ALAN MELVILLE

INTERNATIONAL FINANCIAL REPORTING

A PRACTICAL GUIDE

Pearson

EIGHTH EDITION

International Financial Reporting

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International Financial Reporting

A Practical Guide

Eighth edition

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Pearson

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PEARSON EDUCATION LIMITED
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Web: www.pearson.com/uk

First published 2008 (print)
Second edition published 2009 (print)
Third edition published 2011 (print)
Fourth edition published 2013 (print and electronic)
Fifth edition published 2015 (print and electronic)
Sixth edition published 2017 (print and electronic)
Seventh edition published 2019 (print and electronic)
Eighth edition published 2022 (print and electronic)

ISBN: 978-1-292-43942-6 (print)
978-1-292-43944-0 (PDF)
978-1-292-43943-3 (ePub)

British Library Cataloguing-in-Publication Data
A catalogue record for the print edition is available from the British Library

Library of Congress Cataloging-in-Publication Data
A catalog record for the print edition is available from the Library of Congress

10 9 8 7 6 5 4 3 2 1
26 25 24 23 22

Front cover image: MNBB Studio/Shutterstock

Printed and Bound by CPI UK

NOTE THAT ANY PAGE CROSS REFERENCES REFER TO THE PRINT EDITION

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Preface

The purpose of this book is to explain International Financial Reporting Standards (IFRS® Standards) and International Accounting Standards (IAS® Standards) at a level which is appropriate for students who are undertaking an intermediate course of study in financial reporting. It is assumed that the reader has already completed an introductory accounting course and is therefore familiar with the basics of financial accounting. The book has not been written with any specific syllabus in mind but should be useful to second-year undergraduates studying for a degree in accounting and finance and to those who are preparing for the examinations of the professional accounting bodies.

IFRS Standards and IAS Standards (referred to in this book as "international standards") have gained widespread acceptance around the world and most accountancy students are now required to become familiar with them. The problem is that the standards and their accompanying documentation occupy over 4,000 pages of fine print and much of this content is highly technical and difficult to understand. What is needed is a textbook which explains each standard as clearly and concisely as possible and then provides students with plenty of worked examples and exercises. This book tries to satisfy that need.

The standards are of international application but (for the sake of convenience) most of the monetary amounts referred to in the worked examples and exercises in this book are denominated in £s. Other than this, the book contains very few UK-specific references and should be relevant in any country which has adopted international standards.

Each chapter of this book concludes with a set of exercises which test the reader's grasp of the topics introduced in that chapter. Some of these exercises are drawn from the past examination papers of professional accounting bodies. Solutions to most of the exercises are located at the back of the book but solutions to those exercises which are marked with an asterisk (*) are intended for lecturers' use and are provided on a supporting website.

This eighth edition is in accordance with all international standards and amendments to standards issued as at 1 January 2022.

Alan Melville
February 2022

Acknowledgements

I would like to thank the IFRS® Foundation for permission to use extracts from various IASB® standards. This publication contains copyright material of the IFRS® Foundation in respect of which all rights are reserved. Reproduced by Pearson Education Limited with the permission of the IFRS Foundation. No permission granted to third parties to reproduce or distribute. For full access to IFRS Standards and the work of the IFRS Foundation, please visit http://ifrs.org.

The International Accounting Standards Board®, the IFRS Foundation, the authors and the publishers do not accept responsibility for any loss caused by acting or refraining from acting in reliance on the material in this publication, whether such loss is caused by negligence or otherwise.

I would also like to thank the following accounting bodies for granting me permission to use their past examination questions:

- Association of Chartered Certified Accountants (ACCA)
- Chartered Institute of Public Finance and Accountancy (CIPFA)
- Association of Accounting Technicians (AAT).

I must emphasise that the answers provided to these questions are entirely my own and are not the responsibility of the accounting body concerned. I would also like to point out that the questions which are printed in this textbook have been amended in some cases so as to reflect changes in accounting standards which have occurred since those questions were originally published by the accounting body concerned.

Please note that, unless material is specifically cited with a source, any company names used within this text have been created by me and are intended to be fictitious.

Alan Melville
February 2022

List of international standards

A full list of the International Financial Reporting Standards (IFRS® Standards) and the International Accounting Standards (IAS® Standards) which are in force at the time of writing this book is given below. Standards missing from the list have been withdrawn. Alongside each standard is a cross-reference to the relevant chapter of the book.

It is important to appreciate that new or modified standards are issued fairly often. The reader who wishes to keep up-to-date is advised to consult the website of the International Accounting Standards Board (IASB®) at www.ifrs.org.

International Financial Reporting Standards		*Chapter*
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It should be noted that some of these standards are beyond the scope of this book and are considered no further here. These are IFRS6, IFRS14, IFRS17, IAS26 and IAS41.

As well as the international standards, three further IASB documents (none of which are standards) are dealt with in this book. These are:

(a) the *Conceptual Framework for Financial Reporting* (see Chapter 2) which sets out a number of concepts that underlie financial reporting and which is referred to by the IASB during the development of new and amended standards

(b) IFRS Practice Statement 1 *Management Commentary*, which provides a broad, non-binding framework for the presentation of a management commentary to accompany a set of financial statements (see Chapter 3)

(c) IFRS Practice Statement 2 *Making Materiality Judgements*, which provides guidance on the making of materiality judgements when preparing general purpose financial statements (see Chapter 3).

Part 1

INTRODUCTION TO FINANCIAL REPORTING

Chapter 1

The regulatory framework

Introduction

Financial reporting is the branch of accounting that deals with the preparation of financial statements. These statements provide information about the financial performance and financial position of the business to which they relate and may be of value to a wide range of user groups. More specifically, the term "financial reporting" is most often used to refer to the preparation of financial statements for a limited company. In this case, the principal users of the statements are the company's shareholders. However, the information which is contained in financial statements may also be of use to other user groups such as lenders, employees and the tax authorities (see Chapter 2).

The purpose of this book is to explain the rules which govern the preparation of financial statements for organisations which comply with international standards. This first chapter introduces the *regulatory framework* within which financial statements are prepared. The next chapter outlines the main features of a *conceptual framework* setting out the main concepts which underlie financial reporting.

Objectives

By the end of this chapter, the reader should be able to:

- list the main sources of accounting regulations and explain the need for regulation
- explain the term "generally accepted accounting practice" (GAAP)
- outline the structure and functions of the International Accounting Standards Board (IASB®) and its associated bodies
- explain the purpose of an accounting standard and list the main steps in the standard-setting process adopted by the IASB
- outline the structure of an international financial reporting standard or international accounting standard
- explain the main features of IFRS1 *First-time Adoption of International Financial Reporting Standards*.

The need for regulation

Small business organisations are usually managed by their owners. This is generally the situation for sole traders, where the business is run by a single owner-manager, and for partnerships, where the business is owned and managed by its partners. Similarly, small private limited companies are often managed by their shareholders, who might all be members of the same family. In these circumstances, the owner or owners of the business can normally glean considerable amounts of financial information from their day-to-day involvement in managing its affairs and so do not depend solely upon formal financial statements to provide them with this information.

In contrast, large businesses (which are usually limited companies) are generally owned by one group of people but are managed by a different group. A large public company is owned by its shareholders, of whom there may be many thousands, but is managed by a small group of directors. Although some of the shareholders may also act as directors, it is likely that the large majority of the shareholders have no direct involvement in managing the company which they own. Such shareholders are almost entirely reliant upon the company's financial statements for information regarding their company's financial performance and position and to help them determine whether or not the company is being properly managed. Other external user groups (such as the company's creditors) are also dependent to a large extent upon the information contained in financial statements when trying to make economic decisions relating to the company.

If the form and the content of financial statements were not regulated, it would be possible for incompetent or unscrupulous directors to provide shareholders and other users with financial statements which gave a false or misleading impression of the company's financial situation. This would inevitably cause users to make poor economic decisions and so undermine the whole purpose of preparing financial statements. Therefore it is vitally important, especially in the case of larger companies, that financial reporting should be subject to a body of rules and regulations.

Sources of regulation

The rules and regulations which apply to financial reporting may be collectively referred to as the "regulatory framework". In practice, most of this framework applies only to companies, but it is important to realise that financial reporting regulations could be made in relation to any class of business entity. Indeed, the international standards which are the subject of this textbook generally refer to "entities" rather than companies. However, it may be assumed for the remainder of the book that we are dealing primarily with financial reporting by companies. The regulatory framework which applies to financial reporting by companies consists of the following main components:

(a) legislation

(b) accounting standards

(c) stock exchange regulations.

Each of these is explained below.

Legislation

Most of the developed countries of the world have enacted legislation which governs financial reporting by limited companies. This legislation does of course differ from one country to another. In the UK, for example, the Companies Act 2006 contains rules which relate to matters such as:

- the accounting records which companies must keep
- the requirement to prepare annual accounts (i.e. financial statements)
- the requirement that these accounts must give a "true and fair view"
- the requirement that the accounts must be prepared in accordance with either UK national standards or UK-adopted international standards†
- certain information which must be provided in the notes to the accounts
- the duty of the directors to prepare a strategic report, a directors' report and (for quoted companies) a director's remuneration report
- the circumstances in which group accounts must be prepared (see Chapter 18)
- the circumstances in which an audit is required
- the company's duty to circulate its accounts to shareholders and (for quoted companies) to make the accounts publicly available on a website.

† *The distinction between national and international standards is explained below. The notion of UK-adopted international standards is considered later in this chapter.*

Accounting standards

Whilst legislation generally sets out the broad rules with which companies must comply when preparing financial statements, detailed rules governing the accounting treatment of transactions and other items shown in those statements are laid down in *accounting standards*. Many of the developed countries of the world have their own standard-setting bodies, each of which is responsible for devising and publishing accounting standards for use in the country concerned. In the UK this is the Financial Reporting Council (FRC). The USA has a Financial Accounting Standards Board (FASB) and there are standard-setters in other countries such as Germany, Japan, Australia etc.

