STATEMENT

# STATEMENT OF PRINCIPLES FOR FINANCIAL REPORTING

ACCOUNTING
STANDARDS
BOARD

# STATEMENT OF PRINCIPLES FOR FINANCIAL REPORTING

The Statement of Principles for Financial Reporting was agreed on by the Accounting Standards Board in October 1999. At that time, the Board comprised:



ACCOUNTING
STANDARDS
BOARD

STATEMENT

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# INTRODUCTION

## PURPOSE

1 This Statement of Principles for Financial Reporting sets out the principles that the Accounting Standards Board believes should underlie the preparation and presentation of general purpose financial statements.*

2 The primary purpose of articulating such principles is to provide a coherent frame of reference to be used by the Board in the development and review of accounting standards and by others who interact with the Board during the standard-setting process.

3 Such a frame of reference should clarify the conceptual underpinnings of proposed accounting standards and should enable standards to be developed on a consistent basis by reducing the need to debate fundamental issues each time a standard is developed or revised. As such, it will play an important role in the development of accounting standards. It is expected that it will play a similar role in the development of Statements of Recommended Practice.

4 The Statement is being published because knowledge of the principles should assist preparers and users of financial statements, as well as auditors and others, to understand the Board's approach to formulating accounting standards and the nature and function of information reported in general purpose financial statements. The principles will also help preparers and auditors faced with new or emerging issues to carry out an initial analysis of the issues involved in the absence of applicable accounting standards.

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* *The meaning of the term 'general purpose financial statements' is explained in paragraph 6(b)(i).*

## STATUS

5 The Statement of Principles is not an accounting standard, nor does it have a status that is equivalent to an accounting standard. It therefore does not contain requirements on how financial statements should be prepared or presented.

## SCOPE

*Types of financial report*

6 Financial information takes many different forms. For the purposes of the Statement, it has been categorised:

(a) *special purpose financial reports*—Financial information prepared by the entity itself at the behest of, and in the form specified by, persons who have the authority to obtain the information they require to meet their needs. Regulatory returns, tax returns and financial reports prepared for bankers are examples of such reports.

(b) *general purpose financial reports*—Financial information that, although prepared by the entity itself, is not in the form of a special purpose financial report. Such reports comprise:

   (i) *general purpose financial statements*—for example, annual financial statements and the financial statements contained in interim reports, preliminary announcements and summary financial statements. General purpose financial statements are generally referred to in the Statement hereafter simply as 'financial statements'.

   (ii) *other types of general purpose financial report*—for example, directors' reports, statements by the chairman, operating and financial reviews, historical summaries and trend information (such as five-year summaries), letters to shareholders and similar items.

(c) *other financial information*—Financial information that has not been prepared by the reporting entity itself, such as news articles and analysts' reports.

A diagram summarising and providing examples of the various categories of financial information is on page 12.

7 The primary focus of the Statement of Principles is on those financial statements that are required to give a true and fair view of the reporting entity's financial performance and financial position. For most entities, those statements will be their full annual financial statements. The Statement's principles will also be applicable to financial statements that are intended to be consistent with financial statements required to give a true and fair view (such as financial statements contained in interim reports, preliminary announcements and summary financial statements), although additional considerations are relevant in the context of such statements.

8 Whilst the Statement does not address to any significant extent other types of general purpose financial report, it will be relevant to such reports insofar as they provide financial information that is intended to be consistent with the financial statements.

*Types of entity*

9 The principles in the Statement are intended to be relevant to the financial statements of profit-oriented reporting entities, regardless of their size and whether they are private or public sector entities.[*] The Statement is, broadly speaking, also relevant to the financial statements of not-for-profit entities, although some of the principles need to be re-expressed and others need changes of emphasis before they can be applied to that sector.

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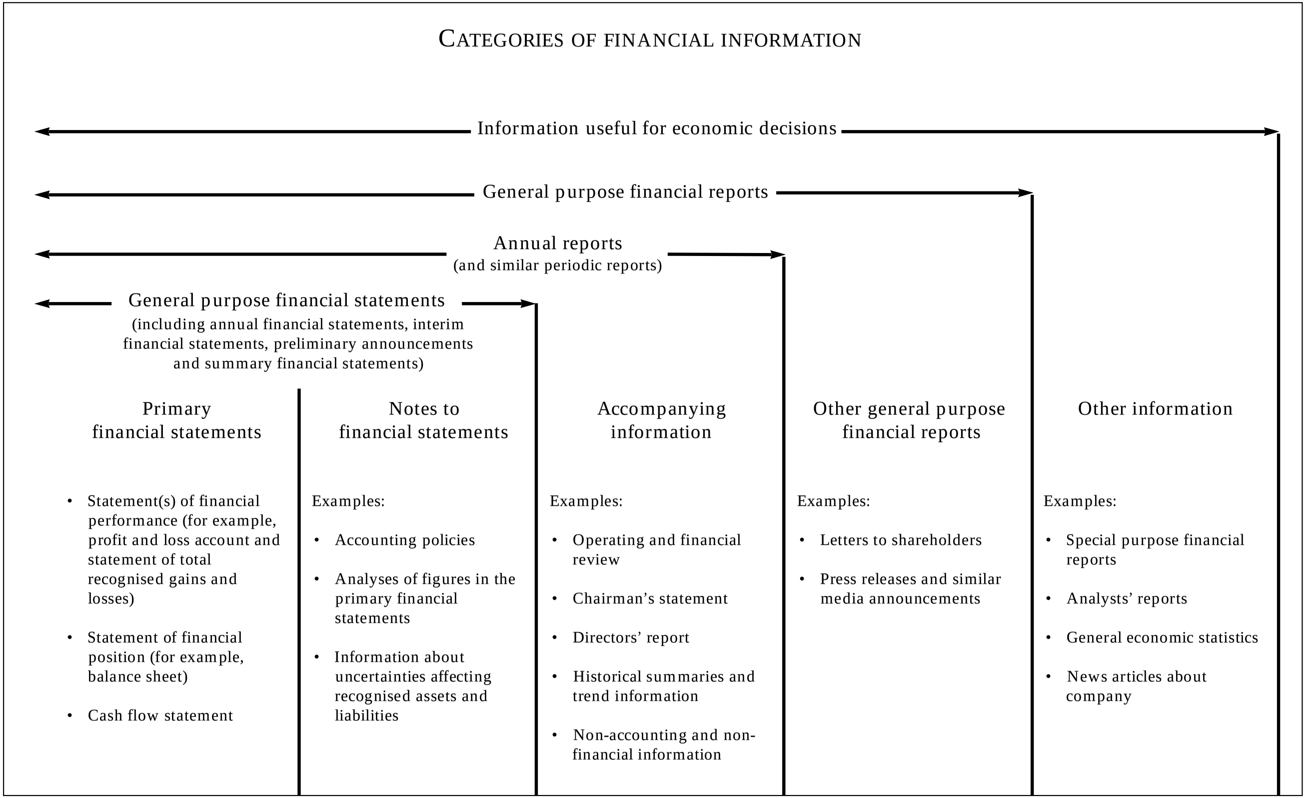
* *The application of accounting standards to the public sector is discussed more fully in the Foreword to Accounting Standards.*


CATEGORIES OF FINANCIAL INFORMATION
Information useful for economic decisions
General purpose financial reports
Annual reports
(and similar periodic reports)
General purpose financial statements
(including annual financial statements, interim financial statements, preliminary announcements and summary financial statements)
Primary financial statements
• Statement(s) of financial performance (for example, profit and loss account and statement of total recognised gains and losses)
• Statement of financial position (for example, balance sheet)
• Cash flow statement
Notes to financial statements
Examples:
• Accounting policies
• Analyses of figures in the primary financial statements
• Information about uncertainties affecting recognised assets and liabilities
Accompanying information
Examples:
• Operating and financial review
• Chairman's statement
• Directors' report
• Historical summaries and trend information
• Non-accounting and non-financial information
Other general purpose financial reports
Examples:
• Letters to shareholders
• Press releases and similar media announcements
Other information
Examples:
• Special purpose financial reports
• Analysts' reports
• General economic statistics
• News articles about company

## True and fair

10 The concept of a true and fair view lies at the heart of financial reporting in the UK and the Republic of Ireland. It is the ultimate test for financial statements and, as such, has a powerful, direct effect on accounting practice. No matter how skilled the standard-setters and law-makers are, it is the need to show a true and fair view that puts their requirements in perspective.

11 The true and fair view is, furthermore, a dynamic concept because its content evolves in response to changes in, inter alia, accounting and business practice. This dynamism pervades the whole system of financial reporting, affecting the interpretation of every requirement and instigating and providing direction to the development of accounting practice.

12 It is inherent in the nature of the true and fair view concept that financial statements will not give a true and fair view unless the information they contain is sufficient in quantity and quality to satisfy the reasonable expectations of the readers to whom they are addressed. Such expectations change over time and the Board seeks, through its accounting standards and other authoritative pronouncements, both to respond to those expectations and to influence them. The Statement of Principles may therefore be expected to contribute to the development of the concept.

13 The Statement of Principles does not, however, define the meaning of true and fair—it is detailed legal requirements, accounting standards and, in their absence, other evidence of generally accepted accounting practice, rather than the Statement itself, that normally determine the content of financial statements. Nevertheless, as the Statement is a set of high-level principles designed to help in setting standards, it has the true and fair view concept at its foundation. Its insistence on relevance and reliability as prime indicators of the quality of financial information is just one example of this.

## THE STANDARD-SETTING PROCESS

14 As already explained, the main role of the Statement of Principles is in the standard-setting process. The principles are, however, only one of the factors that are considered when setting standards. Other factors include:

(a) legal requirements,

(b) cost/benefit considerations,

(c) industry-specific issues,

(d) the desirability of evolutionary change, and

(e) implementation issues.

15 The relative importance of each of these factors in the formulation of an accounting standard will vary from case to case. As a result, a standard may adopt an approach that is different from that suggested by the principles. For example:

(a) In order not to deny the Statement the opportunity to assist in the law's development, it has not been developed within the constraints imposed by legislation. However, accounting practice develops within the legal frameworks that regulate financial reporting; therefore, if there is an inconsistency between the law and the principles on a particular issue, any accounting standard on that issue will usually need to adopt an approach that is different from that suggested by the principles.*

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* *The relationship between the accounting requirements imposed by legislation and the Statement of Principles and the inconsistencies between the two are explained in Appendix I.*

(b) In setting standards the Board weighs the costs and benefits of its proposals to ensure that they are justified on cost/benefit grounds, and this may also result in an accounting standard adopting an approach that is different from that suggested by the principles. The benefits of new accounting practices will come from improvements in economic decision-making by users. The costs will include the costs of preparation and might also include, for example, the possible loss or diminution of competitive position.

16 As legal requirements, accounting techniques and markets evolve, the Board believes that it will be possible to reduce the number of conflicts between the Statement and accounting standards and that fewer new conflicts will emerge.

17 It will be made clear in each accounting standard how the standard relates to the Statement of Principles.

## Revisions to the statement

18 The Statement may be revised from time to time in the light of the Board's experience of working with it and in response to developments in accounting thought.

# CHAPTER 1: THE OBJECTIVE OF FINANCIAL STATEMENTS

*Put simply, the objective of financial statements is to provide information that is useful to those for whom they are prepared. However, the objective needs to be expressed more precisely if it is to be of any use in determining the form and content of financial statements. This chapter does that by considering the persons for whom financial statements are prepared, the information needs of such persons and the role that financial statements play in meeting those needs.*

## PRINCIPLES

- The objective of financial statements is to provide information about the reporting entity's financial performance and financial position that is useful to a wide range of users for assessing the stewardship of the entity's management and for making economic decisions.

- That objective can usually be met by focusing exclusively on the information needs of present and potential investors, the defining class of user.

- Present and potential investors need information about the reporting entity's financial performance and financial position that is useful to them in evaluating the entity's ability to generate cash (including the timing and certainty of its generation) and in assessing the entity's financial adaptability.

## EXPLANATION

### THE OBJECTIVE OF FINANCIAL STATEMENTS

*Useful to a wide range of users*

1.1 Financial information about the activities and resources of an entity is typically of interest to many people. Although some of these people are able to command the preparation of special purpose financial reports in order to obtain the information they need, the rest—usually the vast majority—rely on general purpose financial reports, such as financial statements and other financial information. Many people are therefore potentially interested in an entity's financial statements.

1.2 It does not follow that financial statements are prepared specifically for all those interested persons. However, although there continues to be debate about for whom precisely they are prepared, there is no doubt that they are prepared for a range of persons that extends far beyond existing investors. These persons are referred to in the Statement as the 'users'.

*Useful for making economic decisions*

1.3 The persons potentially interested in an entity's financial statements need information on that entity for a variety of purposes.

(a) *Present and potential investors (hereafter generally referred to simply as 'investors').* In its stewardship role, management is accountable for the safekeeping of the entity's resources and for their proper, efficient and profitable use. Providers of risk capital are interested in information that helps them to assess how effectively management has fulfilled this role. They are also interested in information that is useful in taking decisions about their investment or potential investment in the entity. They are, as a result, concerned with the risk inherent in, and return provided by, their investments, and need information on the entity's financial performance and financial position that helps them to assess its cash-generation abilities and its financial adaptability.

(b) *Lenders.* Lenders are interested in information that helps them to assess whether their loans will be repaid, and related interest will be paid, when due. Similarly, potential lenders are interested in information that helps them to decide whether to lend to the entity and on what terms.

(c) *Suppliers and other trade creditors.* Suppliers and other trade creditors are interested in information that helps them to decide whether to sell to the entity and to assess the likelihood that amounts owing to them will be paid when due.

(d) *Employees.* Employees are interested in information on their employer's stability and profitability, with particular reference to that part (for example, the subsidiary or branch) of the entity in which they work. They are also interested in information that enables them to assess their employer's ability to provide remuneration, employment opportunities and retirement and other benefits.

(e) *Customers.* Customers are interested in information about the entity's continued existence. That is especially so when they have a long-term involvement with, or are dependent on, the entity, as will generally be the case if product warranties are involved or if specialised replacement parts may be needed.

(f) *Governments and their agencies.* Governments and their agencies are interested in the allocation of resources and, therefore, the activities of entities. They also require information that assists them in regulating the activities of entities, assessing taxation and providing a basis for national statistics. Although much of this information is obtained through special purpose financial reports, its consistency with published general purpose financial reports such as financial statements often needs to be demonstrated.

(g) *The public.* Entities affect members of the public in a variety of ways. For example, they may make a substantial contribution to a local economy by providing employment and using local suppliers. The public, including the local community, may therefore be interested in information that is useful in assessing the trends and recent developments in the entity's prosperity and the range of its activities.

1.4 This analysis illustrates that, although those potentially interested in an entity's financial statements need that information for a variety of purposes, all the purposes involve taking informed economic decisions. Even present investors assessing the stewardship of the entity's management do so in order to decide whether, amongst other things, to hold or sell their investment in the entity and to reappoint or replace the management.

*Information on financial performance and financial position*

1.5 The economic decisions for which users need financial statements will not all be the same. Although different decisions usually require different information, there is, as can be seen from paragraph 1.3, some overlap in the information required: all potential users are interested, to varying degrees, in the financial performance and financial position of the entity as a whole.

1.6 General purpose financial reports focus on this common interest of users. Their objective is therefore to provide information about the financial performance and financial position of an entity that is useful to a wide range of users for assessing the stewardship of management and for making economic decisions (including those based on assessments of the stewardship of management).

1.7 As financial statements are the principal means of communicating accounting information on an entity to interested parties and are a central feature of general purpose financial reporting, they carry much of the burden that is placed on general purpose financial reporting to meet this objective.

*The limitations of financial statements*

1.8 Financial statements do not seek to meet all the information needs of users: users will usually have to supplement the information they obtain from financial statements with information from other sources. Furthermore, financial statements have various inherent limitations that make them an imperfect vehicle for reflecting the full effects of transactions and other events on a reporting entity's financial performance and financial position. For example:

(a) they are a conventionalised representation of transactions and other events that involves a substantial degree of classification and aggregation and the allocation of the effects of continuous operations to discrete reporting periods.

(b) they focus on the financial effects of transactions and other events and do not focus to any significant extent on their non-financial effects or on non-financial information in general.

(c) they provide information that is largely historical and therefore do not reflect future events or transactions that may enhance or impair the entity's operations, nor do they anticipate the impact of potential changes in the economic environment.

1.9 These inherent limitations mean that some information on the financial performance and financial position of the reporting entity can be provided only by general purpose financial reports other than financial statements—or in some cases is better provided by such reports. For example, although a description of the business environment and markets in which a reporting entity operates and the strategies it has adopted is usually needed to put into context the numerical information provided by the financial statements, it is generally better to provide such information in the material accompanying the financial statements than in the financial statements themselves.*

* *Accompanying information is discussed in Chapter 7.*

## Investors as the defining class of user

1.10 As explained in paragraph 1.3, the perspective from which investors view financial performance and financial position is one that focuses on the entity's cash-generation ability and financial adaptability. This perspective is also of fundamental importance to other users, because an entity's ability to generate cash and to respond to unexpected needs and opportunities ultimately determines its capacity over the medium to long term to repay loans, meet interest payments, pay employees and suppliers, and undertake investment. For example, although in origin the perspective of lenders and other creditors differs from that of investors, they require similar information to investors when their interests are long-term or the risk of loss is significant. That is because they will want to use that information as a frame of reference against which to evaluate the more specific information they obtain.

1.11 Therefore, in preparing financial statements, the rebuttable assumption is made that financial statements that focus on the interest that investors have in the reporting entity's financial performance and financial position will, in effect, also be focusing on the common interest that all users have in that entity's financial performance and financial position.

1.12 It follows that, in determining which information to include in the financial statements and how to present that information, it can usually be presumed that:

(a) information that is needed by investors will be given in either the financial statements or some other general purpose financial report; and

(b) information that is not needed by investors need not be given in the financial statements.

## THE INFORMATION REQUIRED BY INVESTORS

### *Financial performance*

1.13 The financial performance of an entity comprises the return it obtains on the resources it controls, the components of that return and the characteristics of those components.

1.14 Investors require information on financial performance because such information:

(a) provides an account of the stewardship of management and is useful in assessing the past and anticipated performance of the entity;

(b) is useful in assessing the entity's capacity to generate cash flows from its existing resource base and in forming judgements about the effectiveness with which the entity has employed its resources and might employ additional resources; and

(c) provides feedback on previous assessments of financial performance and can therefore assist users in modifying their assessments for, or in developing expectations about, future periods.

### *Financial position*

1.15 An entity's financial position encompasses the economic resources it controls, its financial structure, its liquidity and solvency, its risk profile and risk management approach, and its capacity to adapt to changes in the environment in which it operates.

1.16 Investors require information on financial position because:

(a) information about the economic resources controlled and the use made of them in the past helps in assessing the stewardship of management and the entity's ability to generate cash in the future;

(b) information about financial structure is useful in assessing how future cash flows will be distributed among those with an interest in or claims on the entity. It is also useful in assessing how successful the entity has been in managing its resources, its requirements for future finance and its ability to raise that finance;

(c) information about liquidity and solvency helps in assessing the ability of the entity to meet its financial commitments as they fall due;

(d) information on an entity's risk profile and risk management approach is useful in evaluating its current performance and financial adaptability, and in assessing its ability to generate cash in the future; and

(e) information on an entity's capacity to adapt to changing circumstances (in other words, its financial adaptability) is useful in assessing the extent to which the entity is at risk, or able to benefit, from unexpected changes.

*Generation and use of cash*

1.17 Information about the ways in which an entity generates and uses cash in its operations, its investment activities and its financing activities provides an additional perspective on its financial performance—one that is largely free from allocation and valuation issues.

1.18 Investors need such information because it is useful in assessing and reviewing previous assessments of:

(a) liquidity and solvency;

(b) the relationship between profits and cash flows;

(c) the implications that financial performance has for future cash flows; and

(d) other aspects of financial adaptability.

*Financial adaptability*

1.19 An entity's financial adaptability is its ability to take effective action to alter the amount and timing of its cash flows so that it can respond to unexpected needs or opportunities.

