8

Accounting theory and conceptual frameworks

After studying this chapter you should be able to:
- explain what accounting theory is
- describe the main attempts at constructing an accounting theory
- appraise current developments in the area
- describe and discuss the contents of the IASB Framework
- appraise the quality and usefulness of the IASB Framework in the context of its self-declared purposes
- describe and discuss the parts of IAS 1 relating to accounting concepts and policies
- appraise the overall effect of the Framework and comparable parts of IAS 1.

Introduction

This chapter is about to deal with something that many people believe does not exist – a single generally accepted accounting theory. There is no generally accepted accounting theory at this time even though many attempts have been made to formulate one. According to Eldon S. Hendriksen in *Accounting Theory* (1977),

> Theory as it applies to accounting is the coherent set of hypothetical, conceptual and pragmatic principles forming the general frame of reference for a field of inquiry. Thus accounting theory may be defined as logical reasoning in the form of a set of broad principles that
>
> **1** Provide a general frame of reference by which accounting practices can be evaluated and
> **2** Guide the development of new practices and procedures.
>
> Accounting theory may also be used to explain existing practices to obtain a better understanding of them. But the most important goal of accounting theory should be to provide a coherent set of logical principles that form the general frame of reference for the evaluation and development of sound accounting practices.

Let's compare this with what many believe is the accounting framework, the IASC Framework for the Preparation and Presentation of Financial Statements. This Framework purports to:

1 assist the board of IASC in the development of standards and review of existing standards
2 provide a basis for reducing the number of permitted alternative accounting treatments
3 assist preparers in dealing with topics that have yet to form the subject of a standard.

This certainly sounds like an accounting theory. But if it is, then this theory would clearly determine how we should provide information to users and different practices would not prevail. The primary purpose of an accounting theory should be to provide a basis for the prediction and explanation of accounting behaviour and events.

Is an accounting theory possible?

According to both Hendriksen (1977) and McDonald (1972) the development of an accounting theory should be possible. McDonald argues that a theory must have three elements:

1 encoding of phenomena to symbolic representation
2 manipulation or combination according to rules
3 translation back to real-world phenomena.

Activity 8.1

Do the three elements that McDonald states are necessary for a theory exist in accounting?

Activity feedback

The first obviously exists as we have the symbols of 'debits and credits' and we have also developed accounting terminology e.g. depreciation, accruals, matching, current cost, revaluation etc. all unique to accounting.

The second also exists as we have a wealth of rules and regulations for manipulating or combining these debits and credits.

Translation is evidenced in how we present these debits and credits to users in the form of financial reports.

Approaches to the formulation of accounting theory

If it *is* possible to develop an accounting theory (Hendriksen and McDonald) then how do we approach its development? Research in this area has centred on traditional approaches, regulatory approaches and what has come to be regarded as new approaches. We will look briefly at each of these three types.

Traditional approaches

Traditional approaches cover:

- non-theoretical
- theoretical.

Non-theoretical approaches to accounting theory are concerned with developing a theory or accounting techniques and principles that will be useful to users, particularly decision makers. This approach can be developed in a pragmatic or authoritarian way. In essence this is the approach the accounting profession has used in the past to develop an accounting theory and it is fairly apparent it has not been able to resolve conflict in accounting practices or principles. Theoretical approaches to the development of an accounting theory are many but Belkaoui, in his text *Accounting Theory*, categorizes these as:

- deductive
- inductive
- ethical
- sociological
- economic
- eclectic.

Deductive approach

This approach involves developing a theory from basic propositions, premises and assumptions which results in accounting principles that are logical conclusions about the subject. The theory is tested by determining whether its results are acceptable in practice. Edwards and Bell (1961) are deductive theorists (Chapter 4) and historical cost accounting was also derived from a deductive approach.

Inductive approach

For this approach we start with observed phenomena and move towards generalized conclusions. The approach requires empirical testing, i.e. the theory must be supported by sufficient instances/observations that support the derived conclusions. Quite often the deductive and inductive approaches are mixed as researchers use their knowledge of accounting practices. As Riahi-Belkaoui states: General propositions are formulated through an inductive process, but the principles and techniques are derived by a deductive approach. He also observes that when an inductive theorist, Littleton (1935), collaborates with a deductive theorist, Paton (1922), a hybrid results showing compromise between the two approaches.

Ethical approach

Activity 8.2

Identify concepts that could be at the core of the ethical approach to an accounting theory.

Activity feedback

Basically, this approach consists of the concepts of 'true and fair'. These concepts have, of course, been taken on board by the EU in the Fourth Directive.

Writers/researchers in this area are D. R. Scott (1941) and Yu (1976).

Sociological approach

This is actually an ethical approach that centres on social welfare. In other words, accounting principles and techniques are evaluated for acceptance after considering all effects on all groups in society. Thus within this approach we would need to be able to account for a business entity's effect on its social environment. We consider this type of reporting in Chapter 10.

Economic approach

This approach focuses on general economic welfare. Thus accounting principles and techniques are evaluated for acceptance depending on their impact on the national economy. Sweden, in its national GAAP, uses an economic approach to its development. The IASB in developing its standards does tend to take an economic approach into account. For example, the current discussion on accounting for leases focuses on the effect that a standard requiring the capitalization of all leases, whether finance or operating, might have on the economy or business in general. Traditionally, accounting standards have been set without considering economic consequences but lobby pressures from groups who perceive themselves as being affected can be strong.

Eclectic approach

This is perhaps our current approach where we have a combination of all the approaches already identified appearing in our accounting theory. This approach has come about more by accident than as a deliberate attempt, due to the interference in the development of accounting theory by professionals, governmental bodies (including the EU) and individuals. This eclectic approach has also led to the development of new approaches to accounting theory.

Regulatory approaches

Many would regard this as the approach we currently have to accounting theory. They hold this view because to them it does not appear that standards, even those of the IASB, are based on broad, relevant theories but are developed as solutions to current conflicts that emerge in our attempts to provide useful information to users. Indeed, they might argue that new standards are only developed when a particular user complains about misinformation or non-information. But there are questions to consider if we do adopt this approach to the development of accounting theory. In the main these questions centre on whether we should adopt a freemarket approach to the regulation, a private sector regulatory approach or public sector regulatory approach.

This regulatory approach is also one that tends to identify solutions to difficulties that have occurred in our reporting rather than providing us with a theory that anticipates the issues.

New approaches

These attempt to use both conceptual and empirical reasoning to formulate and verify an accounting framework (Belkaoui, *Accounting Theory*, Chapter 10). The approaches are:

- events
- behavioural
- human information processing
- predictive
- positive.

Events approach

The events approach was developed in 1969 by George Sorter and was defined as 'providing information about relevant economic events that might be useful in a variety of decision models'. The events approach leaves the user to aggregate and assign weights and values to the event. The accountant would only provide information on the economic event to the user, he would not assume a decision model. Thus, for example, the event approach income statement would not indicate financial performance in a period but would communicate events that occurred during the period without any attempt to determine a bottom line.

Activity 8.3

Identify advantages and disadvantages of the events approach to the development of an accounting theory.

Activity feedback

1 Research has shown that structured/aggregate reports are preferable for high-analytic decision makers but not for low-analytic decision makers. Thus, the success of the events approach is dependent on the analytical skills of the user.
2 Users, in attempting to evaluate all information provided, may reach 'information overload'.
3 No criteria have yet been developed for the choice of events to be reported.
4 It will probably prove difficult to measure all characteristics of an event.

Behavioural approach

The behavioural approach attempts to take into account human behaviour as it relates to decision making in accounting. Devine (1960) stated the following:

> On balance it seems fair to conclude that accountants seem to have waded through their relationships to the intricate psychological network of human activity with a heavy handed crudity that is beyond belief. Some degree of crudity may be excused in a new discipline, but failure to recognise that much of what passes as accounting theory is hopelessly entwined with unsupported behaviour assumptions is unforgiveable.

This to us seems fair comment. Given that financial reporting is about communicating information to users to enable them to make decisions, a lack of consideration of how that information influences their behaviour is indeed unforgivable. Studies in this area have tended to concentrate on:

- the adequacy of disclosure
- usefulness of financial statement data
- attitudes about corporate reporting practices
- materiality judgements
- decision effects of alternative accounting practices.