However, the increasing globalisation of business has fuelled the search for one single set of accounting standards. These standards would apply throughout the world and would greatly improve the consistency of financial reporting. To this end, the International Accounting Standards Board (IASB®) has developed and is continuing to develop a set of international standards which it hopes will attain global acceptance. These standards are already used in a great many countries of the world (see later in this chapter).

Most of the remainder of this book is concerned with the international standards and an introduction to the work of the IASB is given later in this chapter.

Stock exchange regulations

A company whose shares are listed (or "quoted") on a recognised stock exchange must comply with the regulations of that stock exchange, some of which may relate to the company's financial statements. A stock exchange may, for example, require its member companies to produce financial statements more frequently than required by law (e.g. to publish interim financial reports at quarterly or half-yearly intervals) or to provide a more detailed analysis of some of the items in its financial statements than is required by law or by accounting standards.

Generally accepted accounting practice

The term "generally accepted accounting practice" (GAAP) refers to the complete set of regulations (from all sources) which apply within a certain jurisdiction, together with any general accounting principles or conventions which are usually applied in that jurisdiction even though they may not be enshrined in regulations. Since accounting rules and regulations may still differ from one country to another, it is correct to use terms such as "UK GAAP", "US GAAP" and so forth. At present, there is no globally accepted set of accounting regulations and principles but the IASB is working towards that goal and is trying to achieve a convergence between the various regulations which are in force throughout the world (see later in this chapter). The term "international GAAP" is used to refer to the standards issued by the IASB and the principles on which those standards are based.

A distinction is sometimes drawn between big GAAP and little GAAP, as follows:

(a) The term "big GAAP" refers to the accounting regulations which apply to large companies (generally listed companies). The financial affairs of these companies can be very complex and therefore the regulations concerned need to be correspondingly complex. Some of the international standards described in this book appear to have been written mainly with large companies in mind.

(b) The term "little GAAP" refers to the simpler accounting regulations which apply to smaller companies. In the UK, for instance, standard FRS102 (the main UK national financial reporting standard) contains special rules for "small entities". Furthermore, "micro-entities" may choose to adopt FRS105 *The Financial Reporting Standard applicable to the Micro-entities Regime*, rather than complying with FRS102.

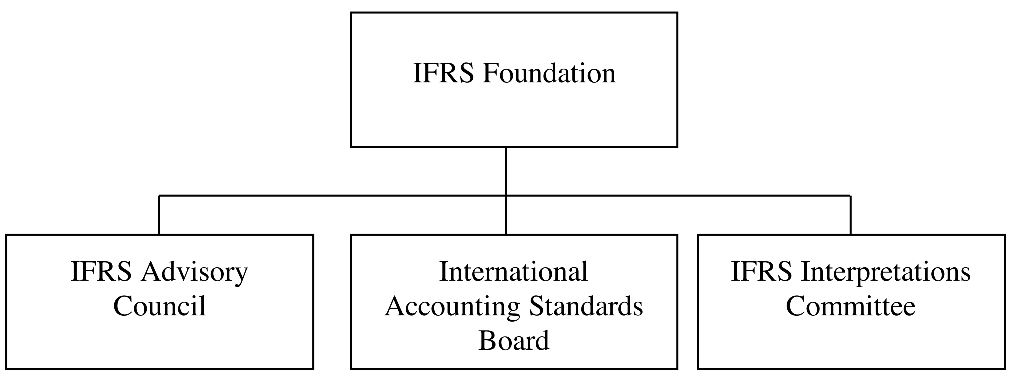
At the international level, the IASB has issued the *IFRS for SMEs®* Standard. This standard is essentially a simplified version of the full international standards and is intended for use by small and medium-sized entities (mainly unlisted companies). A brief summary of the SMEs standard is given in Chapter 25 of this book.

The International Accounting Standards Board

International standards are developed and published by the International Accounting Standards Board (IASB) which was formed in 2001 as a replacement for the International Accounting Standards Committee (IASC). Standards published by the IASB are known as International Financial Reporting Standards (IFRS® Standards). The standards that were published by the IASC are International Accounting Standards (IAS® Standards). Many of these IAS Standards are still in force, since they were adopted by the IASB when it was formed. At present, the list of extant standards comprises sixteen IFRS Standards and twenty-four IAS Standards. A full list of the standards is given at the front of this book.

The IASB consists of fourteen members, of whom up to three may be part-time. The members of the IASB are chosen for their professional competence and their relevant experience and are selected in such a way that a broad geographical balance is maintained on the Board. The current Chair of the IASB is Andreas Barckow, who succeeded Hans Hoogervorst on 1 July 2021.

The IASB is responsible to the Trustees of the IFRS Foundation, as is shown in the following diagram:



As well as the bodies shown in this diagram, the IFRS Foundation has also established a further body known as the International Sustainability Standards Board (ISSB®). So as to distinguish between financial reporting standards issued by the IASB and sustainability standards issued by the ISSB, the IFRS Foundation constitution refers to standards issued by the IASB as "IFRS Accounting Standards" and standards issued by the ISSB as "IFRS Sustainability Disclosure Standards".

This book is almost entirely concerned with IFRS Accounting Standards but the role of the ISSB in developing IFRS Sustainability Disclosure Standards is explained briefly at the end of this chapter.

The IFRS Foundation

The constitution of the IFRS Foundation states that its objectives are as follows:

(a) through the IASB and the ISSB, to develop, in the public interest, high-quality, understandable, enforceable and globally accepted standards (referred to as "IFRS Standards") for general purpose financial reporting based on clearly articulated principles. The IASB is responsible for developing a set of accounting standards ... and the ISSB is responsible for developing a set of sustainability disclosure standards ... These complementary sets of IFRS Standards are intended to result in the provision of high-quality, transparent and comparable information ... that is useful to investors and other participants in the world's capital markets in making economic decisions;

(b) to promote the use and rigorous application of IFRS Standards;

(c) in fulfilling the objectives associated with (a) and (b) above, to take account of, as appropriate, the needs of a range of sizes and types of entities in diverse economic settings;

(d) to promote and facilitate adoption of the IFRS Standards through the convergence of national and regional standards and IFRS Standards.

The activities of the IFRS Foundation are directed by twenty-two Trustees who are appointed subject to approval by a Monitoring Board (see below) and who are drawn from a diversity of geographical and professional backgrounds. The Trustees are responsible for appointing the members of the IASB, the ISSB and the other bodies shown in the above diagram and for establishing and maintaining the funding for their work. The Trustees are also responsible for reviewing the effectiveness of the IASB and ISSB. Financial support for the IFRS Foundation's activities is received from a variety of sources, including:

(a) a number of countries which have established national financing regimes, generally comprising either a levy on companies or a system of publicly supported financing

(b) income from publications and related activities

(c) major international accounting firms.

The Monitoring Board comprises high-level representatives of public authorities such as the European Commission and the US Securities and Exchange Commission. The Trustees are required to make an annual written report to the Monitoring Board.

The IFRS Advisory Council

The IFRS Advisory Council provides a forum for participation by organisations and individuals with an interest in international corporate reporting. The Advisory Council comprises thirty or more members (drawn from diverse geographical and functional backgrounds) and provides broad strategic advice to the Trustees, the IASB and the ISSB. The Chair of the Advisory Council cannot be a member of either the IASB or the ISSB.

The IFRS Interpretations Committee

The main role of the IFRS Interpretations Committee is to interpret the application of IFRS Accounting Standards (issuing "IFRIC® Interpretations") and to provide timely guidance on financial reporting matters which are not specifically addressed in those standards. The Interpretations Committee has fourteen voting members and a non-voting Chair.

The IASB standard-setting process

The IASB develops standards by means of a "due process" which involves wide consultation with interested and affected parties such as investors, business analysts, the preparers of financial statements, national standard-setters, stock exchanges etc. This due process may involve any or all of the following steps:

- identification and review of all the issues associated with the topic area concerned
- consideration of the way in which the IASB *Conceptual Framework* (see Chapter 2) applies to these issues
- a study of national accounting requirements in relation to the topic
- publication of a discussion document and consideration of comments received
- publication of an "exposure draft" of the standard and consideration of comments
- approval and publication of the finalised standard.

Publication of an international standard requires approval by at least nine of the fourteen members of the IASB.

The *Preface to IFRS Standards* states that these standards are designed to apply to the general purpose financial statements (and other financial reporting) of profit-oriented entities, whether organised in corporate form or other forms. For this reason, the standards usually refer to "entities" rather than companies. The word "entity" is also used in this textbook, although in practice the international standards apply principally to companies.

The structure of an international standard

An IFRS Standard or IAS Standard consists of a set of numbered paragraphs and is typically made up of some or all of the following sections:

- objectives and scope of the standard
- definitions of terms used in the standard (these may be in an Appendix)
- the body of the standard
- effective date and transitional provisions
- approval by the IASB and any dissenting opinions by IASB members.

A standard may be accompanied by a Basis for Conclusions, which is not actually part of the standard itself but which sets out the considerations which were taken into account when the standard was devised. There may also be application or implementation guidance and illustrative examples.

The purpose of accounting standards

The main purpose of accounting standards (whether national or international) is to reduce or eliminate variations in accounting practice and to introduce a degree of uniformity into financial reporting. In particular, accounting standards usually set out requirements with regard to the recognition, measurement, presentation and disclosure of transactions and other items in financial statements. The main advantages of this standardisation are as follows:

(a) **Faithful representation**. If the preparers of a set of financial statements are obliged to comply with accounting standards, then it is much more likely that the information given in the statements will provide a faithful representation of the financial performance and financial position of the organisation concerned. Accounting standards help to ensure that financial reporting is free from bias and that "creative accounting" practices are outlawed.