1.20 Financial adaptability is desirable for an entity because it helps it to mitigate the risks associated with operations, which in turn helps it to survive during a time of low (or possibly negative) cash flows from operations. It may also enable an entity to take advantage of unexpected investment opportunities. On the other hand, it also generally involves making sacrifices. For example, although holding assets that are readily marketable provides some financial adaptability, the rate of return involved may be lower than could be earned from holding less liquid assets.

1.21 The extent to which—and the ways in which—it is desirable for an entity to be financially adaptable will depend on the risks the entity faces and on the appetite for risk of its investors.

1.22 Financial adaptability comes from several sources, including the ability to:

(a) raise new capital, perhaps by issuing debt securities, at short notice;

(b) repay capital or debt at short notice;

(c) obtain cash by selling assets without disrupting continuing operations; and

(d) achieve a rapid improvement in the net cash inflows generated by operations.

# CHAPTER 2: THE REPORTING ENTITY

*It is important that entities that ought to prepare and publish financial statements do, in fact, do so and that those financial statements report on all relevant activities and resources. This chapter focuses on these issues—in other words, on identifying and circumscribing the reporting entity.*

## PRINCIPLES

- An entity should prepare and publish financial statements if there is a legitimate demand for the information that its financial statements would provide and it is a cohesive economic unit.

- The boundary of the reporting entity is determined by the scope of its control. For this purpose, first direct control and, secondly, direct plus indirect control are taken into account.

## EXPLANATION

### ENTITIES THAT SHOULD PREPARE AND PUBLISH FINANCIAL STATEMENTS

2.1 It is essential that entities that ought to prepare and publish financial statements do, in fact, do so. For similar reasons, if there is no justification for an entity to prepare and publish financial statements, it should not be required to do so.

2.2 For the preparation of financial statements to be justified in any particular case, there needs to be a legitimate demand for the information that the financial statements would provide. This means, inter alia, that the information provided by the financial statements will need to be useful and that the benefits to be derived by providing the financial statements will need to exceed the costs of doing so.

2.3 The financial statements of an entity will report on the entity's transactions and on other events that affect its financial performance and financial position. However, if the information provided by the financial statements is to be useful, the entity that is the subject of the financial statements (the reporting entity) needs to be a cohesive economic unit. This ensures accountability—the reporting entity is held to account for all the things it can control—and it gives the reporting entity a determinable boundary—because activities and resources are either within its control or outside its control.

## THE BOUNDARY OF A REPORTING ENTITY

2.4 The control an entity exerts can be direct or indirect.

(a) An entity has direct control of an asset if it has the ability in its own right to obtain the future economic benefits embodied in that asset and to restrict others' access to those benefits. An entity has direct control of its own activities and resources but does not have direct control of any other activities and resources.

(b) An entity indirectly controls an asset if it has control of an entity that has direct control of the asset.* A parent company therefore has indirect control of the activities and resources of its subsidiary.

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* *For simplicity, the discussion in this chapter assumes that one entity (the parent) directly controls the other (the subsidiary). However, the discussion applies equally if the parent controls the subsidiary by controlling one or more other entities that themselves control the subsidiary. It also applies when a parent's control of its subsidiary is achieved through the combined influence of itself and other entities that it controls.*

2.5 If the boundary of the reporting entity is determined by reference to direct control only, when one entity controls another, there will be two reporting entities: the controlling entity and its activities and resources; and the controlled entity and its activities and resources. On the other hand, if the boundary is determined by reference to direct plus indirect control, there will in the same circumstances be a reporting entity that comprises the controlling entity, the controlled entity and all their activities and resources. This reporting entity is often referred to as 'the group'.

2.6 Both these approaches result in useful information being provided, and both are therefore used in the model described in the Statement.

(a) Direct control is used to determine the boundary of the reporting entity that prepares single entity financial statements. Those financial statements will therefore deal with the gains, losses, assets and liabilities directly controlled or borne by the entity but no other gains, losses, assets or liabilities.

(b) Direct plus indirect control is used to determine the boundary of the reporting entity that prepares consolidated financial statements. Those financial statements will deal with the gains, losses, assets and liabilities directly controlled or borne by the entity as well as those that are indirectly controlled or borne by that entity through its control of other entities.

2.7 It may be that, although an entity can influence another entity, it does not control it. Such entities do not comprise a single reporting entity.*

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* *The accounting treatment of such relationships is addressed in Chapter 8.*

## What is control?

2.8 Control has two aspects: the ability to deploy the economic resources involved and the ability to benefit (or to suffer) from their deployment. To have control, an entity must have both these abilities.

2.9 This can be contrasted with the position in a trusteeship or agency arrangement, where the abilities are held by different parties. For example, in a trusteeship, the trustee—unless required to act in a predetermined way—has the power to deploy the trust's resources whilst the beneficiaries benefit from their deployment.

2.10 Control in the context of assets and liabilities is considered in more detail in Chapter 4; indirect control—through control over other entities—is considered in the paragraphs below.

## Controlling an entity

### *When does one entity control another?*

2.11 An entity will have control of a second entity if it has the ability to direct that entity's operating and financial policies with a view to gaining economic benefit from its activities.

2.12 Control may be evidenced in a variety of ways depending on its basis (for example ownership or other rights) and the way in which it is exercised (interventionist or not). Although control of another entity has traditionally involved share ownership and voting rights, that need not be the case. Indeed, some forms of control do not involve an investment of any kind.*

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* *Although control need not involve an investment, for simplicity this chapter uses the term 'investor' to mean 'entity with the interest in the other entity' and 'investee' to mean 'entity in which the investor has an interest'.*

2.13 There is no single piece of evidence that is proof of an investor's control in all circumstances, although evidence that will help to determine whether control exists can be obtained by considering:

(a) the respective rights held;

(b) the inflows and outflows of benefit; and

(c) exposure to risk—how and to what extent the investor suffers or gains from variability in outcome.

2.14 These sources of evidence are interrelated because the rights an investor holds in the investee usually determine its entitlement to benefits generated by the investee and therefore usually its exposure to risk from variations in the benefits that the investee generates.

2.15 When determining whether the investor controls the investee, it is the relationship between the entities in practice, rather than the theoretical level of influence, that is important. The paragraphs below explain some of the factors that may need to be taken into account in determining whether control exists.

*Powers of veto and reserve powers*

2.16 Control implies the ability to restrict others from directing the financial and operating policies of the controlled entity. Powers of veto and reserve powers may therefore form part of the rights by which an investor exercises control. However, such powers are unlikely to form the sole basis of control because they do not provide a basis for deploying the resources of the investee nor do they ensure the corresponding flows of benefit.

*Predetermined operating and financial policies*

2.17 An investee whose operating and financial policies are predetermined will be controlled by the investor if the investor gains the benefits arising from the investee's net assets and is exposed to the risks inherent in them (ie the variability of outcome).

*Latent control*

2.18 If an investor has the ability to control an investee, it is usually presumed to be exercising control, even if such control is not apparent. Generally speaking, the only evidence that could rebut this presumption is evidence that a third entity is actually deploying the investee's resources on its own behalf and benefiting from them. It is, for example, not enough to show that the investee appears to be independent—it may be implementing the operating and financial policies desired by its investor without being given explicit instructions to do so.

*Management but not control*

2.19 Control needs to be distinguished from management. If an entity manages a second entity on its own behalf (ie it expects to benefit from the net assets of the second entity other than merely receiving a management fee) then it controls the second entity because it has the two abilities referred to in paragraph 2.8. A fee structure that in substance amounts to an interest in the net assets of an entity is treated as an ability to benefit (or to suffer) from the deployment of those net assets (sometimes referred to as an equity interest), whatever it is called.

2.20 On the other hand, if an entity manages the second entity on behalf of another party, it is not exposed to the benefits arising from, or risks inherent in, the activities of the second entity because the manager's interest in the managed entity is normally limited to its fee. As such, it does not have the second ability referred to in paragraph 2.8 and therefore does not have control of the second entity.

# CHAPTER 3: THE QUALITATIVE CHARACTERISTICS OF FINANCIAL INFORMATION

*In deciding which information to include in financial statements, when to include it and how to present it, the aim is to ensure that financial statements yield information that is useful. This chapter considers the qualities of financial information that make it useful.*

## PRINCIPLES

- Information provided by financial statements needs to be relevant and reliable and, if a choice exists between relevant and reliable approaches that are mutually exclusive, the approach chosen needs to be the one that results in the relevance of the information provided being maximised.

- Information is relevant if it has the ability to influence the economic decisions of users and is provided in time to influence those decisions.

- Information is reliable if:

  (a) it can be depended upon by users to represent faithfully what it either purports to represent or could reasonably be expected to represent, and therefore reflects the substance of the transactions and other events that have taken place;

  (b) it is free from deliberate or systematic bias and material error and is complete; and

  (c) in its preparation under conditions of uncertainty, a degree of caution has been applied in exercising the necessary judgements.

- Information in financial statements needs to be comparable.

- As an aid to comparability, information in financial statements needs to be prepared and presented in a way that enables users to discern and evaluate similarities in, and differences between, the nature and effects of transactions and other events over time and across different reporting entities.

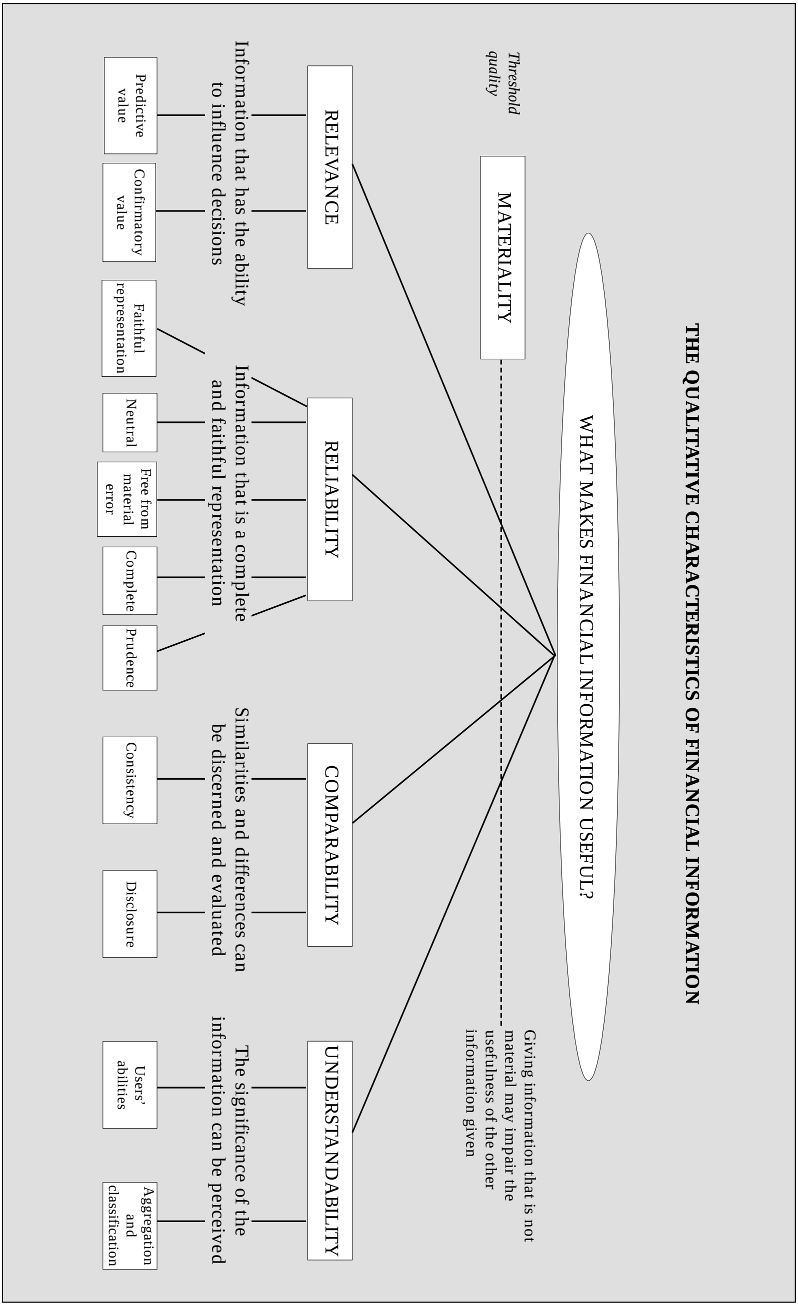
- Information provided by financial statements needs to be understandable, although information should not be excluded from the financial statements simply because it would not be understood by some users.

- Information is understandable if its significance can be perceived by users that have a reasonable knowledge of business and economic activities and accounting and a willingness to study with reasonable diligence the information provided.

- Information that is material needs to be given in the financial statements and information that is not material need not be given.

- Information is material to the financial statements if its misstatement or omission might reasonably be expected to influence the economic decisions of users.

The relationship between these characteristics is portrayed in the diagram on page 34.


THE QUALITATIVE CHARACTERISTICS OF FINANCIAL INFORMATION
WHAT MAKES FINANCIAL INFORMATION USEFUL?
Threshold quality
MATERIALITY
Giving information that is not material may impair the usefulness of the other information given
RELEVANCE
Information that has the ability to influence decisions
Predictive value
Confirmatory value
RELIABILITY
Information that is a complete and faithful representation
Faithful representation
Neutral
Free from material error
Complete
Prudence
COMPARABILITY
Similarities and differences can be discerned and evaluated
Consistency
Disclosure
UNDERSTANDABILITY
The significance of the information can be perceived
Users' abilities
Aggregation and classification

## EXPLANATION

### RELEVANCE

3.1 Relevance is a general quality that is used as a selection criterion at all stages of the financial reporting process. Information provided by financial statements needs to be relevant. Furthermore, where choices have to be made between options that are relevant and reliable but mutually exclusive, the option selected should be the one that results in the relevance of the information package as a whole being maximised—in other words, the one that is reliable and would be of most use in taking economic decisions.

3.2 Information is relevant if it has the ability to influence the economic decisions of users and is provided in time to influence those decisions.

3.3 Relevant information has predictive value or confirmatory value. It has predictive value if it helps users to evaluate or assess past, present or future events, and it does not need to be in the form of an explicit forecast to have predictive value. Information has confirmatory value if it helps users to confirm or correct their past evaluations and assessments. Information may have both predictive value and confirmatory value. For example, information about the current level and structure of asset holdings helps users to assess the entity's ability to exploit opportunities and react to adverse situations. The same information helps to confirm past assessments about the structure of the entity and the outcome of operations.

3.4 The ability to use information in financial statements to make assessments is enhanced by the way in which it is presented. For example, the predictive value of information provided by the financial performance statement is enhanced if unusual or infrequent items of gains or losses are disclosed and if information is provided that helps users to assess the likely incidence of similarly unusual or infrequent gains or losses in the future. In the same way, presentations that help users to understand the recurring/non-recurring nature of the various gains and losses also improve the predictive value of the performance statement.

3.5 Maximising the relevance of financial information involves maximising its predictive and confirmatory value.

3.6 There are a number of different perspectives from which an entity's financial performance and financial position could be viewed and the perspective adopted could have a significant effect on the assets and liabilities recognised and on their carrying amounts. In view of the objective of financial statements, the perspective that is usually most relevant is based on the assumption that the entity is to continue in operational existence for the foreseeable future. This perspective is commonly referred to as the going concern assumption.

## Reliability

3.7 Information provided by financial statements needs to be reliable.

3.8 Information is reliable if:

(a) it can be depended upon by users to represent faithfully what it either purports to represent or could reasonably be expected to represent;

(b) it is free from deliberate or systematic bias (ie it is neutral);

(c) it is free from material error;

(d) it is complete within the bounds of materiality; and

(e) in its preparation under conditions of uncertainty, a degree of caution (ie prudence) has been applied in exercising judgement and making the necessary estimates.

*Faithful representation*

3.9 The portrayal of a transaction or other event in the financial statements depends, inter alia, on:

(a) the rights and obligations arising and the weight attached to each;

(b) how the rights and obligations to which most weight has been attached are characterised;

(c) which measurement basis (or bases) and presentation techniques are used to depict the rights and obligations; and

(d) the way in which the elements arising from the transaction or other event are presented in the financial statements.

3.10 A transaction or other event is faithfully represented in the financial statements if the way in which it is recognised, measured and presented in those statements corresponds closely to the effect of that transaction or event.

3.11 It needs to be borne in mind that most financial information is subject to some risk of being less than a faithful representation of what it purports to portray. This is partly due to inherent difficulties in identifying the transactions and other events to be dealt with and in identifying the consequences of such transactions and events that need to be measured. It reflects the difficulties in devising and applying measurement and presentation techniques that can convey messages that reflect those transactions and events. Furthermore, references to faithful representation need to be understood in the context of the Statement as a whole, which limits the kind of information that may properly be included in financial statements.

3.12 Faithful representation involves identifying *all* the rights and obligations arising from the transaction or event, giving greater weight to those that are likely to have a commercial effect in practice, then accounting for and presenting the transaction or other event in a way that reflects that commercial effect—in other words, in a way that reflects its substance.

3.13 The substance of a transaction or other event is not always consistent with that suggested by its legal form: although the effects of the legal characteristics of a transaction or other event are themselves a part of its substance and commercial effect, they have to be construed in the context of the transaction as a whole, including any related transactions. For example, an entity may pass legal ownership of an item of property to another party, yet, when the circumstances are looked at as a whole, it may be found that arrangements exist that ensure that the entity continues to have access to the future economic benefits embodied in that item of property. In such circumstances, the accounting needs to reflect this continuing interest.

3.14 A group or series of transactions that achieves an overall commercial effect will often need to be viewed as a whole in order to be accounted for in accordance with its substance.

*Neutrality*

3.15 The information provided by financial statements needs to be neutral—in other words, free from deliberate or systematic bias. Financial information is not neutral if it has been selected or presented in such a way as to influence the making of a decision or judgement in order to achieve a predetermined result or outcome.

*Complete and free from material error*

3.16 In requiring information provided by financial statements to represent faithfully what it purports to represent and to be neutral, there is an implication that the information is complete and free from error—at least within the bounds of materiality. Information that contains a material error or has been omitted for reasons other than materiality can cause the financial statements to be false or misleading and thus unreliable and deficient in terms of their relevance.

3.17 This reference to being complete within the bounds of materiality is important because completeness is relative: financial statements are a highly aggregated portrayal of an entity's financial performance and financial position and therefore cannot show everything.

*Prudence*

3.18 Uncertainty surrounds many of the events and circumstances that are reported on in the financial statements and it is dealt with in those statements by disclosing the nature and extent of the uncertainty involved and by exercising prudence.

3.19 Prudence is the inclusion of a degree of caution in the exercise of the judgements needed in making the estimates required under conditions of uncertainty, such that gains and assets are not overstated and losses and liabilities are not understated. In particular, under such conditions it requires more confirmatory evidence about the existence of, and a greater reliability of measurement for, assets and gains than is required for liabilities and losses.

3.20 However, it is not necessary to exercise prudence where there is no uncertainty. Nor is it appropriate to use prudence as a reason for, for example, creating hidden reserves or excessive provisions, deliberately understating assets or gains, or deliberately overstating liabilities or losses, because that would mean that the financial statements are not neutral and, therefore, are not reliable.

## COMPARABILITY

3.21 Information in an entity's financial statements gains greatly in usefulness if it can be compared with similar information about the entity for some other period or point in time in order to identify trends in financial performance and financial position. Information about an entity is also much more useful if it can be compared with similar information about other entities in order to evaluate their relative financial performance and financial position.

3.22 Information in financial statements therefore needs to be comparable—at least as far as is possible. Furthermore, to help users to make comparisons, such information needs to be prepared and presented in a way that enables users to discern and evaluate similarities in, and differences between, the nature and effects of transactions and other events taking place over time and across different reporting entities. This can usually be achieved through a combination of consistency and disclosure of accounting policies.

### *Consistency*

3.23 Comparability generally implies consistency throughout the reporting entity within each accounting period and from one period to the next. However, consistency is not an end in itself nor should it be allowed to become an impediment to the introduction of improved accounting practices. Consistency can also be useful in enhancing comparability between entities, although it should not be confused with a need for absolute uniformity.

*Disclosure of accounting policies*

3.24 In order to determine whether consistency exists or to assist in the making of comparisons despite inconsistencies, users need to be able to identify any differences between:

(a) the accounting policies adopted by an entity to account for like transactions and other events;

(b) the accounting policies adopted from period to period by an entity; and

(c) the accounting policies adopted by different entities.

