historic cost, whereas plant, which does diminish in value through usage, is often measured at depreciated historic cost.
- IAS 2 *Inventory*: Inventory is measured at lower of cost and net realisable value, where 'cost' is an example of a measurement at historic cost.
- IFRS 9 *Financial instruments*: Certain financial liabilities are measured at amortised cost.

Current value

A current value measurement is one that presents the 'current conditions' at measurement date. There are three examples of the current value method referred to in the *Conceptual Framework*:

- Fair value
- Current cost
- Value in use of an asset or fulfilment value of a liability.

The **fair value** is an exit price that reflects the price that would be received to sell an asset, or paid to transfer a liability, in an orderly transaction between market participants at the measurement date. The measurement of fair value is sufficiently complex that there is an IFRS dedicated to this (IFRS 13 *Fair value measurement*). An example of an IFRS that allows measurement at fair value is IAS 40 *Investment property*.

The **current cost** is an entry price, but it reflects the consideration that would be paid to acquire an *equivalent* asset, (i.e. in its current second-hand condition), at measurement date, or, if it is a liability, the consideration that would be received for an *equivalent* liability. It includes transaction costs: in the case of an asset, transaction costs are added; whereas, in the case of a liability, transaction costs are deducted. An example would be a machine that was purchased new for \$1,000, but which, at measurement date, is now 3 years old. On this date, purchasing a new replacement machine would cost \$1,500, whereas a second-hand 3-year old machine would cost \$900. The current cost is \$900 (note that the historic cost is \$1,000).

Value in use is an exit price that reflects the present value of an asset's economic benefits that an entity expects to obtain from the combination of its use and eventual disposal. This measurement is often used to test certain assets for impairment. For example, it is one of the measures referred to in IAS 36 *Impairment of assets* used to test assets accounted for in terms of IAS 16 *Property plant and equipment* and IAS 38 *Intangible assets*.

Fulfilment value of a liability is an exit price that reflects the present value of the outflow of economic benefits that an entity expects to be obliged to transfer in fulfilment (settlement) of its liability.

The measurement basis most commonly adopted by entities is the historic cost basis, although over time, IFRSs have increasingly allowed or mandated the use of the current value basis, for example, through the use of fair values to measure property and value in use, used to test assets for impairment. There is little use of current cost (replacement cost) in financial statements, being a measurement basis appropriate for entities using the physical concept of capital (this is explained in a later section of this chapter).

1.8.4 Choosing a measurement basis

Significant professional judgement is needed when choosing which measurement basis to use. Consideration must be given to 'the nature of the information that the choice of measurement basis will produce in both the statement of financial position and the statement of financial performance' (paragraph 6.43). Ultimately, the objective is to present *useful* information. In other words, the measurement basis chosen must reflect information that is relevant and a faithful representation (these are fundamental qualitative characteristics). The information should ideally also be comparable, timely, verifiable and understandable.

As mentioned above, selecting a measurement basis that produces a faithful representation is not the only objective. In this regard, a measurement basis that reflects a directly observable price would be a faithful representation (it is 100% accurate), but it may not necessarily be relevant information. For example, measuring a plant at fair value, where this plant has an active market and a fair value that is directly observable, may be considered a faithful representation but, if it is to be used internally and not sold, its fair value would not be relevant information. Thus, it is advisable to first decide what information is relevant to users and then select a measurement basis that is a faithful representation thereof.

It should be noted that a measurement that is a faithful representation is not necessarily 'free from error'. Information that is relevant may require a measurement involving estimates. The use of estimates introduces 'measurement uncertainty', but even a high degree of measurement uncertainty does not necessarily mean the information is not a faithful representation. Conversely, some estimates may involve such a high level of uncertainty that the information ceases to be a faithful representation, in which case, a different measurement basis must be sought that will still produce relevant information. (Paragraphs 59–60)

Not only does *measurement* uncertainty sometimes arise, but *outcome* uncertainty and *existence* uncertainty may also exist.

- *outcome* uncertainty refers to the uncertainty regarding the timing and amount of the cash flows; and
- *existence* uncertainty refers to the uncertainty as to whether an asset or liability exists. (Paragraph 61)

Existence uncertainty normally affects the decision as to whether to recognise the asset or liability but, like *outcome* uncertainty, it can also affect measurement uncertainty. (Paragraph 62)

When selecting a measurement basis, its usefulness in terms of both the initial measurement *and* subsequent measurement must be considered. This is because, if different measurement bases were to be used for each of the initial measurement and subsequent measurement, it could happen that income or expenses arise when the initial measurement basis is switched to the subsequent measurement basis when, in fact, no transaction or event had occurred. (Paragraph 6.48)