(b) **Comparability**. It is important that users should be able to compare the financial statements of an organisation over time so as to identify trends in its financial performance and position. It is also important that users should be able to compare the financial statements of different organisations and assess their relative strengths and weaknesses. Such comparisons will not be meaningful unless all of the financial statements concerned have been drawn up on a consistent basis. This is much more likely to be the case if accounting standards have been observed.

A more detailed explanation of these and certain other "qualitative characteristics" of the information that is provided in financial statements is given in the IASB *Conceptual Framework* (see Chapter 2).

It is the view of the IASB that standards should ensure that like items are accounted for in a like way and that unlike items are accounted for in different ways. Therefore the IFRS Standards issued by the IASB do not generally permit a choice of accounting treatment. Some of the IAS Standards which were adopted by the IASB on its inception do allow a choice of accounting treatment but the IASB has reconsidered (and will continue to reconsider) the items for which a choice of treatment is permitted, with a view to reducing the number of choices available or eliminating choice altogether.

It could, of course, be argued that accounting standards should allow some degree of flexibility and that compliance with the single accounting treatment which is permitted by a standard might sometimes be inappropriate. The IASB takes the view that this situation is very unlikely to occur. However, international standard IAS1 (see Chapter 3) allows an entity to depart from the requirements of a standard in the "extremely rare circumstances" in which compliance would prevent the financial statements from faithfully representing transactions and other items.

Worldwide use of international standards

As stated above, the main objective of the IFRS Foundation is to develop a set of global accounting standards, promote their use and bring about convergence between national standards and international standards. This goal has not yet been achieved in full but the worldwide influence of international standards has increased significantly since the IASB was formed and this process seems likely to continue.

At present, over 140 countries require all or most domestic listed companies to comply with IFRS Standards† when preparing their group accounts (see Chapter 18). The countries concerned include the UK (see below) and all EU member states, together with countries such as Australia, Brazil, Canada, Russia and South Korea. The use of IFRS Standards is permitted (but not required) in several other countries. Furthermore:

(a) India's national standards are largely converged with IFRS Standards. Most listed companies and large unlisted companies are required to comply with these standards.

(b) Japan permits most listed companies to use IFRS Standards.

(c) China has substantially converged its national standards with IFRS Standards.

(d) Hong Kong has fully converged its national standards with IFRS Standards.

(e) The US Financial Accounting Standards Board (FASB) has been working with the IASB on a number of convergence projects and foreign companies listed on US stock exchanges are already permitted to use IFRS Standards. Whether these standards will eventually be adopted for US domestic companies remains to be seen.

† *Note that, in this context, the term "IFRS Standards" refers to the international standards in their entirety, including IFRS Standards, IAS Standards and IFRIC Interpretations.*

Perhaps understandably, international standards have made rather less impact in relation to unlisted companies, which tend to have straightforward financial affairs and to operate in one country only. However, over 80 countries now require or permit unlisted companies to use the *IFRS for SMEs* Standard (see Chapter 25).

The UK Endorsement Board

For accounting periods commencing on or after 1 January 2021 (the end of the "transition period" for the UK's departure from the EU) Companies Act 2006 requires UK listed companies to apply "UK-adopted international accounting standards" when preparing their group financial statements. These standards comprise all international standards approved by the EU as at the end of the transition period, together with any further standards (or amendments to standards) issued since that date by the IASB and endorsed for use in the UK by the newly-established UK Endorsement Board (UKEB).

At the time of writing, there have been no new international standards since the end of the transition period, though there have been some amendments. The UKEB has endorsed many of these and is considering others but it is too early to say whether UK-adopted international standards will eventually diverge from the full IFRS Standards.

First-time adoption of international standards

In 2003, the IASB issued IFRS1 *First-time Adoption of International Financial Reporting Standards*. The objective of IFRS1 is to ensure that an entity's first financial statements which comply with international standards should contain high-quality information that:

(a) is transparent for users and comparable for all periods presented
(b) provides a suitable starting point for accounting under international standards
(c) can be generated at a cost that does not exceed the benefits to users.

The main features of IFRS1 are as follows:

(a) An entity's "first IFRS† financial statements" are defined as the first financial statements in which the entity adopts international standards and makes an explicit and unreserved statement of compliance with those standards.

   † *This standard uses the term "IFRS" to refer to the international standards in their entirety, including IFRS Standards, IAS Standards and IFRIC Interpretations.*

(b) The "first IFRS reporting period" is defined to be the reporting period covered by the first IFRS financial statements.

(c) The "date of transition" to international standards is defined as the beginning of the earliest period for which an entity presents comparative information in its first IFRS financial statements. Most financial statements cover a period of one year and give comparative information for the previous year. Thus the date of transition is normally the date which falls two years before the end of the first IFRS reporting period.

(d) When first adopting international standards, an entity must prepare an "opening IFRS statement of financial position" as at the date of transition. This is the starting point for accounting in accordance with international standards. The opening IFRS statement of financial position must comply with international standards *as at the end of the first IFRS reporting period* and should:

   (i) recognise all assets and liabilities whose recognition is required by international standards, but not recognise items as assets or as liabilities if this is not permitted by international standards
   (ii) reclassify items which were recognised as one type of asset or liability under previous GAAP but which are classified as a different type of asset or liability under international standards
   (iii) apply international standards in measuring all recognised assets and liabilities.

   Note that the term "statement of financial position" has now replaced the term "balance sheet" throughout the international standards (see Chapter 3).

(e) The same accounting policies must be used in the entity's opening IFRS statement of financial position and in all the periods presented in the first IFRS financial statements (i.e. the first IFRS reporting period and the comparative period(s)). These accounting policies (and these financial statements) must comply with all international standards in effect *as at the end of the first IFRS reporting period*, even if some of those standards were not actually in effect at the date of transition or during some or all of the periods for which information is being presented.

(f) The first IFRS financial statements must include the following reconciliations:

(i) a reconciliation of equity (share capital and reserves for a company) as reported under previous GAAP with equity re-calculated under international standards, for the date of transition and for the end of the last period in which the entity reported under previous GAAP

(ii) a reconciliation of total comprehensive income for the last period in which the entity reported under previous GAAP with total comprehensive income as re-calculated under international standards.

Note that the term "total comprehensive income" refers to an entity's profit or loss together with certain other gains or losses such as revaluation gains (see Chapter 3).

(g) IFRS1 grants limited exemptions from some of its requirements, generally in cases where full compliance would involve undue cost or effort.

EXAMPLE

A company which has always prepared financial statements to 31 December each year prepares its first IFRS financial statements for the year to 31 December 2022. These statements show comparative figures for the year to 31 December 2021.

(a) Identify the first IFRS reporting period and state the date of transition.

(b) Explain the procedure which must be followed in order to prepare the financial statements for the year to 31 December 2022.

(c) Identify the reconciliations which the company must include in its financial statements for the year to 31 December 2022.

Solution

(a) The first IFRS reporting period is the year to 31 December 2022. The date of transition to international standards is therefore the start of business on 1 January 2021, which is equivalent to the close of business on 31 December 2020.

(b) (i) An opening IFRS statement of financial position as at 31 December 2020 must be prepared in accordance with all international standards that are effective for accounting periods ending on 31 December 2022.

(ii) The company must then prepare a revised version of its financial statements for the year to 31 December 2021, once again applying all international standards effective for periods ending on 31 December 2022. This provides comparative figures for the 2022 financial statements.

(iii) The financial statements for the year to 31 December 2022 are then prepared.

(c) The required reconciliations are:

  (i) a reconciliation of the company's equity (i.e. share capital and reserves) as reported under previous GAAP with equity as calculated under international standards, at both 31 December 2020 and 31 December 2021.

  (ii) a reconciliation of the company's total comprehensive income as reported under previous GAAP for the year to 31 December 2021 with total comprehensive income for that year as calculated under international standards.

The International Sustainability Standards Board

In November 2021, the Trustees of the IFRS Foundation announced the formation of the International Sustainability Standards Board (ISSB). The role of the ISSB is to develop, in the public interest, a comprehensive global set of high-quality sustainability disclosure standards that meet the information needs of investors with regard to climate change and other sustainability issues.

Investors and other providers of capital (e.g. lenders) need to assess the risks and the opportunities facing individual companies from environmental matters. This need creates a significant demand for high-quality sustainability disclosure standards which will result in globally comparable sustainability reporting (in much the same way as the accounting standards developed by the IASB result in globally comparable financial reporting). For instance, sustainability disclosure standards might be developed in relation to:

(a) the environmental risks and opportunities to which an entity is exposed

(b) the entity's environmental policies and targets

(c) the entity's strategies (and timelines) for reaching those targets

(d) an analysis of the performance of the entity in achieving environmental targets set in previous reporting periods.

The ISSB will normally consist of fourteen members, of whom a minority may be part-time. The members of the ISSB will be chosen for their professional competence and relevant experience and will be selected in such a way that a broad geographical balance is maintained on the Board. The Trustees of the IFRS Foundation will appoint one of these members to be the Chair of the ISSB.

The ISSB will work in close co-operation with the IASB, ensuring compatibility between IFRS Accounting Standards and the standards issued by the ISSB, referred to as "IFRS Sustainability Disclosure Standards". The IASB and the ISSB will be independent from each other but both boards will be overseen by the IFRS Foundation.