3.25 Disclosure of the accounting policies employed in the preparation of the financial statements, of any changes in those policies and of the effects of such changes therefore enhances the usefulness of financial statements.

## Understandability

3.26 Information provided by financial statements needs to be understandable—in other words, users need to be able to perceive its significance.

3.27 Whether financial information is understandable will depend on:

(a) the way in which the effects of transactions and other events are characterised, aggregated and classified. For example, information that does not properly reflect and communicate the substance of transactions and other events will not help users to understand the entity's financial performance or financial position.

(b) the way in which the information is presented. (This is considered further in Chapter 7.)

(c) the capabilities of users. Those preparing financial statements are entitled to assume that users have a reasonable knowledge of business and economic activities and accounting and a willingness to study with reasonable diligence the information provided.

## Materiality

3.28 Materiality is the final test of what information should be given in a particular set of financial statements. While the paragraphs above describe the characteristics that, if present, will mean that the usefulness of the financial information has been maximised, the materiality test asks whether the resulting information content is of such significance as to require its inclusion in the financial statements.

3.29 Materiality is therefore a threshold quality that is demanded of all information given in the financial statements. Furthermore, when immaterial information is given in the financial statements, the resulting clutter can impair the understandability of the other information provided. In such circumstances, the immaterial information will need to be excluded.

3.30 An item of information is material to the financial statements if its misstatement or omission might reasonably be expected to influence the economic decisions of users of those financial statements, including their assessments of management's stewardship.

3.31 Whether information is material will depend on the size and nature of the item in question judged in the particular circumstances of the case. The principal factors to be taken into account are set out below. It will usually be a combination of these factors, rather than any one in particular, that will determine materiality.

(a) The item's size is judged in the context both of the financial statements as a whole and of the other information available to users that would affect their evaluation of the financial statements. This includes, for example, considering how the item affects the evaluation of trends and similar considerations.

(b) Consideration is given to the item's nature in relation to:

(i) the transactions or other events giving rise to it;

(ii) the legality, sensitivity, normality and potential consequences of the event or transaction;

(iii) the identity of the parties involved; and

(iv) the particular headings and disclosures that are affected.

3.32 If there are two or more similar items, the materiality of the items in aggregate as well as of the items individually needs to be considered.

## Constraints on the qualitative characteristics

3.33 On occasion, a conflict will arise between the characteristics of relevance, reliability, comparability and understandability. In such circumstances, a trade-off needs to be found that still enables the objective of financial statements to be met.

### *Relevance and reliability*

3.34 Sometimes the information that is the most relevant is not the most reliable and vice versa. Choosing the amount at which to measure an asset or liability will sometimes involve just such a conflict. In such circumstances, it will usually be appropriate to use the information that is the most relevant of whichever information is reliable.*

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* *Choosing between alternative measurement bases is considered in Chapter 6.*

3.35 Conflict between relevance and reliability can also arise over the timeliness of information. That is because a delay in providing information can make it out-of-date, which will affect its relevance, yet reporting on transactions and other events before all the uncertainties involved are resolved may affect the information's reliability. On the other hand, leaving information out of the financial statements because of reliability concerns may affect the completeness, and therefore reliability, of the information that *is* provided. Although financial information should generally be made available as soon as it is reliable and entities should do all that they reasonably can to speed up the process necessary to make information reliable, financial information should not be provided until it is reliable.

*Neutrality and prudence*

3.36 There can also be tension between two aspects of reliability—neutrality and prudence—because, whilst neutrality involves freedom from deliberate or systematic bias, prudence is a potentially biased concept that seeks to ensure that, under conditions of uncertainty, gains and assets are not overstated and losses and liabilities are not understated. This tension exists only where there is uncertainty, because it is only then that prudence needs to be exercised. When there is uncertainty, the competing demands of neutrality and prudence are reconciled by finding a balance that ensures that the deliberate and systematic understatement of gains and assets and overstatement of losses and liabilities do not occur.

*Understandability*

3.37 It may not always be possible to present a piece of relevant, reliable and comparable information in a way that can be understood by all the users with the capabilities described in paragraph 3.27(c). However, information that is relevant and reliable should not be excluded from the financial statements simply because it is too difficult for some users to understand.

# CHAPTER 4:
# THE ELEMENTS OF FINANCIAL STATEMENTS

*Elements of financial statements are the building blocks with which financial statements are constructed—the classes of items that financial statements comprise. This chapter identifies those elements and explains their attributes.*

## PRINCIPLES

- The elements of the financial statements are:

  (a) assets

  (b) liabilities

  (c) ownership interest*

  (d) gains†

  (e) losses◊

  (f) contributions from owners

  (g) distributions to owners.

- Assets are rights or other access to future economic benefits controlled by an entity as a result of past transactions or events.

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* *This element is given various descriptions in financial statements including, for example, equity, owners' equity, shareholders' equity, equity capital, capital, capital and reserves, partners' capital, shareholders' funds, proprietorship and ownership.*

† *This term incorporates all forms of income and revenue as well as all recognised gains (realised and unrealised) on non-revenue items.*

◊ *This term incorporates all forms of expenses, sometimes referred to as revenue expenditure, and all recognised losses (realised and unrealised) on non-revenue items.*

- Liabilities are obligations of an entity to transfer economic benefits as a result of past transactions or events.

- Ownership interest is the residual amount found by deducting all of the entity's liabilities from all of the entity's assets.

- Gains are increases in ownership interest not resulting from contributions from owners.

- Losses are decreases in ownership interest not resulting from distributions to owners.

- Contributions from owners are increases in ownership interest resulting from transfers from owners in their capacity as owners.

- Distributions to owners are decreases in ownership interest resulting from transfers to owners in their capacity as owners.

## EXPLANATION

### THE ELEMENTS OF FINANCIAL STATEMENTS

*Depicting the effects of transactions and other events*

4.1 Financial statements need to reflect, in an appropriate manner and as far as is practicable, the effects of transactions and other events on the reporting entity's financial performance and financial position. This involves a high degree of classification and aggregation. Order is imposed on this process by specifying and defining the classes of items—the elements of financial statements—that encapsulate the key aspects of the effects of those transactions and other events.

4.2 The elements of financial statements are:

(a) in the case of the balance sheet (or statement of financial position)—assets, liabilities and ownership interest;

(b) in the case of the profit and loss account and any other statement of financial performance—gains and losses;

(c) contributions from owners; and

(d) distributions to owners.

4.3 Contributions from owners and distributions to owners are not the same as, and need to be distinguished from, other increases or decreases in ownership interest (in other words, gains and losses), which is why they are elements even though they are not identified with any particular primary financial statement.

4.4 Elements have been specified and defined to analyse comprehensively the way in which the financial effects of transactions and other events are represented in financial statements. However, as the cash flow statement represents only one type of financial effect—cash flows—analysis into elements is not relevant to that statement.

*Recognition*

4.5 Simply because a transaction or other event results, say, in a new asset being created, it does not follow that that new asset will be recognised. The criteria that need to be met before the effects of a transaction or other event on the elements will be recognised are considered in Chapter 5.

## ASSETS

### *Definition*

4.6 Assets are defined as follows:

> Assets are rights or other access to future economic benefits controlled by an entity as a result of past transactions or events.

4.7 Although assets commonly have other features that help identify them—for example, they may be acquired at a cost and they may be tangible, exchangeable or legally enforceable—those features are not essential characteristics of an asset and their absence is not sufficient in itself to preclude an item from qualifying as an asset.

### *Rights or other access*

4.8 An asset is not the item of property itself, but rather the rights or other access to some or all of the future economic benefits derived from the item of property.*

4.9 These rights or other access can be obtained in various ways. Often they are obtained by legal ownership of the underlying item of property. Such ownership usually gives the owner access to a number of future economic benefits, including the ability to use the item of property, to sell or exchange it or to exploit its value by, for example, pledging it as security for borrowing.

4.10 However, legal rights to future economic benefits derived from an item of property can be obtained without having legal ownership of the property itself, as is the case, for example, where property is leased.

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* *The term 'item of property' has been used in this chapter to differentiate between the control of rights or other access to future economic benefits (the asset) and the thing from which those future economic benefits are derived (the item of property). It is recognised however that, in other contexts, the term may have a different meaning and could, for example, refer to the subdivided property rights.*

4.11 Other legal rights that give rise to assets include the right to require other parties to make payments or render services and the right to use a patent or trade mark.

4.12 Access to future economic benefits—and therefore an asset—can also exist in the absence of legal rights. An example might be an unpatented invention.

*Future economic benefits*

4.13 Capacity to obtain future economic benefits is the essence of an asset and is common to all assets irrespective of their form. Therefore, to be an asset, the right or other access must be capable, singly or in combination with other assets, of yielding economic benefits.

4.14 This future economic benefit need not, however, be certain. Indeed, there is always some uncertainty whether expected future economic benefits will be obtained either to the extent expected or at all. In some cases, that uncertainty is so great that the asset is not recognised.[*]

4.15 Future economic benefits eventually result in net cash inflows to the entity. Assets are not, however, always direct representations of cash flows: they are rights and other access to the future economic benefits that can generate or be used to generate future cash flows. In particular:

(a) cash (including bank deposits) can be exchanged for virtually any good or service that is available or it can be saved and exchanged for them in the future. The command that cash gives over resources is the basis of its future economic benefits.

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* *The recognition process is discussed in Chapter 5.*

(b) debtors, investments and similar assets represent future economic benefits because they are direct claims to cash inflows that are expected to occur when customers pay their accounts, when investees pay interest or dividends, or when an investment is repaid or sold.

(c) payments made to external parties for services to be received from them in the future (such as prepayments) result in access to future economic benefits because they represent rights to receive services or to return of the payment.

(d) other assets provide access to future economic benefits through their ability to be:

   (i) exchanged for cash, claims to cash or other goods and services;

   (ii) used to provide goods or services; or

   (iii) used to settle liabilities.

4.16 As there does not need to be certainty that the economic benefits will arise, items that represent the right to exchange property on terms that will or may be favourable are also assets. For example, an option to acquire an asset will, subject to the other criteria being met, be an asset even if the price payable under the option is currently more than the market price of the asset.

*Controlled by the entity*

4.17 The definition of an asset requires that the rights or other access to future economic benefits are controlled by the reporting entity. An entity will control the rights or other access if it has the ability both to obtain for itself any economic benefits that will arise and to prevent or limit the access of others to those benefits.

4.18 This control does not need to be legally enforceable, which means that weight can be given to economic and social sanctions when these are effective in inducing entities to fulfil promises or to comply with widely accepted business practices or customs.

4.19 The requirement that the rights or other access should be controlled by the entity treating them as its asset means that a particular right or other access to future economic benefits will appear in only one set of single entity financial statements, because such rights or access can be directly controlled by only one entity. (As indirect control is important in determining the boundaries of reporting entities, a right that is directly controlled by one entity and indirectly controlled by a second—through its control of the first entity—will be an asset both of the first entity and of the reporting entity that comprises both entities, ie the group.*)

4.20 On the other hand, a single item of property may give rise to assets of more than one entity. If two entities control the rights to different future economic benefits from the same item of property, both entities will have an asset (subject to the other aspects of the definition being met). However, although the item of property underlying the asset will be the same, the assets will be different because the future economic benefits are different. For example, if an entity leases an item of property to another entity, both entities will recognise an asset based on rights relating to the leased item of property although, as the lessor's rights will not be identical to the lessee's, the assets will not be the same.

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* *Determining the boundaries of reporting entities is considered in Chapter 2.*

4.21 An item of property will be an asset of an entity even though that entity cannot dispose of it without fundamentally changing the nature of its business, as would be the case if, for example, a hotel company with one hotel sold its hotel or a television franchise company sold its franchise. In such cases, although the rights to future economic benefits derived from the hotel or television franchise are the essence of the entity's business, it controls those rights and is therefore still in a position to choose if and when to realise the economic benefits involved. On the other hand, it is generally not possible for an entity to choose if and when to realise the economic benefits derivable from factors such as its market share, superior management or good labour relations because the rights or other access to such benefits cannot be controlled independently of the business as a whole. The entity therefore does not have the control of these benefits envisaged by the Statement, which means that such factors are not assets of the entity.

*Past transactions or events*

4.22 If the reporting entity's control of the rights or other access to the future economic benefits involved is to represent an asset, it needs to be the result of *past* transactions or events. A reporting entity that has access to future economic benefits but did not, until after the balance sheet date, have the ability to restrict the access of others to those benefits, did not have an asset at the balance sheet date.

LIABILITIES

*Definition*

4.23 Liabilities are defined as follows:

> Liabilities are obligations of an entity to transfer economic benefits as a result of past transactions or events.

*Obligations*

4.24 For there to be a liability there must be an obligation that might result in the transfer of economic benefits.

4.25 The notion of an obligation implies that the entity is not free to avoid the outflow of resources. If an obligation exists, although an entity may offer inducements to its creditors to cancel or postpone settlement, it will not be able to insist that they accept such an offer.

4.26 Although many liabilities are based on legal obligations, a legal obligation is not a *necessary* condition: a liability can exist in the absence of legal obligations if commercial considerations create a constructive obligation.

4.27 A decision to transfer economic benefits does not, in itself, create a constructive obligation because the transfer can be avoided by changing the decision. On the other hand, a constructive obligation would be created if such a decision was coupled with an event that both created a valid expectation that the entity involved would implement that decision and meant that the entity could not realistically withdraw from it. For example, a constructive obligation may be created by communicating a decision to follow a particular course of action to another party. Such an obligation may also be created by an established pattern of past practice.

4.28 When preparing financial statements, it is usually most relevant to assume that the reporting entity is to continue in operational existence for the foreseeable future. It does not follow from this assumption, however, that, in preparing financial statements, the entity should be treated as being obliged to adopt a course of action that will enable it to continue in operational existence. Even if an obligation needs to be incurred to enable the entity to continue existing operations, until the entity ceases to be able to avoid the outflow of resources involved, there will be no obligation and, therefore, no liability.

*Transfer of economic benefits*

4.29 Certainty that the obligation *will* result in a transfer of future economic benefits is not necessary. Obligations that are not likely to result in a transfer of economic benefits—such as the guarantee of another entity's debt where that entity is expected to remain solvent—are liabilities, even though they may not be recognised in financial statements (or may be recognised with a carrying amount of nil).

4.30 Similarly, although many liabilities involve transfers of known amounts of cash, that need not be the case: a liability could involve an obligation to transfer an uncertain amount, and it could involve an obligation to transfer economic benefits other than cash—for example, by providing services or by undertaking to repair goods that are the subject of warranties. The recognition criteria described in Chapter 5 will filter out those liabilities that involve too much uncertainty to be recognised in the primary financial statements.

*Past transactions or events*

4.31 For a liability to exist at the balance sheet date, the obligation to transfer economic benefits must have resulted from a *past* transaction or event. For example, in the circumstances described in paragraph 4.27—where the event that gave rise to the obligation was the communication of the decision to transfer economic benefits—the liability will have existed at the balance sheet date only if the communication took place on or before that date.

4.32 Sometimes a series of events must take place before the entity will have an obligation to transfer economic benefits. In such circumstances, whether the obligation exists depends on whether any of the events that have still to take place are under the entity's control. If they are, the entity retains discretion to avoid the transfer, so no obligation exists. For example, as long as it is possible to avoid a penalty clause in a contract by performing, a liability in respect of the penalty will not arise. In contrast, an obligation to repair goods subject to warranty cannot be avoided once the goods have been sold on terms that include the warranty, so the sale marks the inception of the liability.

### OFFSETTING RIGHTS AND OBLIGATIONS

4.33 When a transaction or other event gives rise to a number of rights and obligations, it is necessary to consider whether some or all of those rights and obligations need to be offset either with each other or with rights and obligations that arise from other transactions or events. This raises issues of:

(a) definition—when do rights and obligations represent separate assets and liabilities and when should some or all of them be aggregated or offset? This issue is considered in paragraphs 4.34–4.36.

(b) recognition—when should rights that represent an asset and obligations that represent a liability be combined and recognised as a single asset or liability? This Statement envisages no circumstances in which assets and liabilities will be treated in this way.

(c) presentation—when is it appropriate to present assets offset against liabilities (or vice versa) in the balance sheet? This issue is considered in Chapter 7.

4.34 If a right to receive future economic benefits and an obligation to transfer future economic benefits exist and the reporting entity has the ability—which is assured—to insist on net settlement of the balances, the right and obligation together form a single asset or liability regardless of how the parties intend to settle the balances.

4.35 When an entity enters into an agreement with another, it usually obtains certain rights and, in exchange, accepts certain obligations. Before any act of performance under the agreement has taken place, the entity does not have control of the future economic benefits arising from performance, nor does it have an obligation to transfer economic benefits that arise on performance. What it *does* have, however, is a contract that represents a net position comprising a combined right and obligation either to participate in the exchange or alternatively to be compensated (or to compensate) for the consequences of the exchange not taking place. Initially, the rights and obligations are likely to be exactly offsetting, although that will often not remain the case. The rights and obligations arising under such unperformed executory contracts together represent a single asset or liability.

4.36 It may be that the contract has been performed partially but is equally proportionately unperformed—in other words, that both parties to the contract have still to perform to an equal degree the actions promised by and required of them under the contract. In such a case, although the rights and obligations relating to the performed part of the contract may represent separate assets and liabilities, the rights and obligations relating to the unperformed part will together represent a single asset or liability.

### Ownership interest

4.37 Ownership interest is defined as follows:

> Ownership interest is the residual amount found by deducting all of the entity's liabilities from all of the entity's assets.

4.38 Since ownership interest is defined as a residual interest, the distinction between liabilities and ownership interest is highly significant. Owners invest in an entity in the hope of a return, at least part of which will usually be provided by the transfer to them from the entity of economic benefits (for example the payment of dividends). However, owners, unlike creditors, do not have the ability to insist that a transfer is made to them regardless of the circumstances: theirs is a residual interest in the assets of the entity after all the liabilities have been deducted.

## GAINS AND LOSSES

### *Definitions*

4.39 Financial statements draw a distinction between changes in ownership interest arising from transactions with owners in their capacity as owners and other changes. These latter changes are gains and losses and are defined as follows:

> Gains are increases in ownership interest not resulting from contributions from owners.
>
> Losses are decreases in ownership interest not resulting from distributions to owners.

4.40 The terms 'gains' and 'losses' therefore include items that are often referred to as 'revenue' and 'expenses', as well as gains and losses arising from, for example, the disposal of fixed assets and the remeasurement of assets and liabilities.

### *Offsetting gains and losses*

4.41 Some transactions give rise to a gain (or a loss) that is the net of two amounts: the revenue or income arising from the transaction and the expenses or costs incurred in generating that revenue. For example, the profit that arises on selling an item of stock is the difference between the sale proceeds and the cost of the item sold. For the purpose of the Statement, the sale proceeds and cost of the item sold are separate items—the former being a gain and the latter a loss. Whether such gains and losses are shown separately in the financial statements is a presentation issue and is considered in Chapter 7.

## CONTRIBUTIONS FROM OWNERS AND DISTRIBUTIONS TO OWNERS

*Definitions*

4.42 The remaining elements of financial statements relate to transactions with the owners in their capacity as owners and are defined as follows:

> Contributions from owners are increases in ownership interest resulting from transfers from owners in their capacity as owners.
>
> Distributions to owners are decreases in ownership interest resulting from transfers to owners in their capacity as owners.

*In their capacity as owners*

4.43 Contributions from, and distributions to, owners include only those transactions to which owners are a party *in their capacity as owners*. Increases or decreases in ownership interest that result from transactions entered into with owners in other capacities (for example, as customers or suppliers) are gains or losses. In some cases a single transaction combines a transaction with owners in their capacity as owners and a transaction with them in some other capacity.

*Contributions from owners*

4.44 Contributions from owners involve the owners making a contribution to the entity by transferring assets, performing services, or accepting ownership interest in satisfaction of liabilities. Rights in the ownership interest are usually granted in return for a contribution from owners.

*Distributions to owners*

4.45 Distributions to owners include the payment of dividends and the return of capital. A purchase by a company of its own shares is an example of a return of capital and is therefore reflected in financial statements by reducing the amount of ownership interest.