In one of these areas, materiality, it was discovered that users' assessment of materiality was individualistic and that the provider of the information was not in the best position to determine materiality for a user. There is much work still to do within the behavioural approach.

Human information processing approach

This is similar to a behavioural approach in that it focuses on how users interpret and use the information provided.

Predictive approach

This approach attempts to formulate an accounting theory by focusing on the predictive nature/ability of a particular method of reporting an event that would be of use to the user. Such approaches are most prevalent in what could be regarded as management accounting. Efficient market hypothesis, Beta models, chaos theory are all examples of this approach.

Positive approach

This can be best explained by quoting Jensen (1976), who called for the:

> development of a positive theory of accounting which will explain why accounting is what it is, why accountants do what they do, and what effects these phenomena have on people and resource utilisation.

The approach is based on the proposition that managers, shareholders and regulators are rational and that they attempt to maximize their utility. The theory became known as 'the Rochester school of accounting'. The positive approach is completely opposite to the normative approach and attempts to explain why accounting procedures and policies are as they are, whereas the normative approach attempts to prescribe the accounting procedures and policies to be implemented.

The future of theory

This section has been very brief and has mainly merely listed the approaches to the development of an accounting theory that exist in the current literature. For an in-depth study of this area we recommend *Accounting Theory* by Belkaoui.

This does, however, leave us with several questions:

- Can we develop an all-encompassing accounting theory?
- Would such a theory be useful to users?

- Should any theory be global in aspect and take into account behavioural aspects?
- Do researchers need to take into account their own underlying cultural beliefs and behaviour when developing an accounting theory?

As Glen Lehman states in *Accounting Forum* (2001) in his editorial:

> Accounting might benefit by exploring its direction and future. Accounting must improve 'community usefulness' and not just simply expand into other fields such as information technology if it is to remain committed to the public interest. The technology of accounting might benefit through consideration of the relationships between regulation and construction of community virtues. Accountants have been criticised for assuming that if the 'figures' are constructed in line with current mandatory and legislative requirements, then the accounts are true and fair. Yet what is reported often bears little relation to a reasonable view of the true financial health of the enterprise. Future accounting research might work toward explaining the means through which corporations might be enabled to act in the interests of the communities they serve.

This statement is particularly pertinent given the Enron and Worldcom disasters in the USA.

The IASB conceptual framework

We have already outlined some of the fundamental general concepts of accounting in Chapter 1. We quickly noted that they are not always compatible between themselves and that they do not necessarily provide a prescriptive solution to a given problem. They do not, therefore, provide a rational coherent basis, which can be applied, in a scientific sense, to solve problems in ways which are likely to be themselves consistent and compatible. They are not true 'theories' in the sense discussed earlier.

A number of attempts have been made since the 1970s to create some form of more coherent conceptual framework. The IASB version, known as the Framework for the Preparation and Presentation of Financial Statements, was issued in 1989. It belongs to the family of conceptual frameworks for financial reporting that have been developed by accounting standard setters in a number of countries where accounting standard setting is carried out by a private sector body. On one level, such conceptual frameworks may be considered attempts to assemble a body of accounting theory (or interrelated concepts) as a guide to standard-setting, so that standards are (as far as possible) formulated on a consistent basis and not in an ad hoc manner. On another but complementary level, they may be thought of as devices to confer legitimacy and authority on a private sector standard setter that lacks the legal authority of a public body. The IASB, as a private sector standard setter, shares these reasons for developing a conceptual framework.

Conceptual frameworks developed by accounting standard setters are essentially based on identification of 'good practice' from which principles are derived inductively. The criteria for identifying 'good practice' are related to the assumed objectives of financial reporting. At the same time, attention is paid to conceptual coherence, and the development process typically involves 'conceptual tidying up'. Conceptual frameworks may be written in a prescriptive style or a descriptive style, or a mixture of the two. In any event, they are essentially *normative*, since they seek to provide a set of principles as a guide to setting and interpreting accounting standards. Such guidance, however, does not necessarily preclude a standard being issued that, for compelling pragmatic reasons, departs from a principle set out in the applicable conceptual framework.

The IASB's Framework is written in a descriptive style (in fact, it is IASB policy to use the word 'should' only in Standards) and seeks to avoid being excessively prescriptive. A principal reason for this is that it needs to have broad international applicability. In the final paragraph of the Framework, the IASB states:

> This Framework is applicable to a range of accounting models and provides guidance on preparing and presenting the financial statements constructed under the chosen model. At the present time [1989], it is not the intention of the Board of IASB to prescribe a particular model other than in exceptional circumstances, such as . . . a hyperinflationary economy.

The Framework was intended to be separate from the IASs and to avoid binding the IASB to particular accounting treatments in IASs. It was approved and issued in April 1989 and has not been revised since that time, although the need to update it is now clearly recognized by the new board.

However, the Framework has been quite influential in the recent development of IASs and in major revisions. For example, its definitions (and especially those of assets and liabilities) were highly influential in the preparation of IAS 22, *Business Combinations*; IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*; IAS 38, *Intangible Assets* and IAS 39, *Financial Instruments: Recognition and Measurement*.

The Framework is not an IAS and does not override any specific IAS; in case of conflict between it and an IAS, the requirements of the latter prevail. *One may, however, consider the Framework as embodying IAS GAAP in respect of issues that are not dealt with in any IAS.* This is apparent from the way in which the purpose and status of the Framework are described (see points 4 and 5 in the following list). For example, in the case of topics that have not yet been the subject of an IAS, the purpose of the Framework is to assist preparers in dealing with such topics. Moreover, the IASB will be guided by the Framework in the development of future IASs and in reviewing existing ones, so that the number of cases of conflict between the Framework and IASs are likely to diminish over time. The Framework itself will be subject to revision in the light of experience. A revision can be expected over the next few years as part of the new board's development programme.

The IASB Framework

As indicated earlier, the Framework does not have the status of an IAS, does not override any specific IAS and, in case of conflict between the Framework and an IAS, the latter prevails (paras 2–3). The purpose of the Framework is stated as follows (para. 1):

1 To assist the Board of IASC in the development of future IASs and in its review of existing IASs;

2 To assist the Board of IASC in promoting harmonization of regulations, accounting standards and procedures relating to the presentation of financial statements by providing a basis for reducing the number of alternative accounting treatments permitted by IASs;

3 To assist national standard-setting bodies in developing national standards;

4 To assist preparers of financial statements in applying IASs and in dealing with topics that have yet to form the subject of an IAS;
5 To assist auditors in forming an opinion as to whether financial statements conform with IASs;
6 To assist users of financial statements in interpreting the information contained in financial statements prepared in conformity with IASs;
7 To provide those who are interested in the work of the IASC with information about its approach to the formulation of accounting standards.

The overall scope of the document covers:

1 objectives of financial statements
2 qualitative characteristics that determine the usefulness of financial statement information
3 definition, recognition and measurement of financial statement elements
4 concepts of capital and capital maintenance.

The Framework is concerned with 'general purpose financial statements', including consolidated financial statements. These are described as being prepared and presented at least annually and being directed toward the common information needs of a range of users. They do not include special purpose reports such as prospectuses and tax computations (para. 6).

The Framework applies to the financial statements of all commercial, industrial and business reporting enterprises, whether in the private or public sectors (para. 8).

The Framework first of all outlines the users of accounting information in a manner broadly similar to our discussion in Chapter 1:

- *Investors.* The providers of risk capital and their advisers are concerned with the risk inherent in and return provided by, their investments. They need information to help them determine whether they should buy, hold or sell. Shareholders are also interested in information which enables them to assess the ability of the enterprise to pay dividends.
- *Employees.* Employees and their representative groups are interested in information about the stability and profitability of their employers. They are also interested in information which enables them to assess the ability of the enterprise to provide remuneration, retirement benefits and employment opportunities.
- *Lenders.* Lenders are interested in information that enables them to determine whether their loans, and the interest attaching to them, will be paid when due.
- *Suppliers and other trade creditors.* Suppliers and other creditors are interested in information that enables them to determine whether amounts owing to them will be paid when due. Trade creditors are likely to be interested in an enterprise over a shorter period than lenders unless they are dependent on the continuation of the enterprise as a major customer.
- *Customers.* Customers have an interest in information about the continuance of an enterprise, especially when they have a long-term involvement with, or are dependent on, the enterprise.
- *Governments and their agencies.* Governments and their agencies are interested in the allocation of resources and, therefore, the activities of enterprises. They also require information in order to regulate the activities of enterprises, determine taxation policies and as the basis for national income and similar statistics.