Although different measurement bases may be used for different assets, liabilities, income and expenses, the *Conceptual Framework* cautions that ‘measurement inconsistencies’ (also called ‘accounting mismatches’) might arise if different measurement bases are used for assets and liabilities that are ‘related in some way’ (e.g. when the cash flows from an asset are linked to the cash flows from a liability). Such accounting mismatches may lead to financial information that is not a faithful representation. (Paragraph 6.58)



1.9 UNIT OF ACCOUNT

A unit of account is a term used when deciding how to recognise and measure assets and liabilities. The ‘unit of account’ is defined as:

- the right or group of rights, the obligation or group of obligations, or the group of rights and obligations, to which recognition criteria and measurement concepts are applied. (Paragraph 4.48)

When deciding what the ‘unit of account’ is, we must be guided by the objective of general-purpose financial reporting, which is to provide *useful* financial information. This means that the decision regarding the ‘unit of account’ must result in relevant information that is faithfully represented and, as with all financial reporting decisions, the cost constraint (cost versus benefit) must be considered. Achieving the objective of useful information may necessitate using different ‘units of account’ for recognition and for measurement.

By way of example, an entity may decide that when *recognising* its contracts, the unit of account is the ‘individual contract’ whereas, when *measuring* the contract, for reasons of cost-effectiveness, the unit of account is a larger ‘portfolio of contracts’. In other words, this entity looks at each contract to decide whether that specific individual contract should be recognised, but, once recognised, that contract, instead of being individually measured, is measured as part of a larger *portfolio* of contracts (i.e. in this example, the unit of account for recognition purposes is the ‘individual contract’ but the unit of account for measurement purposes is the ‘portfolio of contracts’).

Since information should always faithfully represent the substance of transactions and events, care must be taken when identifying the unit of account. For example, it may be necessary to account for rights and obligations as separate units of account even if they arose from a single source transaction. Conversely, however, it may be necessary to account for rights and obligations arising from multiple source transactions as a single unit of account.



1.10 PRESENTATION AND DISCLOSURE

Elements that meet the definition and recognition criteria are recognised and included in the statement of financial position or statement of profit or loss and other comprehensive income. These are financial statements that are presented on the accrual basis. These elements will need to also be presented using the cash basis and included in the statement of cash flows. Further detailed information may be needed regarding these recognised elements and also regarding those elements that were not recognised because they failed to meet the definitions and/or recognition criteria. This detailed information is provided in the notes to the financial statements.

Guidance regarding the level of presentation and disclosure is generally stipulated in the specific IFRSs. However, the 2018 *Conceptual Framework* introduces a chapter (chapter 7) dedicated to understanding the concepts of presentation and disclosure. This chapter reiterates that, as with recognition and measurement, presentation and disclosure decisions must be guided by the overall objective of providing users with financial information that is relevant and a faithful representation of the transactions and events (i.e. useful information). Similarly, these decisions may need to be constrained when assessing the cost versus benefit.

The essence of this chapter on presentation and disclosure is that effective communication in the financial information requires:

- focusing on presentation and disclosure objectives and principles rather than focusing on rules;
- classifying information in a manner that groups similar items and separates dissimilar items; and
- aggregating information in such a way that it is not obscured either by unnecessary detail or by excessive aggregation. (Paragraph 7.2)



1.11 CONCEPTS OF CAPITAL

The concept of capital has a direct impact on profits, with the concept of capital maintenance referring to the specific point at which profit may be recognised. In this regard, profit is recognised only to the extent that the capital existing at the end of a period exceeds the capital that existed at the beginning of that period. In other words, profit is only recognised if the closing capital exceeds that required for capital maintenance. It is thus imperative that entities identify the capital that they seek to maintain. In this regard, two main concepts of capital are discussed in the *Conceptual Framework*, namely financial capital and physical capital.

Under the **financial capital concept**, capital is synonymous with the *net assets* (i.e. *equity*) of the entity. Profit exists only after the entity has maintained its capital, measured as the financial amount of *equity*, using either nominal monetary units (currency) or units of constant purchasing power. In other words, profit is only recognised if the *equity* at the end of the period exceeds the *equity* at the beginning of the period, adjusted for distributions to and contributions from owners. (Paragraph 8.3 (a))

Under the **physical capital concept**, capital represents the *operating capability* of the entity. Profit exists only after the entity has maintained its capital, measured as its *operating capability*. In other words, profit is recognised if the *operating capability* at the end of the period exceeds the *operating capability* (or the resources or funds needed to achieve that capacity) that existed at the beginning of the period, after adjusting for distributions to and contributions from owners. (Paragraph 8.3 (b))

The decision as to which capital concept to adopt is driven by the needs of users. Most entities use the financial capital concept. If an entity adopted the physical capital concept, it would need to use the current cost basis of measurement. (Paragraphs 8.2–8.5)

1.12 SUMMARY

This chapter has provided an overview of the structure of the IASB and the process of setting IFRSs, including IFRIC Interpretations. The adoption of IFRSs in many parts of the world has increased the importance of developments in international standards setting. This chapter also provides an overview of some of the most important aspects of the *Conceptual Framework*.