Summary

- The regulatory framework within which the financial statements of companies are prepared consists of a mixture of legislation, accounting standards and (where applicable) stock exchange regulations.
- Legislation generally sets out the broad rules with which companies must comply when preparing their financial statements. Accounting standards provide detailed rules regarding the accounting treatment of transactions and other items.
- The increasing globalisation of business has led to the establishment of the IASB and the development of international standards. These standards have not yet achieved global acceptance but their influence has increased greatly in recent years.
- The term "generally accepted accounting practice" (GAAP) refers to the complete set of accounting regulations and principles which are usually applied within a certain jurisdiction.
- The IASB issues IFRS accounting standards and is responsible to the Trustees of the IFRS Foundation. The IFRS Advisory Council provides broad strategic advice to the Trustees, the IASB and the newly-formed ISSB. The IFRS Interpretations Committee is responsible for the interpretation of international standards and for providing timely guidance on matters not specifically addressed in the standards.
- The standard-setting process adopted by the IASB usually involves the publication of a discussion document and an exposure draft (with consideration of comments received at each stage) before the final standard is published.
- The main purpose of accounting standards is to reduce or eliminate variations in accounting practice and to introduce a degree of uniformity into financial reporting.
- IFRS1 *First-time Adoption of International Financial Reporting Standards* sets out the procedure which must be followed when an entity adopts international standards for the first time.

Exercises

A set of multiple choice questions for this chapter is available on the accompanying website.

1.1 Explain the term "regulatory framework" as it applies to financial reporting. Why is this framework needed?

1.2 Outline the structure and functions of the following bodies:

(a) the IFRS Foundation
(b) the International Accounting Standards Board
(c) the IFRS Advisory Council
(d) the IFRS Interpretations Committee.

1.3 Explain the term "generally accepted accounting practice" (GAAP). Is there just one GAAP which is accepted worldwide? If not, why not?

1.4 Outline the structure of an IFRS Accounting Standard.

1.5 Explain the purpose of accounting standards (whether national or international) and identify the advantages that stem from the standardisation of accounting practice. Are there any disadvantages?

1.6 A company adopts international standards for the first time when preparing its financial statements for the year to 30 June 2023. These financial statements show comparative figures for the previous two years.

Explain the main requirements of IFRS1 *First-time Adoption of International Financial Reporting Standards* which must be satisfied when preparing the company's financial statements for the year to 30 June 2023.

1.7 The International Accounting Standards Board (IASB) develops IFRS Accounting Standards by means of a "due process". The main stages of this process are listed in the IASB *Due Process Handbook*. The "scope" of IFRS standards is identified in the *Preface to IFRS Standards*.

(a) List the main stages of the IASB due process.

(b) State the scope of IFRS Accounting Standards (i.e. the types of financial reports to which these standards are intended to apply).

*__1.8__ Baxen is a public limited company that currently uses local accounting standards for its financial reporting. However, the board of directors of Baxen is considering the adoption of IFRS in the near future. The company has ambitious growth plans which will involve extensive trading with many foreign companies and the possibility of acquiring at least one of its trading partners as a subsidiary.

Required:

Identify the advantages that Baxen could gain by adopting IFRS. *(ACCA)*

*__1.9__ IFRS1 *First-time Adoption of International Financial Reporting Standards* lays down the procedure which must be followed when an entity prepares its first financial statements that comply with IFRS Standards and IAS Standards.

(a) State the objective of IFRS1.

(b) Explain the terms "first IFRS reporting period" and "date of transition" as defined by IFRS1.

(c) A company adopts international standards for the first time in its financial statements for the year to 31 October 2023. These financial statements provide comparative figures for the previous five years. Explain the requirements of IFRS1 which must be satisfied when preparing these financial statements.

Chapter 2

The IASB conceptual framework

Introduction

A "conceptual framework" for financial reporting consists of a coherent set of fundamental principles which underpin financial accounting and so provide a sound theoretical basis for the development of accounting standards. Amongst other things, a conceptual framework should consider the objectives of financial statements, the elements from which these statements are built, the circumstances in which elements may be shown ("recognised") in the financial statements and the ways in which elements are measured and presented.

In the absence of a conceptual framework, accounting standards are more difficult to develop since each standard must begin from scratch. It is also more likely that there will be inconsistencies and contradictions between one standard and another.

The IASB contribution to the development of a conceptual framework is its *Conceptual Framework for Financial Reporting*. Although devised by a standard-setting body, the IASB *Conceptual Framework* is not itself an accounting standard and does not override the standards. If there is any conflict between the *Conceptual Framework* and an international standard, then the standard prevails. But the *Conceptual Framework* identifies certain concepts which, in the view of the IASB, underlie the preparation and presentation of financial statements. The purpose of this chapter is to explain these concepts.

Development of the Conceptual Framework

The completed version of the IASB *Conceptual Framework* was issued in March 2018 and replaced the *Framework for the Preparation and Presentation of Financial Statements* which was issued in 1989 by the IASB's predecessor body (the IASC).

The first phase of the *Conceptual Framework* was published in 2010 as the result of a collaborative project between the IASB and the US FASB. This phase consisted of two sections which dealt with the objectives of financial reporting and the qualitative characteristics of useful financial information. However, the further development of the *Conceptual Framework* between 2011 and 2018 (comprising some minor changes to the two existing sections, plus a further six sections) was not conducted jointly with the US FASB.

Objectives

By the end of this chapter, the reader should be able to:

- state the main purposes of the IASB *Conceptual Framework*
- state the objective of general purpose financial reporting and identify the primary users of financial reports
- state and explain the qualitative characteristics of useful financial information
- explain the "going concern" assumption which usually underlies the preparation of financial statements
- define each of the main elements of financial statements
- explain the criteria which determine whether or not an element should be recognised in the financial statements
- explain the measurement bases which are identified in the *Conceptual Framework* and the factors which should be considered when selecting a measurement basis
- distinguish between financial capital maintenance and physical capital maintenance.

Purpose and status of the IASB *Conceptual Framework*

The IASB *Conceptual Framework for Financial Reporting* states the objective of general purpose financial reporting and then sets out the concepts that underlie the preparation of general purpose financial reports. The main purposes of the *Conceptual Framework* are:

(a) to assist the IASB in the development of international standards that are based on consistent concepts

(b) to assist those who prepare financial reports to develop consistent accounting policies (see Chapter 4) when no international standard applies to a particular transaction or event, or when an international standard permits a choice of accounting policy

(c) to assist all parties to understand and interpret the international standards.

As stated above, the *Conceptual Framework* is not itself an international standard and does not override the standards. But the *Conceptual Framework* provides the foundation for standards which enhance the comparability and quality of financial information, providing the information needed to hold management to account and helping investors to identify opportunities and risks. The use of a single set of international standards based on the *Conceptual Framework* also reduces financial reporting costs.

Contents of the IASB Conceptual Framework

The March 2018 version of the *Conceptual Framework* deals with the following matters:

1. The objective of general purpose financial reporting

2. Qualitative characteristics of useful financial information
3. Financial statements and the reporting entity
4. The elements of financial statements
5. Recognition and derecognition of the elements of financial statements
6. Measurement of the elements of financial statements
7. Presentation and disclosure
8. Concepts of capital and capital maintenance

Each of these is explained below.

Objective of general purpose financial reporting

The *Conceptual Framework* states that the objective of general purpose financial reporting is "*to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions relating to providing resources to the entity*". Such decisions may be concerned with buying, selling or holding equity in the entity (e.g. shares), providing credit to the entity (e.g. loans) or voting on the actions of the entity's management. Existing and potential investors, lenders and other creditors are referred to collectively as the "primary users" of general purpose financial reports. In more detail, the *Conceptual Framework* states that:

(a) Decisions by existing and potential investors depend upon the returns they expect to receive from an investment in the entity concerned (e.g. dividends or increases in the market value of the entity's shares). Decisions by lenders and other creditors also depend upon the expected returns (e.g. loan interest and debt repayments). Therefore these "primary users" need information that will help them in assessing the amount, timing (and degree of uncertainty) of future cash inflows to the entity. This includes information about the entity's economic resources, claims against the entity and changes in those resources and claims.

Decisions by the primary users will also depend upon their assessment of the entity's management and its "stewardship" of the entity's resources. Therefore information is needed about the efficiency and effectiveness with which the entity's management has used those resources.

(b) The primary users cannot require an entity to provide information directly to them and so they rely on general purpose financial reports for much of the information which they need. However, these financial reports cannot provide all of the required information and primary users will also need to consider information from other sources (e.g. general economic forecasts, industry outlooks etc.).

(c) General purpose financial reports are not designed to show the value of the reporting entity but may help primary users to estimate the entity's value.

(d) Individual primary users may have differing information needs. When developing international standards, the IASB seeks to ensure that financial reports prepared in accordance with those standards will provide information that meets the needs of the maximum number of primary users. However, there is nothing that prevents an entity from disclosing additional information that might be useful to a particular subset of primary users.

(e) Financial reports are based to some extent upon estimates, judgements and models and so cannot be exact. The *Conceptual Framework* establishes the concepts that underlie those estimates, judgements and models.

(f) In addition to the primary users, other parties might find general purpose financial reports useful, although these reports are not primarily intended for their benefit. The *Conceptual Framework* does not list these other parties but the IASC *Framework* issued in 1989 indicated that the users of financial reports might also include:

   (i) employees and their representatives, who may use financial reports to help them assess the profitability and stability of an entity and so determine the entity's ability to provide employment opportunities, fair pay and retirement pensions

   (ii) customers, who may use financial reports to help them assess whether the entity is likely to continue in business and so act as a reliable source of supply

   (iii) governments and their agencies, who may use the information provided in financial reports to help determine taxation policies, regulate business and compile national statistics

   (iv) the public, who may wish to assess an entity's prosperity and developments in its range of activities, especially if that entity is making a substantial contribution to the local economy (e.g. by providing local employment or by its patronage of local suppliers).