# CHAPTER 5: RECOGNITION IN FINANCIAL STATEMENTS

*When the reporting entity undertakes a transaction or when some other relevant event occurs, the effect of that transaction or event on the elements of financial statements will need to be recognised in the financial statements if certain criteria are met. This chapter considers that recognition process.*

## PRINCIPLES

- If a transaction or other event has created a new asset or liability or added to an existing asset or liability, that effect will be recognised* if:

  (a) sufficient evidence exists that the new asset or liability has been created or that there has been an addition to an existing asset or liability; and

  (b) the new asset or liability or the addition to the existing asset or liability can be measured at a monetary amount with sufficient reliability.

- In a transaction involving the provision of services or goods for a net gain, the recognition criteria described above will be met on the occurrence of the critical event in the operating cycle involved.

- An asset or liability will be wholly or partly derecognised† if:

  (a) sufficient evidence exists that a transaction or other past event has eliminated◊ all or part of a previously recognised asset or liability; or

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** The term 'recognised' is used in the Statement to mean depicting an item both in words and by a monetary amount and including that amount in the primary financial statement totals.*

*† The term 'derecognised' is used in the Statement to mean that an item ceases to be recognised.*

*◊ To simplify the text, the word 'eliminated' is used in this chapter in place of the phrase 'consumed, transferred, disposed of, expired, settled or extinguished'.*

(b) although the item continues to be an asset or a liability, the criteria for recognition are no longer met.

## EXPLANATION

### The recognition process

*The stages of the recognition process*

5.1 The objective of financial statements is achieved to a large extent through the recognition of elements in the primary financial statements—in other words, the depiction of elements both in words and by monetary amounts and the inclusion of those amounts in the primary financial statement totals. This recognition process has the following stages:

(a) initial recognition, which is where an item is depicted in the primary financial statements for the first time;

(b) subsequent remeasurement, which involves changing the amount at which an already recognised asset or liability is stated in the primary financial statements; and

(c) derecognition, which is where an item that was until then recognised ceases to be recognised.

*Transactions and events other than transactions*

5.2 The recognition process requires that all events that may have an effect on elements of the financial statements are, as far as is possible, identified and reflected in an appropriate manner in the financial statements.

5.3 Transactions are the most common form of such events and are therefore the most common reason for recognising and derecognising items. Events other than transactions may nevertheless also result in the recognition or derecognition of items. For example:

(a) events such as discovery, growth, extraction, processing or innovation may result in the creation of new assets that may meet the recognition criteria. Similarly, the imposition of a penalty by a court may create a new liability that meets the recognition criteria.

(b) events (such as a fire) that cause damage to an asset and events (such as the elapse of time) that result in an obligation expiring may result in a need to derecognise the asset or liability involved.

*The effect of transactions and other events*

5.4 No matter what element or change in element is being considered, the starting point for the recognition process is the effect that the transaction or other event involved has had on the reporting entity's assets and liabilities, because it is the assets and liabilities that demonstrate the lasting effect of changes in other elements. The interrelationship between the elements means that the recognition of one item as an element (or the recognition of a change in an element, including its derecognition) will inevitably result in the recognition of, or change in, another element. Thus, if a new asset is recognised, there will also be recognised a decrease in another asset, a new or increased liability, a gain, or a contribution from owners (or a combination of these).

5.5 A transaction or other event could have one of several effects on a reporting entity's assets and liabilities.

(a) It might create a new asset or liability or add to an existing asset or liability. When this is the case, it will be necessary to determine whether the new asset or liability (or the addition thereto) should be recognised, because not all assets and liabilities are recognised. Paragraphs 5.12–5.21 consider initial recognition in detail.

(b) It might provide additional evidence about an existing but unrecognised asset or liability and, as a result, enable that item to be recognised. This is also considered in paragraphs 5.12–5.21.

(c) It might change some aspect of an already recognised asset or liability. This change may involve:

  (i) the nature of the item. For example, an item of raw material may be converted through the production process into finished goods. Similarly, convertible debt may be converted into equity shares. A change in the nature of an item will usually require a change in description, possibly by reclassification from one balance sheet caption to another or by renaming within a balance sheet caption. The amount at which the item is stated in the financial statements may also need to be changed.

  (ii) a change to the flow of benefits associated with an already recognised asset or liability. For example, the market value of a property may change as a result of changes in its development or income potential. Doubts about the creditworthiness of a debtor may alter perceptions of the collectability of the amount due from that debtor. Similarly, new information may cause the reporting entity to alter its estimate of the amount to be paid out to settle a liability of uncertain amount. A change in the flow of benefits associated with an item may require a change in the amount at which the item is stated. Changes in the amount at which an item is stated (in other words, subsequent remeasurements) are considered in Chapter 6.

(d) It might involve transferring, using up or consuming an asset or settling, extinguishing or transferring a liability. On the other hand, it might leave intact certain of the rights to future economic benefits inherent in an asset whilst transferring, using up or consuming others, or it might leave intact certain obligations inherent in a liability whilst settling, extinguishing or transferring others. In all such circumstances it will be necessary to consider whether the existing asset or liability that has been affected should be derecognised in whole or in part. Paragraphs 5.22-5.25 consider derecognition further.

5.6 The references in the definitions of assets and liabilities to past transactions or events ensure that the non-cash effects of transactions and other events will, as far as is possible, be reflected in the financial statements in the accounting period in which they occur and not, for example, in the period in which any cash involved is received or paid. This is commonly referred to as the 'accruals concept'.

5.7 Whether the reporting entity is a going concern can play a significant role in the recognition process. For example, some contracts stipulate that the rights they give one party to the contract will lapse if that party discontinues its operations. Similarly, the reliability of measures—an important factor in the recognition process—may be affected if the reporting entity is not able to continue its operations. As explained in Chapter 3, the qualitative characteristic of relevance usually requires the going concern assumption to be applied.

*Uncertainty and the recognition process*

5.8 Ideally, all assets, liabilities, gains, losses and other elements would be recognised immediately they arise. Similarly, in an ideal world an asset or liability would be derecognised as soon as it had ceased to exist or would be remeasured as soon as the need for remeasurement arose. In practice, however, entities operate in an uncertain environment and this uncertainty may sometimes make it necessary to delay the recognition process.

5.9 If uncertainty exists, totally reliable information will become available only when the uncertainty has resolved itself. However, to defer a stage of the recognition process until the uncertainty has resolved itself will often reduce the relevance of the financial statements. It may also reduce their reliability because they will not represent faithfully the transactions and other events of the reporting period. Financial statements achieve a balance between these competing demands by seeking to provide information that has no more than an acceptable degree of uncertainty but not seeking to provide information that is totally free from uncertainty.

5.10 In the business environment, uncertainty usually exists in a continuum, so the recognition process involves selecting the point on the continuum at which uncertainty becomes acceptable. The exact location of this point on the continuum will vary, depending on circumstances. For example, if additional information about the possible outcomes of an obligation is disclosed, it will usually be possible to recognise a liability despite this uncertainty. Furthermore, if a number of similar uncertain items are involved, it may be practicable to determine a sufficiently reliable measure for the items taken as a whole despite the impracticality of determining a sufficiently reliable measure for each item individually.

5.11 There will nevertheless be circumstances in which it is not possible to reduce the uncertainty to an acceptable level. If that is the case, the recognition process will be deferred until such time as the uncertainty has been reduced to an acceptable level (and the effect of the transaction or other event will instead usually be reported in the notes to the financial statements).

## INITIAL RECOGNITION

### *Categories of uncertainty*

5.12 In the initial recognition process, there are two broad categories of uncertainty that could arise:

(a) element uncertainty, which involves uncertainty whether an item exists and meets the definitions of the elements of financial statements; and

(b) measurement uncertainty, which concerns the appropriate monetary amount at which to recognise the item.

### *Element uncertainty*

5.13 Whether the rights or other access that underlie a potential asset exist, whether they are controlled by the reporting entity and whether they may yield future economic benefits may all be subject to uncertainty. Similarly, in the case of a potential liability there could be uncertainty whether the obligation exists and whether that obligation might require the reporting entity to transfer economic benefits.

5.14 Uncertainty of this kind (element uncertainty) is countered by evidence—the more evidence there is about an item and the better the quality of that evidence, the less uncertainty there will be over the item's existence and nature. To recognise an item it is necessary to have sufficient evidence, both in amount and quality, that the item exists and is an asset or liability of the reporting entity. This is reflected in the first of the two criteria for initial recognition, which requires that sufficient evidence must exist that a new asset or liability has been created or that there has been an addition to an existing asset or liability.

5.15 What constitutes sufficient evidence is a matter of judgement in the particular circumstances of each case although, while the evidence needs to be adequate, it need not be (and often cannot be) conclusive. The main source of evidence will be past or present experience with the item itself or with similar items, including:

(a) evidence provided by the event that has given rise to the possible asset or liability;

(b) past experience with similar items (for example, successful research and development in the past);

(c) current information directly relating to the possible asset or liability; and

(d) evidence provided by transactions of other entities in similar assets and liabilities.

*Measurement uncertainty*

5.16 To recognise an item, it is necessary to attribute a monetary amount to it. This involves two steps: selecting a suitable measurement basis (ie historical cost or current value) for the item and determining an appropriate monetary amount for the basis chosen.*

5.17 Uncertainty about the appropriate monetary amount at which to recognise the item (in other words, measurement uncertainty) is reflected in the second of the criteria for initial recognition, which requires that the new asset or liability or addition to an existing asset or liability can be measured at a monetary amount with sufficient reliability.

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* *The measurement process is described in Chapter 6.*

*Prudence*

5.18 As explained earlier, in order to recognise a loss (or gain), it is necessary to consider whether there is sufficient evidence that a decrease (or increase) in ownership interest has occurred and whether the amount of the loss (or gain) can be measured with sufficient reliability. As explained in Chapter 3, if there is uncertainty prudence requires:

(a) more confirmatory evidence about the existence of an asset or gain than about the existence of a liability or loss; and

(b) a greater reliability of measurement for assets and gains than for liabilities and losses.

5.19 However, the exercise of prudence does not justify the omission of assets or gains when there is sufficient evidence of occurrence and reliability of measurement or the inclusion of liabilities or losses when there is not. Nor does it justify any other deliberate and systematic overstatement of liabilities or losses or deliberate and systematic understatement of assets or gains.

*Unperformed contracts*

5.20 As explained in Chapter 4, when an entity enters into an agreement with another party, it obtains certain rights and, in exchange, accepts certain obligations. Before any act of performance under the agreement has taken place, the entity will have only a net position comprising a combined right and obligation either to participate in the exchange or alternatively to be compensated (or to compensate) for the consequences of the exchange not taking place. Although this right and the obligation will usually be in balance initially, changing circumstances may cause an imbalance to arise, in which case the net position will be either an asset or a liability.

5.21 This asset or liability will be recognised if the recognition criteria described in paragraphs 5.14 and 5.17 are met (and if the amount at which the asset or liability is to be measured is not nil). In particular:

(a) the criterion that sufficient evidence must exist that the new asset or liability has been created will generally be met if it can be shown that the agreement is enforceable and, as a result, that a party to the agreement cannot cancel it (or otherwise fail to perform in accordance with it) without being obliged to compensate for such non-performance.

(b) the criterion that the new asset or liability must be capable of being measured at a monetary amount with sufficient reliability is dealt with in Chapter 6.

(c) if the historical cost basis of measurement is being used, the carrying amount will be the cost of entering into the agreement, which is usually nil. In effect, therefore, the contract is recognised at nil. An unperformed non-derivative contract with no initial cost will nevertheless be recognised if it has become an onerous contract.

## DERECOGNITION

*Derecognition because the asset or liability has been eliminated*

5.22 Assets tend, in due course, to be consumed, transferred or otherwise disposed of, or they expire. For example, cash may be spent, debtors may be collected, raw materials may be consumed or processed, finished goods may be sold and the service potential of a machine may be fully used up. Similarly, liabilities tend to be settled, extinguished, transferred, or they expire. For example, creditors may be paid, a warranty attaching to goods sold may expire, long-term debt may be exchanged for other debt and obligations to perform in accordance with agreed contractual terms may be met. In all such circumstances, it may be necessary to derecognise some or all of the asset or liability involved.

5.23 It is usually relatively simple to determine whether and when a previously recognised asset or liability needs to be derecognised. For example, using the examples given in the previous paragraph, the cash will be derecognised when it is paid out, the raw materials as they are being used and so on (in other words, when the asset is eliminated). However, some transactions leave intact certain of the rights to future benefits inherent in an asset (or obligations inherent in a liability) while eliminating others. In such circumstances, analysis is required to ascertain whether the effect of the transaction should be reflected by derecognising some or all of the assets and liabilities involved. For example, if the reporting entity no longer has control of some of the rights that previously constituted an asset while retaining control of some of the other rights, the asset may need to be partially derecognised (or the existing asset completely derecognised and a new asset recognised instead).

5.24 Ideally, an asset or liability would be derecognised as soon as it has been eliminated. However, there will sometimes be uncertainty about an item's continued existence. In such circumstances, derecognition will not take place until sufficient evidence exists that the transaction or other event has resulted in the elimination of the item. When there is uncertainty, prudence usually requires more confirmatory evidence about the existence of, and a greater reliability of measurement for, assets than is required for liabilities. This tends to mean that, if there is any significant uncertainty about an asset's continued existence, it will be derecognised. However, in the case of a liability, more evidence of its elimination will be needed before it will be derecognised.

*Derecognition because the criteria for recognition are no longer met*

5.25 After initial recognition, an asset or liability will usually continue to be recognised until it has been eliminated, at which point it will be derecognised. It is possible, however, that, although there has been no significant change in the inherent nature of an already recognised asset or liability—in other words, although the asset or liability has not been eliminated—the criteria for recognition described in paragraphs 5.14 and 5.17 are no longer met. For example, an event may have occurred since initial recognition that has resulted in there no longer being sufficient evidence that the asset or liability concerned exists. Similarly, an event may have created additional uncertainty and, as a result, a previously recognised asset or liability can no longer be measured with sufficient reliability. On the rare occasions when this is the case, that asset or liability will be derecognised even though it has not been eliminated.

## Revenue recognition

5.26 It was explained earlier in the chapter that, because of the interrelationship between the elements, the starting point for the recognition process is always the effect that the transaction or other event involved has had on the reporting entity's assets and liabilities. For example, assuming that no contribution from owners or transfer to owners is involved:

(a) if the effect of the transaction or other event is to increase the entity's recognised net assets, a gain will be recognised.

(b) a loss will be recognised if, and to the extent that, previously recognised assets have been reduced or eliminated or cease to qualify for recognition as assets without a commensurate increase in other assets or reduction in liabilities. Similarly, a loss will be recognised when and to the extent that a liability is incurred or increased without a commensurate increase in recognised assets or a reduction in other liabilities.

5.27 However, although the starting point for the recognition process may be the effect on assets and liabilities, the notions of matching and the critical event in the operating cycle will often help in identifying these effects.

*Matching*

5.28 Matching has two forms.

(a) Time matching involves the recognition of receipts (and payments) directly associated with the passage of time as gains (and losses) on a systematic basis over the course of the period involved. For example, rent paid at the beginning of a rental period is recognised as a loss over the course of the rental period, with amounts paid in advance of such recognition being recognised as an asset.

(b) Revenue/expenditure matching involves the recognition of expenditure directly associated with the generation of specific gains as a loss in the same period as the gains are recognised, rather than in the period in which the expenditure is incurred. For example, the cost incurred in obtaining or producing an item of stock is recognised in the performance statement as a loss in the same reporting period as the gain on selling that item, and in the meantime is recognised as an asset.

5.29 Almost all expenditure is undertaken with a view to acquiring some form of benefit in exchange. Consequently, if matching were used in an unrestricted way, it would be possible to delay the recognition in the performance statement of most items of expenditure insofar as the hoped-for benefits still lay in the future. The Statement imposes a degree of discipline on this process because only items that meet the definitions of, and relevant recognition criteria for, assets, liabilities or ownership interest are recognised in the balance sheet.

5.30 This means that the Statement does not use the notion of matching as the main driver of the recognition process. Nevertheless, the Statement envisages that:

(a) if the future economic benefits embodied in the asset are eliminated at a single point in time, it is at that point that the asset will be derecognised and a loss recognised; and

(b) if the future economic benefits are eliminated over several accounting periods—typically because they are being consumed over a period of time—the cost of the asset that comprises the future economic benefits will be recognised as a loss in the performance statement over those accounting periods.

5.31 When expenditure is being allocated to more than one accounting period, the amount allocated to each accounting period will depend on the circumstances involved, although the aim is always to recognise the expenditure as a loss on a systematic basis over the periods in which the asset delivers up its benefits. For example, if the association of the expenditure with the generation of specific gains can be only broadly or indirectly determined, it will often be necessary to assume that the asset declines in a systematic manner over its expected life.

5.32 Two implications of adopting the approach in the Statement, rather than using matching as a main driver of recognition, are that:

(a) expenditure or some other form of loss that cannot justifiably be shown to be associated with control of rights or other access to future economic benefits will be recognised in the performance statement as a loss in the period in which it is incurred; and

(b) expenditure incurred with a view to future economic benefits but whose relationship to such benefits is too uncertain to warrant recognition of an asset will be recognised immediately as a loss.

*Critical event in the operating cycle*

5.33 Sometimes it is easier to identify the appropriate point at which to recognise gains* arising from the provision of services or goods—and therefore changes to the entity's assets and liabilities—by focusing on the operating cycle of the reporting entity and, in particular, on the critical event in that cycle.

5.34 The critical event is the point in an operating cycle at which there will usually be sufficient evidence that the gain exists and it will usually be possible to measure that gain with sufficient reliability. In other words, it is the point at which the recognition criteria described earlier in the chapter will be met and the gain and related change to assets and liabilities will be recognised.

5.35 For many types of transaction, the critical event in the operating cycle is synonymous with full performance. In such cases a gain will be recognised when the entity providing the service or goods has fully performed. That need not, however, be the case: the critical event could occur at other times in the cycle and there could be more than one critical event in the cycle.

5.36 The identity of the critical event or events of an operating cycle will depend on the particular circumstances involved. For example:

(a) if the reporting entity has carried out all its obligations under an agreement except for a few minor acts of performance, the critical event will have occurred.

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* *In order to keep the explanation simple, it has been assumed in paragraphs 5.33-5.36 that the transaction being discussed is expected to generate a net profit and that the issue is therefore when to recognise that profit when using the historical cost basis of measurement. If the contract is expected to generate a loss the historical cost carrying amount will be adjusted immediately to reflect that expected loss.*

(b) if a sale is contingent upon acceptance by the buyer, the critical event will usually occur before acceptance unless the act of acceptance creates substantial uncertainty whether the contractual obligations will be met. The critical event will not usually have occurred if the likelihood of the goods or services not being accepted is significant.

(c) the operating cycle might involve a contract that is performed in stages, for each of which there is a critical event. (Contracts to build large buildings are usually an example of such an operating cycle.) In such circumstances, the gain that is expected to be earned on the contract as a whole will need to be allocated among the critical events.

# CHAPTER 6: MEASUREMENT IN FINANCIAL STATEMENTS

*Measuring an asset or liability entails deciding on the measurement basis to be used and determining the monetary amount that is appropriate for that basis. It may also involve revising the monetary amount when certain events occur. This chapter describes the measurement process and explains how a choice is made between the measurement bases available.*

## PRINCIPLES

- In drawing up financial statements, a measurement basis—either historical cost or current value*—needs to be selected for each category of assets or liabilities. The basis selected will be the one that best meets the objective of financial statements and the demands of the qualitative characteristics of financial information, bearing in mind the nature of the assets or liabilities concerned and the circumstances involved.

- An asset or liability being measured using the historical cost basis is recognised initially at transaction cost. An asset or liability being measured using the current value basis is recognised initially at its current value at the time it was acquired or assumed.

- Subsequent remeasurement will occur if it is necessary to ensure that:

  (a) assets measured at historical cost are carried at the lower of cost and recoverable amount;

  (b) monetary items denominated in foreign currency are carried at amounts based on up-to-date exchange rates; and

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* *The term 'historical cost' is, unless stated otherwise, used in the Statement to refer to the particular version of the historical cost basis described in paragraph 6.18. Similarly, the term 'current value' is used to refer to the value determined in accordance with paragraphs 6.7-6.9.*

   (c) assets and liabilities measured on the current value basis are carried at up-to-date current values.