- *Public*. Enterprises affect members of the public in a variety of ways. For example, enterprises 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 enterprise and the range of its activities.

Para. 10 states the following:

> While all of 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 enterprise, the provision of financial statements that meet their needs will also meet most of the needs of other users that financial statements can satisfy.

Activity 8.4

Does the last sentence of para. 10 follow logically?

Activity feedback

As a matter of *logic*, the answer is definitely not. The suggestion that *because* investors are providers of risk capital, information meeting the needs of investors will also meet most of the needs of, say, employees is clearly nonsense. Nevertheless, as an empirical pragmatic issue, the emphasis on investors, or at least an emphasis on providers of finance generally, may have some validity. Either way it is widely accepted in practice.

The Framework then goes on to summarize the overall objectives of financial statements. This is pretty standard stuff and can be briefly extracted here:

> **12** The objective of financial statements is to provide information about the financial position, performance and changes in financial position of an enterprise that is useful to a wide range of users in making economic decisions.
>
> **13** Financial statements prepared for this purpose meet the common needs of most users. However, financial statements do not provide all the information that users may need to make economic decisions since they largely portray the financial effects of past events and do not necessarily provide non-financial information.
>
> **15** The economic decisions that are taken by users of financial statements require an evaluation of the ability of an enterprise to generate cash and cash equivalents and of the timing and certainty of their generation. This ability ultimately determines, for example, the capacity of an enterprise to pay its employees and suppliers, meet interest payments, repay loans and make distributions to its owners. Users are better able to evaluate this ability to generate cash and cash equivalents if they are provided with information that focuses on the financial position, performance and changes in financial position of an enterprise.

19 Information about financial position is primarily provided in a balance sheet. Information about performance is primarily provided in an income statement. Information about changes in financial position is provided in the financial statements by means of a separate statement.

20 The component parts of the financial statements interrelate because they reflect different aspects of the same transactions or other events. Although each statement provides information that is different from the others, none is likely to serve only a single purpose or provide all the information necessary for particular needs of users. For example, an income statement provides an incomplete picture of performance unless it is used in conjunction with the balance sheet and the statement of changes in financial position.

Next the Framework discusses the various 'assumptions and characteristics' of accounting statements. These correspond closely to the conventions and characteristics of Chapter 1, but they are arranged in a series of subgroups with various headings and subheadings, which give interesting nuances of degrees of relative significance and importance. In order to give the full flavour of this the Framework is quoted here at some length.

Underlying assumptions

Accrual basis

22 In order to meet their objectives, financial statements are prepared on the accrual basis of accounting. Under this basis, the effects of transactions and other events are recognized 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 the 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

23 The financial statements are normally prepared on the assumption that an enterprise is a going concern and will continue in operation for the foreseeable future. Hence it is assumed that the enterprise 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 statement may have to be prepared on a different basis and, if so, the basis used is disclosed.

Qualitative characteristics of financial statements

24 Qualitative characteristics are the attributes that make the information provided in financial statements useful to users. The four principal qualitative characteristics are understandability, relevance, reliability and comparability.

Understandability

25 An essential quality of the information provided in financial statements is that is it readily understandable by users. For this purpose, users are assumed to have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information with reasonable diligence. However, information about complex matters that should be included in the financial statements because of its relevance to the economic decision-making needs of users should not be excluded merely on the grounds that it may be too difficult for certain users to understand.

Relevance

26 To be useful, information must be relevant to the decision-making needs of users. Information has the quality of relevance when it influences the economic decisions of users by helping them to evaluate past, present or future events or confirming, or correcting, their past evaluations.

27 The predictive and confirmatory roles of information are interrelated. For example, information about the current level and structure of asset holdings has value to users when they endeavour to predict the ability of the enterprise to take advantage of opportunities and its ability to react to adverse situations. The same information plays a confirmatory role in respect of past predictions about, for example, the way in which the enterprise would be structured or the outcome of planned operations.

28 Information about financial position and past performance is frequently used as the basis for predicting future financial position and performance and other matters in which users are directly interested, such as dividend and wage payments, security price movements and the ability of the enterprise to meet its commitments as they fall due. To have predictive value, information need not be in the form of an explicit forecast. The ability to make predictions from financial statements is enhanced, however, by the manner in which information on past transactions and events is displayed. For example, the predictive value of the income statement is enhanced if unusual, abnormal and infrequent items of income or expense are separately disclosed.

Materiality

29 The relevance of information is affected by its nature and materiality. In some cases, the nature of information alone is sufficient to determine its relevance. For example, the reporting of a new segment may affect the assessment of the risks and opportunities facing the enterprise irrespective of the materiality of the results achieved by the new segment in the reporting period. In other cases, both the nature and materiality are important, for example, the amounts of inventories held in each of the main categories that are appropriate to the business.

30 Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement. Thus, materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which information must have if it is to be useful.

Reliability

31 To be useful, information must also be reliable. Information has the quality of reliability when it is free from material error and bias and can be depended on by users to represent faithfully that which it either purports to represent or could reasonably be expected to represent.

32 Information may be relevant but so unreliable in nature or representation that its recognition may be potentially misleading. For example, if the validity and amount of a claim for damages under a legal action are disputed, it may be inappropriate for the enterprise to recognize the full amount of the claim in the balance sheet, although it may be appropriate to disclose the amount and circumstances of the claim.

Faithful representation

33 To be reliable, information must represent faithfully the transactions and other events it either purports to represent or could reasonable be expected to represent. Thus, for example, a balance sheet should represent faithfully the transactions and other events that result in assets, liabilities and equity of the enterprise at the reporting date which meet the recognition criteria.

34 Most financial information is subject to some risk of being less than a faithful representation of that which it purports to portray. This is not due to bias, but rather to inherent difficulties either in identifying the transactions and other events to be measured or in devising and applying measurement and presentation techniques that can convey messages that correspond with those transactions and events. In certain cases, the measurement of the financial effects of items could be so uncertain that enterprises generally would not recognize them in the financial statements; for example, although most enterprises generate goodwill internally over time, it is usually difficult to identify or measure that goodwill reliably. In other cases, however, it may be relevant to recognize items and to disclose the risk of error surrounding their recognition and measurement.

Substance over form

35 If information is to represent faithfully transactions and other events that it purports to represent, it is necessary that they are accounted for and presented in accordance with their substance and economic reality and not merely their legal form. The substances of transactions or other events is not always consistent with that which is apparent from their legal or contrived form. For example, an enterprise may dispose of an asset to another party in such a way that the documentation purports to pass legal ownership to that party; nevertheless, agreements may exist that ensure that the enterprise continues to enjoy the future economic benefits embodied in the asset. In such circumstances, the reporting of a sale would not represent faithfully the transaction entered into (if indeed there was a transaction).

Neutrality

36 To be reliable, the information contained in financial statements must be neutral, that is, free from bias. Financial statements are not neutral if, by the selection or presentation of information, they influence the making of a decision or judgement in order to achieve a pre-determined result or outcome.

Prudence

37 The preparers of financial statements do, however, have to contend with the uncertainties that inevitably surround many events and circumstances, such as the collectability of doubtful receivables, the probable useful life of plant and equipment and the number of warranty claims that may occur. Such uncertainties are recognized by the disclosure of their nature and extent and by the exercise of prudence in the preparation of the financial statements. Prudence is the inclusion of a degree of caution in the exercise of the judgements needed in making the estimates required under conditions of uncertainty, such that assets or income are not overstated and liabilities or expenses are not understated. However, the exercise of prudence does not allow, for example, the creation of hidden reserves or excessive provisions, the deliberate understatement of assets or income or the deliberate overstatement of liabilities or expenses, because the financial statements would not be neutral and, therefore, not have the quality of reliability.