   The management of an entity is obviously interested in financial information about that entity. However, management is able to obtain financial information internally and so does not rely upon general purpose financial reports.

Information about an entity's resources and claims

General purpose financial reports should provide information about the *financial position* of the reporting entity (i.e. information about the entity's economic resources and claims against the entity). Such financial reports should also provide information about transactions and other events that change the entity's financial position. Changes in financial position may result from the entity's *financial performance* (e.g. the making of a profit) or perhaps from other events such as share issues. Both of these types of information are useful when making decisions about providing resources to the entity. Note that:

(a) Information about an entity's financial position helps primary users to identify that entity's financial strengths and weaknesses and to assess its liquidity and solvency.

(b) Information about an entity's financial performance helps primary users to understand the return that the entity has made on the resources at its disposal and whether those resources have been managed efficiently and effectively (so helping users to assess the stewardship of management). Information about past financial performance may also be useful when predicting future returns on an entity's economic resources.

(c) Financial performance information is prepared on an "accrual accounting" basis. This means that transactions and other events are recognised in the periods in which they occur (not necessarily the periods in which cash is received or paid). This approach provides better financial performance information than information based solely on cash receipts and payments occurring during a reporting period.

However, information about cash flows during a period is also important, since it indicates how an entity generates and spends cash and helps users to assess the entity's ability to generate future net cash inflows.

(d) Finally, information about changes in an entity's financial position which have not resulted from its financial performance (e.g. changes caused by share issues) is also necessary since it gives users a complete understanding of how and why the entity's financial position has changed.

This section of the IASB *Conceptual Framework* does not specify (or name) the financial statements in which each of the four classes of information that are listed above should be presented. However, financial statements are introduced in a later section under the heading "Financial statements and the reporting entity" (see below) and the four main financial statements are identified in international standard IAS1 (see Chapter 3).

Qualitative characteristics of financial information

The *Conceptual Framework* identifies six "qualitative characteristics" of useful financial information. These six characteristics indicate the types of information that are likely to be most useful to the primary users of financial reports. Two of the qualitative characteristics are stated to be "fundamental". These are:

- relevance
- faithful representation.

The remaining four qualitative characteristics are described as "enhancing characteristics" since they further enhance the usefulness of financial information that is already relevant and faithfully represented. The enhancing characteristics are:

- comparability
- verifiability
- timeliness
- understandability.

Each of these characteristics is explained below.

Relevance

The first fundamental qualitative characteristic of useful financial information is that it should be relevant to users' decision-making needs (i.e. capable of making a difference to user decisions). Irrelevant information is obviously not useful. In particular, information is relevant if it has predictive value or confirmatory value, as follows:

(a) Information has "predictive value" if can help users to predict future outcomes (e.g. future financial performance). In order to have predictive value, information does not have to take the form of an explicit forecast, since information on past transactions or events may be used as a basis for predictions about the future.

(b) Information has "confirmatory value" if it provides feedback which helps to confirm or refute previous predictions.

The relevance of financial information is affected not only by its nature but also by its level of materiality. Materiality is mainly concerned with the size or monetary amount of an item and information is said to be "material" if omitting, mis-stating or obscuring it could influence users' decisions. Information about an item which is so small as to be immaterial is not relevant to users' needs. The IASB cannot specify a generally applicable materiality threshold, since materiality is entity-specific, but IFRS Practice Statement 2 *Making Materiality Judgements* (see Chapter 3) provides guidance on this matter.

Faithful representation

The second fundamental qualitative characteristic of useful financial information is that it must faithfully represent the transactions and other events that it purports to represent. A perfectly faithful representation would be *complete*, *neutral* and *free from error*. The objective of the IASB is to maximise these qualities to as great an extent as possible.

(a) **Completeness**. Financial information is complete if it includes all of the information required in order that a user should understand the transactions and other events being represented, including all necessary descriptions and explanations.

(b) **Neutrality**. A neutral representation is one that is unbiased. Financial information is not neutral if it is manipulated in some way to achieve a predetermined result, with the aim of increasing the probability that the information will be received favourably (or unfavourably) by users.

The *Conceptual Framework* states that neutrality is supported by the application of prudence, where "prudence" is the exercise of due caution when making judgements under conditions of uncertainty. Although prudence does not necessarily imply an asymmetric approach to financial reporting (e.g. a tendency to understate assets and income or to overstate liabilities and expenses) it is accepted that certain international standards may adopt such an approach so as to provide users with information which is relevant to their needs and which gives a faithful representation.

(c) **Freedom from error**. Financial information does not have to be 100% accurate but it must be free from material error. Freedom from error implies that there are no errors or omissions in the description of the items being represented and that no errors have been made when selecting and applying the process used to produce the reported information. For instance, an estimate can be regarded as free from error as long as the amount is clearly described as being an estimate, the estimating process is fully explained and no errors are made when selecting or applying that process.

The *Conceptual Framework* makes it clear that the use of reasonable estimates is essential to the preparation of financial information and does not undermine the usefulness of that information, as long as the estimates are clearly explained.

Furthermore, financial information must represent the economic substance of transactions and other events. If the legal form of such transactions and events differs from their economic substance, then providing information only about their legal form would not give a faithful representation. This is the "substance over form" concept.

Finally, financial information must both be relevant and provide a faithful representation. A faithful representation of irrelevant information would not help users to make good decisions. Nor would an unfaithful representation of relevant information.

Enhancing qualitative characteristics

As stated above, the enhancing qualitative characteristics are comparability, verifiability, timeliness and understandability. These characteristics enhance the usefulness of financial information which is already both relevant and faithfully represented.

(a) **Comparability**. This characteristic enables users to compare financial information about an entity for a reporting period with similar information about other entities for the same period and with similar information about the same entity for other periods. Such comparisons will help users to make economic decisions.

Comparability is improved through consistency. Consistency refers to the use of the same accounting treatments for the same types of item, either from period to period by one reporting entity or in a single period across entities. The IASB takes the view that permitting alternative accounting treatments for an item diminishes consistency and therefore diminishes comparability. This is an argument in favour of the IASB's stated intention of reducing the number of choices of accounting treatment allowed by international standards or possibly eliminating choice altogether (see Chapter 1).

(b) **Verifiability**. Financial information is said to be "verifiable" if independent, knowledgeable observers are able to agree that the information concerned gives a faithful representation. Verification may be direct or indirect.

Direct verification involves direct observation (e.g. counting cash). Indirect verification involves checking the inputs to a model and then recalculating the outputs of that model. For example, closing inventory measured by the FIFO cost formula (see Chapter 10) may be verified by checking inventory movements and costs during the reporting period and then using the FIFO formula to recalculate closing inventory.

(c) **Timeliness**. Financial information is timely if it is made available to users in time for it to be capable of influencing their economic decisions.

(d) **Understandability**. It is clearly desirable that the information provided in financial reports should be understandable by users. Incomprehensible information would have no value. The understandability of financial information is improved if it is classified and presented clearly and concisely. But omitting unavoidably complex information from financial reports on the grounds that it would be difficult to understand is not acceptable since this would make those reports incomplete.

The IASB *Conceptual Framework* states that financial reports are prepared for users who "have a reasonable knowledge of business and economic activities and who review and analyse the information diligently". These are the users who should generally be able to understand financial reports. However, it is accepted that even well-informed users may sometimes need the help of an advisor to understand information about complex transactions and other events.

The cost constraint on useful financial reporting

The *Conceptual Framework* recognises that there are cost constraints on the information which can be provided in financial reports. Reporting financial information imposes costs and obviously these costs should be justified by the benefits of reporting that information. Although the costs of financial reporting are borne initially by the providers of financial reports, these costs are borne ultimately by users (e.g. shareholders) in the form of reduced returns (e.g. lower profits). Users may also bear the additional costs of analysing and interpreting the information provided in financial reports.

When developing an international standard, the IASB assesses whether the benefits of reporting the information required by that standard are likely to justify the costs incurred to provide and use it. This assessment is conducted in the light of information obtained from providers, users, auditors and others about the expected costs and benefits.

Financial statements and the reporting entity

The remaining sections of the *Conceptual Framework* discuss the information provided in general purpose financial statements,. The objective of financial statements is:

" *to provide financial information about the reporting entity's assets, liabilities, equity, income and expenses that is useful to users of financial statements in assessing the prospects for future net cash inflows to the reporting entity and in assessing management's stewardship of the entity's economic resources*".

This information is provided in the following financial statements:

(a) a statement of financial position, which shows or "recognises" the entity's assets, its liabilities and its equity (i.e. share capital and reserves for a company)

(b) a statement of financial performance, showing the entity's income and expenses

(c) other statements and notes which present information relating to matters such as the entity's cash flows, the contributions received from equity holders (and distributions made to them) and the methods, assumptions and judgements used in preparing the financial statements.

Financial statements are prepared for a specified period of time (a "reporting period") and they should also provide comparative information for at least one preceding period. The financial statements do not typically provide forward-looking information, such as management forecasts. A reporting entity may be a single entity (e.g. a single company) or may comprise more than one entity. For instance, "consolidated" financial statements may be prepared for a group of companies (see Chapter 18).

Going concern assumption

The *Conceptual Framework* states that financial statements are normally prepared on the assumption that the reporting entity is a "going concern" and will continue in operation for the foreseeable future. It is assumed that the entity has neither the intention nor the need to close down or materially reduce the scale of its operations. This allows (for example) the net realisable value of inventories to be based upon their normal sale price and items such as property, plant and equipment to be depreciated over their normal useful lives.

However, if an entity is not a going concern, the financial statements will have to be prepared on a different basis and that basis should be disclosed.