- Such remeasurements, however, will be recognised only if:

   (a) there is sufficient evidence that the monetary amount of the asset or liability has changed; and

   (b) the new amount of the asset or liability can be measured with sufficient reliability.

## EXPLANATION

### ALTERNATIVE BASES OF MEASUREMENT

6.1 Assets and liabilities have several different monetary attributes that could be represented in financial statements. Assets could, for example, be stated at historical cost, replacement cost or net realisable value and liabilities could, for example, be stated at historical cost, the cost of discharging the liability by the most economical means available or (in some cases) the amount that the entity could currently raise by issuing a similar debt security. The single most important characteristic that distinguishes these monetary attributes (which are known as measurement bases) is whether they are based on historical cost or current value. This chapter concentrates on that distinction.

6.2 These measurement bases could be used in financial statements in one of several ways. In particular:

(a) a single measurement basis could be used for all assets and liabilities. For example, all assets and liabilities could be measured using historical cost. This is known as the historical cost system. Alternatively, all assets and liabilities could be measured at current value. This is known as the current value system.

(b) some categories of assets or liabilities could be measured on a historical cost basis and some on a current value basis. This is known as the mixed measurement system. In reality there is not one mixed measurement system but many, each involving a different mix of historical cost and current value.

6.3 The mixed measurement system permits the measurement basis to be selected separately for each category of assets or liabilities. It also permits the use of historical cost (or current value) for all assets and liabilities if historical cost (or current value) is the most appropriate measure for each of those categories. Thus it can be adapted to fit the particular circumstances involved.

6.4 The Statement therefore envisages that the mixed measurement system will be used and it focuses on the mix of historical cost and current value to be adopted. In doing so, it describes a framework that would guide the choice of basis for each category of assets or liabilities.

6.5 One approach that is not appropriate is to remeasure a category of assets or liabilities at current value, then retain those assets or liabilities at that same amount indefinitely or for a long period of time. Such measures will usually soon cease to be up-to-date current values and will then be neither a historical cost nor a current value. As such, they disturb the comparability and consistency of accounting measurement and are not consistent with the principles contained in the Statement.

## Alternative measures of current value

6.6 The current value of an asset could be determined by reference to entry value (replacement cost), exit value (net realisable value) or value in use (discounted present value of the cash flows expected from continuing use and ultimate sale by the present owner). For some assets (for example investments in actively traded securities), these three alternative measures of current value produce very similar amounts, with only small differences due to transaction costs. However, for other assets (for example fixed assets specific to the business), differences between the alternative measures can be material.

6.7 It is therefore necessary to select from these alternative measures of current value the measure that maximises the relevance of the current value basis. Current value is at its most relevant when it reflects the loss that the entity would suffer if it were deprived of the asset involved. That measure, which is often referred to as the 'deprival value' or the 'value to the business', will depend on the circumstances involved.

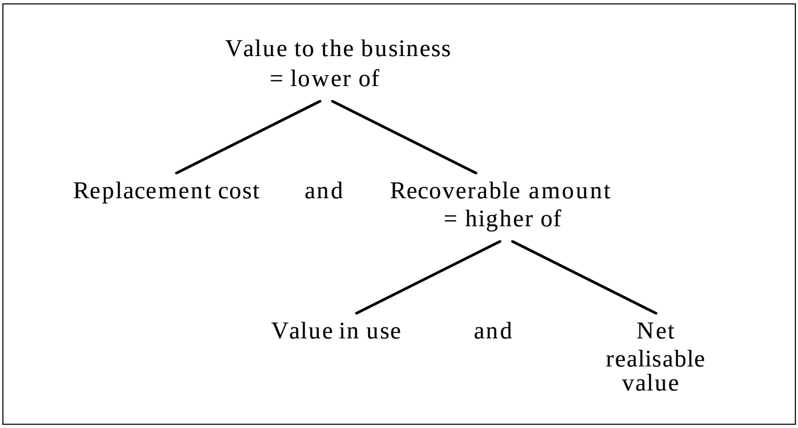
(a) In most cases, as the entity will be putting the asset to profitable use, the asset's value in its most profitable use (in other words, its recoverable amount) will exceed its replacement cost. In such circumstances, the entity will, if deprived of the asset, replace it, and the current value of the asset will be its current replacement cost.

(b) An asset will not be replaced if the cost of replacing it exceeds its recoverable amount. In such circumstances, the asset's current value is that recoverable amount.

   (i) When the most profitable use of an asset is to sell it, the asset's recoverable amount will be the amount that can be obtained by selling it, net of selling expenses; in other words, its net realisable value.

(ii) When the most profitable use of an asset is to consume it—for example by continuing to operate it—its recoverable amount will be the present value of the future cash flows obtainable and cash flows obviated as a result of the asset's continued use and ultimate disposal, net of any expenses that would need to be incurred; in other words, its value in use.

6.8 This can be portrayed diagrammatically as follows:




6.9 It is possible to select a current value for a liability in a similar manner (using the concept of 'relief value'). The relief value of a liability is the lowest amount at which the entity could divest itself of the obligation involved—in other words, the lowest amount at which the liability could, hypothetically, be settled.

## The measurement process

6.10 It is not the function of financial statements to represent directly the total value that the reporting entity would fetch in an exchange transaction. Instead, the financial statements provide information designed to assist users to make judgements about the entity's financial performance and financial position and it is these judgements, in combination with other information, that enable, inter alia, a value for the entity to be assessed. The purpose of the measurement process is therefore to measure the effects of the transactions and events of the period on the financial performance and financial position of the entity.

### *Initial recognition*

6.11 An asset or liability that is being measured using the historical cost basis will be recognised initially at transaction cost or, if an event other than a transaction is involved, at its fair value at the time it was acquired or assumed. The transaction cost of an asset acquired or liability assumed is the fair value of the consideration given or received in exchange for that asset or liability.

6.12 An asset or liability that is being measured using the current value basis will be recognised initially at its current value at the time it was acquired or assumed.

6.13 This means that, regardless of the measurement basis used, assets and liabilities that arise from transactions carried out at fair value—which is the vast majority of assets and liabilities—will be measured on initial recognition at their transaction cost. That is because, in the case of such a transaction, the fair value of the consideration paid or received (ie the transaction cost) is equal to the current value of the asset or liability at the time of acquisition.

6.14 It can generally be assumed that, in the absence of evidence to the contrary, a transaction has been carried out at fair value. In such circumstances, the transaction cost involved can be determined by reference to the fair value of either the asset (or liability) acquired or the consideration paid (or received); whichever fair value is easiest to measure will usually be used. For example (and assuming in both cases that there is no evidence suggesting that the transaction was not carried out at fair value):

(a) if the reporting entity purchases mining rights in exchange for an immediate cash payment, those rights would usually be measured on initial recognition at the cash amount because that amount is easier to measure than the fair value of the rights.

(b) if the entity purchases an asset from an employee for an immediate cash payment, it may not be clear whether it also involves a payment for services provided by the employee. Where such uncertainty exists, it may be easier to measure the fair value of the asset purchased than the fair value of the services provided. If the former amount is, for example, less than the amount of the payment, the difference will be remuneration.

6.15 If an asset or liability arises from a transaction that was not carried out at fair value, it will often be more appropriate to measure the asset or liability at current value rather than historical cost. Choosing a measurement basis is considered in paragraphs 6.23-6.29.

6.16 The initial recognition criteria described in Chapter 5 stipulate that, to be recognised, the asset or liability involved needs to be capable of being measured at a monetary amount with sufficient reliability. Whether a measure is sufficiently reliable for inclusion in primary financial statements depends on the quantity and quality of the evidence available to confirm that the measure has the attributes of reliability described in Chapter 3. A measure derived from a generally accepted valuation methodology and supported by a reasonable amount of confirmatory evidence will usually be a sufficiently reliable measure.

*Subsequent remeasurement*

6.17 If a *pure* historical cost measurement basis is being used, the carrying amount of an asset or liability will always be the amount at which it was initially recognised; in other words, there is no subsequent remeasurement stage. The carrying amount of an asset or liability measured at historical cost may nevertheless need to be changed so that the item remains at cost. For example, as work is carried out on work-in-progress, so the carrying amount is changed to reflect the additional costs incurred. Similarly, in the case of assets that are consumed over more than one accounting period (such as fixed assets), the amount at which the asset was recognised initially will be reduced over the expected life of the asset so as to allocate the asset's cost over its expected life. Adjustments may also need to be made to the carrying amount of other assets and liabilities to reflect cost and income allocations. These adjustments are not remeasurements; they are adjustments to maintain the carrying amount at an amount based on historical cost.

6.18 In practice, however, this 'pure historical cost basis' is rarely used. Instead, to make historical cost more relevant to the needs of users, a variation is used that involves a limited amount of remeasurement. The purpose of this remeasurement is to ensure that:

(a) assets are not reported at amounts greater than their recoverable amount; and

(b) monetary assets and liabilities denominated in currencies other than the reporting currency are stated at an amount that is based on up-to-date exchange rates.

All references in the Statement to the historical cost basis are, unless stated otherwise, references to this version of the historical cost basis.

6.19 When the current value basis of measurement is being used, remeasurement takes place to ensure that the assets or liabilities involved are measured at an up-to-date current value. Such remeasurements will, however, be recognised in the financial statements only if:

(a) there is sufficient evidence that the amount of the asset or liability has changed. For example, if consideration is being given to writing down the carrying amount of an asset to its recoverable amount, there will need to be sufficient evidence that the asset's recoverable amount *is* lower than its carrying amount; and

(b) the new amount of the asset or liability is capable of being measured with sufficient reliability.

6.20 What constitutes sufficient evidence is a matter of judgement in the particular circumstances of each case although, whilst the evidence will need to be adequate, it need not (and often cannot) be conclusive. Relevant considerations as to whether the evidence is sufficient will include its persuasiveness and whether the change implies that a gain or a loss has occurred.*

6.21 Although the nature of the evidence will vary from item to item, its primary source will be past or present experience with the item itself or with similar items. This will include evidence provided by:

(a) current information directly relating to the item (eg the current physical condition of items of stock, their current selling price, and current levels of orders for them).

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* *These factors, and the sources of evidence referred to in paragraph 6.21, are broadly similar to those that need to be taken into account when considering, in the initial recognition stage, whether there is sufficient evidence that an asset or liability itself has been changed (see paragraph 5.15).*

(b) other entities' transactions in similar assets and liabilities. If such transactions are frequent and the items traded are very similar to the item held by the reporting entity (ie there is an efficient market in homogeneous items), such evidence will often be sufficient. However, as the frequency of transactions decreases or differences between the items traded and the item held by the reporting entity increase, the evidence will become less persuasive and is less likely to be sufficient on its own.

(c) past experience with a group of similar items (eg the levels of losses arising in the past on stock of different ages).

6.22 The issues to be considered in deciding whether the new amount of the asset or liability is capable of being measured with sufficient reliability are identical to the reliability of measurement issues considered in the context of initial recognition (see paragraph 6.16).

### CHOOSING A MEASUREMENT BASIS AND DECIDING WHETHER TO CHANGE IT

6.23 In choosing the measurement basis to be used for a particular category of assets or liabilities, the aim is to select the basis that is most appropriate bearing in mind:

(a) the objective of financial statements and the qualitative characteristics of financial information, in particular relevance and reliability;

(b) the nature of the assets or liabilities concerned; and

(c) the particular circumstances involved.

6.24 Although these factors may not change, the measurement basis that best meets them may. For example, to the extent that markets develop, measurement bases that were once thought unreliable may become reliable. Similarly, to the extent that access to markets develops, so a measurement basis that was once thought insufficiently relevant may become the most relevant measure available.

6.25 Although it is often difficult to make general statements about the appropriate measurement basis for any particular category of assets or liabilities, the observations set out in paragraphs 6.26–6.29 can be made.

6.26 The need for financial information to be relevant means that, in selecting a measurement basis, the focus will be on providing information about financial performance and financial position that is useful in evaluating the reporting entity's cash-generation abilities and in assessing its financial adaptability.

6.27 The carrying amounts of assets and liabilities need to be sufficiently reliable.* If only one of the measures available is reliable, it will be the one used provided that it is also relevant. On the other hand, if both the historical cost measure and the current value measure are reliable, the better measure to use will be the one that is the most relevant.

6.28 Current value measures are sometimes characterised as less reliable than historical cost measures. Such a characterisation tends to assume, however, that all historical cost measures are transaction-based and involve little estimation, which is not the case. For example, adjustments made to the historical cost carrying value of debtors to make allowance for bad and doubtful debts involve a degree of estimation that is not dissimilar to that

* *What the characteristic of reliability entails is considered in detail in Chapter 3 and is also dealt with in paragraphs 6.16 and 6.35-6.38.*

involved in estimating current values not derived from an active market—and the results are often of broadly similar reliability. There is a similar level of estimation involved in determining the cost of self-generated assets and by-products, and generally in all circumstances involving allocations of substantial amounts of indirect costs. The hurdle that a measure must clear to be deemed reliable is set at the same height for current value measures as for historical cost measures.

6.29 Assessments of relevance and reliability need to take into account what the asset or liability represents. For example, if an entity 'stores' its spare cash by making an investment, that investment's relevance to the entity will be derived from the specific future cash flows that it represents rights to. The measure that will most faithfully represent those rights will generally be current value. Similarly, if an entity has a liability of uncertain amount, that liability's relevance to the entity will be derived from the most up-to-date information about those uncertainties. The measure that most faithfully represents those uncertainties will again generally be current value.

## Measurement issues

### *Going concern*

6.30 Financial statements are usually prepared—and measures are usually arrived at—on the basis that the reporting entity is a going concern because measures based on break-up values tend not to be relevant to users seeking to assess the entity's cash-generation ability and financial adaptability.

### *Discounting*

6.31 Most transactions take place at fair value. Rational buyers and sellers will ensure that this fair value reflects the time value of money and the risk associated with the future expected cash flows, which means that market prices generally will reflect such factors.

6.32 This chapter has explained that assets will, depending on the circumstances, be carried in the financial statements at historical cost, replacement cost, net realisable value or value in use and that liabilities will, again depending on the circumstances, be carried at historical cost or the lowest amount at which the liability could be settled. Historical cost and replacement cost are both market prices and will therefore, for the reason set out in paragraph 6.31, take into account the time value of money and the risk associated with the future expected cash flows.

6.33 To be consistent, these factors need also to be reflected in the other measures that can be used to determine the carrying amount of assets (in other words, value in use and net realisable value) and the carrying amount of any liabilities measured by reference to expected future cash flows. It follows that, when basing carrying amounts on future cash flows, those cash flows will need to be discounted.

6.34 The discount rate used will reflect the risks associated with the future expected cash flows involved (unless those future expected cash flows are already risk-adjusted) and the time value of money. As such, it will reflect the risks specific to the item being measured but not the more general risks of the entity as a whole.*

*Arriving at a measure in the face of uncertainty*

6.35 It is quite common for there to be uncertainty about the appropriate monetary amount at which to measure an asset or liability. The existence of this uncertainty (measurement uncertainty) is acknowledged in the initial recognition and subsequent remeasurement criteria, both of which insist that the monetary amount at which an asset or liability is to be recognised is capable of being measured with sufficient reliability.

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* *Discounting is discussed in greater detail in a Working Paper 'Discounting in Financial Reporting' published by the Board in April 1997.*

6.36 If uncertainty exists, the only way to determine an appropriate monetary amount for the asset or liability is through the use of estimates. As long as a generally accepted estimation method is used and the measure is supported by a reasonable amount of confirmatory evidence—prudence requires a greater reliability of measurement for assets (and gains) than for liabilities (and losses)—the use of estimates is acceptable and will not prevent the measure from being sufficiently reliable to be used in the financial statements.

6.37 Estimating an appropriate carrying amount will often involve adopting one of the following approaches.

(a) If there is a reasonably efficient market for the item or for very similar items, a market-based measure such as a market price could be used as the carrying amount because the market consensus over the amount of the benefits inherent in the item is likely to mean that the measure will be reliable.

(b) If the entity has a group of homogeneous but not identical items, the expected value of the entire group could be used, provided the group is of a sufficient size and there is sufficient evidence of the various possible outcomes and their probabilities to permit an explicit calculation of expected value.*

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* *Expected value is a weighted average of all possible outcomes, calculated using the probability of occurrence of an outcome as its weight. For a group of similar items, individual items will have different outcomes, and the number of items having a particular outcome will be related to the probability of that outcome. Hence, the expected value will represent a reasonable estimate of the monetary amount of the benefits associated with the entire group. For instance, in considering a large portfolio of non-interest bearing debts, it may be unlikely that any individual debt will prove to be bad, but some degree of non-payment is normally expected; hence a loss representing this expected reduction in economic benefits is recognised. If each debt were to be considered individually and measured at its most likely outcome, each debtor might be judged more likely than not to pay, and hence no bad debt provision would be made. However, this would not represent a reasonable measure of future economic benefits for the entire group.*

(c) If neither of these approaches is practicable, a best estimate will need to be used. If there is a minimum amount that is reasonably assured, the item will be stated at no less than that minimum amount, and a higher amount will be used if that is a better estimate.

6.38 If the monetary amount at which an asset or liability is recognised is subject to significant uncertainty, the degree of uncertainty surrounding the estimate will usually be disclosed in order to avoid the impression that the outcome is certain. Such a disclosure might provide details of the significant assumptions and measurement basis used, the range of possible outcomes, and the principal factors that affect the outcome.

## Capital maintenance adjustments and changing prices

6.39 Put simply, accounting profit is the return the reporting entity has earned on its capital. Therefore, in order to account properly for accounting profit, it is necessary to differentiate between return *on* capital and return *of* capital. This involves defining and measuring the capital of the entity.

6.40 Under the accounting model described by the Statement and adopted by almost all profit-making entities, the capital of the entity is defined as the monetary amount of ownership interest (the financial capital maintenance concept) and is measured in nominal amounts.

6.41 With this approach, the capital of the entity will be maintained if the amount of gains during a period is at least equal to the amount of losses in that period. This means that any surplus of gains over losses during a period represents a return *on* capital for that period.

6.42 Whilst this approach is satisfactory under conditions of stable prices, it is open to criticism when general or specific price changes are significant.

(a) General price changes can affect the significance of reported profits and of ownership interest. If this problem is acute, an approach will need to be adopted that involves recognising profit only after adjustments have been made to maintain the purchasing power of the entity's financial capital.

(b) Specific price changes can affect the significance of reported profits and financial position. If the problem is acute, it will be necessary to adopt a system of accounting that informs the user of the significance of specific price changes for the entity's financial performance and financial position.

# CHAPTER 7: PRESENTATION OF FINANCIAL INFORMATION

*Good presentation ensures that the essential messages of the financial statements are communicated clearly and effectively and in as simple and straightforward a manner as possible. This chapter explains what good presentation entails. It also considers the information that often accompanies financial statements and explains some of the roles fulfilled by such information.*

## PRINCIPLES

- Financial statements comprise primary financial statements and supporting notes that amplify and explain the primary financial statements. The primary financial statements themselves comprise the statement of financial performance,* the statement of financial position or balance sheet, and the cash flow statement.

- The presentation of information on financial performance focuses on the components of that performance and on the characteristics of those components.

- The presentation of information on financial position focuses on the types and functions of assets and liabilities held and on the relationships between them.

- The presentation of cash flow information will show the extent to which the entity's various activities generate and use cash, and will distinguish in particular between those cash flows that result from operations and those that result from other activities.

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* *Although many entities in the UK and the Republic of Ireland at present prepare two statements of financial performance, the number of statements prepared is a matter of convention and legal requirement; no significant financial reporting principle is involved. For simplicity, however, the Statement generally refers to 'the statement of financial performance'.*

- Disclosure of information in the notes to the financial statements is not a substitute for recognition and does not correct or justify any misrepresentation or omission in the primary financial statements.

## EXPLANATION

### Presentation of information in financial statements

*Clear, effective and simple communication*

7.1 As financial statements are a means of communication, the objective of the presentation adopted is to communicate clearly and effectively and in as simple and straightforward a manner as is possible without loss of relevance or reliability and without unnecessarily increasing the length of the financial statements.