Completeness

38 To be reliable, the information in financial statements must be complete within the bounds of materiality and cost. An omission can cause information to be false or misleading and thus unreliable and deficient in terms of its relevance.

Comparability

39 Users must be able to compare the financial statements of an enterprise through time in order to identify trends in its financial position and performance. Users must also be able to compare the financial statements of different enterprises in order to evaluate their relative financial position, performance and changes in financial position. Hence, the measurement and display of the financial effect of like transactions and other events must be carried out in a consistent way throughout an enterprise and over time for that enterprise and in a consistent way for different enterprises.

40 An important implication of the qualitative characteristic of comparability is that users be informed of the accounting policies employed in the preparation of the financial statements, any changes in those policies and the effects of such changes. Users need to be able to identify differences between the accounting policies for like transactions and other events used by the same enterprise from period to period and by different enterprises. Compliance with International Accounting Standards, including the disclosure of the accounting policies used by the enterprise, helps to achieve comparability.

41 The need for comparability should not be confused with mere uniformity and should not be allowed to become an impediment to the introduction of improved accounting standards. It is not appropriate for an enterprise to continue accounting in the same manner for a transaction or other event if the policy adopted is not in keeping with the qualitative characteristics of relevance and reliability. It is also inappropriate for an enterprise to leave its accounting policies unchanged when more relevant and reliable alternatives exist.

42 Because users wish to compare the financial position, performance and changes in financial position of an enterprise over time, it is important that the financial statements show corresponding information for the preceding periods.

Constraints on relevant and reliable information

Timeliness

43 If there is undue delay in the reporting of information it may lose its relevance. Management may need to balance the relative merits of timely reporting and the provision of reliable information. To provide information in a timely basis it may often be necessary to report before all aspects of a transaction or other event are known, thus impairing reliability. Conversely, if reporting is delayed until all aspects are known, the information may be highly reliable but of little use to users who have had to made decisions in the interim. In achieving a balance between relevance and reliability, the overriding consideration is how best to satisfy the economic decision-making needs of users.

Balance between benefit and cost

44 The balance between benefit and cost is a pervasive constraint rather than a qualitative characteristic. The benefits derived from information should exceed the cost of providing it. The evaluation of benefits and costs is, however, substantially a judgemental process. Furthermore, the costs do not necessarily fall on those users who enjoy the benefits. Benefits may also be enjoyed by users other than those for whom the information is prepared; for example, the provision of further information to lenders may reduce the borrowing costs of an enterprise. For these reasons, it is difficult to apply a cost benefit test in any particular case. Nevertheless, standard setters in particular, as well as the preparers and users of financial statements, should be aware of this constraint.

Balance between qualitative characteristics

45 In practice a balancing, or trade-off, between qualitative characteristics is often necessary. Generally the aim is to achieve an appropriate balance among the characteristics in order to meet the objective of financial statements. The relative importance of the characteristics in different cases is a matter of professional judgement.

True and fair view/fair presentation

46 Financial statements are frequently described as showing a true and fair view of, or as presenting fairly, the financial position, performance and changes in financial position of an enterprise. Although this framework does not deal directly with such concepts, the application of the principal qualitative characteristics and of appropriate accounting standards normally results in financial statements that convey what is generally understood as a true and fair view of or as presenting fairly such information.

This last paragraph concerning fair presentation has been rather overtaken by events, and is effectively superseded by IAS 1, discussed next.

It is worth emphasizing the suggested interrelationships between these various notions. There are two, and only two, *underlying assumptions*, the accrual basis and the going concern assumption. There are four *principal qualitative characteristics*, some with related sub-characteristics, as shown in Table 8.1.

There are a number of peculiarities about these suggested relationships. Not every national tradition would accept them. Note that the importance of prudence is significantly downgraded, to the lowest level. Neither is it at all obvious how prudence (which is hardly 'neutral') is necessary for 'reliability', however important one may think prudence is in itself.

Table 8.1 Assumptions and characteristics of accounting statements

Principal characteristic	*Sub-characteristic*
Understandability	
Relevance	Materiality
Reliability	Faithful representation
	Substance over form
	Neutrality
	Prudence
	Completeness
Comparability	

The elements of financial statements

The section of the Framework concerning the elements of financial statements (paras 47–80) consists essentially of definitions of the elements of financial statements as identified by the Framework. The definitions given in this section, and especially those of assets and liabilities, are the core of the Framework as a prescriptive basis for standard setting. The section on 'Recognition of Elements' (paras 82–98) acts to reinforce this core. In particular:

1 The Framework defines income and expenses in terms of increases and decreases in economic benefits that are equated with changes in assets and liabilities;

2 The latter are defined in terms of 'resources controlled' and 'present obligations' to exclude some of the types of items that have been recognized as assets or liabilities (accruals and deferrals) in the name of 'matching' expenses and revenues.

In other words, the definitions of assets and liability are the starting point for the entire edifice, putting the focus on balance sheet items, not on profit (revenue and expense) calculation.

The elements considered to be 'directly related to the measurement of financial position' are assets, liabilities and equity, which are defined as follows (para. 49):

1 An asset is a resource
   (a) controlled by the enterprise,
   (b) as a result of past events, and
   (c) from which future economic benefits are expected to flow to the enterprise.

Recognition as an asset thus requires that the three components of the definition, (a), (b) and (c), be satisfied.

2 A liability is
   (a) a present obligation of the enterprise,
   (b) arising out of past events,
   (c) the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits.

Recognition as a liability thus requires that the three components of the definition, (a), (b) and (c), be satisfied.

3 Equity is defined as the residual interest in the assets of the enterprise after deducting all its liabilities.

Merely satisfying these definitions does not entail recognition, since the recognition criteria in paras 82–98 must also be satisfied and also the principle of 'substance over form' must be respected. For example, this principle requires fixed assets held under finance leases to be recognized by the lessee as fixed assets (with corresponding leasing liabilities), while the lessor recognizes a financial asset (paras 50–51).

Balance sheets drawn up in accordance with 'current' [in 1989] IASs may include items the treatment of which does not satisfy these definitions, but the definitions will underlie 'future' reviews of existing standards and the formulation of new ones (para. 52). As noted earlier, the IASB has acted accordingly and it would be unusual to find an item whose treatment according to a recently issued IAS would conflict with the definitions.

Assets

The 'future economic benefit embodied in an asset' is defined as 'the potential to contribute, directly or indirectly, to the flow of cash and cash equivalents to the enterprise', including 'a capability to reduce cash outflows'. In case that definition should leave the status of cash itself as an asset unclear, it is stated that cash satisfies this definition, because it 'renders a service to the enterprise because of its command over other resources'. Assets embody future economic benefits that may flow to the enterprise by having one or more of the following capabilities:

- being exchanged for other assets
- being used to settle a liability
- or being distributed to the enterprise's owners.

Cash conspicuously possesses these three capabilities; as well as that of being used singly or in combination with other assets in the production of goods and services to be sold by the enterprise (paras 53–55).

Neither having physical form nor being the object of a right of ownership is an essential attribute of an asset. Intangible items such as patents and copyrights may satisfy the definition of an asset, as may a fixed asset held under a finance lease (by virtue of which it is a resource controlled though not owned by the enterprise and from which future benefits are expected to flow to). Moreover, knowledge obtained from development activity may meet the definition of an asset (capitalized development costs) even though neither physical form nor legal ownership is involved, provided there is de facto control such that, by keeping the knowledge secret, the enterprise controls the benefits that are expected to flow from it (paras 56–57).

Assets may result from various types of past transactions and other past events. Normally, these are purchase transactions and the events associated with production, but they may include donation (for example, by way of a government grant) or discovery (as in the case of mineral deposits). Expected future transactions or events do not give rise to assets; for example, a binding contract by an enterprise to purchase inventory does not cause the inventory in question to meet the definition of an asset of that enterprise until the purchase transaction that fulfils the contract has occurred. While expenditure is a common way to acquire or generate an asset, expenditure undertaken with a view to generating future economic benefits may fail to result in an asset, for example, if the intended economic benefits cannot be expected or are not controlled by the enterprise (paras 58–59).