Elements of financial statements

This section of the *Conceptual Framework* identifies the main elements of financial statements and provides a definition of each element. The most important definitions are those of "asset" and "liability" since each of the other elements is defined in terms of its relationship to an entity's assets or liabilities.

Elements relating to financial position

The elements directly related to the measurement of financial position are assets, liabilities and equity. These are defined as follows:

(a) **Assets**. An asset is "*a present economic resource controlled by the entity as a result of past events*". An economic resource is "*a right that has the potential to produce economic benefits*". Note the following points with regard to this definition:

- Rights that have the potential to produce economic benefits include the right to receive money (e.g. a trade receivable), the right to receive goods or services (e.g. a prepayment), rights over physical items (e.g. property, plant and equipment or inventories) and the right to use intellectual property.

- There is no requirement for an item to be legally *owned* by the entity concerned in order that it should qualify as an asset, merely that it should be *controlled* by the entity. This means that certain leased items may be classified as assets (see Chapter 9). This is an application of the principle of substance over form.
- An asset can arise only as the result of a past event. Expected future transactions (e.g. the intention to buy an item) do not give rise to assets at the present time.
- An item cannot be classed as an asset unless it is has the potential of generating future economic benefits for the entity. But if this potential is low, it is possible that the item might not be shown or "recognised" in the entity's statement of financial position (see later in this chapter).

(b) **Liabilities**. A liability is "*a present obligation of the entity to transfer an economic resource as a result of past events*". Note that:

- An essential characteristic of a liability is that the entity must be under an obligation. This means that the entity must have a duty or responsibility to transfer economic resources to another party. However, there is no requirement that the obligation should be legally enforceable, even though this would normally be the case. For instance, if it is an entity's policy to rectify faults in its products even after the warranty period has expired, the amounts expected to be expended in relation to goods already sold are indeed obligations of the entity, even though they are not legally enforceable. Such obligations are known as "constructive obligations" (see Chapter 12).
- A further characteristic of a liability is that the obligation must be a *present* obligation, not a future commitment. For instance, a decision by management to buy an asset in the future does not give rise to a present obligation to pay for the asset, since the decision could be reversed. A present obligation is one that the entity cannot practically avoid.
- A liability can arise only as the result of a past event. A present obligation exists as a result of past events if the entity has already obtained economic benefits (e.g. by receiving goods or services) or has taken an action and, in consequence, is now under an obligation to transfer economic resources (e.g. to make a payment).
- An obligation cannot be classed as a liability unless it is has the potential of requiring the entity to transfer economic resources to another party. But if this potential is low, it is possible that the obligation might not be recognised in the entity's statement of financial position (see later in this chapter).

(c) **Equity**. Equity is "*the residual interest in the assets of the entity after deducting all its liabilities*". This is of course an expression of the well-known accounting equation (assets = liabilities + capital). But the *Conceptual Framework* uses the term "equity" rather than "capital". In the case of a company, equity will usually consist of share capital, retained earnings and other reserves. These are referred to in the *Conceptual Framework* as "components of equity".

Elements relating to financial performance

The elements directly related to the measurement of financial performance are income and expenses. These are defined as follows:

(a) **Income**. Income is "*increases in assets, or decreases in liabilities, that result in increases in equity, other than those relating to contributions from holders of equity claims*". Note that:

- The term "income" encompasses both revenue which arises in the course of an entity's ordinary activities and also gains (e.g. gains arising on the disposal or revaluation of long-term assets).
- Income is defined in terms of an increase in net assets but does not include increases caused by contributions from equity holders (e.g. share issues).

(b) **Expenses**. Expenses are "*decreases in assets, or increases in liabilities, that result in decreases in equity, other than those relating to distributions to holders of equity claims*". Note that:

- The term "expenses" encompasses both expenses which arise in the course of an entity's ordinary activities and also losses (e.g. losses arising on the disposal or revaluation of long-term assets).
- Expenses are defined in terms of a decrease in net assets but do not include decreases caused by distributions to equity holders (e.g. dividends).

The fact that income and expenses are both defined in terms of increases or decreases in net assets means that profits (or losses) are also defined in these terms.

Recognition of the elements of financial statements

Recognition is defined as "... *the process of capturing for inclusion in the statement of financial position or the statement(s) of financial performance an item that meets the definition of one of the elements of financial statements*". Recognition of an item in a financial statement involves depicting that item in words and by a monetary amount and "*including that amount in one or more totals in that statement*". Items which are merely disclosed in the notes that accompany the financial statements have not been recognised.

The *Conceptual Framework* states that an asset or liability should be recognised only if the recognition of that asset or liability (and any resulting income, expenses or changes in equity) would provide users of the financial statements with useful information. In other words, the information provided must be relevant to user needs and must offer a faithful representation. Whether recognising an asset or liability provides useful information (at a cost that does not outweigh benefits) is a matter of judgement and depends upon the facts of the case. Recognition might <u>not</u> provide useful information if (for example):

(a) there is uncertainty as to whether the asset or liability exists, or

(b) the probability of an inflow or outflow of economic benefits is low, or
(c) there is a very high level of "measurement uncertainty", so it is impossible to obtain a reasonable estimate of the monetary amount of the asset or liability concerned.

An item which qualifies as an element but fails to satisfy the recognition criteria may instead warrant disclosure in the notes.

Derecognition

Derecognition is defined as "*... the removal of all or part of a recognised asset or liability from an entity's statement of financial position*". Derecognition of an item should occur when the item concerned no longer meets the definition of an asset or liability. For an asset, this is normally when the entity loses control of that asset. For a liability, this is normally when the entity no longer has a present obligation for that liability.

Measurement of the elements of financial statements

Measurement is the process of determining the monetary amount at which an element is to be shown in the financial statements. The *Conceptual Framework* identifies a number of different measurement bases which could be used in principle. These are:

(a) **Historical cost**. Assets are measured at the amounts paid to acquire them. Unlike current value (see below), historical cost does not reflect changes in values since the asset was acquired. But the historical cost of an asset will normally be updated over time to reflect matters such as the consumption of all or part of the economic benefits provided by the asset (i.e. depreciation) or events that cause all or part of the asset's historical cost to be irrecoverable (i.e. impairment (see Chapter 7)).

Liabilities are normally measured at the amount of the consideration received in exchange for taking on the obligation concerned. However, in cases where there is no such consideration (e.g. tax liabilities) it may be necessary to measure a liability at the amount expected to be paid to satisfy the obligation.

(b) **Current value**. The current value basis measures assets and liabilities using information which has been updated to reflect conditions at the measurement date. The current value of an asset or a liability is not in any way related to the original price of the transaction or other event that gave rise to that asset or liability. Current value measurement bases include:

(i) **Fair value**. Fair value is defined as "*the price that would be received to sell an asset, or paid to transfer a liability, in an orderly transaction between market participants at the measurement date*". Fair value may be determined directly by observing prices in an active market. But if no such market exists, it may be necessary to measure fair value indirectly by using appropriate measurement techniques (see Chapter 5 Appendix).

(ii) **Value in use**. The "value in use" of an asset is the present value† of the net cash flows (or other economic benefits) that the entity expects to derive from use of the asset and from its eventual disposal. Similarly, the "fulfilment value" of a liability is the present value of the cash (or the other economic benefits) that the entity expects to be required to transfer in order to fulfil the liability.

Note that the fair value of an asset or liability may differ from its value in use (or its fulfilment value) because the former reflects the expectations of market participants, whilst the latter reflects entity-specific expectations.

(iii) **Current cost**. The current cost of an asset is the amount that would have to be paid to acquire an equivalent asset at the measurement date (replacement cost). The current cost of a liability is the amount that would be received for taking on an equivalent liability at the measurement date.

† *Readers who are not familiar with the concepts of discounting and present value are referred to the appendix at the end of this chapter in which these concepts are explained.*

Selection of measurement basis

The *Conceptual Framework* does not prescribe the use of any particular measurement basis and states that a consideration of the qualitative characteristics of useful financial information (and the cost constraint) may result in the selection of different measurement bases for different assets, liabilities, income and expenses. The factors which should be considered when choosing a measurement basis include:

(a) **Relevance**. The degree to which a measurement basis provides relevant information is affected by the characteristics of the asset or liability to which it is applied and the way in which that asset or liability is expected to contribute to the entity's future cash flows. For instance, if the value of an asset is sensitive to market factors, use of the historical cost basis will not provide relevant information if the asset is held primarily for sale (so that changes in value are particularly important). Similarly, the use of a current value basis in relation to such an asset may not provide relevant information if the entity concerned holds the asset solely for use and has no intention of selling it.

(b) **Faithful representation**. The degree to which a measurement basis can provide a faithful representation is impacted by the level of uncertainty involved. For instance, use of the fair value basis when measuring an asset will usually provide an uncertain measurement if there is no active market for that type of asset. Although measurement uncertainty does not necessarily preclude the use of a measurement basis that provides relevant information, too high a level of uncertainty may make it necessary to consider alternative measurement bases.

A further factor to consider is "measurement inconsistency". This arises if different measurement bases are used for related assets and liabilities, so that the financial statements do not faithfully represent certain aspects of the entity's financial position and performance. In this case, a more faithful representation may be achieved by using the same measurement basis for all of the assets and liabilities concerned.

Presentation and disclosure

The *Conceptual Framework* states that the effective communication of information in an entity's financial statements makes that information more relevant and contributes to a faithful representation of the entity's assets, liabilities, equity, income and expenses. It also enhances the understandability and comparability of the information provided. Effective communication requires that:

(a) information is classified in such a way that similar items are grouped together and dissimilar items are separated, and

(b) information is aggregated in such a way that both unnecessary detail and excessive aggregation are avoided.

The offsetting of assets and liabilities (reporting an asset and a liability as a single net amount) classifies dissimilar items together and therefore is usually inappropriate.