*Highly structured and aggregated*

7.2 Even if it were practicable it would not be appropriate for financial statements to report every single aspect of every relevant transaction and event: the mass of detail would obscure the message. The presentation of information in financial statements therefore involves a high degree of interpretation, simplification, abstraction and aggregation—in other words, a loss of detailed information. Nevertheless, if this process is carried out in an orderly manner, greater knowledge will result because such a presentation will:

(a) convey information that would otherwise have been obscured;

(b) highlight those items, and relationships between items, that are generally of most significance;

(c) facilitate comparability between different entities' financial statements; and

(d) be more understandable to users.

7.3 The primary focus of financial statements is on the entity's cash generation and financial adaptability. This focus is met through a set of interrelated reports (known as the primary financial statements) on:

(a) financial performance (the profit and loss account and the statement of total recognised gains and losses are examples of financial performance statements);

(b) financial position (the balance sheet); and

(c) cash inflows and outflows (the cash flow statement),

and a series of supporting disclosures (the notes to the financial statements).

7.4 The notes and primary financial statements form an integrated whole, with the notes amplifying and explaining the statements by, for example, providing:

(a) more detailed information on items recognised in the primary financial statements. Good presentation strikes a balance between the detail provided on the face of the primary financial statements and that provided in the notes, thus avoiding cluttering up the former and obscuring their message.

(b) context for, or an alternative view of, items recognised in the primary financial statements. For instance, if a balance sheet includes a liability that is in dispute, the related note might disclose the range of possible outcomes. Similarly, the notes usually provide segmental information to supplement the primary financial statements, which focus on the reporting entity in aggregate.

(c) relevant information that it is not practicable to incorporate in the primary financial statements, for example because of pervasive uncertainty.

7.5 The notes to the financial statements therefore represent a very important part of the overall information package. Nevertheless, disclosure of information in the notes is not a substitute for recognition and does not correct or justify any misrepresentation in or omission from the primary financial statements.

*Classification*

7.6 In order to facilitate the analysis of the information provided, items that are similar are presented together in the financial statements and distinguished from dissimilar items.

7.7 The classifications used to achieve this also have regard to the additional insights that can be obtained by considering the relationships between different classes of items, for example the relative sizes of profits and capital employed or debtors and sales.

7.8 Classifications that are similar or related are presented in financial statements in a manner that highlights that similarity or relationship. For example, different kinds of current assets are shown adjacent to each other, and current liabilities are usually shown in a manner that highlights their relationship to current assets.

## Good presentation

*Statement of financial performance*

7.9 The financial performance of a reporting entity is made up of components that exhibit differing characteristics in terms of, for example, nature, cause, function, relative continuity or recurrence, stability, risk, predictability and reliability. All these components are relevant to an assessment of financial performance and therefore need to be reported on in the statement of financial performance, although their individual characteristics mean that some will carry more weight in some assessments of financial performance than others.

7.10 Information on financial performance needs to be presented in a way that focuses attention on these components and on their key characteristics. Therefore, although it is not of fundamental importance whether one or more than one performance statement is provided, the presentation—including the headings used and the items that appear under each heading—is important. Good presentation of financial performance information typically involves:

(a) recognising only gains and losses in the statement of financial performance.

(b) classifying components by reference to a combination of function (such as production, selling and administrative) and of the nature of the item (such as employment costs, interest payable and amounts written off investments).

(c) distinguishing amounts that are affected in different ways by changes in economic conditions or business activity (for example, by providing segmental information or by presenting income from continuing and discontinued operations as separate components).

(d) identifying separately:

    (i) items that are unusual in amount or incidence judged by the experience of previous periods or expectations of the future.

    (ii) items that have special characteristics, such as financing costs and taxation.

    (iii) items that are related primarily to the profits of future, rather than current, accounting periods, such as some research and development expenditure.

7.11 Gains and losses are generally not offset in presenting information on financial performance. For example, as explained in Chapter 4, if a transaction involves both a receipt and a cost (as is the case, for example, when an item of stock is sold), the transaction will usually be best presented by showing the gain (the receipt) separately from the loss (the cost). However, gains and losses will be offset if:

(a) they relate to the same event or circumstance; and

(b) disclosing the gross components is not likely to be useful for an assessment of either future results or the effects of past transactions and events.

For example, if a profit is made on the disposal of a fixed asset, that profit is usually best presented by showing it as a gain rather than by showing the sales proceeds as a gain separately from the depreciated cost of the asset.

*Balance sheet*

7.12 In assessing the financial position of an entity, users are most interested in the types and amounts of assets and liabilities held and the relationship between them, and in the function of the various assets. Information on the reporting entity's financial position therefore needs to be presented in a way that focuses attention on these aspects. Good presentation typically involves:

(a) recognising only assets, liabilities and ownership interest in the balance sheet;

(b) delineating the entity's resource structure (major classes and amounts of assets) and its financial structure (major classes and amounts of liabilities and ownership interest). The main basis for deciding the number of classes and the content of each is that the result will help users to assess the nature, amounts and liquidity of available resources and the nature, amounts and timing of obligations that require or may require liquid resources for settlement.

(c) distinguishing assets by function. For example, assets held for sale will be reported separately from assets held on a continuing basis for use in the entity's activities.

7.13 In presenting information on the reporting entity's financial position, assets will not be offset against liabilities.*

*Cash flow statement*

7.14 Cash flow information will be of most use if it shows the extent to which the entity's activities generate and use cash, distinguishing in particular cash flows that are the result of operations from cash flows that result from other activities. This might include, for example, showing separately cash received from trading activities, cash used to repay debt, cash used to distribute dividends and cash reinvested.

## Accompanying information

7.15 Financial statements are often accompanied and complemented by information that does not form part of the financial statements. Examples of such information include five-year trend information, operating and financial reviews, directors' reports and statements by the chairman. The Statement refers to such information as accompanying information.†

7.16 Although accompanying information generally has the same objective as financial statements, it usually comprises a different kind of information. For example, it often includes:

(a) narrative disclosures describing and explaining the entity's activities;

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* *The offsetting of rights and obligations to produce a single asset or liability is considered in paragraphs 4.33-4.36.*

† *Such information is sometimes referred to as 'supplementary information'. However, the Statement avoids that term because it is also sometimes used to refer to certain information that is included within the financial statements.*

(b) historical summaries and trend information;

(c) non-accounting, and non-financial, information; and

(d) evolutionary or experimental disclosures that are not considered suitable for inclusion in the financial statements.

7.17 Some of the accompanying information therefore deals with matters that are not in the financial statements and some deals with matters that are in the financial statements, but from a different perspective. However, none of the accompanying information will be inconsistent with the information in the financial statements.

7.18 The more complex entities and their transactions become, the more users need an objective and comprehensive analysis and explanation of the main features underlying their financial performance and financial position. Such disclosures, which are typically included in the reporting entity's operating and financial review, are best presented in the context of a discussion of the entity's business as a whole and will be most useful if they discuss:

(a) the main factors underlying the entity's financial performance, including the principal risks, uncertainties and trends involved in each of the main business areas and how the entity is responding to them;

(b) the dynamics of the entity's financial position, including the strategies being adopted on capital structure and treasury policy; and

(c) the activities and expenditure of the period that can be regarded as a form of investment in the future.

## HIGHLIGHTS AND SUMMARY INDICATORS

7.19 Financial statements and accompanying information sometimes include amounts, ratios, and other computations that attempt to distil key information about the reporting entity's financial performance and financial position. Such highlights and summary indicators cannot, on their own, provide a basis for meaningful analysis or prudent decision-making. It is therefore essential that they are not presented in a way that exaggerates their importance.

7.20 That having been said, well-presented highlights and summary indicators are useful to users who:

(a) require only very basic information, such as the amount of sales or dividends; or

(b) will proceed to a detailed appraisal of all the financial information, since highlights and summary indicators may suggest particular aspects of the information that need to be analysed further.

7.21 As already mentioned, financial statements are a means of communication. Therefore, notwithstanding the limited usefulness of highlights and summary indicators, if such information is provided it needs to be presented in a manner and context that enable its meaning to be communicated to users. This will often entail explaining the reasons for changes in the relative or absolute size of the figures from one period to the next.

# CHAPTER 8: ACCOUNTING FOR INTERESTS IN OTHER ENTITIES

*Financial statements need to reflect the effect on the reporting entity's financial performance and financial position of its interests in other entities. This involves various measurement and presentation issues. Rather than being dealt with in the relevant chapters and therefore in isolation from each other, they are dealt with together in this chapter. For similar reasons, various consolidation issues are dealt with in this chapter.*

## PRINCIPLES

- Single entity financial statements and consolidated financial statements present the interests the reporting entity may have in other entities from different perspectives.

- In single entity financial statements, interests in other entities are dealt with by focusing on the income and (depending on the measurement basis adopted) capital growth arising from those interests.

- In consolidated financial statements, the way in which interests in other entities are dealt with depends on the degree of influence involved.

  (a) An interest that involves control of another entity's operating and financial policies is dealt with by incorporating the controlled entity as part of the reporting entity.

  (b) An interest that involves joint control of, or significant influence over, another entity's operating and financial policies is dealt with by recognising the reporting entity's share of that other entity's results and resources in a way that does not involve showing those results and resources in the performance statement and balance sheet as if they were controlled by the reporting entity.

(c) Other interests are dealt with in the same way as any other asset.

- Although consolidated financial statements are the financial statements of the group as a whole, they are prepared from the perspective of the parent's shareholders and, as a result, ultimately focus on the parent's ownership interest in its subsidiaries. The effect on benefit flows of any outside equity interest in the subsidiaries will therefore be separately identified.

- Consolidated financial statements reflect the whole of the parent's investment in its subsidiaries, including purchased goodwill.

- A transaction involving the amalgamation of two or more reporting entities is reflected in the consolidated financial statements in accordance with its character. Therefore, a transaction that is of the character of:

  (a) an acquisition is reflected in the consolidated financial statements as if the acquirer purchased the acquiree's assets and liabilities as a bundle of assets and liabilities on the open market.

  (b) a merger is reflected in the consolidated financial statements as if the new reporting entity, comprising all the parties to the transaction, had always existed.

## EXPLANATION

### Degree of influence

8.1 Although an entity's interest in a second entity may take many different forms, the key factor in determining its effect on the first entity's financial performance and financial position is the degree of influence it exerts over the operating and financial policies of the second entity involved.

8.2 The degree of influence exerted will depend on the facts of each particular case. Ownership of shares is usually the main basis of influence because owning voting rights confers influence. However, while the level of ownership of shares and voting rights is indicative of an entity's relationship with its investee,* it is not by itself sufficient to define the relationship because of the possible effect of other agreements, arrangements or working practices. Indeed, any mixture of share ownership, voting rights or agreements, formal or informal, can provide a means of influencing or controlling another entity.

8.3 The highest degree of influence that an entity can have over an investee is control. As Chapter 2 explains, control comprises the ability to deploy the economic resources involved and to benefit (or to suffer) by their deployment. Other degrees of influence have these same aspects; in effect, the ability to influence the activities of the investee with a view to gaining economic benefits from that influence.

8.4 Although it is possible to classify the degree of influence that an entity has over its investee in an almost infinite number of ways, it is sufficient for the purposes of the Statement to classify it as follows:

(a) *Control*—where the entity controls the investee.

(b) *Joint control*—where the entity does not itself control the investee, but shares control through some form of arrangement jointly with others.

(c) *Significant influence*—where the entity has neither control nor joint control, but exerts a degree of influence over the investee's operating and financial policies that is at the least a significant influence and at the most just short of control.

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* *Although it is not necessary for an interest in another entity to involve an investment, that is the most common form. For simplicity, therefore, this chapter uses the term 'investee' to mean 'entity in which the first entity has an interest'.*

(d) *Lesser or no influence*—where any influence that the entity has over the investee's operating and financial policies is less than a significant influence.

## Reflecting the effects of interests in other entities

### *Consolidated financial statements and single entity financial statements*

8.5 The effect on the entity's financial performance and financial position of an interest in an investee is reflected in the first entity's financial statements in different ways depending on the type of financial statements being prepared.

(a) Financial statements of a reporting entity whose boundary has been drawn by reference to the scope of its direct control—in other words, single entity financial statements—take a narrow view of the reporting entity's interests in other entities and, as a result, reflect only the income and (depending on the measurement basis adopted) capital growth arising from those interests.

(b) Financial statements of a reporting entity whose boundary has been drawn by reference to the scope of the entity's control (both direct and indirect)—in other words, consolidated financial statements—present an expanded view of the reporting entity's interests in other entities that reflects the reporting entity's influence over, and its accountability for, the activities and resources of its investees.

8.6 Because of the narrow view taken in single entity financial statements, interests in other entities are treated like any other asset in those financial statements. On the other hand, the treatment of such interests in the consolidated financial statements will depend on the degree of influence involved, as explained more fully in paragraphs 8.7–8.10.

*Interests involving control*

8.7 As already explained in Chapter 2, if an entity controls* one or more other entities, the controlling entity (the parent) and the controlled entities (the subsidiaries) will be a reporting entity (the group). The group's financial statements (consolidated financial statements) are prepared by aggregating the gains, losses, assets, liabilities and cash flows of the parent and its subsidiaries. This ensures that the effects on the parent's financial performance and financial position of its interests in its subsidiaries are fully reflected in the financial statements.

8.8 Paragraphs 8.11-8.13 consider various issues relating to the preparation of consolidated financial statements.

*Interests involving joint control or significant influence*

8.9 If the reporting entity shares joint control of, or exercises significant influence over, another entity, it will be directly involved in and affected by that other entity's activities. Its interest in its investee is therefore reflected in the consolidated financial statements in a way that:

(a) recognises the reporting entity's share of the results and net assets of the investee; and

(b) does not misrepresent the extent of its influence over the investee—in other words, it does not treat activities and resources that are not controlled by the reporting entity as if they are controlled by the reporting entity. At present, the only commonly recognised method of accounting for investments that achieves this end is the equity method of

* *For simplicity, the discussion in the chapter assumes that the ultimate parent has 'direct' control of all its subsidiaries. However, it applies equally to situations in which the parent controls its subsidiary through its control of that subsidiary's parent. It also applies when the parent's control of its subsidiary is achieved through the combined influence of itself and other entities that it controls.*

accounting. This is where the reporting entity's share of the results and net assets of the investee are brought into its financial statements on a single line in the performance statement and balance sheet respectively. There are different types of equity method, usually involving the presentation of a greater or lesser degree of information than that just described, but in each case the reporting entity's share of the net results and of the position of the investee are not combined in the primary financial statements on a line-by-line basis with the reporting entity's own activities and resources.

*Interests involving lesser or no influence*

8.10 If the reporting entity's influence over its investee does not involve control, joint control or significant influence, the reporting entity will not be accountable for the investee's activities. In such circumstances, the only amounts recognised in the consolidated financial statements will be the investment (if any) and any income derived therefrom.

## Consolidated financial statements

8.11 The gains, losses, assets, liabilities and cash flows of all subsidiaries are reflected in full in the consolidated financial statements, even if a subsidiary is not wholly-owned. This reflects the parent's ability, through its control, to deploy both its own economic resources and those of its subsidiaries even where it does not wholly own the subsidiaries.

8.12 However, the extent of outside ownership interests is an important factor in considering the parent's access and exposure to the results of its subsidiaries. Therefore, although consolidated financial statements are the financial statements of the group as a whole, they ultimately focus on the parent's ownership interest in the entities within its control. The effect of any outside equity interest (the minority interest) on benefit flows will therefore be separately identified in the financial statements.

8.13 Purchased goodwill (sometimes referred to as goodwill arising on acquisition) is the part of a parent's investment in its subsidiary that has not been attributed to the separately identified assets and liabilities of the subsidiary. Although it is not an asset in itself, it is part of a larger asset (the investment). Furthermore, it does not represent a decrease in that larger asset's value and therefore a loss: it represents *part* of the asset's value. Therefore, if the parent's investment is to be fully reflected in the group's financial statements and the parent is to be held accountable for its investment in full, purchased goodwill needs to be recognised as if it were an asset.

## Accounting for business combinations

8.14 An amalgamation of two or more reporting entities—sometimes referred to as a business combination—can take a number of different forms. All these forms can be characterised as either:

(a) a purchase—such transactions are commonly referred to as acquisitions; or

(b) a uniting of interests—such transactions are commonly referred to as mergers.

8.15 An acquisition is a business combination that is in the nature of an acquisition by one entity of another entity. The transaction therefore results in an existing reporting entity being enlarged and is reflected in the consolidated financial statements by treating the assets and liabilities of the entity acquired and the purchased goodwill as if the transaction was the purchase of a bundle of assets and liabilities on the open market.

8.16 On the other hand, a merger is in the nature of a coming together of two entities to form a new reporting entity. This is reflected in the financial statements of the new reporting entity comprising all the parties to the transaction as if that entity had always existed. As a result, the assets and liabilities of each party to the transaction are treated as if they were acquired by the new reporting entity at the time that they were acquired by the party concerned: none of the assets or liabilities is treated as being purchased at the time of the business combination as part of a bundle of assets and liabilities on the open market.

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# APPENDIX I — THE STATEMENT AND THE LEGAL REQUIREMENTS CONCERNING THE FORM AND CONTENT OF FINANCIAL STATEMENTS

## INTRODUCTION

1 The Statement was not developed within the constraints imposed by the law. As a result, there was a risk that inconsistencies could arise between the Statement and the law that would invalidate the Statement as a frame of reference for standard-setting. The purpose of this appendix is to:

(a) explain why the approach was nevertheless adopted;

(b) describe the main respects in which legislation is inconsistent with the Statement; and

(c) explain why these inconsistencies do not prevent the Statement from being an acceptable framework to be used by standard-setters.

## WHY THE STATEMENT WAS NOT DEVELOPED WITHIN LEGAL CONSTRAINTS

2 There are two main reasons why the Statement was developed without taking into account the legal frameworks that regulate financial reporting. First, on a practical level, the Statement is intended to be relevant to the financial statements of *all* profit-oriented organisations, and it would have been difficult to develop a set of principles that was both consistent in all respects with all the legal requirements relating to such financial statements and also sufficiently detailed for the Board's purposes. Secondly, there was a concern that, if the Statement of Principles was developed within the constraints imposed by the law, it

would be denied the opportunity to assist in the development of that law. This would have been a pity because it is framework documents such as the Statement that provide direction to the development of such legal frameworks and help to ensure that such development takes place in a coherent way.

3 It is nevertheless recognised that the approach would not have been appropriate, despite these reasons, if there had been many significant differences between the Statement and the various legal frameworks involved. Paragraphs 4–13 describe briefly the main inconsistencies that exist at present between the principles in the Statement and the legal requirements that apply in Great Britain to the form and content of individual and group accounts prepared by companies that are not banks or insurance companies. Paragraph 14 concludes that these inconsistencies do not invalidate the Statement as a frame of reference to be used in the development of accounting standards for such entities. Although the paragraphs below deal with one type of entity only, the inconsistencies identified are believed to be typical of those that exist in the case of other entities. As a result, it is believed that the conclusion reached in paragraph 14 can be applied to all entities.

## Main inconsistencies between the statement and the law

### *The reporting entity*

4 Section 258 of the Companies Act 1985 identifies subsidiary undertakings by a list of tests. Although these tests are founded mainly on the concept of control, they may in some cases either fail to identify as a subsidiary undertaking an entity that is controlled by another or they may identify as a subsidiary undertaking an entity that is not controlled. Hence those companies that are identified as subsidiary undertakings by applying the Companies Act tests may not always correspond to those the Statement would identify as subsidiaries.

5 In practice, this difference tends not to be a problem because of other factors. For example, the Act's requirements concerning the treatment of subsidiaries that involve severe long-term restrictions on the rights of the parent reduce the practical effect of this difference in approach, as do the treatments of quasi-subsidiaries and jointly controlled entities required by FRS 5 'Reporting the Substance of Transactions' and FRS 9 'Associates and Joint Ventures'.

*The elements of financial statements*

6 One implication of the Act is that proposed dividends are required to be recognised as liabilities, although they would not usually fall within the Statement's definition of a liability.