The *Conceptual Framework* describes the basic concepts that underlie financial statements prepared in conformity with IFRSs. It mainly serves as a guide to the standard setters in developing accounting standards but is also a guide for preparers in resolving accounting issues that are not addressed directly in an accounting standard and for users to assist in better understanding financial reports.

The *Conceptual Framework* identifies the principal classes of users of an entity's general purpose financial statements and 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 certain users of the financial statements. It specifies the fundamental qualities that make financial information useful, namely relevance and faithful representation, and the qualities that enhance usefulness, being comparability, verifiability, timeliness and understandability, and admits that achieving all these qualities may be constrained by cost.

The *Conceptual Framework* also defines the basic elements in financial statements (assets, liabilities, equity, income and expenses) and discusses the criteria for both recognising and derecognising them. It also provides an overview of various measurement bases and principles to consider when measuring these elements. The concept of 'unit of account', used when making decisions regarding recognition, derecognition and measurement, is also introduced. The concepts of presentation and disclosure are also explained. The *Conceptual Framework* also describes two alternative concepts of capital maintenance, which directly influence when profit may be recognised.

Discussion questions

1. Describe the standard-setting process of the IASB.
2. Identify the potential benefits of a globally accepted set of accounting standards.
3. Outline the fundamental qualitative characteristics of financial reporting information to be considered when preparing general purpose financial statements.
4. Discuss the importance of the going concern assumption to the practice of accounting.
5. Discuss the essential characteristics of an asset as described in the *Conceptual Framework*.
6. Discuss the essential characteristics of a liability as described in the *Conceptual Framework*.
7. Discuss the difference, if any, between income, revenue and gains.
8. Distinguish between the financial and physical concepts of capital and their implications for the measurement of profit.

References

IFRS Foundation 2020, *IASB and IFRS Interpretations Committee Due Process Handbook*, www.ifrs.org.

IFRS Foundation and the International Accounting Standards Board 2018, *IASB and the IASB Foundation: Who We Are and What We Do*, www.ifrs.org.

ACADEMIC PERSPECTIVE — CHAPTER 1

The *Conceptual Framework* highlights the decision usefulness property of accounting numbers and identifies certain underlying qualities that enhance it. It is therefore an important question, in light of the large resources society expends on accounting regulation and profession, whether published financial statements do in fact provide useful information. In attempting to address this question, accounting research largely has focused on the ‘value relevance’ property of accounting numbers as a way to operationalise criteria such as relevance and faithful representation (or, as previously known, reliability). There may be several ways to assess the value relevance and reliability of specific numbers or disclosures, but a common approach in the archival empirical academic literature has been to examine the association between specific disclosures and stock prices or stock returns. Extensive reviews that go well beyond the scope of this section are offered by, for example, Barth et al. (2001) and Kothari (2001).

Modern empirical accounting research traces its origin to the seminal paper of Ball and Brown (1968) which shows that stock returns and earnings surprises tend to move in the same direction. From this evidence one can infer that earnings and share prices impound similar information, although causality (i.e., whether accounting numbers shape stock prices and trading decisions) is more difficult to show. Beaver’s (1968) seminal paper on trading volume around earnings announcements provides more persuasive evidence that earnings announcements furnish useful *news* to market participants. Specifically, he documents a spike in trading activity around earnings announcements, suggesting information conveyed in these announcements leads investors to revise their prior beliefs and hence trade. Notwithstanding the centrality of the value relevance strand in accounting research, it is not without shortcomings. Criticisms of the value relevance literature can be found in Holthausen and Watts (2001) and the interested reader should bear these in mind. In particular, many academics stress the role of accounting in contracting, such as in debt and compensation. However, contracting is not a consideration in the *Conceptual Framework*.

Of the extensive research that links earnings to stock prices and returns, we mention here only a few important papers. Kormendi and Lipe (1987) link returns to earnings surprises (or, earnings innovations) by regressing stock returns on earnings surprises. The coefficient on the earnings surprise is called the earnings response coefficient (ERC). If the surprise is permanent *and* value relevant, then \$1 of a surprise should translate into more than \$1 of return. Kormendi and Lipe (1987) show that greater earnings persistence translates to a larger ERC.