Other comprehensive income

In principle, all of an entity's income and expenses for a reporting period should be taken into account when calculating the profit or loss for the period. However, the IASB may determine that certain items of income or expense that arise from a change in the current value of an asset or a liability (e.g. a revaluation gain) should be excluded from the calculation or profit or loss if this would provide more relevant information or a more faithful representation. Such items are not shown in the statement of profit or loss but are presented instead as "other comprehensive income" (see Chapter 3).

Concepts of capital and capital maintenance

As explained above, the *Conceptual Framework* defines income and expenses in terms of changes to an entity's equity (or capital). Therefore one way of looking at profit is to say that the profit or loss for a reporting period is equal to the increase (or decrease) in the entity's capital during that period (other than increases/decreases relating to contributions by the entity's owners or distributions to those owners). In other words, the calculation of profit is closely linked to the measurement of capital.

In general, it could be said that an entity has "maintained" its capital if it has as much capital at the end of a reporting period as it had at the start of that period. Any amount by which the entity's capital at the end of a period exceeds the amount required to maintain opening capital is profit. The *Conceptual Framework* distinguishes between two main ways of comparing an entity's capital at the beginning and end of a reporting period and so determining the profit for that period. These are as follows:

(a) **Financial capital maintenance**. Under this concept, a profit is earned only if the financial or money amount of an entity's net assets at the end of an accounting period is greater than the financial or money amount of the net assets at the beginning of that period, after adjusting for any amounts contributed by or distributed to owners during the period. Financial capital can be measured either in nominal monetary units or in units of purchasing power, where purchasing power is determined in accordance with changes in an index of general prices.

(b) **Physical capital maintenance**. Under this concept, a profit is earned only if the physical operating capability of the entity at the end of an accounting period is greater than its physical operating capability at the start of the period, after adjusting for any amounts contributed by or distributed to owners during the period.

In practice, most entities use the concept of nominal financial capital maintenance, if only because this avoids the accounting complexities associated with the alternatives.

The *Conceptual Framework* states that an entity's choices of measurement bases and capital maintenance concept determine the accounting model used in the preparation of the entity's financial statements. However, the IASB does not prescribe the use of any particular model, except in the special case of those entities which are reporting in the currency of a hyperinflationary economy (see Chapter 17). Instead, the *Conceptual Framework* merely points out that each model exhibits different levels of relevance and reliability and states that an entity's management should seek a balance between these characteristics when choosing an appropriate model.

EXAMPLE

At the beginning of a reporting period, a business had cash of £1m and capital of £1m. The cash was spent on acquiring inventory which was all sold during the accounting period for £1.25m. There were no other transactions.

(a) Calculate the profit for the period in nominal money terms.

(b) If the general prices index stood at 100 on the first day of the accounting period and at 110 on the last day of that period, calculate the profit for the period in terms of the general purchasing power of the business.

(c) If it would cost £1.13m at the end of the accounting period to replace the sold inventory, calculate the profit for the period in terms of the power of the business to maintain its physical operating capability.

Solution

	Financial capital maintenance (nominal)	*Financial capital maintenance (purchasing power)*	*Physical capital maintenance*
	£m	£m	£m
Assets at the end of the period	1.25	1.25	1.25
Assets required at the end of the period to be as well off as at the beginning of the period:			
(a) nominal monetary units	1.00		
(b) general purchasing power units (£1m x 110/100)		1.10	
(c) physical operating capability			1.13
Profit for the period	0.25	0.15	0.12

Notes:

(a) In nominal monetary terms, the business is £0.25m better off at the end of the period than it was at the beginning of the period. This is the profit figure which would be shown by a conventional set of financial statements.

(b) £1.1m is needed at the end of the period to give the same general purchasing power as was given by £1m at the beginning of the period. Since the business has capital of £1.25m at the end of the period, its profit is calculated as £1.25m – £1.1m = £0.15m.

(c) £1.13m is needed at the end of the period to buy the same inventory as could be bought for £1m at the start of the period. Since the business has capital of £1.25m at the end of the period, its profit is calculated as £1.25m – £1.13m = £0.12m.

It could be argued that the conventional approach to profit measurement (maintenance of nominal financial capital) has overstated the profit figure. Even though profits are stated to be £0.25m, no more than £0.15m could be withdrawn from the business without reducing its general purchasing power. And no more than £0.12m could be withdrawn without reducing the power of the business to replace its inventory and maintain its physical operating capability. If the conventionally-calculated profits were withdrawn in full each year, the business would suffer depletion of its capital. This would lead to a reduction in the operating capability of the business and possibly, in the long run, to its eventual closure.

Summary

- The IASB *Conceptual Framework* consists of a set of fundamental principles and definitions which underlie financial accounting. The main purpose of the *Conceptual Framework* is to assist the IASB in the development of international standards.
- The *Conceptual Framework* states that the objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity. These users are referred to as "primary users".
- General purpose financial reports provide information about the financial position and financial performance of the reporting entity. Financial performance information should be prepared on the accruals basis but information about cash flows is also important. In addition, information should be provided about changes in an entity's financial position not resulting from its financial performance (e.g. changes caused by share issues or dividend payments).
- Financial information is useful if it possesses certain qualitative characteristics. The fundamental characteristics are relevance and faithful representation. The enhancing characteristics are comparability, verifiability, timeliness and understandability.
- Financial statements are normally prepared on the going concern basis. But if the reporting entity is not a going concern, the financial statements should be prepared on a different basis and that basis should be disclosed.
- The main elements of financial statements are assets, liabilities, equity, income and expenses. Each of these elements is defined in the *Conceptual Framework*.
- An asset or liability is recognised in the financial statements only if the recognition of that asset or liability (and any resulting income, expenses or changes in equity) would provide the users of the financial statements with useful information. Derecognition occurs when the item no longer meets the definition of an asset or liability.
- Elements are measured at their historical cost or at a current value. The *Conceptual Framework* provides guidance as to the selection of a measurement basis.
- Certain items of income or expense arising from a change in the current value of an asset or a liability are not shown in the statement of profit or loss but are presented instead as "other comprehensive income".
- Profits and losses may be measured in terms of changes in the financial amount of an entity's net assets (financial capital maintenance) or in terms of changes in the entity's physical operating capability (physical capital maintenance). Financial capital may be measured either in nominal monetary units or in units of purchasing power.

Appendix

Discounting and present value

The IASB *Conceptual Framework* states that an asset might be measured at the "present value" of the future cash inflows that the asset is expected to generate. Similarly, a liability might be measured at the present value of the future cash outflows that are expected to be required to settle the liability. Various international standards also refer to the concept of present value, including:

	Chapter
IAS19 *Employee Benefits*	14
IAS36 *Impairment of Assets*	7
IAS37 *Provisions, Contingent Liabilities and Contingent Assets*	12
IFRS9 *Financial instruments*	11
IFRS15 *Revenue from Contracts with Customers*	13
IFRS16 *Leases*	9

Therefore, an understanding of present value calculations is a necessary prerequisite to a grasp of these international standards.

The concept of present value is fairly simple and is concerned with the fact that money has a "time value". For instance, if money can be invested at an interest rate of 10% per annum, each £1 invested now will grow to become £1.10 after one year, £1.21 after two years and so forth. So the current equivalent (or "present value") of £1.10 to be received in a year's time is £1. Similarly, the present value of £1.21 to be received in two years' time is also £1 (assuming interest at 10% per annum)†.

The process of determining the present value of an amount to be received (or paid) in the future is known as "discounting" and involves multiplying the amount concerned by a discounting factor. Discounting factors can either be calculated or looked up in a set of present value tables. In this book, discounting factors are calculated.

† *If amounts to be received or paid in the future are fixed in money terms and will not grow in line with inflation, the discounting rate used will also need to take into account the expected rates of inflation in future years.*

EXAMPLE

Determine the present values of the amounts listed below. The applicable "discounting rate" is 8% (i.e. money can be invested at an interest rate of 8% per annum).

(a) £1,000 to be received in one year's time

(b) £5,000 to be received in two years' time

(c) £20,000 to be received in three years' time.

Calculate discounting factors to three decimal places only.

Solution

(a) £1 invested now will become £1.08 after one year. So the present value of an amount to be received in one year's time is equal to that amount divided by 1.08. Dividing by 1.08 is the same as multiplying by a discounting factor of 0.926 (1/1.08). So the present value of £1,000 to be received in one year's time is £926 (£1,000 x 0.926).

Check: interest at 8% on £926 is £74 and £926 + £74 = £1,000.

(b) £1 invested at 8% will become £1 x 1.08 x 1.08 after two years. So the present value of an amount to be received in two years' time is equal to that amount divided by $(1.08)^2$. This is the same as multiplying by a discounting factor of 0.857 ($1/1.08^2$). The present value of £5,000 to be received in two years' time is £4,285 (£5,000 x 0.857).

Check: interest at 8% on £4,285 for one year is £343, giving a total of £4,628. Interest on £4,628 for the second year is £370, giving a total of £4,998. This is not quite £5,000 because the discounting factor was rounded to three decimal places.

(c) The present value of an amount to be received in three years' time is equal to that amount divided by $(1.08)^3$. This is the same as multiplying by a discounting factor of 0.794 ($1/1.08^3$). The present value of £20,000 to be received in three years' time is £15,880 (£20,000 x 0.794).

Check: interest at 8% on £15,880 for one year is £1,270, giving a total of £17,150. Interest on £17,150 for the second year is £1,372, giving a total of £18,522. Interest on £18,522 for the third year is £1,482, giving a total of £20,004. There is a rounding difference of £4.

Exercises

A set of multiple choice questions for this chapter is available on the accompanying website.