*Recognition*

7 The Act states that only profits realised at the balance sheet date can be included in the profit and loss account (Schedule 4, paragraph 12). The Act defines realised profits, but does so in a way that allows the precise meaning of the term to be capable of development. The Statement adopts a different approach in which, rather than restrict the recognition of gains in the statement or statements of financial performance to those that are realised, it restricts their recognition to those that can be measured with sufficient reliability and for which sufficient evidence exists that they have actually arisen.

8 Although the Statement and the Act clearly adopt different approaches, the way in which the Act defines a realised profit means that the exact effect of this difference is not clear. The potential inconsistency described in paragraph 12—concerning the number and format of the statement or statements of financial performance—makes the effect of the difference in approach even less clear.

*Measurement*

9 The Statement envisages that, if the current value basis of measurement is regarded as the most appropriate measurement basis for a particular category of assets, all assets within that category will be recognised at their current value. That current value will, furthermore, be determined by reference to the value to the business rule. However, although the Act (Schedule 4, paragraph 31) permits:

(a) intangible fixed assets other than goodwill to be included at current cost;

(b) tangible fixed assets to be included at market value or current cost;

(c) fixed asset investments to be included at market value or directors' valuation; and

(d) current asset investments and stocks to be included at current cost,

current assets other than investments and stocks are required to be included in the balance sheet at the lower of cost and net realisable value (Schedule 4, paragraphs 22 and 23). Thus, for some assets the Act requires the use of measurement bases that may differ from those suggested by the Statement. It also means that the Act does not permit the use of the range of current value measures that are envisaged by the Statement's value to the business rule.*

* *Legislative proposals are being prepared by the European Commission to permit a wider use of current values in the measurement of financial instruments. This demonstrates both that the constraints of law are not immutable and that desirable change can be motivated by accounting developments guided by the framework described in the Statement.*

10 The Statement also envisages that some categories of liabilities could be measured at current value, whereas the Act does not specifically refer to this possibility.

*Presentation*

11 The balance sheet and profit and loss account of a company must be prepared in accordance with one of the statutory formats (although these formats may, subject to certain constraints, be adapted to suit the particular circumstances). Some specific items are also required to be shown in every profit and loss account (Schedule 4, paragraphs 1-3). These requirements may necessitate a presentation that differs in certain respects from what would be suggested by following the presentation principles set out in the Statement. These inconsistencies can, however, generally be overcome by providing additional disclosures.

12 The Act requires in most cases the preparation of, inter alia, a profit and loss account in one of the statutory formats and it makes no reference to any other performance statement. The Statement, on the other hand, is less specific about the format of any profit and loss account provided, and it acknowledges that entities may prepare more than one performance statement or may alternatively prepare a single statement that is more comprehensive than the profit and loss account the Act requires. As such, although the preparation of a profit and loss account in one of the statutory formats would meet the requirements of the Act *and* (subject to the point made in the preceding paragraph) be consistent with the Statement, other presentations possible under the Statement may not comply with the Act's requirements.

13 The Act requires the profit and loss account to show separately the aggregate amount of any dividends paid and proposed (Schedule 4, paragraph 3(7)). The Statement envisages that, as dividends are a distribution to owners and not a gain or loss, they will *not* be reported in a performance statement but will instead be reported in the reconciliation of movements in shareholders' funds.

## The statement as a satisfactory frame of reference for standard-setters

14 Of the inconsistencies identified above, probably the most significant is the one relating to the recognition of gains: the Act requires that only profits realised at the balance sheet date are to be recognised in the profit and loss account, whilst the Statement adopts an approach that is not based on the notion of realisation. Although, as already mentioned, the precise effect of this difference in approach is not clear, the Board does not believe that this difference in approach invalidates the statement as a satisfactory frame of reference for standard-setting. It notes, for example, that realised profits are defined in the Act in a way that is intended to enable its meaning to develop. It also notes that EU legislative proposals are being prepared which, if implemented, would permit the recognition in the profit and loss account of certain gains that might not be regarded by some as realised profits. This suggests that the legal requirements in this area are capable of evolving in response to the reasonable demands of accounting practice. In such circumstances, it seems appropriate that the Statement of Principles should try to give direction to, rather than merely follow, such changes.

15 As the Statement is expected to provide direction to the development of the legal requirements concerning the form and content of financial statements, the Board's expectation is that inconsistencies between the Statement and legal requirements will tend to be temporary and that the law will not be a permanent impediment to the adoption of approaches consistent with the Statement.

## Northern ireland and the republic of ireland

16 The following table gives the references to legislation in Northern Ireland and in the Republic of Ireland corresponding to the legislation in Great Britain referred to in this appendix.

| Paragraph | *Great Britain* Companies Act 1985 | *Northern Ireland* Companies (Northern Ireland) Order 1986 | *Republic of Ireland** |
|---|---|---|---|
| 4 | Section 258 | Article 266 | GAR 1992, Regulation 4 |
| 7 | Schedule 4, paragraph 12 | Schedule 4, paragraph 12 | CAA 1986, section 5 |
| 9 | Schedule 4, paragraphs 22 and 23 | Schedule 4, paragraphs 22 and 23 | CAA 1986, Schedule, paragraphs 10 and 11 |
| 9 | Schedule 4, paragraph 31 | Schedule 4, paragraph 31 | CAA 1986, Schedule, paragraph 19 |
| 11 | Schedule 4, paragraphs 1-3 | Schedule 4, paragraphs 1-3 | CAA 1986, section 4 |
| 13 | Schedule 4, paragraph 3(7) | Schedule 4, paragraph 3(7) | CAA 1986, section 4(15) |

* CAA 1986 = Companies (Amendment) Act 1986
GAR 1992 = European Communities (Companies: Group Accounts) Regulations 1992

# APPENDIX II — THE STATEMENT AND IASC'S 'FRAMEWORK FOR THE PREPARATION AND PRESENTATION OF FINANCIAL STATEMENTS'

1 It is the Board's view that a common set of principles is necessary to achieve further harmonisation in international accounting practice. For that reason, the Statement of Principles is based on the International Accounting Standards Committee's 'Framework for the Preparation and Presentation of Financial Statements' (the IASC Framework), which was itself derived from the Statements of Financial Accounting Concepts issued in the USA by the Financial Accounting Standards Board.

2 This appendix compares the Statement with the IASC Framework and highlights and explains the main differences. The appendix does not deal in detail with any other conceptual documents, although the principles and explanations in the Statement are similar to those set out in the conceptual statements issued by other leading accounting standard-setters, including those in Australia, Canada, New Zealand and the USA.

3 The Statement is much more detailed than the IASC Framework, which means that it deals with many issues on which the IASC Framework is silent. These differences in detail have not been treated as differences for the purposes of this appendix.

4 The commentary below follows the structure and order of the Statement and it uses the headings of that document.

## Introduction

5 There are no significant differences between the two documents.

## Chapter 1: The objective of financial statements

6 The objective of financial statements set out in the Statement is almost identical to that set out in the IASC Framework, although there are two minor differences.

(a) The Statement's description of the objective refers specifically to information that is useful for "assessing the stewardship of management", while the IASC Framework's description does not. However, as both documents refer to providing information that is useful for making economic decisions and agree that the reason why the stewardship of management is assessed is to take economic decisions, this difference is of no practical effect.

(b) Although the objective in the IASC Framework refers to providing information about changes in financial position while the Statement's objective does not, it is clear from both documents that it is expected that such information will be provided.

7 Only the Statement refers to the notion of a defining class of user (the investor). This notion is used in the Statement to give a focus that would otherwise be lacking for the selection and presentation of financial information.

## Chapter 2: The reporting entity

8 This chapter deals with two separate reporting entity issues: identifying a reporting entity and determining the boundary of a reporting entity. The two documents adopt a similar approach to the first issue, although neither deals with it in any detail. Only the Statement deals with the second issue. It was thought that the Statement would not be complete if it did not explain which activities and resources should be reported on in financial statements.

## CHAPTER 3: THE QUALITATIVE CHARACTERISTICS OF FINANCIAL INFORMATION

9 In most respects the two documents adopt the same approach to the desirable characteristics of financial information. For example, they both identify relevance, reliability, understandability and comparability as qualitative characteristics, and they describe those characteristics in very similar terms. There are however some differences:

(a) Materiality is not treated in the same way in that, while the IASC Framework treats it as a subcategory of relevance and describes it as a *quantitative* characteristic, the Statement treats it as a separate characteristic and describes it as relating to both the nature and size of the item. However, the overall effect of the two documents will be the same because they agree that information should be included in the financial statements if it might reasonably be expected to influence the economic decisions of users and it can be excluded if it is not expected to have that effect.

(b) The IASC Framework describes the accruals basis and the going concern assumption as underlying assumptions. Although the Statement does not give them such a title, their role and the way in which they are described are, to all intents and purposes, the same.

These differences are minor and will have little effect in practice.

## Chapter 4: The elements of financial statements

10 The two documents adopt the same approach to this subject, although:

(a) the elements that the Statement refers to as ownership interest, gains and losses are referred to by the IASC Framework as equity, income and expenses;

(b) the Statement defines as elements contributions by owners and distributions to owners while, in the IASC Framework, these are merely movements within owners' equity.

These differences are essentially concerned with nomenclature rather than principle.

## Chapter 5: Recognition in financial statements

11 Both the IASC Framework and the Statement approach the initial recognition process by asking whether a new asset or liability has been created (or an existing one has been added to), then applying recognition criteria to that new (or increased) asset or liability to determine whether it should be recognised. Both documents also adopt similar recognition criteria, although they are described in slightly different terms in that, while the Statement's criteria require, inter alia, that sufficient evidence should exist that the new asset or liability has been created or that there has been an addition to an existing asset or liability, the IASC Framework refers to it needing to be probable that any future economic benefit associated with the item will flow to or from the enterprise. The Board believes that this difference reflects a development in accounting thought since the publication of the IASC Framework.

12 The Statement deals with derecognition, a topic not covered in the IASC Framework. The Board believes that this reflects the fact that, as transactions and the instruments transacted have become more complex since the IASC Framework was published, greater emphasis than hitherto needs to be placed on the principles that underlie the derecognition process.

## CHAPTER 6: MEASUREMENT IN FINANCIAL STATEMENTS

13 The Statement and the IASC Framework adopt different approaches to the subject of measurement. For example, while the IASC Framework briefly describes the measurement bases that might be used, the Statement goes on to develop a framework to guide the choice of measurement basis. It also discusses the measurement bases much more extensively than the IASC Framework and it uses the value to the business model to decide between alternative measures of current value. This material has been included in the Statement in order to help introduce a degree of consistency into the measurement process. For similar reasons, the Statement, unlike the IASC Framework, discusses subsequent remeasurement in detail.

## CHAPTER 7: PRESENTATION OF FINANCIAL INFORMATION

14 The IASC Framework contains very little on this subject. The Statement nevertheless deals with it because the Board believes that good presentation is an essential element in effective financial reporting.

## CHAPTER 8: ACCOUNTING FOR INTERESTS IN OTHER ENTITIES

15 Although the IASC Framework contains no material on this subject, the Statement deals with it because the Board believes it is an important issue.

# APPENDIX III — BACKGROUND TO ISSUES DEALT WITH IN THE STATEMENT

## Background to the statement of principles

1 When the Board was formed in 1990, it recognised that, if it was to develop accounting standards that were consistent with each other, it needed to develop a coherent frame of reference to guide it in its work. Indeed, one of the recommendations of the committee that recommended that the Accounting Standards Board should be established was that further work on a conceptual framework should be undertaken.*

2 The frame of reference that the Board subsequently developed became the basis for a series of discussion drafts of individual chapters that were published in the early 1990s. Those drafts were revised and reissued together, in 1995, as an exposure draft of the complete Statement of Principles for Financial Reporting. A second exposure draft was published in March 1999.

3 The Board started to develop its frame of reference by looking to the accounting principles that, at that time, underpinned accounting practice in the UK. However, those principles were found wanting because:

(a) they were developed piecemeal at different times in response to particular problems and were not consistent with one another.

* *See 'The Making of Accounting Standards': Report of the Review Committee under the Chairmanship of Sir Ron Dearing CB (1988)*

(b) some of them had not kept up with modern developments. For example, many had their origins in accounting solutions devised for manufacturing companies with an emphasis on accounting for stocks and fixed assets. Some of those principles are not as effective in coping with the more complex financial reporting issues of today, such as those arising from intangibles and complex contractual arrangements.

(c) some of them were out of line with developments internationally.

The Board therefore concluded that, although many of those principles continued to be relevant and appropriate, some would have to be modified and some additional principles were needed to produce a framework that was consistent, up-to-date and reasonably complete.

4 The main principles in this Statement are derived from that informal frame of reference. Many of them have been examined closely over the last nine years during the development of new accounting standards (and the revision of existing ones) and have benefited from that examination, with some of the principles being refined and some developed further as a result. Furthermore, a number of the principles now play significant roles in accounting standards and have found general acceptance. For example:

(a) FRS 2 'Accounting for Subsidiary Undertakings' uses the reporting entity concept described in Chapter 2 of the Statement;

(b) FRS 4 'Capital Instruments', FRS 5 'Reporting the Substance of Transactions', FRS 7 'Fair Values in Acquisition Accounting' and FRS 12 'Provisions, Contingent Liabilities and Contingent Assets' are based on the definitions of assets and liabilities set out in Chapter 4; and

(c) FRS 11 'Impairment of Fixed Assets and Goodwill' uses the recoverable amount notion described in Chapter 6.

Therefore, although in places the Statement may sound unfamiliar, it actually bears a close resemblance to much of existing practice.

5 The Board has in its work programme a number of projects that are exploring further some of the issues covered in the Statement. Although it is possible that this work may result in changes needing to be made to what is said in the Statement, that does not create a difficulty because the Board does not regard the Statement as its final word on the principles that underlie financial reporting. Accounting thought is continually evolving and it is only to be expected that the Statement will need to be revised from time to time.

6 The remainder of this appendix discusses, and sets out the rationale behind, aspects of the Statement that would benefit from a fuller explanation. The discussion is organised by reference to the sections in the Statement (ie Introduction, Chapter 1 etc) to which they relate.

## INTRODUCTION

### *General purpose financial statements*

7 The Statement classifies financial information into special purpose financial reports, general purpose financial reports and other financial information, and explains that annual financial statements prepared to comply with companies legislation are examples of a general purpose financial report. Describing annual financial statements in this way is not intended to imply that such statements are all-purpose financial statements, because they are not. The term 'general purpose financial reports' has been used because it highlights the difference between special purpose financial reports and other financial reports.

### *Smaller entities and not-for-profit entities*

8 Although the principles set out in the Statement are intended to be relevant to the financial statements of all profit-oriented entities, it has been prepared with large entities uppermost in mind: accounting issues are generally at their most complex where large entities are involved and it is only right that the Board should seek to prepare a Statement that will help it to address these issues. That does not mean, however, that the Statement would have been fundamentally different had it been prepared with smaller entities in mind. The principles in Chapters 2-8, for example, would have remained unchanged. As the financial statements of small entities probably have a narrower range of users and tend to be used for a narrower range of purposes, the objective of those financial statements might have needed to be expressed differently. This difference would, however, be one of application rather than principle.

9 The Statement explains that, although it is relevant to the financial statements of not-for-profit entities, some of the principles need to be re-expressed and others need changes of emphasis before they can be applied to that sector. The Board has requested its Public Sector and Not-for-profit Committee to study the issue and make recommendations in due course.

## Chapter 1: The objective of financial statements

### *A wide range of users*

10 Although it is sometimes suggested that the legal position is that a company's annual financial statements are prepared for its shareholders only, neither companies legislation nor, so far as the Board is aware, case law suggests that the courts should or would take such a view. Indeed, since companies legislation requires companies to put a copy of their annual financial statements on the public record, it is clear that the law envisages that those financial statements will be used by the public at large—a much wider range of people than existing shareholders. This position is reflected in the Statement.

11 It is not reasonable to expect financial statements to meet the information needs of everyone who chooses to use them. They focus on the common interest that users have in the financial performance and financial position of the reporting entity as a whole. That means that they do not address the special interests that many users will have and they do not satisfy all users equally well. Users will therefore usually need to supplement the information they obtain from financial statements with information from other sources.

### *Investors as the defining class of user*

12 The Statement explains that investors are to be treated as the defining class of user. Investors are interested in financial information on the reporting entity as a whole. Other users require exactly the same information as a frame of reference against which to judge the more specialised information they obtain from other sources. For example, although potential lenders will gather specialised information from a range of sources to help them decide whether, and at what price, to lend to the reporting entity, they will also use information derived from the financial statements of the entity as a whole.

### *Economic decisions and stewardship*

13 The Statement explains that the financial statements provide information that is useful in assessing stewardship and for making economic decisions. At first sight these objectives—assessing stewardship and making economic decisions—seem mutually exclusive because stewardship reports are often thought to be limited to the use of historical cost whereas decision-useful reports are thought to require the comprehensive use of current values. The Board does not, however, believe that they are mutually exclusive.

(a) Stewardship reports are limited to using historical cost only if a very narrow view is taken of what a stewardship report entails. However, the Statement takes a broad view in that it regards stewardship as being not merely about the safekeeping and proper use of an entity's resources but also about their efficient and profitable use.

(b) The need for financial statements to provide information that is relevant for making economic decisions seems to suggest that more assets and liabilities than hitherto should be measured at current value. However, it does not necessarily follow that there needs to be comprehensive use of current values: experience shows that much historical cost information can also have predictive value.

## CHAPTER 2: THE REPORTING ENTITY

### *Identifying a reporting entity*

14 Although those who are entrusted with resources by others are accountable to them for those resources and should therefore probably provide them with a set of accounts, when the Statement considers which entities should prepare financial statements it is considering a much wider issue: which entities should prepare financial statements and make them available to a wide range of users? This is a complex issue and, as it has been the practice in the UK and the Republic of Ireland for legislators to determine which profit-oriented entities should prepare financial statements, is an issue that the Statement discusses in general terms only.

## *The boundary of the reporting entity*

15 There are two main approaches that can be used to determine the boundary of a reporting entity: one approach concentrates wholly on ownership (the proprietary view) and the other concentrates on the group as an entity, unified and encompassed by the parent's control (the entity view).

(a) The proprietary view regards ownership and the resulting access to benefits as of paramount interest to users. As a result, ownership is used to provide the basis of consolidated financial statements. On a strict proprietary view, the investor's ability to influence or even control its investee is irrelevant: consolidated financial statements will aggregate the parent's direct and indirect ownership interests in a proportional consolidation (the line-by-line consolidation of the investor's share of each item) as this shows the parent's access to benefit from all of its investments.

(b) On the entity view, the parent's ability to control its subsidiaries is all-important, regardless of the size of its ownership interest in the activities of the entity that it directs. The consolidated financial statements therefore consolidate in full the assets and liabilities of any entity that the parent controls—even if the entity is not a wholly-owned subsidiary—and the parent's ownership interest and any outside equity interest in a subsidiary are treated merely as part of an overall ownership interest.

16 The appropriate perspective to use depends on the relative usefulness of the information each provides. The Statement regards the entity view as providing the most useful information, and therefore uses control to determine the boundary of a reporting entity.

### *Single entity financial statements of parent companies*

17 The Statement explains that, once a reporting entity has been identified, two boundaries will be drawn—one based on direct control and one based on direct plus indirect control. This means that, where a company is controlled by another company, both companies will be reporting entities as will the group of companies that they constitute.

18 Some commentators suggest that, because the activities and resources of a parent and its subsidiary are difficult to separate economically, it is inappropriate for an entity to report on the activities it carries out and the resources it holds in isolation from the activities and resources of its subsidiaries. This view suggests that companies preparing consolidated financial statements should not also be expected to prepare single entity financial statements. Some might argue that the present legal position—in which parent companies are not required to prepare profit and loss accounts—could be used to support this view. However, if it is inappropriate for a parent to report on the activities it carries out and the resources it holds in isolation from the activities and resources of its subsidiaries, it would seem to follow that it is also inappropriate for those subsidiaries to report in isolation from their parent; in other words, subsidiaries whose activities and resources are reported on in consolidated financial statements should not be required to prepare single entity financial statements. That is not the present legal position.