Activity 8.5

Consider whether each of the following are assets, giving reasons for your answers.

1 A heap of rusty metal worth €10 as scrap but costing €20 to transport to the scrap dealer.
2 A municipal or trades union social or welfare centre outside the factory that substantially improves the overall working conditions of a firm's employees.
3 The benefits derived from next year's sales.

Activity feedback

None of these is an asset because:

1 has no probable future benefit
2 is not possessed or controlled by the business
3 contains no earlier transaction or event.

Assets are always divided into *fixed assets* and *current assets*. The definition of fixed assets is often misunderstood. A fixed asset is not an asset with a long life. The essential criterion is the *intention* of the owner, the intended *use* of the asset. A fixed asset is an asset that the firm intends to *use* within the business, over an extended period, in order to assist its daily operating activities. A current asset, by way of contrast, is usually defined in terms of time. A current asset is an asset likely to change its form, i.e. likely to undergo some transaction, usually within 12 months. Consider two firms, *A* and *B*. Firm *A* is a motor trader. It possesses some motor vehicles that it is attempting to sell, and it also possesses some motor vehicles used by the sales staff and for delivery purposes. In the accounts of *A*, the motor vehicles are current assets and the desks are fixed assets. In the accounts of *B*, the motor vehicles are fixed assets and the desks are current assets. Note incidentally that a fixed asset, which, after several years' use, is about to be sold for scrap, remains in the fixed asset part of the accounts even though it is about to change its form.

These two definitions, because they are based on different criteria (one on use and one on time), are not mutually exclusive. It is possible to think of assets that do not conveniently appear to be either fixed or current. Investments, for example, or goodwill.

Liabilities

An essential characteristic of (or necessary condition for) a liability is that the enterprise should have a 'present obligation'. An obligation is 'a duty or responsibility to act or perform in a certain way'. The duty or responsibility may arise from the law, for example, the law of contract; or it may arise from normal business practice, which leads to legitimate expectations that the enterprise will act or perform in a certain way (that is, a constructive obligation). An example of the latter is a constructive obligation to extend the benefits of a warranty for some period beyond the contractual warranty period, because this is an established practice (para. 60).

A present obligation (in the relevant sense) is not the same as a future commitment. An enterprise may have a commitment to purchase an asset in the future at an agreed price; however, this does not entail a net outflow of resources. The commitment does not give rise to a liability, which arises only when the purchase has actually taken place and title in the asset has passed to the enterprise, leaving the latter with an obligation to pay for it. (In the case of a cash transaction, no liability would arise (para. 61.)

There are a number of ways in which a liability may be settled or discharged, which include replacement by another obligation, conversion into equity and the creditor waiving or forfeiting his rights. There are also various types of 'past transactions or past events' from which liabilities may result (paras 62–63). If a provision involves a present obligation and satisfies the rest of the definition of a liability given in the Framework, it is a liability even if the amount has to be estimated (para. 64). Paragraph 64 does not emphasize the equally important point that a provision that fails to satisfy the criterion of being an *obligation* arising from a past transaction or past event is not a liability. This point, however, was crucial in arriving at the requirements for recognition of provisions in IAS 22, *Business Combinations* and IAS 37, *Provisions, Contingent Liabilities and Contingent Assets* (see Chapters 18 and 24).

Equity

Paras 65–68 are concerned with equity. The fact that equity is defined as a residual interest (assets minus liabilities) does not mean that it cannot be meaningfully divided into sub-classifications that are shown separately in the balance sheet. Examples are the difference among the following:

- paid-in capital (capital stock and paid-in surplus)
- retained earnings

- reserves representing appropriations of retained earnings
- reserves representing the amounts required to be retained in order to maintain 'real' capital, that is, either real financial capital or (real) physical capital (para. 65).

There are various legal, tax and valuation considerations that affect equity, such as requirements for legal reserves and whether or not the enterprise is incorporated. It is emphasized that transfers to legal, statutory and tax reserves are appropriations of retained earning and not expenses. (Likewise, releases from such reserves are credits to retained earnings and not income, but this is not spelled out.) The rather obvious point is made that the amount at which equity is shown in the balance sheet is not intended to be a measure of the market value of the enterprise, either as a going concern or in a piecemeal disposal. It is stated that the definition and treatment of equity in the Framework are appropriate for unincorporated enterprises, even if the legal considerations are different.

Performance

Paras 69–81 contain the section of the Framework in which definitions of the financial statement elements relating to performance are given. 'Profit is frequently used as a measure of performance or as the basis for other measures, such as return on investment and earnings per share' (para. 69). However, this section of the Framework does not discuss the relationship between the elements of performance and the profit measure, except to say that 'the recognition and measurement of income and expenses, and hence profit, depends in part on the concepts of capital and capital maintenance used by the enterprise in preparing its financial statements'. The determination of profit and related issues are discussed in a later section of the Framework (paras 102–110).

The elements of income and expenses are defined as follows:

1. Income is increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.
2. Expenses are decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants (para. 70).

These definitions identify the essential features of income and expenses but do not attempt to specify their recognition criteria (para. 71). The definition makes it clear that the Framework's approach treats the definitions of assets and liabilities as *logically prior to* those of income and expenses. This is sometime characterized as a 'balance sheet approach' to the relationship between financial statements. This term is potentially misleading, however. The Framework's approach should certainly not be understood as implying the subordination of the income statements to the balance sheet from an *informational* perspective.

Income

The Framework's definition of income encompasses both revenue and gains. Revenue is described as arising in the course of the ordinary activities of an enterprise and includes sales, fees, interest, royalties and rent. Gains may or may not arise in the course of ordinary activities. Gains may arise on the disposal of non-current assets and also include unrealized gains such as those arising on the revaluation of marketable securities and from increases in the carrying amount of long-term assets. Gains, when recognized in the income statements, are usually displayed separately because their economic significance tends to differ from that of revenue, and they are often reported net of related expenses (paras 74–77).

The counterpart entry corresponding to a credit for income may be to various asset accounts (not only cash or receivables) or to a liability account such as when a loan is discharged by the provision of goods or services (para. 77).

Expenses

The Framework's definition of expenses encompasses losses as well as expenses that arise in the course of the ordinary activities of the enterprise. Examples given of expenses that arise in the course of ordinary activities are cost of sales, wages and depreciation. They usually take the form (that is, are the accounting counterpart) of an outflow or depletion of assets such as cash and cash equivalents, inventory, property or plant and equipment (para. 78).

Losses represent items that may or may not arise in the course of ordinary activities. They include those that result from such disasters as fire or flood, as well as those arising on the disposal of non-current assets and also encompass unrealized losses, such as those arising from the effects of adverse currency exchange rate movements on financial assets or liabilities. Losses, when recognized in the income statement, are usually displayed separately because their economic significance tends to differ from that of other expenses and they are often reported net of related income (paras 79–80).

Recognition of the elements of financial statements

Recognition issues are dealt with in paras 82–98. Recognition is described as 'the process of incorporating in the balance sheet or [the] income statement an item that meets the definition of an element and satisfies the criteria for recognition set out in paragraph 83'. (The statement of changes in financial position is not mentioned because its elements consist of those that are also elements of financial position or performance.) Failure to recognize *in the main financial statements* items that satisfy the relevant definition and recognition criteria is not rectified by disclosure of the accounting policies used or by use of notes or other explanatory material.

The recognition criteria set out in para. 83 are that an item which meets the definition of an element should be recognized if:

1. It is probable that any future economic benefit associated with the item will flow to or from the enterprise; and
2. The item has a cost or value that can be measured with reliability.

Recognition is subject to materiality. Accounting interrelationships are also significant, since recognition in the financial statements of an item that meets the definition and recognition criteria for a particular element, for example an asset, entails the recognition of another (counterpart) element, such as income or a liability (para. 84). (This refers, strictly speaking, to the initial recognition of an item. However, a similar point could be made about the implications of remeasurement or valuation adjustments.)