2.1 Explain what is meant by a "conceptual framework" for financial reporting and list the main purposes of the IASB *Conceptual Framework for Financial Reporting*.

2.2 (a) State the objective of general purpose financial reporting.

(b) Identify the main classes of information that should be presented in general purpose financial reports.

(c) Identify the primary users of general purpose financial reports and any other parties who might find these reports useful. Explain why each user group might be interested in the information provided in general purpose financial reports.

2.3 Define each of the five elements of financial statements and state the circumstances in which an element should be recognised in the financial statements. Also explain why each of the following items meets the definition of an asset or a liability:

(a) a trade receivable (b) a trade payable (c) inventory.

2.4 Identify and explain the qualitative characteristics of useful financial information, distinguishing between fundamental characteristics and enhancing characteristics.

2.5 The *Conceptual Framework* states that an entity's choices of measurement bases and capital maintenance concept determine the accounting model used in the preparation of the financial statements. Explain the measurement bases and the capital maintenance concepts identified in the *Conceptual Framework*.

2.6 The qualitative characteristics of relevance, faithful representation and comparability which are identified in the IASB *Conceptual Framework* are some of the attributes that make financial information useful to the various users of financial statements.

Explain what is meant by relevance, faithful representation and comparability and how they make financial information useful. *(ACCA)*

*__2.7__ Assuming that today's date is 1 January 2023, calculate the present value of each of the following (using a discount rate of 7% in each case):

(a) £50,000 to be received on 1 January 2026

(b) £100,000 to be received on 1 January 2028

(c) £10,000 to be received on I January each year from 2024 to 2027 inclusive.

*__2.8__ The IASB *Conceptual Framework* sets out the criteria for the recognition of assets and liabilities in financial statements. For each of the following scenarios explain with reasons whether an asset or liability is created and state how this will impact on the financial statements of each company.

(a) Lakeview plc is a large furniture retailer. The company provides a two year warranty on all furniture sales.

(b) For many years, Carson plc has owned and operated a small coalmine. A report commissioned by the company's directors confirms that all coal has been extracted from the mine. The area around the mine is heavily polluted and will cost £3m to clean up. Once cleaned up, the mine and surrounding land can be sold for £1m.

(c) Astoria plc has agreed to employ a marketing manager. The manager has just signed a three year contract and will earn £75,000 per annum.

(d) Oxnard plc has just paid £80,000 to acquire computer software that will allow the company to improve its inventory control. The software has a useful life of four years and is expected to reduce inventory storage costs by £40,000 per year.

(e) Stockton plc operates a chain of fitness clubs in the UK and prepares financial statements to 31 July each year. During the year to 31 July 2023, members paid a total of £850,000 relating to subscriptions for the year to 31 July 2024.

(CIPFA)

Chapter 3

Presentation of financial statements

Introduction

The main purpose of this chapter is to explain the requirements of international standard IAS1 *Presentation of Financial Statements*. The objective of IAS1 is to specify the overall structure and content of general purpose financial statements and so ensure that an entity's financial statements for a reporting period are comparable with those of other periods and with those of other entities†.

This chapter also outlines the main requirements of IAS34 *Interim Financial Reporting* and summarises the guidance provided by the IASB on the inclusion of a "management commentary" in an entity's annual report and on the making of materiality judgements.

† *In December 2019, the IASB issued an exposure draft of a new IFRS Standard which is intended to replace IAS1. Having considered the responses to this ED, the IASB is now redeliberating some of its proposals and cannot say when the final standard will be published. However, it seems unlikely that this standard will take mandatory effect until at least 1 January 2024. A summary of the main features of the proposed standard is given in an appendix at the end of this chapter.*

Objectives

By the end of this chapter, the reader should be able to:

- identify the components of a complete set of financial statements
- explain the general features of a set of financial statements
- explain the structure and content of each component of a set of financial statements
- distinguish between current and non-current assets and between current and non-current liabilities
- prepare a statement of financial position, a statement of comprehensive income and a statement of changes in equity, in accordance with the requirements of IAS1
- outline the main requirements of international standard IAS34
- summarise the guidance provided by IFRS Practice Statement 1 *Management Commentary* and IFRS Practice Statement 2 *Making Materiality Judgements*.

Purpose of financial statements

The requirements of IAS1 apply to all general purpose financial statements prepared and presented in accordance with international standards. General purpose financial statements are those intended for users who are not in a position to demand reports that are tailored for their own particular information needs.

According to IAS1, the objective of such financial statements is "*to provide information about the financial position, financial performance and cash flows of an entity that is useful to a wide range of users in making economic decisions*". To meet this objective, general purpose financial statements should provide information about an entity's:

(a) assets, liabilities and equity
(b) income and expenses, including gains and losses
(c) contributions by and distributions to owners in their capacity as owners
(d) cash flows.

This information is given in four primary financial statements. Further information is given in the notes which accompany these statements.

Components of financial statements

IAS1 states that a complete set of financial statements comprises:

(a) a statement of financial position as at the end of the accounting period
(b) a statement of profit or loss and other comprehensive income for the period
(c) a statement of changes in equity for the period
(d) a statement of cash flows for the period
(e) a set of notes, comprising material accounting policy† information together with other explanatory information
(f) comparative information in respect of the previous period (see later in this chapter)
(g) a statement of financial position as at the *beginning* of the previous period, in the case that the entity has applied an accounting policy† retrospectively or has made a retrospective restatement of items in its financial statements (see Chapter 4).

These titles have replaced more traditional titles (such as "balance sheet") and are thought by the IASB to reflect more closely the function of each statement. However, entities are allowed to use titles for the financial statements other than those used in the standard if they so wish. In particular, IAS1 states that an entity may use the title "statement of comprehensive income" rather than "statement of profit or loss and other comprehensive income". For the sake of brevity, this is the practice adopted throughout this textbook.

† *Accounting policies are defined in international standard IAS8 (see Chapter 4).*

The structure and the content of most of these statements is specified in IAS1. But the statement of cash flows is dealt with by IAS7 *Statement of Cash Flows* (see Chapter 16). The notes which accompany the four primary statements are an integral part of the financial statements and so fall within the scope of IAS1 and all other international standards.

In addition to the financial statements, IAS1 recognises that an entity's annual report may contain a management review which explains the main features of the entity's financial position and performance. Such a review is outside the scope of international standards but the IASB has issued a non-binding Practice Statement to assist entities that wish to include a "management commentary" in their annual reports (see later in this chapter).

General features

Under the heading "general features", IAS1 sets out a number of general rules which relate to the presentation of financial statements. Many of these are clearly based upon principles established in the *Conceptual Framework* (see Chapter 2). The main areas dealt with in this part of IAS1 are:

(a) fair presentation and compliance with international standards
(b) going concern basis and accrual basis
(c) materiality and aggregation
(d) offsetting
(e) frequency of reporting
(f) comparative information
(g) consistency of presentation.

Each of these is considered below.

Fair presentation and compliance with international standards

Financial statements must present fairly the financial position, financial performance and cash flows of the entity concerned. This requires that the effects of transactions and other events should be faithfully represented in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses set out in the *Conceptual Framework*. It is assumed that the application of international standards will result in financial statements that achieve a fair presentation. An entity which produces financial statements that comply with international standards must make an explicit and unreserved statement to that effect in the notes. A fair presentation also requires the entity to:

(a) select and apply appropriate accounting policies in accordance with the requirements of international standard IAS8 (see Chapter 4)
(b) provide information that is relevant, reliable, comparable and understandable
(c) provide further disclosures if compliance with international standards is insufficient to enable users to understand the impact of transactions and other events.

On very rare occasions, compliance with a requirement in an international standard may produce misleading information and so conflict with the objective of financial statements. In these circumstances, the entity should depart from that requirement and the notes should disclose that the entity has complied with international standards except that it has departed from a particular requirement in order to achieve a fair presentation. The notes should identify the title of the standard concerned, the nature of the departure, the reason for the departure, the accounting treatment that the standard would have required, the accounting treatment actually adopted and the financial impact of the departure.

Going concern basis and accrual basis

Financial statements should be prepared on the going concern basis (see Chapter 2) unless the entity intends to cease trading or has no realistic alternative but to do so. If there are significant doubts as to whether the entity is a going concern, the uncertainties which give rise to these doubts should be disclosed. If 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 reasons that the entity is not regarded as a going concern.

Financial statements other than the statement of cash flows should be prepared using the accrual basis of accounting (see Chapter 2). The statement of cash flows is an obvious exception to this rule since, by definition, it is prepared on a cash basis (see Chapter 16).

Materiality and aggregation

IAS1 states that information is material if "*omitting, mis-stating or obscuring it could reasonably be expected to influence decisions that the primary users of general purpose financial statements make on the basis of those financial statements*". Materiality should be judged in context and either the size or the nature of an item (or both) could determine whether or not the item is material. Further guidance on this is provided in IFRS Practice Statement 2 *Making Materiality Judgements* (see later in this chapter).

In general, financial statements are prepared by analysing transactions and other events into classes and then aggregating (i.e. totalling) each of these classes to produce line items which appear in the statements. For instance, all sales transactions are aggregated into a single revenue figure shown in the statement of comprehensive income. IAS1 requires that each material class of similar items should be presented separately in the financial statements. If an item is not individually material, it may be aggregated with other line items.

IAS1 states that there is no need to disclose information required by an international standard if the information is not material. Similarly, IAS8 (see Chapter 4) states there is no need to apply an accounting policy required by an international standard if the effect of applying that policy would be immaterial. This means that compliance with standards can be achieved without having to apply complex accounting treatments to insignificant items.

Offsetting

In general, assets and liabilities should be reported separately in the statement of financial position and they should not be offset against one another. Similarly, income and expenses