Using changes in earnings as a proxy for new information can shed light on how informative earnings are when they are announced. Because earnings may not be timely, in the sense that news from other sources is already impounded in prices before the earnings are announced (Beaver et al. 1980), changes in annual or quarterly earnings may be only weakly related to returns. Therefore, a smaller earnings response coefficient may indicate a lack of timeliness (rather

than weaker persistence), which is an enhancing qualitative characteristic of accounting information. The relatively small magnitude observed for earnings response coefficients from the extant research (Kothari, 2001) may be then attributed to the fact that earnings lag behind share prices. Another, not mutually exclusive, explanation for the low magnitude of the earnings response coefficient is that the quality of accounting standards is poor (Lev and Zarowin, 1999).

Research that followed includes Easton and Harris (1991) who refine the specification used in Kormendi and Lipe (1987) to show that prices and returns are also related to earnings levels as well as earnings changes. Kothari and Sloan (1992) argue that the earnings response coefficient is a function of news about future growth in earnings that is contained in current earnings. As is suggested by Kormendi and Lipe (1987), the earnings response coefficient may also be smaller when earnings changes are transitory. In particular, losses are transitory because they cannot continue for a long time; in such a case the reporting entity will go out of business or be purchased by another company. Hayn (1995) provides evidence on the earnings response coefficient in loss firms that is consistent with this idea.

Surprisingly, only in recent years have accounting researchers started to look at the value relevance of earnings in the much larger debt markets. Easton et al. (2009) find that bond returns and earnings are positively associated, and more so for negative earnings surprises. This is explained by the sensitivity of investors in bonds to bad news, as this may affect the return on their investments (whereas increases in firm value normally benefit equity investors). They also find that trading activity in bonds increases around earnings announcements, evidence that extends the findings of Beaver (1968) to debt markets. Overall, therefore, the accounting literature has provided evidence that accounting numbers are capable of, and likely are, providing information that is useful to investors.

The qualitative characteristic that received most scrutiny in more recent accounting research is probably faithful representation. Faithful representation requires the accounting treatment to be unbiased and neutral. In particular, it negates the concept of conservatism that requires estimates to be cautious in that, if a range of estimates is available for an item of assets or income, a lower estimate should be selected. The opposite holds for liabilities and expenses. It should be noted that historically conservatism has been one of the fundamental principles in accounting (Watts, 2003) and the requirement for neutral and unbiased treatment is relatively new. That many standards, old and new, are nevertheless conservative may be surprising given standard setters’ insistence on neutrality as per the *Conceptual Framework* of 2010 and 2018. However, as Watts (2003) argues, conservatism reduces political cost for standard setters and so when they promulgate specific standards they still require conservatism in measurement procedures. Consistent with this argument, Barker and McGeachin (2015) find many examples in accounting standards promulgated by the IASB that show that IAS and IFRS are, in practice, conservative. Basu (1997) operationalised the concept of conservatism to predict that

bad news is incorporated into earnings at a faster rate than good news. Employing negative share returns as a proxy for bad news he finds that in a regression of earnings on returns and negative returns the coefficient on negative returns is positively associated with earnings. This implies that negative returns (bad news) reduce earnings more than positive returns (good news) increase earnings, thus confirming his conjecture. Basu (1997) has been a highly influential paper. It has spawned a very large number of studies that investigate the relation between conservatism and an array of economic phenomena. As of writing this section, Basu (1997) has been cited more than 7100 times (source: Google Scholar on 7 January 2025).

Other qualitative characteristics may be less amenable to empirical research. For example, several accountings researchers attempted to look at the economic consequences of comparability. De Franco et al. (2011) propose a novel approach to the operationalisation of comparability. The underlying concept in their paper is that two accounting systems are comparable if the same economic event maps into earnings in a similar way. They employ time series of earnings and stock returns for each firm in their sample to regress the former on the latter. The regression coefficients are then used to calculate expected earnings given an economic event, which is proxied by returns. Comparability is defined with respect to the difference between expected earnings between any two firms within the same industry and financial year assuming both firms experience the same return. The smaller the absolute difference, the greater the comparability. Employing this measure De Franco et al. (2011) show that analyst following increases in comparability of one firm's earnings to other firms. This suggests that comparability reduces barriers for analysts. Chen et al. (2018) use the same measure of comparability as De Franco et al. (2011) to further show that greater comparability assists in making more profitable acquisition decisions and Zhang (2018) shows that greater comparability within the same industry assists auditors in reducing erroneous audit opinions.

In concluding this perspective, it is important to note that although the *Conceptual Framework* provides the 'accounting constitution' for standard-setting, whether the IASB has adhered to its own constitution in setting standards is unclear. This is because, as several researchers have argued, standard-setting is a political process rather than purely technical (e.g., André et al. 2009) resulting in, for example, the conceptual departure from neutrality discussed above, and more recently in developing IFRS 16 for leases (Kabir and Rahman, 2018).

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