The probability of future economic benefit

The concept of *probability* is used in the recognition criteria 'to refer to the degree of uncertainty [as to whether] the future economic benefits associated with the time will flow to or from the enterprise ... in keeping with the uncertainty that characterizes the environment in which an enterprise operates'. Assessments of such uncertainty are made on the basis of the evidence available when the financial statements are prepared. In regard to receivables, for example, for a large population of accounts, some statistical evidence will usually be available regarding collectibility (para. 85).

Reliability of measurement

Reliability, the second recognition criterion, was discussed earlier in the section on qualitative characteristics of financial statements. If an item does not possess a cost or value that can be measured with reliability (so that the information has that qualitative characteristic), then it is not appropriate to recognize it. However, in many cases, cost or (more particularly) value must be estimated; indeed, the use of reasonable estimates is an essential part of the financial reporting process and need not undermine reliability. In cases where an item satisfied the definition of an element but not the recognition criteria, it will not be recognized in the financial statements themselves, but its relevance is likely to require its disclosure in the notes to the financial statements or in other supplementary disclosures. This applies when the item meets the probability criterion of recognition but not the reliability criterion, but may also apply to an item that meets the definition of an element when neither recognition criterion is met. The key issue here is whether the item is considered to be relevant to the evaluation of financial position, performance or changes in financial position. An item that does not satisfy the recognition criteria for an asset or a liability at one time may do so later, if more information relevant to estimating its probability, cost or value becomes available (paras 86–88).

It is important to note that 'probable' and 'reliability' are both relative and subjective concepts. The Framework does not pretend otherwise. Professional judgement is required in the context of the particular situation in which the enterprise concerned operates.

Recognition of assets

An asset is recognized in the balance sheet when it is probable that future economic benefits will flow to the enterprise (as a result of its control of the asset) and the asset's cost or value can be measured reliably. When expenditure has been incurred but it is not considered probable that economic benefits will flow to the enterprise beyond the current accounting period, this expenditure will be recognized as an expense, not as an asset. The intention of management in undertaking the expenditure is irrelevant (paras 89–90).

Recognition of liabilities

A liability is recognized in the balance sheet when it is probable that an outflow of resources embodying economic benefits will result from the settlement of a present obligation and the amount of that settlement can be measured reliably. Obligations under executory contracts, that is, non-cancellable contracts that are equally proportionately unperformed (such as the amount that will be a liability when inventory ordered and awaiting delivery is received), are not generally recognized as liabilities in the balance sheet, neither are the related assets recognized in the balance sheet. In some cases, however, recognition may be required (para. 91).

Recognition of income

Recognition of income occurs simultaneously with the recognition of increases in assets or decreases in liabilities (or a combination of the two). The normal recognition procedures used in practice are applications of the Framework's recognition criteria. An example is the requirement that revenue should be earned (that is, it should be associated with a simultaneous increase in assets or decrease in liabilities). These procedures are concerned with restricting the recognition of income to items that, in effect, meet the Framework's recognition criteria of *probability* (a sufficient degree of certainty that an economic benefit has flowed or will flow to the enterprise) and *reliability* of measurement (paras 92–93).

Recognition of expenses

Recognition of expenses occurs simultaneously with the recognition of an increase in liabilities or a decrease in assets (or a combination of the two). Expenses are commonly recognized in the income statement on the basis of an association (matching) between the incurrence of costs and the earning of specific items of revenue, that result directly and jointly from the same transactions or other events. An example is the matching of the cost of goods sold with the associated sales revenue. However, the Framework does not permit the application of the matching procedure to result in the recognition of items in the balance sheet that do not meet the definition of assets or liabilities (paras 94–95).

Measurement of the elements of the financial statements

Para. 99–101 deal with measurement issues, insofar as these are covered in the Framework. The treatment here is descriptive and avoids being prescriptive. Measurement is described as 'the process of determining the monetary amounts at which the elements of the financial statements are to be recognized and carried in the balance sheet and income statement'. It involves the selection of a particular basis of measurement.

Four different measurement bases are specifically mentioned and described (without any claim to exhaustiveness): historical cost, current cost (of replacement or settlement), realizable or (for liabilities) settlement value and present value. Historical cost is mentioned as the measurement basis most commonly adopted by enterprises in preparing their financial statements, usually in combination with other measurement bases. An example of the latter is the carrying of inventories at the lower of historical cost and net realizable value. Marketable securities may be carried at market value and pension liabilities are carried at their present value. Current cost may be used as a means of taking account of the effects of changing prices of non-monetary assets.

Concepts of capital and capital maintenance

Concepts of capital

The Framework identifies two main concepts of capital: the financial concept and the physical concept. The financial concept of capital may take two forms: invested money (nominal financial) capital or invested purchasing power (real financial) capital. In either case, capital is identified with the equity of the enterprise (in either nominal or real financial terms) and with its net assets measured in those terms. The physical concept of capital is based on the notion of the productive capacity or operating capability of the enterprise, as embodied in its net assets. Most enterprises adopt a financial concept of capital, normally (in the absence of severe inflation) nominal financial capital (para. 102).

Capital maintenance and the determination of profit

Choice of a concept of capital is related to the concept of capital maintenance that is most meaningful, given the implications of the choice for profit measurement and the needs of the users of the financial statements in that regard, as follows:

1. *Maintenance of nominal financial capital.* Under this concept a profit is earned only if the money amount of the net assets at the end of the period exceeds the money amount of the net assets at the beginning of the period, after excluding any distributions to, and contributions from, equity owners during the period.
2. *Maintenance of real financial capital.* Under this concept a profit is earned only if the money amount of the net assets at the end of the period exceeds the money amount of the net assets as the beginning of the period, restated in units of the same purchasing power, after excluding distributions to, and contributions from, owners. Normally, the units of purchasing power employed are those of the currency at the end of the period, into which the net assets at the beginning of the period are restated.
3. *Maintenance of real physical capital.* Under this concept a profit is earned only if the operating capability embodied in the net assets at the end of the period exceeds the operating capability embodied in the net assets at the beginning of the period, after excluding distributions to, and contributions from, owners. Operating capability embodied in assets may, in principle, be measured by employing the current cost basis of measurement

(paras 103–106).

The main difference among the three concepts of capital maintenance is the treatment of the effects of changes in the carrying amounts of the enterprise's assets and liabilities. Under nominal financial capital maintenance, increases in the money-carrying amounts of assets held over the period (to the extent that they are recognized as gains) are part of profit.

Under real financial capital maintenance, such increases are part of profit only if they are 'real' increases, that is, increases that remain after money-carrying amounts have been restated in units of the same purchasing power. The total amount of the restatement is known as a 'capital maintenance adjustment' and is transferred to a capital maintenance reserve, which is part of equity (but not of retained profits). Real financial capital maintenance may be used in conjunction with historical cost as a measurement basis but would more normally be used in conjunction with the current cost basis.

Under real physical capital maintenance, changes in the money prices at current costs of assets and liabilities held over the period are considered not to affect the amount of operating capability embodied in those items and therefore the total amount of those changes is treated as a capital maintenance adjustment and excluded from profit.

Illustration

Let us assume that a company begins with capital stock of €100 and cash of €100. At the beginning of the year, one item of inventory is bought for €100. The item of inventory is sold at the end of the year for €150, its replacement cost at that time is €120 and general inflation throughout the year is 10%. Profit measured using each of the capital maintenance concepts mentioned earlier would be as shown:

	Nominal financial capital maintenance	Real financial capital maintenance	Real physical capital maintenance
Sales	€150	€150	€150
less Cost of sales	(100)	(100)	(120)
Operating profit	50	50	30
less Inflation adjustment	—	(10)	—
Total gain	€50	€40	€30
Capital maintenance adjustment	€0	€10	€20

Column 1 shows the gain after ensuring the maintenance of the stockholders' opening capital measured as a sum of money. Column 2 shows the gain after ensuring the maintenance of the stockholders' opening capital measured as a block of purchasing power. Both of these are concerned, under different definitions, with the maintenance of financial capital – in terms either of its money amount or of its general purchasing power. Column 3 shows the gain after ensuring the maintenance of the company's initial operating capacity and is therefore of a completely different nature.