19 The Board's view is that, although the usefulness of single entity financial statements has decreased as the structure of business organisations has become more complex, single entity financial statements—whether for parent companies or subsidiaries—still have a role to play, albeit a much narrower role than that of the financial statements of the group as a whole. Drawing a boundary by reference to direct control reflects this view.

## CHAPTER 3: THE QUALITATIVE CHARACTERISTICS OF FINANCIAL INFORMATION

### *Materiality and relevance*

20 Although the Statement of Principles expects the financial information given in financial statements to be both material and relevant, it describes these two characteristics in similar ways. In particular, the tests of whether information is material and whether it is relevant are both based on influencing the economic decisions of users—although relevance involves *the ability* to influence decisions while materiality involves the reasonable expectation that decisions *will* be influenced. Similarly, both characteristics involve a consideration of the size and nature of the items or information involved. There are, however, important differences between the characteristics.

(a) Materiality is a threshold characteristic—a discrete test—used to decide whether to include information in the financial statements. If an item of information is material, it will need to be included and if it is not, it need not be included. Relevance, on the other hand, is a 'continuous' quality; one item of information will be more relevant than another and the information given will (subject to other constraints) be that which is the most relevant.

(b) Put simply, characteristics such as relevance, reliability, comparability and understandability provide direction to the financial reporting selection process, thus enabling the usefulness of the information to be maximised. The materiality test, which recognises that some information has to be left out of financial statements, then asks whether the information is useful enough to be given.

### *Prudence*

21 Accounting practice has evolved significantly over the last thirty years and, as a result, has become much more sophisticated in the way that it seeks to reflect the nuances of business activity. This is acknowledged in the Statement through its emphasis on specific principles rather than general notions and assumptions. In the case of prudence, for example, the smoothing of reported profits has become as great a concern as their overstatement and, as a result, the deliberate understatement of assets and gains and the deliberate overstatement of liabilities and losses are no longer seen as a virtue. Indeed, it is now widely accepted that the use of prudence in this way can seriously affect the quality of the information provided.

22 This has been reflected in international practice for some time now. For example, the framework documents published by the International Accounting Standards Committee (IASC) and the accounting standard-setters in Canada and the USA describe prudence (sometimes referred to as conservatism) as involving a degree of caution in the exercise of the judgements needed in making the estimates required under conditions of uncertainty. The standard-setters in Australia and New Zealand have adopted a similar approach, although they have subsumed prudence within the notion of reliability.

23 The Statement's approach to prudence is consistent with the way in which accounting practice has evolved and with the approaches adopted internationally. It:

(a) treats prudence as one of the attributes that need to be present if financial information prepared under conditions of uncertainty is to be reliable;

(b) describes prudence as the inclusion of a degree of caution in the exercise of the judgements needed in making the estimates required under conditions of uncertainty; and

(c) makes it clear that prudence is a potentially biased concept and that care should therefore be taken to ensure that it does not result in the deliberate and systematic understatement of assets and gains and the overstatement of liabilities and losses.

***Understandability***

24 In an ideal world, financial statements would be prepared in a way that makes them intelligible to all users, regardless of their level of expertise or experience. However, as entities are increasingly complex and many of them enter into increasingly complex transactions, it can be difficult to represent their financial performance and financial position both faithfully and in a way that can be understood by all users. The Statement recognises this by explaining that the basis on which financial statements are to be prepared is that users have a reasonable knowledge of business and economic activities and accounting.

25 This means that financial statements will not always be capable of being understood by all users. Although this sounds an unsatisfactory state of affairs, it is, in fact, the present position. Users who do not have a reasonable knowledge of business and economic activities and accounting use the services of those who have that knowledge to help them derive information from the financial statements.

***Relevance versus reliability***

26 Although it is sometimes argued that the characteristics of relevance and reliability are often in conflict, such conflicts are exaggerated. As the Statement makes clear, reliability is a hurdle to be cleared (ie is the information sufficiently reliable?), not a competition that has to be won (ie is this information the most reliable?). This means that the approach to be adopted in preparing the financial statements will be the one that is the most relevant of those that are reliable. A conflict will therefore arise between the characteristics only in the rare circumstances in which the reliable approaches are not relevant and the relevant approaches are not reliable.

## Chapter 4: The elements of financial statements

### *Identifying the elements*

27 In essence, the preparation of financial statements involves finding the best way to categorise financial information about the transactions and other events that affect a reporting entity's financial performance and financial position. It is generally accepted that the best way to report this information is to focus on what has happened to the entity over the reporting period (for example, revenues and expenses, gains and losses, cash flows, and capital transactions) and what is its position as a result (assets and liabilities). These effects will inevitably have to be reflected in the financial statements in a highly aggregated form, and the Statement envisages that order will be imposed on this process by specifying and defining the classes of items (elements) that encapsulate the key aspects of those effects.

### *Should the definitions of the elements be interrelated and, if so, which definitions should be based on which?*

28 The performance statement elements and the balance sheet elements could, in theory, be defined independently of each other. However, such an approach risks leaving gaps or creating areas of overlap. It would also have been inconsistent with the notion that primary financial statements should articulate, a fundamental and long-accepted characteristic of such statements. The Statement therefore uses definitions that are interrelated.

29 It follows that either the balance sheet elements should be based on the definitions of the performance statement elements or vice versa. As the accounting process is essentially about allocating the effects of transactions and other events to reporting periods, it might seem more logical to define the performance statement elements and then base the balance sheet elements on those definitions. This approach requires the use of robust definitions of the performance statement elements in order to provide the unity, order and discipline needed for an effective framework. Those definitions need therefore to be precise and

comprehensive, and they need to avoid placing reliance on management intent or referring to generally accepted accounting principles. However, accounting standard-setters around the world have carried out an exhaustive search for robust definitions of performance statement elements and have concluded that such definitions do not exist. On the other hand, robust definitions of balance sheet elements do exist. The Statement, like all the conceptual documents developed by all the leading accounting standard-setters around the world, therefore defines the balance sheet elements and bases the definitions of the performance statement elements on those definitions.

***How many elements should there be and how should they be defined?***

30 It is obviously both important and necessary to distinguish cash flows and capital transactions from other things that happen to an entity. It is, however, not immediately clear whether it is important or realistic to treat, say, all the credits in the performance statement as a single type of element and expect them to meet a single definition (and all the debits as a separate single element and expect them to meet a single definition). A similar question arises concerning the debits and credits in the balance sheet.

31 Reporting on the financial performance and financial position of an entity involves providing an account of the reporting entity's use of, and command over, economic resources. The Statement therefore bases its definitions on flows and prospective flows of future economic benefits embodied in economic resources. Thus, assets are defined as "rights or other access to future economic benefits controlled by an entity as a result of past transactions or events", liabilities as "obligations of an entity to transfer economic benefits as a result of past transactions or events", and, apart from ownership interest, no other balance sheet elements are identified.

32 As the items in the profit and loss account are typically referred to as revenue, expenses, gains and losses, it would seem natural to use similar terminology in the Statement. Indeed, that is the approach adopted in the USA by the Financial Accounting Standards Board. However, as it has been decided that the definitions of the performance statement elements should be based on the definitions of the balance sheet elements, it is possible to define the credits in the performance statement in terms of increases in net assets not resulting from capital contributions and the debits in the performance statement as decreases in net assets not resulting from capital distributions. The issue the Board therefore had to consider was whether more comprehensive definitions should be used in order to differentiate between types of performance statement debits and credits.

33 At the moment, the Board is carrying out a review of FRS 3 'Reporting Financial Performance'. As part of this work, it is considering possible ways of restructuring the performance statements that are provided at present. It may be that, as a result of this work, it will conclude that gains and revenue should be differentiated from each other. Similarly, it may be concluded that losses and expenses should be differentiated from each other. However, until then, there does not appear to be sufficient reason for the Statement of Principles to distinguish revenue from gains and expenses from losses. It therefore identifies one credit performance statement element (gains) and one debit performance statement element (losses). IASC's 'Framework for the Preparation and Presentation of Financial Statements' adopts the same approach, except that it calls the two elements 'income' and 'expenses'.

34 It is recognised that, by not differentiating gains from revenue (and losses from expenses), items that are commonly referred to as 'revenue' (and 'expenses') have had to be referred to in the Statement as 'gains' (and 'losses') or vice versa. That is not ideal but is not regarded as sufficient reason to justify differentiation.

### *Implications of the approach adopted to specifying and defining the elements*

35 Under the approach adopted in the Statement, if costs are to be carried forward (ie deferred) to a subsequent period to match income being earned in that period, they will need to meet the definition of an asset (and meet the relevant recognition criteria). This will mean, inter alia, asking whether the costs to be deferred constitute future economic benefits. It is recognised that the application of this approach in practice will result in some of the costs that are at present deferred and shown as assets being recognised as losses because they do not represent future economic benefits. Similarly, some of the credit items that are deferred at present in the balance sheet might, under the principles, need instead to be recognised as income because they do not qualify as liabilities. Nevertheless, the Board believes that the approach provides what is needed for an effective framework.

36 It is worth noting that the Statement's approach is almost identical to the approach adopted in the conceptual documents of IASC and the other leading accounting standard-setters around the world, including the standard-setters in Australia, Canada, New Zealand and the USA. It is also worth noting that the definitions of assets and liabilities set out in the Statement already provide the foundation for several UK accounting standards, including FRS 5 'Reporting the Substance of Transactions'. Indeed, through the Board's own work, the work of UK bodies preparing Statements of Recommended Practice, and the work of the aforementioned standard-setters, the elements and their definitions have for many years now been playing an important role in the standard-setting process throughout the world.

37 It has nevertheless been suggested by some that the approach means that the balance sheet will become the main accounting statement and the performance statement will be relegated to a statement of residual amounts. It means nothing of the kind. First, the Board accepts that the primary focus of users is on the performance statement and that this is likely to remain the case for the foreseeable future. Secondly, using definitions of assets and liabilities to define gains and losses is merely a means to an end—that end being to improve the quality of financial statements in general and, through the discipline that the definitions will impose on the recognition of gains and losses, performance statements in particular.

38 It has also been suggested in the past that the approach means that the profit or loss for the period will be the difference between the opening and closing balance sheets, adjusted for capital contributions and distributions. Although it is correct to say that the amount of the difference is equal to the total of all the components of financial performance, it is an oversimplification to suggest that this means that the difference is regarded as the profit or loss for the period. The Board has spent much time and energy since its inception on improving the way in which financial performance is reported, and the focus of this work has been the need to move away from placing so much significance on any one line of the performance statement. FRS 3—which was issued in 1992—makes it clear that the focus of performance reporting should be on the components of financial performance and on the characteristics of those components. This is also the approach adopted in the Statement.

39 Finally, some commentators have suggested that, by defining the performance statement elements by reference to movements in assets and liabilities, the Statement will shift the focus of accounting away from transactions. The Board does not agree with this suggestion. Accounting is a process that is primarily concerned with allocating the effects of transactions to reporting periods, and the approach set out in the Statement will achieve exactly that.

## CHAPTER 5: RECOGNITION IN FINANCIAL STATEMENTS

### *The role of realisation in the Statement*

40 The Statement envisages that all gains and losses will be recognised in a performance statement. Furthermore, as the Statement does not specify different recognition criteria for different performance statements (or for different parts of the same, single performance statement), realised profits may conceivably be shown alongside unrealised profits.

41 An alternative approach might have been to base recognition on the notions of realisation and realised profit. For example, the Statement could have assumed that only realised gains would be recognised in the performance statements. It could, alternatively, have assumed that realised gains would be recognised in one performance statement (or in one part of a single performance statement) while unrealised gains would be recognised in a second performance statement (such as the statement of total recognised gains and losses) or in a separate part of the single performance statement. The main reasons that are usually put forward in support of this approach, and the counter-arguments, are set out below.

*Companies legislation*

42 Companies legislation specifies that companies should include only profits realised at the balance sheet date in their profit and loss account. It could be argued that, for this reason alone, realisation should be acknowledged as a recognition criterion.

43 However, the development of the Statement has not been constrained by legal requirements because the Board believes that accounting practice evolves best if regard is had in documents such as the Statement of Principles to what is deemed to be right rather than what is required by law. The implications of this for the Statement of Principles are considered in Appendix I.

*Distributable profits*

44 Companies making distributions of income to their shareholders must make them from distributable profits. It is therefore sometimes argued that, if users are to have a proper understanding of the level of sustainable dividends and of the prospects of dividend growth, it is important that the level of distributable profits is reported and that dividends paid and payable are reported in the context of those distributable profits.

45 However, in practice—and particularly for a group—the potential for distributions, whether from profits or return of capital, is dependent on many factors, including companies legislation in the countries in which the operations are carried out, corporate structure, currency and dividend controls, and the entity's financial adaptability. In these circumstances it is unrealistic to suppose that distributability per se can serve as a primary focus of the presentation of financial performance.

*Realisation as a criterion for determining what should be recognised*

46 Regardless of the legal requirements, it is a desirable attribute of items included in the profit and loss account, particularly gains, that their existence should be reasonably certain. The realisation notion is one means of determining whether the existence of a gain is reasonably certain. However, in the Board's view, it is not necessarily the best way.

47 The realisation notion originally came into use in order to protect creditors from the uncertainties that arise in accruals accounting, and its purpose was to try to ensure that profits were not overstated and that there was sufficient cash available to distribute those profits without the company becoming insolvent. In this guise the notion was understood to involve the conversion into cash of non-cash resources and rights to cash.

48 As business practice developed, so the purpose of the notion changed and it came to be used to ensure that only gains that were reasonably certain and unlikely to reverse were included in the profit and loss account. Similarly, its meaning evolved to include conversion into claims to cash.

49 Developments since then have, however, made even this version of the notion irrelevant in some areas. For example, it is now often possible to be reasonably certain that a gain exists and to measure that gain reliably even if no disposal has occurred. Furthermore, the introduction of cash flow statements means that cash-based profit and loss accounts have largely been outgrown. A number of attempts have been made to update the notion to take account of these developments. For example, it has been suggested that changes in the market value of securities for which an active market exists are also realised, even though no claim to cash is involved. Similarly, some have suggested that the test should be extended to include gains that are realisable, in other words capable of being converted into cash or claims for cash.

50 However, in general it is not a good idea to bend a term so that it has a meaning other than its natural meaning. A better approach in this case would seem to be to focus on the underlying objective and then encapsulate that objective in the recognition criteria. It is the Board's view that the objective is to recognise a gain only if there is reasonable certainty that it exists and if it can be measured reliably. The initial recognition and subsequent remeasurement criteria set out in the Statement are designed to achieve that end.

## Chapter 6: Measurement in financial statements

### *The mixed measurement system*

51 For many years entities carried all their assets and liabilities in their balance sheet at historical cost. However, the relevance of such measures in periods when prices have moved markedly has often been questioned and, to counteract this perceived fading relevance, the majority of larger UK listed companies now measure some of their assets at current values and some at cost. (According to Company Reporting No 80 (February 1997), more than 65 per cent of the companies in that journal's database had adopted this approach.)

52 Although this approach is commonly referred to as the modified historical cost basis, that term is something of a misnomer because it is a mixed measurement system. The Statement therefore uses this latter term.

53 The Statement explains that assets and liabilities have a number of different monetary attributes that could be represented in financial statements. It also explains that the single most important characteristic that distinguishes these monetary attributes is whether they are based on historical cost or current value. The remainder of its discussion is expressed in terms of this distinction.

54 In theory, the Statement could have adopted one of three broad approaches to measurement.

(a) It could have assumed strict adherence to historical cost in all circumstances. In view of existing practice, this would have been a revolutionary step. For example, when respondents to the Accounting Standards Committee's ED 51 'Accounting for fixed assets and revaluations' (1990) were asked whether it would be practicable to prohibit the carrying of selected fixed assets at revalued amounts, 96 per cent of those who answered the question believed it was not practicable.

(b) It could have assumed the adoption of a comprehensive current value system under which all assets and all liabilities, or at least the great majority of them, would be carried at current values. This too would have been a revolutionary step and it is not an approach that the Board has considered in the past nor is it one that it expects to consider in the foreseeable future.

(c) It could have assumed the continuance of the present, mixed measurement system. Previous consultations have shown that the majority of respondents favour this approach. For example, just over 70 per cent of those who responded to the Board's Discussion Paper 'The Role of Valuation in Financial Reporting' (1993) favoured continued use of the mixed measurement system.

55 In preparing the Statement, the Board has assumed the continued use of the mixed measurement system. This system has the advantage of requiring reporting entities to match the measurement basis used for a particular category of assets or liabilities to the circumstances relating to that category and, in so doing, acknowledges the different trade-offs between relevance and reliability in the measurement of different types of balance sheet item. The system is also flexible in that the mix of historical cost and current value can be changed as accounting thought develops and markets evolve.

## *Choosing a measurement basis*

56 The main focus of the Statement's chapter on measurement is the measurement debate that is of most relevance today—what mix of historical cost and current value should be used. The Statement provides a framework to guide the choice of an appropriate measurement basis for each balance sheet category and thereby helps to apply some discipline and logic to the selection process. This should result in an improvement in the relevance and comparability of the information being provided.

57 The characteristic of relevance plays a major role in the framework described in the Statement. Current value information can be relevant in two rather different ways.

(a) For assets that generate cash flows indirectly through use—such as property, plant and equipment—a current value gives an up-to-date measure of the total resources invested and provides a basis for calculating the current cost of using the asset within the period.

(b) For assets and liabilities that represent rights to specific future cash flows—financial assets and financial liabilities—the market price gives the value of those cash flows at that time.

58 Whereas for the first type of balance sheet item some degree of choice may be appropriate for each entity in determining whether market values should be used as the basis of measure, the same flexibility may be less appropriate if extended to the second type because of their more direct relationship to future cash flows.

59 As the Statement explains, although the factors that should be used to determine the most appropriate measurement basis are unlikely to change, the measurement basis that best meets those factors may. Indeed, the Board expects that, if markets develop, greater use will probably be made of current value because measures that were once thought not relevant or unreliable may

become both the most relevant measure and reliable. That having been said, it is unlikely that the framework set out in the Statement will suggest the use of current values other than for certain types of investments, commodity stocks and financial instruments. Under the framework, the practice of measuring some fixed assets at current value is also likely to continue.

## CHAPTER 7: PRESENTATION OF FINANCIAL INFORMATION

### *Presentation of gains and losses*

60 The way in which information on financial performance is presented is of fundamental importance to the quality of financial reporting. The Statement does not, however, deal with this matter in any detail, primarily because it is an issue that is being actively considered in the Board's review of FRS 3. If that review identifies principles about the presentation of gains and losses that could usefully be incorporated in the Statement, the Statement will be amended.

### *Dividends paid and payable*

61 The Statement makes it clear that, regardless of the number of performance statements prepared, they will deal with gains and losses only and no items that are not gains and losses will be recognised in them. As dividends paid and payable are not gains and losses, the Statement envisages that they will not be included in the profit and loss account or other performance statement. Although that seems logical—dividends are not a component of financial performance—it is not consistent with how such dividends are dealt with at present. This issue is being considered as part of the review of FRS 3.

### *Recycling*

62 The Statement explains that items that are not gains or losses are not included in the performance statement, which means that the notion of recycling* is not consistent with the principles. This is another matter that is being considered in the review of FRS 3.

## Chapter 8: Accounting for interests in other entities

### *Accounting for minority interests*

63 As explained in paragraph 15, there are, in theory, two opposing perspectives from which minority interests could be viewed when preparing consolidated financial statements: one perspective concentrates wholly on ownership (the proprietary view) and the other on the group as an entity, unified and encompassed by the parent's control (the entity view). The Statement considers that the entity view provides the most useful information and therefore uses control to determine the boundary of a reporting entity.

64 One implication of adopting the entity view is that all subsidiaries, even those that are not wholly-owned, will be fully consolidated. However, it is useful to show the extent of outside ownership interests since this is an important factor in determining the interest of investors in the reporting entity as a whole. This important feature—ownership—would be ignored if the focus was exclusively on the entity view. The Statement therefore envisages that any outside equity interests in entities within the parent's control will be identified in the primary financial statements. In this way the financial statements will reflect the parent's ownership interests in the entities within its control.

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* *By 'recycling' the Statement means recognising a gain or loss in the performance statement in one period then, in a later period, recognising some or all of that gain or loss under a different heading in either the same or a different performance statement because the nature of the item is deemed to have changed in some way.*

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