Different combinations of measurement bases and capital maintenance concepts provide different accounting models, between which management should choose, taking into account relevance and reliability. Readers should be very familiar with the concepts underlying these alternatives, which have been fully discussed in Chapters 4–7.

IAS 1 *Presentation of Financial Statements*

It is most important to remember that the Framework has not been revised since 1989 and is now, as the IASB is well aware, in need of further development. However, to complicate the situation further, a revised version of IAS 1, *Presentation of Financial Statements*, was issued in 1997 and this covers some of the topics discussed in the Framework. As a full Standard, IAS 1 automatically takes priority over the Framework where there is any overlap or conflict.

Presentation of Financial Statements represents an attempt to cover several important aspects. The objective of the Standard is to prescribe the basis for presentation of general purpose financial statements, in order to ensure comparability both with the enterprise's own financial statements of previous periods and with the financial statements of other enterprises. To achieve this objective, the Standard sets out overall considerations for the presentation of financial statements, guidelines for their structure and minimum requirements for the content of financial statements.

In principle, therefore, IAS 1 applies to all aspects of all businesses. Many aspects of financial reporting are covered additionally by other more specific International Accounting Standards, as detailed elsewhere in this volume. However, some other aspects are not further developed and IAS 1 therefore comprises the IAS GAAP in those respects. For example, disclosure of fixed assets is discussed in IAS 16, *Property Plant and Equipment* (see Chapter 12), but disclosure of current assets has no additional Standard, except for component parts such as inventories, covered by IAS 2, *Inventories* (see Chapter 15).

Broadly speaking, IAS 1 consists of two parts. Part 1 discusses a number of 'overall considerations' consisting of general principles, conventions and requirements. Much of Part 1 is a restatement of aspects of the Framework, as discussed already. Part 2 discusses in some detail the required contents of general purpose financial statements. It is worth noting that most national accounting standards operate, and are designed to operate, within the context of national legislation, especially for corporations. There is, of course, no single international company or corporation statute. To some extent, IAS 1 provides a minimal filling in of this lacuna.

Consistent with our chapter structure in this book, the first part of IAS 1 is discussed here. Part 2 is covered in Chapter 9.

Scope

The scope and applicability of IAS 1 revised (hereafter IAS 1) is very wide. It should be applied in the presentation of all general purpose financial statements prepared and presented in accordance with International Accounting Standards.

General purpose financial statements are those intended to meet the needs of users who are not in a position to demand reports tailored to meet their specific information needs. They include statements presented separately or those within another public document such as an annual report or prospectus.

IAS 1 does not apply to condensed interim financial information, but it must be applied in full to all general purpose statements as already described which claim to be in accordance with International Accounting Standards. This includes banks and insurance companies and IAS 1 notes that IAS 30, *Disclosures in the Financial Statements of Banks and Similar Financial Institutions*, contains additional requirements which are 'consistent with the requirements of' IAS 1. Not-for-profit organizations can also apply the Standard (and IAS GAAP generally) by amending item descriptions in the financial statements as appropriate.

IAS 1 repeats the objective of general purpose financial statements from the Framework, as being to provide information about the financial position, performance and cash flows of an enterprise that is useful to a wide range of users in making economic decisions. Financial statements also show the results of management's stewardship of the resources entrusted to it. Financial statements provide information about an enterprise's (para. 5):

- assets
- liabilities
- equity
- income and expenses, including gains and losses
- cash flows.

A complete set of financial statements therefore includes the following components (para. 7):

1 Balance sheet.
2 Income statement.
3 A statement showing either:
 (**a**) all changes in equity
 (**b**) or changes in equity other than those arising from capital transactions with owners and distribution to owners.
4 Cash flow statements.
5 Accounting policies and explanatory notes.

Item 3 may be a new concept in some jurisdictions. To deal with users' demands for more comprehensive information on 'performance', measured more broadly than the 'profit' shown in the income statement, the Standard establishes a new requirement for a primary financial statement showing those gains and losses not presented in the income statement. (This is discussed and illustrated in more detail in Chapter 9.)

IAS 1 encourages, but does not require, the additional presentation, 'outside the financial statements', of a management report about the financial performance and financial position of the enterprise and about its environment, risks and uncertainties. Brief suggestions as to coverage are made in paragraph 8, but none of the suggestions is mandatory. Further additional statements and reports, for example on environmental matters, are also encouraged.

Fair presentation and compliance with International Accounting Standards

The first substantive part of IAS 1 concerns the vexed question of the override. The issue at stake is whether or not the detailed regulations, i.e. the Standards in this case, are always and automatically both necessary and sufficient conditions for the preparation of adequate financial statements or whether some more fundamental overriding criterion, such as the provision of a true and fair view, a requirement to present fairly or a requirement not to mislead users is, when a clash occurs, the determining requirement (hence 'overriding' the Standards). IAS 1 recognizes that compliance with the International Standards may be insufficient or inadequate 'in extremely rare circumstances'.

Enterprises which comply with IASs should say so. This requires that they comply with *all* applicable aspects of all applicable Standards and with all applicable interpretations of the Standing Interpretations Committee. However, the overall requirement is that financial statements should present fairly the financial position, financial performance and cash flows of an enterprise. The appropriate application of International Accounting Standards, with additional disclosure when necessary, results, in 'virtually all circumstances', in financial statements that achieve a fair presentation.

In the extremely rare circumstances when management concludes that compliance with a requirement in a Standard would be misleading and therefore that departure from a requirement is necessary to achieve a fair presentation, an enterprise should disclose (para. 13):

1 That management has concluded that the financial statements fairly present the enterprise's financial position, financial performance and cash flows.
2 That it has complied in all material respects with applicable International Accounting Standards except that it has departed from a Standard in order to achieve a fair presentation.
3 The Standard from which the enterprise has departed, the nature of the departure, including the treatment that the Standard would require, the reason why that treatment would be misleading in the circumstances and the treatment adopted.
4 The financial impact of the departure on the enterprise's net profit and loss, assets, equity and cash flows for each period presented.

The question of terminology and national positions here is both important and potentially confusing. The US requirement to present fairly in accordance with (US) GAAP means to follow GAAP, at least as far as accounting standards are concerned, although the situation is slightly less clear as regards US auditing standards. The UK requirement to give a true and fair view equally clearly means to follow Standards where suitable, but to depart from them if a true and fair view requires it. The UK position in essence found its way into the European Union Fourth Directive and hence, subject to varying degrees of bastardization, into other European countries. IAS 1 follows the US *wording* but the UK/EU philosophy. Table 8.2 makes this clear.

This is not to imply that the override is likely to be used in similar ways or in similar volumes in the various jurisdictions where it exists. We predict that its usage under the IASB will indeed be rare. But an important issue of principle is at stake. Can the qualitative characteristics required of financial reporting be ensured by *compliance* with a set of (static) rules, or is some *professional judgement* involved which may, in principle, entail departure from one or more rules?

Although no attempt to define 'fair presentation' is provided (rightly in our view), the presumption 'in virtually all circumstances' is that a fair presentation is achieved by compliance in all material respects with applicable International Accounting Standards. A fair presentation requires (para. 15):

1 Selecting and applying accounting policies as described later.
2 Presenting information, including accounting policies, in a manner which provides relevant, reliable, comparable and understandable information.
3 Providing additional disclosures when the requirements in International Accounting Standards are insufficient to enable users to understand the impact of particular transactions or events on the enterprise's financial position and financial performance.

Table 8.2 Terminology versus philosophy

Jurisdiction	*Terminology*	*Overriding*
UK	True and fair view	Yes
European Union	True and fair view	Yes
USA	Fair presentation	No
IASC	Fair presentation	Yes

In extremely rare circumstances, application of a specific requirement in an International Accounting Standard might result in misleading financial statements. In such circumstances departure from the Standard is required. IASB is at pains to minimize the likelihood of this happening. The override can only be applied when following the Standard plus providing additional information would not give a fair presentation (i.e., presumably, would mislead). The existence of national regulations which conflict with IASB Standards is not an adequate reason for departing from an International Standard.

IAS 1 requires in addition, if the override is employed, that full details of the departure are given in the financial statements, sufficient to enable users to make an informed judgement on whether the departure is necessary and to calculate the adjustments that would be required to comply with the Standard. IASB will monitor instances of non-compliance that are brought to its attention (by enterprises, their auditors and regulators, for example) and will consider the need for clarification through interpretations or amendments to Standards, as appropriate, to ensure that departures remain necessary only in extremely rare circumstances.

More recently the new Board of IASB has taken steps to emphasize the rare nature of the use of the override, suggesting that the circumstances must be ‘unique’. However, no formal revision of IAS 1 has yet appeared.

Accounting policies

Accounting policies are the specific principles, bases, conventions, rules and practices adopted by an enterprise in preparing and presenting financial statements. Management should select and apply an enterprise’s accounting policies so that the financial statements comply with all the requirements of each applicable International Accounting Standard and interpretation of the Standing Interpretations Committee. Where there are no specific requirements, management should develop policies to ensure that the financial statements provide information that is (para. 20):

1 relevant to the decision-making needs of users
2 Reliable in that they:
  (**a**) represent faithfully the results and financial position of the enterprise
  (**b**) reflect the economic substance of events and transactions and not merely the legal form
  (**c**) are neutral, that is, free from bias
  (**d**) are prudent
  (**e**) are complete in all material respects.

All these terms are taken from the Framework and their implications have already been discussed.

In general, choosing appropriate accounting policies is a subjective process. The chosen policies should seek to provide ‘the most useful information to users’ of the financial statements. In the absence of specific requirements in an IAS, the choice of policy should be informed by analogy with similar requirements in IASs or Interpretations, from the definitions, criteria and logic of the Framework and finally from national or industry pronouncements or practices if, but only if, they do not conflict with the contents or the spirit of the IASB Framework and body of Standards.

IAS 1 proceeds to incorporate and discuss some, but not all, of the assumptions and qualitative characteristics of financial statements included in the Framework. The two 'underlying assumptions' are going concern and the accrual basis of accounting. The going concern assumption means that it is assumed that the enterprise will continue in operation for the foreseeable future. Financial statements should be prepared on a going concern basis unless management either intends to liquidate the enterprise 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 which may cast significant doubt on the enterprise's ability to continue as a going concern, those uncertainties should be disclosed. When the financial statements are not prepared on a going concern basis, that fact should be disclosed, together with the basis on which the financial statements are prepared and the reason why the enterprise is not considered to be a going concern. When the financial statements are prepared on the going concern basis it is not necessary to say so. Judgement, and in uncertain cases detailed investigation, may be required.

The accrual basis of accounting (except for cash flow statements) is also an automatic assumption that need not be explicitly stated. Under the accrual basis of accounting, transactions and events are recognized 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.

IAS 1, unlike the Framework, explicitly links together the alternative descriptions of accruals and matching for this concept. IAS 1 notes that the application of the matching concept in IAS GAAP does not allow the recognition of items in the balance sheet which do not meet the IAS definition of assets or liabilities.

The Framework states, however, that financial statements may include items not falling within these definitions if specific Standards require their recognition. Some other Standards do so require, e.g. with regard to the deferral of government grants (IAS 20, see Chapter 12) and the deferral of income and expenses relating to operating leases (IAS 17, Chapter 14). Although there seems to be conflict between the Framework and IAS 1 on this point, standards, explicitly, override the Framework.

IAS 1 also incorporates the principle of consistency from para. 39 of the Framework, but, oddly, only as regards presentation. A change in presentation and classification of items in financial statements between one period and another is permitted only when it results in a more appropriate presentation (which is expected to continue) or is required by a specific International Standard or interpretation. The Framework principle continues to relate, of course, to recognition and measurement.

The IASB has issued an Interpretation, SIC–18, *Consistency, Alternative Methods*, which became effective for annual financial periods beginning on or after July 1, 2000. The issue is how the choice of accounting policy should be exercised in the context of those IASB Standards that allow an explicit choice of accounting policy but are silent on the manner of exercising that choice. The fundamental question is whether, once a choice of policy is made, that policy must be followed consistently for all items accounted for under the specific requirements that provide the choice.

SIC 18 requires that, if more than one accounting policy is available under an International Accounting Standard or interpretation, an enterprise should choose and apply consistently one of those policies unless the Standard or interpretation specifically requires or permits categorization of items, the most appropriate accounting policy should be selected and applied consistently to each category.

The issue of materiality and aggregation raises some important considerations. Each material item should be presented separately in the financial statements. Immaterial amounts should be aggregated with amounts of a similar nature or function and need not be presented separately. In this context, information is material if its non-disclosure could influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size and nature of the item judged in the particular circumstances of its omission. In deciding whether an item or an aggregate of items is material, the nature and the size of the item are evaluated together. Depending on the circumstances, either the nature or the size of the item could be the determining factor. For example, evidence of breaking the law causing a fine could be significant in principle, even if the amount is small. But similar items should be aggregated together however large they or the resulting total are in relation to the enterprise as a whole.

It is important that both assets and liabilities, and income and expenses, when material, are reported separately. Offsetting in either the income statement or the balance sheet, except when offsetting reflects the substance of the transaction or event, would detract from the ability of users to understand the transactions undertaken and to assess the future cash flows of the enterprise. Assets and liabilities should not be offset except when offsetting is required or permitted by another International Accounting Standard. Items of income and expense should be offset when, and only when (para. 34):

1 An International Accounting Standard requires or permits it.
2 Or gains, losses and related expenses arising from the same or similar transactions and events are not material. Such amounts should be aggregated in accordance with the principles just discussed.

It is often not fully appreciated that the prevention of off-setting between assets and liabilities and between income and expenses is not at all the same thing as the prevention of netting out between debits and credits in a bookkeeping sense. Receipts and payments in relation to the purchase of one asset, for example, involve the netting out of debits and credits and are not examples of off-setting as discussed in IAS 1.

It should also be noted that there are several examples where other International Accounting Standards do ‘require or permit’ off-setting. One such example is IAS 11 (see Chapter 15), where contract costs plus recognized profits less losses are offset against progress billings to give a net figure of amount due from customers.

It is explicitly stated that the specific disclosure requirements of International Accounting Standards need not be met if the resulting information is not material. It thus follows that full compliance with IAS GAAP requires the following of complete IAS GAAP except for immaterial disclosure requirements, not the following of complete IAS GAAP period.

The ‘presentation’ section of IAS 1 concludes with requirements about comparative figures. Unless an International Accounting Standard permits or requires otherwise, comparative information should be disclosed in respect of the previous period for all numerical information in the financial statements. Comparative narrative and descriptive information should be included when it is relevant to an understanding of the current period’s financial statements.

Comparative information should be restated if necessary if the presentation or classification of items in the current financial statements is altered, unless it is impractical to do so, in which case the reason for not reclassifying should be disclosed together with 'the nature of the changes that would have been made if amounts were reclassified'. Five- or ten-year summaries should logically be changed as well, although IAS 1 does not consider this point.

It should be noted that IAS 8, *Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies*, applies if changes constitute a change in accounting policy as discussed in that Standard (see Chapter 23).

As already indicated, the remainder of IAS 1 relates to the structure and content of published financial statements, which is dealt with in the next chapter.

Summary

This chapter began with an outline of 'theories about theories' in the accounting context. We then looked at the nearest that accounting seems to have got to a generally agreed theory, as illustrated by the IASB Framework and relevant parts of IAS 1. These documents seem far removed from theory in a scientific sense.

Exercises

1. To what extent is financial reporting a suitable subject for theorizing about?
2. Positive research is a necessary starting point on the road to normative thinking, but can never be enough by itself. Discuss.
3. Is the IASB Framework useful in its present form? How could it be improved?
4. Accounting standards and regulations should aim to state how to deal with all situations. Discuss.
5. Rework question 9 from Chapter 1, specifically by applying the IASB Framework. Does it alter or improve your original answer? Does IAS 1 make any difference?